Insights

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Accounting

Predicting the Future

Comments from RSM McGladrey National Director of Accounting, Jay Hanson

Last week I attended an academic conference, Financial Statement Analysis and Valuation: Forecasting Firm and Industry Fundamentals. This conference featured speakers ranging from academicians presenting their complex papers, to securities analysts talking about how they do their work, to a speech by the CFO of a diverse global Fortune 50 company. The main focus was about predicting the future.

Our work in auditing a client's financial statements is often focused on the daily tasks of sending confirmations, testing schedules, dropping numbers into financial statements, and completing disclosure checklists - all with significant budget pressures and incomplete information. It is easy to lose sight of who our real "clients" are (the financial statement users), since they are not the ones directly paying for our services. Upon listening to the speakers at a conference about forecasting, it is so clear that the service our profession fulfills is critical to lenders and investors who are making decisions.

Why does a financial statement user care about the future? Cash flows to repay a loan come from future earnings. Stock prices increase in value based on how a company performs. How best do you best predict the future? A good starting point is knowing what the past results were. The financial statement users who rely on our work depend on the fairness of that information and the disclosures that go with it. Public companies are required to provide further scrutiny of why the results were achieved through their disclosures in Management's Discussion and Analysis, but private company financial statement users have to ask management for such information.

As we complete our work and the drafting or reviewing of the financial statements, ask yourself:
- If I owned this company, do the statements reflect everything I would want to know?
- If I were making a decision to invest in this company, is everything I would want to know disclosed?
- If I were making a decision to lend or continue to lend to this company, is everything I would want to know disclosed?
- Are the disclosures written in plain English so the meaning is conveyed appropriately?
- If management does not want something disclosed, do we know the real reason? How do we think the external financial statement users would react to its omission?
- If the financial statement users receive and presumably rely on management-prepared internal financial statements throughout the year, how accurate are they? If significant adjustments are required at the end

of the year, does everyone (the owners, the banks, etc.) know about that? This is not a financial statement disclosure, but an internal control letter item.

Many have said the disclosure requirements in place today are overkill for private companies. That may be true. However, given that this situation may not change any time soon, it should be our mission to make the statements as understandable as possible. GAAP-basis financial statements have many limitations, but nothing on the horizon will fix that. Ensuring fairly stated and the most understandable financial statements and disclosures possible is the best service we can perform in our important independent auditor role.

Financial Reporting Alert Released

The American Institute of Certified Public Accountants recently issued a Financial Reporting Alert, Current Economic Instability: Accounting Issues and Risks for Financial Management and Reporting—2010. This Alert is intended to be used by members of an entity's financial management and audit committee to identify and understand current accounting and regulatory developments affecting the entity's financial reporting. It also is intended to help achieve a more robust understanding of the current economic environment in which entities are operating, and is a tool to help identify the significant risks that may result in the material misstatement of financial statements. Among other topics, the Alert discusses:

- Understanding the current economic environment to assess risks for the entity
- Economic, legislative, and regulatory developments, including key economic indicators
- Issues affecting audit and attestation engagements, such as fair value measurements, accounting estimates, and the consideration of an entity's ability to continue as a going concern
- Financial management issues and developments, including:
    - Strategies to navigate the current business environment
    - Assessing liquidity risk
    - Succession and talent management planning
    - Enterprise risk management
    - Global business risks
    - Internal control and processes
    - The role of the audit committee

The Alert also addresses accounting issues and developments, including the following recently issued Accounting Standards Updates (ASUs) among others:

- ASU No. 2010-01, Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash—a consensus of the FASB Emerging Issues Task Force
- ASU No. 2010-02, Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification
- ASU No. 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements
- ASU No. 2010-09, Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements
- ASU No. 2010-10, Consolidation (Topic 810): Amendments for Certain Investment Funds

Auditing

Record of Consultation – Restatement of Previously Issued Financial Statements

The National Professional Standards Group would like to remind auditors that Form 0162.05 ADD, Record of Consultation - Restatement of Previously Issued Financial Statements, is located in the “Interim Documents” section of the MAPS resource intranet site. This section contains interim releases of documents that were not distributed with the applicable industry document library in the MAPS 3.0 release. For situations involving the restatement of previously issued financial statements, Form 0162.05 ADD should be downloaded from the MAPS Resource Site until an updated form is distributed at a later date. Form 0162.01 ADD, Record of Consultation, is not an appropriate substitute.

