
Financial Reporting and Audit Issues Related to the Uncertain Economic Environment

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Auditing in Risky Environments

- “Markets have been wracked this summer by growing fears about a possible default by Greece”
- “A recession in the U.S. looks increasingly likely, mainly because of Europe's struggles and an apparent weakness in developing countries that have driven recent global growth.”
- “Builders' pessimism about the U.S. housing market in early August remained as negative as it was two years ago, the National Association of Home Builders said Monday.”
- “So far this year, the existing home sales are down 3.8%. Over all the real estate market is still going down hill and not effective in rebounding the economy. “

What's an Auditor to Do?

- Discussion Topics:
 - Requirements in the standards
 - Risk Assessments
 - Risky audit areas
 - Disclosure Issues
 - Reporting responses

Risk Assessments – Economic Conditions

AU 324.24 Industry, Regulatory, and Other External Factors

The auditor should **obtain an understanding** of relevant industry, regulatory, and other external factors. These factors include **industry conditions**, such as the competitive environment, supplier and customer relationships, and technological developments; the regulatory environment encompassing, among other matters, relevant accounting pronouncements, the legal and political environment, and environmental requirements affecting the industry and the entity; and other external factors, such as **general economic conditions**.

Risk Assessments – Economic Conditions

AU 316.85 Fraud Risk Factors

The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting.

Incentives/Pressures

Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

- High degree of competition or market saturation, accompanied by declining margins
- High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates
- Significant declines in customer demand and increasing business failures in either the industry or overall economy
- Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent
- Recurring negative cash flows from operations and an inability to generate cash flows from operations while reporting earnings and earnings growth

Planning Considerations*

- Identify areas that need special considerations
- Assessing conditions in which accounting data is produced, reviewed and accumulated
- Evaluate the reasonableness of estimates
- Evaluate the reasonableness of management representations
- Making judgments about the appropriateness of accounting principles applied and adequacy of disclosure

*PCAOB Staff Audit Practice Alert #3 Audit Considerations in the current economic environment

Auditing in Risky Environments

- Understanding the clients and the environment that they operate in
- While the worst maybe behind us, there will be many challenges that need to be addressed and auditors' judgment is likely to be severely tested.
- Our public trust duty is to the users of the financial statements.

Auditing in Risky Environments

- What can go wrong?
- What are the really troublesome areas?
- What are the audit responses?
- What are the reporting responses?

Auditing in Risky Environments

- Valuation of investments
- OTTI
- Derivatives
- Long lived asset impairments
- Goodwill impairments
- Debt

Auditing in Risky Environments

- Inventory
- Consolidations
- Revenue recognition
- Income taxes
- Inter-company accounts
- Financial statement disclosures

Valuation of Investments

The FASB has issued:

- FSP FAS 157-3 *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*
- FSP EITF 99-20-1, *Amendments to the Impairment Guidance of EITF Issue No. 99-20*
- FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*
- FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*
- FSP FAS 115-2 and 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments.*

All of which are primarily designed to deal with valuation of debt securities. Our audit response will need to be adjusted accordingly in those situations where Level 2 and Level 3 measurements are relevant

Note that the new disclosures are extensive and difficult to implement

Valuation of Investments

- No particular problem for equities with ready quotes
- However, nearly all other instruments will be highly influenced by FAS 157 valuation considerations; especially in light of the continuing calibration of the standard by FASB.
- This is particularly relevant to debt securities

Valuation of Investments

- **Alternative investments**

- Equity method investments should be evaluated for impairment. Cannot assume impairment is unlikely
- Fair value investments have new guidance that is valuable. ASU 2009-12 may be very useful, when NAV is available.

Other Than Temporary Impairment

- FAS 115 requires consideration of OTTI with respect to all securities other than trading. But also applies to HTM investments.
- Although some of the declines have moderated there are clearly many structured debt instruments that are still at risk and suffering credit losses
- Credit losses must be recorded through the P&L
- New guidance and disclosure requirements
- Separating credit losses from other components of the loss will be difficult

Other Than Temporary Impairment

- With respect to equity instruments, SEC guidance is losses sustained for 6-9 months is a “strong indicator.” Difficult to disagree with this “guidance.”
- Recent recoveries in the stock market may support
- The FSP specifically does not apply to equities

Other Than Temporary Impairment

- Ability and intent to hold equities
- Must consider liquidity needs of the holder
- Consider investment strategies, how long can they wait?
- For managed assets, there is a high bar with respect to this assertion

ASC 360-10-15 Impairments (Long-Lived Assets)

- Many companies, depending upon the industry, continue to be weak and many continue to lose money. Construction, housing related, banking, consumer products
- Companies may be in situations where they are experience 3+ years of net losses and negative cash flows
- These conditions are usually triggering items and an impairment test is required
- Be careful of the cash flow assumptions in the Step 1 models. Entities may have experienced declines that go beyond a cycle and are in fact a business re-set.