SEC

Auditor Considerations Regarding Significant Unusual Transactions

In December 2008, the Public Company Accounting Oversight Board (PCAOB) issued Staff Audit Practice Alert No. 3, Audit Considerations in the Current Economic Environment, to assist auditors in identifying matters related to the economic environment that might affect audit risk and require additional emphasis. In the view of the PCAOB staff, although the economic conditions have changed since December 2008, the risk factors, including the risks of significant unusual transactions, that existed in December 2008 continue to exist today and may affect the risk of material misstatement. On April 7, 2010, the PCAOB issued Staff Audit Practice Alert No. 5, Auditor Considerations Regarding Significant Unusual Transactions, to complement Practice Alert No. 3 by compiling selected, relevant requirements from existing PCAOB auditing standards regarding significant unusual transactions into one document.

Practice Alert No. 5 reminds auditors of public companies about their responsibilities to assess and respond to the risk of material misstatement of the financial statements due to error or fraud posed by significant unusual transactions. The Practice Alert organizes existing requirements from PCAOB auditing standards regarding significant unusual transactions into the following categories:

- Identifying and assessing risks of material misstatement
- Responding to risks of material misstatement
- Consulting others
- Evaluating financial statement presentation and disclosure
- Communicating with audit committees
- Reviewing interim financial information

While this Alert summarizes certain areas with respect to significant unusual transactions, it does not serve as a substitute for the relevant standards of the PCAOB. The Alert was prepared to highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards and relevant laws. Practice Alert No. 5 is available in full at http://pcaobus.org/Standards/QandA/04-07-2010_APA_5.pdf.

Transition Questions Related to FASB Statement No. 167

FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R), now codified within Accounting Standards Codification (ASC) Topic 810, Consolidation, addresses the effects of eliminating the qualifying special-purpose entity concept from FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, now codified within ASC Topic 860, Transfers and Servicing, and responds to concerns about the application of certain key provisions of FASB Interpretation No. 46(R), Consolidation of Variable Interest Entities, now codified within ASC Topic 810. Statement No. 167 is effective as of the beginning of a company's first annual reporting period that begins after November 15, 2009. Questions have been raised about various practice issues related to Statement No. 167, and the SEC staff recently shared with the CAQ SEC Regulations Committee its views on the following:

- *Filing Registration Statements After Adoption of Statement No. 167*

    If a company has elected to adopt Statement No. 167 retrospectively and has filed interim financial statements for a period that includes the date of adoption, that registrant must recast its prior-period annual financial statements that are incorporated by reference in a registration statement to reflect a material retrospective application of Statement No. 167. If a registrant elects to adopt Statement No. 167 only on a prospective basis, or if the retrospective application of Statement No. 167 is not material, its registration statement may incorporate by reference its most recent Form 10-K, which would include its historical annual financial statements of periods prior to the adoption of Statement No. 167.

- *Applying the Transition Provisions of Statement No. 167*

    Questions have arisen about whether an SEC registrant that retrospectively applies Statement No. 167 to all periods presented in its financial statements would be permitted to retrospectively apply the effects of Statement No. 167 to any additional periods presented in the table of selected financial data. The SEC staff indicated that it expects there to be consistency between the application of Statement No. 167 in the financial statements and in the table of selected financial data. Also, the SEC staff expects a registrant to disclose to which periods it has retrospectively applied Statement No. 167 and, if necessary, the fact that certain periods are not comparable to the periods for which the audited financial statements are provided.

- *Pro Forma Requirements*

    Article 11 of Regulation S-X describes the SEC's requirements for registrants to provide pro forma financial information. Item 2.01 of Form 8-K addresses the reporting requirements relating to a registrant's acquisition or disposition of a significant amount of assets. The SEC staff indicated that the initial adoption of Statement No. 167 would not trigger either an Article 11 or an Item 2.01 Form 8-K reporting requirement.

- *Rule 3-05, Rule 3-14, and Form 8-K Considerations*

    Rule 3-05 of Regulation S-X and Item 9.01(a) of Form 8-K describe the requirements for registrants to provide audited financial statements of a business acquired or to be acquired. Rule 3-14 of

Regulation S-X describes the requirements for audited financial statements of real estate operations acquired or to be acquired. The SEC staff stated that consolidation upon the initial adoption of Statement No. 167 would not trigger a Rule 3-05, Item 9.01(a), or Rule 3-14 reporting requirement.

Disclosures Regarding Repurchase Agreements and Securities Lending Transactions

In March 2010, the SEC's Division of Corporation Finance posted an illustrative letter, which had been sent to certain public companies requesting information about repurchase agreements, securities lending transactions, and other transactions involving the transfer of financial assets with an obligation to repurchase the transferred assets. If any repurchase agreements are accounted for as sales, the letter asks the registrant to:

- Quantify the amount of repurchase agreements qualifying for sales accounting at each quarterly balance sheet date for each of the past three years.
- Quantify the average quarterly balance of repurchase agreements qualifying for sales accounting for each of the past three years.
- Describe all the differences in transaction terms that result in certain repurchase agreements qualifying as sales versus collateralized financings.
- Provide a detailed analysis supporting the use of sales accounting for repurchase agreements.
- Describe the business reasons for structuring the repurchase agreements as sales transactions versus collateralized financings. To the extent the amounts accounted for as sales transactions have varied, discuss the reasons for quarterly changes.
- Describe how the use of sales accounting for certain repurchase agreements impacts any ratios or metrics used publicly.
- Disclose whether the repurchase agreements qualifying for sales accounting are concentrated with certain counterparties and/or concentrated within certain countries and the reasons therefore.
- Disclose certain matters if the original accounting on any repurchase agreements has changed.

For those repurchase agreements accounted for as collateralized financings, the letter asks the registrant to quantify the average quarterly balance for each of the past three years, the period-end balance for each of those quarters, the maximum balance at any month end, and the causes/business reasons for significant variances among these amounts. In addition, the registrant is required to make certain disclosures if it has:

- Any securities lending transactions accounted for as sales
- Any other transactions involving the transfer of financial assets with an obligation to repurchase the transferred assets, similar to repurchase or securities lending transactions that are accounted for as sales
- Offset financial assets and financial liabilities where a right of setoff does not exist

The letter also refers the registrant to paragraphs (a)(1) and (a)(4) of Regulation S-K Item 303 regarding disclosures in Management's Discussion and Analysis for situations in which a registrant accounted for repurchase agreements, securities lending transactions, or other transactions involving the transfer of financial assets with an obligation to repurchase the transferred assets as sales.

The illustrative letter is available in full at http://www.sec.gov/divisions/corpfin/guidance/cforepurchase0310.htm.

Retrospective Adjustments to Provisional Amounts in a Business Combination

Topic 13 of the SEC's Division of Corporation Finance Financial Reporting Manual discusses the effects of subsequent events on financial statements required in filings. Per Topic 13, certain events that occur after the end of a fiscal year will require retrospective revision of that year's financial statements if they are reissued after financial statements covering the period during which the event occurred have been filed. Such events include reporting:

- Disclose certain matters if the original accounting on any repurchase agreements has changed.
- A change in accounting principle
- Discontinued operations
- Change in reportable segments
- Change in the reporting entity
- Stock splits

Re-issuance of the pre-event financial statements is required if those financial statements are required to be included or incorporated by reference into a registration or proxy statement, with the exception of Form S-8. If the pre-event financial statements are not reissued in connection with any filing under the Securities Act or Exchange Act, annual information does not need to be retrospectively revised until that information is included in the registrant's next Annual Report on Form 10-K.

In a recent update to its Financial Reporting Manual, the Division of Corporation Finance added another event that requires retrospective revision of financial statements - retrospective adjustments to provisional amounts in a business combination. Under the acquisition method of accounting for a business combination, the acquirer records provisional amounts if there are any items for which the initial accounting is incomplete at the end of the reporting period in which the business combination occurs. If a registrant determines it must make a material retrospective adjustment to provisional amounts it previously reflected in its financial statements pursuant to the requirements of paragraph 51 of FASB Statement No. 141R, Business Combinations, (ASC 805-10-25) and this adjustment has not yet been reflected in any historical financial statements, the registrant should provide or incorporate by reference revised financial statements reflecting the retrospective adjustment if the adjustment is material. If this retrospective adjustment has been reflected in subsequent interim historical financial statements, but the acquisition occurred in the preceding fiscal year and the adjustments are not reflected in the annual financial statements, the registrant should provide revised audited financial statements for the year of acquisition reflecting the adjustments. The revised financial statements are generally filed via Form 8-K.