ASC 360-10-15 Impairments (Long-Lived Assets)

- If step 2 is indicated, the fair value measurement must now be in accordance with ASC 820.
- Valuation consultants may not have revised their methods to be in accordance with ASC 820. Notably with their determination of market participant and most advantageous market.
- Real estate may be vulnerable due to lack of activity in the market for commercial real estate.
- If a determination of no impairment is made, consider need for SOP 94-6 disclosure of the sensitive and changeable nature of that estimate.

ASC 350-20-35 Impairments (Goodwill)

- Although there has been improvement in the economy, there is no question that there has been a downward reset in valuations, globally
- It is **highly unlikely** that private company valuations will not face the same issue
- For the goodwill recorded in deals prior to 2008 the hurdle to claim zero impairment is exceptionally high
- New accounting standards related to the qualitative testing may prove a challenge to auditors this year

ASC 350-20-35 Impairments (Goodwill)

- As auditors we should:
 - Challenge the paragraph 35-29 scope out as to when a prior year assessment may be carried forward
 - Require a valuation specialist make a current valuation. These valuations must be in accordance with ASC 820 this year.
 - Use of historic discount rates is probably not appropriate; market participant assumptions must inform the risk premiums
 - In any situation where the client does not employ an acceptable valuation specialist, we should be getting audit assistance from valuation specialists

ASC 350-20-35 Impairments (Goodwill)

- Indefinite lived intangibles:
 - Same issue here, items like FCC licenses, trademarks, brands, etc. may in fact have lost value.
 - A specialist needs to be brought in much the same as for the GW valuation

Impairment Testing Sequencing

- Impairment testing cannot be done in silos, there is a required sequence:
 - Long lived assets, including intangible assets that are amortized (asset groups; undiscounted cash flows is less than carrying value; mark to fair value of asset group)
 - Intangible assets not being amortized (if fair value of individual asset is less than carrying value mark to fair value)
 - Goodwill (if fair value of the reporting unit is less than carrying value, hypothetical purchase price allocation (in accordance with the “acquisition method”) with residual GW being the new mark)

Debt

- Debt arrangements need to be carefully evaluated in light of current circumstances
- What actions have been taken by the lenders? Has the client heard from the lenders? Has the client reached out?
- Any situation where there is an expectation of a renewal or refinancing of a current lending arrangement in 2012 needs to be carefully assessed and challenged. Especially if the entity continues to weaken.

Debt

- There is likely to be a need for waivers in many more situations. Lenders may see a waiver request as an opportunity to restructure the terms or to exit the credit.
- Be careful as to content of the waivers or commitments, to be sure of proper debt classification
- Watch out for cross-default issues
- Be careful of “off the record” type interactions with bankers. All “answers” as to plans, strategies, etc. need to come from client not us. No off the cuff assurances. Don’t act for management.

Inventory

- Inventory valuation needs to be challenged for:
 - Slow moving
 - Excess quantities
 - Changes in customer preferences that are expected to occur but have not occurred yet
 - Overhead capitalization is too high due to excess capacity from plant slow down/shut downs. (ASC 330-10-30-3)

Derivatives

- Two major issues related to interest rate swaps
- Applying FAS 157 to swaps:
 - No longer can rely on valuations that are based on interest rate spreads
 - Now must consider non-performance (credit) risk. That is what is the risk associated with the counterparty or the issuer, being unable to meet their obligations. How does that risk impact the valuation of the swap?