It should be noted that the SEC's guidance for retrospective adjustments to provisional amounts in a business combination is different from the guidance relating to changes in accounting principles, discontinued operations, and changes in reportable segments. In the case of a retrospective accounting change, discontinued operation, or change in reportable segment, previously issued financial statements cannot be retrospectively adjusted until after the financial statements covering the period during which the event occurred have been filed.

The Division of Corporation Finance Financial Reporting Manual is available in full at http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf.

PCAOB Proposes Standard for Communications with Audit Committees

On March 29, 2010, the Public Company Accounting Oversight Board (PCAOB) issued a proposed auditing standard, Communications with Audit Committees. The PCAOB's primary objectives in proposing this new standard are to enhance the relevance and effectiveness of the communications between the auditor and the audit committee and to emphasize the importance of effective, two-way communications between the auditor and the audit committee to better achieve the objectives of the audit. If finalized, this standard would replace interim standards AU Section 380, Communication With Audit Committees, and AU Section 310, Appointment of the Independent Auditor.

The proposed standard carries forward substantially all of the required communications in AU 380, and includes requirements that are consistent with the SEC's audit committee communication requirements in Rule 2-07 of Regulation S-X. The proposed standard also requires communication of certain additional matters, including the following among others:

- An overview of the audit strategy, including a discussion of the significant risks identified by the auditor and the timing of the audit
- Significant changes to the planned audit strategy or the significant risks initially identified
- The anticipated application of new accounting or regulatory pronouncements that are not yet effective, but which may, upon adoption, have a significant effect on the company's financial reporting
- Significant accounting matters on which the auditor has consulted outside the engagement team, including discussions with the firm's national office or industry specialists
- Certain matters, when applicable, relating to the auditor's evaluation of a company's ability to continue as a going concern
- A number of new requirements relating to the communication regarding estimates, such as requiring the auditor to communicate, or to evaluate whether management has adequately communicated:
    - How management subsequently monitors critical accounting estimates
    - Management's significant assumptions used in critical accounting estimates that have a high degree of subjectivity
    - A discussion of any significant changes to assumptions or processes made by management to the critical accounting estimates in the year under audit, a description of the reasons for the changes, the effects on the financial statements, and the information that supports or challenges such changes
    - When critical accounting estimates involve a range of possible outcomes how the recorded estimates relate to the range and how various selections within the range would affect the company's financial statements

In addition, the proposed standard includes requirements related to the establishment of a mutual understanding of the terms of the audit engagement with the audit committee. Unlike AU 310, the proposed standard requires that this understanding be established specifically with the audit committee. Further, the proposed standard requires the auditor to record this understanding in a written audit engagement letter to be provided annually.

The proposed standard provides for written or oral communication of the matters required, unless otherwise specified. Having robust dialogue on key matters is viewed as the most important factor in effective communications with the audit committee. The auditor is required to document the communications, whether communicated orally or in writing, in sufficient detail to enable an experienced auditor, having no previous connection with the engagement, to understand the communications made to comply with the provisions of the standard. All matters required by the proposed standard would be required to be communicated annually prior to the issuance of the auditor's report.

If finalized, the proposed standard would be effective, subject to approval by the SEC, for audits of fiscal years beginning after December 15, 2010. The proposed standard is available for comment until May 28, 2010, at http://pcaobus.org/Rules/Rulemaking/Docket030/Release_No_2010-001.pdf.

Public Sector

Revised Communications for Internal Control Related Matters to Participants in OMB Pilot Project

On October 7, 2009, the Office of Management and Budget (OMB) published the parameters of a pilot project, which is a collaborative effort between volunteer nonfederal entities expending American Recovery and Reinvestment Act of 2009 (ARRA) awards (auditees), the auditors performing compliance audits of auditees with ARRA expenditures under OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations, and the federal government. For auditees that volunteer, the pilot project requires their auditors to issue to management an early written communication of significant deficiencies and material weaknesses in internal control over compliance at an interim date, prior to the completion of the compliance audit.

In November 2009, the AICPA issued three interpretations of AU Section 325A, Communicating Internal Control Related Matters Identified in an Audit, to provide answers to questions that had been raised as a result of the above required communication to participants in the OMB pilot project. We addressed interim communications of internal control related matters in Firm Release R09-27.

In March 2010, the AICPA interpretations were revised so as to be based on Statement on Auditing Standards No. 115, Communicating Internal Control Related Matters Identified in an Audit, and related Interpretation No. 1, "Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget (OMB) Circular A133 Audit":

- *Communication of Significant Deficiencies and Material Weaknesses Prior to the Completion of the Compliance Audit for Participants in Office of Management and Budget Single Audit Pilot Project*

  This interpretation concludes that an auditor may issue a communication of significant deficiencies and material weaknesses prior to the completion of the compliance audit for participants in the OMB pilot project. Such a communication must communicate all significant deficiencies and material weaknesses in writing to management and those charged with governance in accordance with paragraphs .20 and .21 of AU Section 325A.

- *Communication of Significant Deficiencies and Material Weaknesses Prior to the Completion of the Compliance Audit for Auditors That Are Not Participants in Office of Management and Budget Pilot Project*

  This Interpretation encourages auditors to promptly inform auditee management and those charged with governance during the audit engagement about control deficiencies related to ARRA funding that are, or likely to be, significant deficiencies or material weaknesses in internal control. Although not required for those who are not participants in the OMB pilot project, if an auditor decides to make such a communication in writing at an interim date, the auditor may issue the interim communication in accordance with AU Section 325A.

- *Appropriateness of Identifying No Significant Deficiencies or No Material Weaknesses in an Interim Communication*

  This Interpretation concludes that in either of the previously described scenarios, the auditor may not issue an interim communication stating that as of the interim communication date, no significant deficiencies or material weaknesses have been noted.

These Interpretations are available in full at http://www.aicpa.org/download/auditstd/FINAL_%20AU%20Section%209325.pdf.

The guidance and samples letters found in Release R09-27 have been updated through the issuance of Release R10-11, Update to Interim Communication of Internal Control Related Matters, which is available in the "What's New" section of the GS Navigator. This Release reminds auditors to avoid situations where the interim communication differs from the final communication included in the Single Audit reporting package. When an interim communication is contemplated, our audit plan should provide for the timely completion of our audit of the respective ARRA programs. An interim communication should not be prepared until our consideration of internal control over applicable compliance requirements for respective ARRA program(s) is complete and the related workpapers and our report have been subjected to all applicable quality control procedures, including reviews by the in-charge, engagement manager, engagement partner, report reviewer, and concurring reviewer, if applicable.

Proposed Statement Regarding the Financial Reporting Entity

The Governmental Accounting Standards Board (GASB) recently issued a proposed Statement, The Financial Reporting Entity, an amendment of GASB Statements No. 14 and No. 34. The proposed Statement is intended to improve guidance for including, presenting, and disclosing information about component units and equity interest transactions of a financial reporting entity by modifying certain requirements in GASB Statements No. 14, The Financial Reporting Entity, and No. 34, Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments.

Component units are legally separate organizations that state and local governments include in their financial reports. The proposed Statement would modify the existing criteria for inclusion of organizations that are "fiscally dependent" on a government by adding a requirement that the potential component unit and the primary government also have a financial benefit or burden relationship. In cases where the government determines it would be misleading to exclude an organization that does not meet the financial accountability concept from its financial reports, the proposed Statement would clarify the manner in which that determination should be made.

The proposed Statement also would amend the criteria for "blending," or the reporting of component units as if they were part of the primary government. Further, it would clarify the reporting of equity interests in legally separate organizations. If finalized, the provisions of the proposed Statement would be effective for financial statements for periods beginning after June 15, 2012, with earlier application encouraged.

The Exposure Draft is available for comment until June 30, 2010, at http://www.gasb.org/exp/ED_financial_reporting_entity_an_amendment_stmts_14and34.pdf.

Employee Benefit Plans

Audit Guide and Audit Risk Alert Released for Audits of Employee Benefit Plans

The American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide, Employee Benefit Plans, was updated as of March 1, 2010, and is now available in the Accounting Research Manager. The AICPA also recently issued an Audit Risk Alert, Employee Benefit Plans Industry Developments—2010, which is also available in the Accounting Research Manager. This Alert is intended to provide auditors of financial statements of employee benefit plans with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits they perform. Among other topics, both the Guide and the Alert cover various aspects of 403(b) plan issues and auditor's reports.

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