Derivatives

- Impact on hedging
 - The deterioration in a counterparty creditworthiness (e.g., Lehman Bros) normally leads to ineffectiveness
 - This may impact the assertion that the hedge is highly effective and therefore require termination of hedge accounting
 - DIG Issue G10 requires companies to consider the likelihood of compliance by counterparty. If the counterparty may default, hedge accounting would terminate

Derivatives

- Accounting for termination of the hedge needs to be carefully assessed
 - Amounts previously recorded to OCI do not immediately get reversed into P&L.
 - Any derivative asset or liability that is terminated may cease to be accounted for under FAS 133, but rather other accounting standards may apply. This is particularly a problem if the swap is an asset with a bankrupt counterparty

Revenue Recognition

- The continuation of a difficult economy increases the inherent risk in revenue recognition
- Issuers may try to push the envelope
- Normal patterns may change
 - Higher level of returns this year requiring higher reserves at year end
 - New business practice in order to retain customers, such as expanded rights of return, payment upon sell through, extended payment terms. All of this may indicate need for more reserves or deferrals of recognition

Income Taxes

- Recognition of deferred tax assets needs to be carefully considered. Need for the valuation reserve. Assumptions about past profitability enabling recognition of current period NOL assets should be challenged

Inter-company accounts

- Be wary of these accounts
- There are significant fraud risks here, if the internal control over reconciliations is not effective

Financial Statement Disclosures

- SOP 94-6:
 - General use of estimates disclosure should be challenged. Every estimate should be considered for increased sensitivity due to economic conditions. Disclosure should be adjusted accordingly.
 - Concentrations, customers and suppliers are obvious. But exposure to only one lender is a concentration that may merit disclosure.

Financial Statement Disclosures

- Going concern assumptions:
 - **Negative trends**—for example, recurring operating losses, working capital deficiencies, negative cash flows from operating activities, adverse key financial ratios
 - **Other indications of possible financial difficulties**—for example, default on loan or similar agreements, arrearages in dividends, denial of usual trade credit from suppliers, restructuring of debt, noncompliance with statutory capital requirements, need to seek new sources or methods of financing or to dispose of substantial assets
 - **Internal matters**—for example, work stoppages or other labor difficulties, substantial dependence on the success of a particular project, uneconomic long-term commitments, need to significantly revise operations
 - **External matters that have occurred**—for example, legal proceedings, legislation, or similar matters that might jeopardize an entity's ability to operate; loss of a key franchise, license, or patent; loss of a principal customer or supplier; uninsured or underinsured catastrophe such as a drought, earthquake, or flood

Financial Statement Disclosures

- Carefully and seriously consider the need for additional disclosure with respect to the going concern assumption.
- Footnotes should be transparent with respect to what is going on and with respect to management's plans.

Auditors' Reports

- Non-standards reporting options:
 - Emphasis of a Matter
 - Scope limitation
 - Going Concern Assumption

Auditors' Reports

- **Emphasis of a matter:**
 - In any report on financial statements, the auditor may emphasize a matter regarding the financial statements. Such explanatory information should be presented in a separate paragraph of the auditor's report. ...Emphasis paragraphs are never required; they may be added solely at the auditor's discretion. Examples of matters the auditor may wish to emphasize are—
 - That the entity is a component of a larger business enterprise.
 - That the entity has had significant transactions with related parties.
 - **Unusually important subsequent events.**
 - **Accounting matters, other than those involving a change or changes in accounting principles, affecting the comparability of the financial statements with those of the preceding period.**

Auditors' Reports

- Emphasis of a matter may be useful when:
 - A client's line of credit has a renewal within 2012 and there is no assurance that bank will renew
 - Concentrations with customer or vendor that puts client at particularly high risk
 - Very sensitive estimate that if it changes would have a severe impact
 - Basis of presentation disclosures
- The paragraph references the footnote where matter is fully disclosed

Auditors' Reports

- Scope limitation:
 - “Restrictions on the scope of the audit, whether imposed by the client or by circumstances, such as the timing of his or her work, **the inability to obtain sufficient appropriate audit evidence**, or an inadequacy in the accounting records, may require the auditor to qualify his or her opinion or to disclaim an opinion.”

Auditors' Reports

- Scope limitation
 - In ability to obtain sufficient competent evidence related to valuations:
 - Alternative investments
 - Hard to value debt instruments
 - Derivative liabilities

Auditors' Reports

- Going Concern Qualification
 - Substantial doubt as to the ability of the issuer to continue in existence for a period not to exceed one year
 - More engagements will require the completion of the Going Concern Checklist and the related consultation
 - We expect to see them

How Do We Cope?

- Maintain a high level of professional skepticism
- Document significant judgments thoroughly
- Step back from the financial statements and make sure they tell the real story

Remember!!



**Don't let the
client's
problems
become your
problem**

