

FINANCIAL STATEMENTS AND THE RETURN OF PROFESSIONAL JUDGMENT

Recent accounting pronouncements have focused on the role of judgment, often highly subjective judgment, in the presentation of financial results. With new guidance in goodwill, uncertain tax positions, fair value accounting, and contingencies, the FASB is placing greater reliance upon the professional opinions of management. This is something of a change. After many years of strict rules-based accounting, the FASB is turning back to the professional judgment of management and their auditors. This has broad implications for risk management and the design of accounting systems.

For some time now, the FASB has relied upon a comprehensive rules-based system, rather than a principles-based system more dependent upon the judgment of management. This was an attempt to provide clear, detailed guidance around increasingly complex business transactions, and at the same time provide a shield against litigation. The proliferation of rules and a heavy reliance upon historical cost accounting provided a relatively comfortable, if complex, environment with more or less predictable outcomes.

This began to change with FAS 142, issued in June 2001, which dealt with goodwill. Prior to FAS 142, the historic cost of goodwill was in most cases amortized into the income statement like any other asset over its useful life. Under FAS 142, goodwill is no longer amortized, but its value is tested against a number of projections, which are management's best estimate of the future performance of the acquisition. If these tests show a value that is less than the amount on the books, the goodwill is impaired with charges normally going against the income statement. Needless to say, projecting future earnings of an acquisition can be a hazardous endeavor, and any downturn in the prospects of acquired business can directly impact the income statement, a point acknowledged by the FASB in the preamble to FAS 142:

“There may be more volatility in reported income than under previous standards because impairment losses are likely to occur irregularly and in varying amounts.”

In July 2006, the FASB released FIN 48, which provided guidance around uncertain tax positions. Uncertain tax positions are areas of tax law that are open to interpretation by taxpayers and the government. For example, a company that deducts a questionable expense runs the risk that the government may disallow the deduction upon examination. The likelihood of such a disallowance, and the related interest and penalties, must be recognized in the financial statements and disclosed in the footnotes. By definition, these outcomes are uncertain. Nevertheless, management must use its best estimate to predict the future, including the hazards of litigation.

In September 2006, FAS 157 was released which covered the area of fair value measurements. Under FAS 157, companies must establish fair market values for certain assets and liabilities, marking them to market each period. Such changes in value, as estimated by management, can have a dramatic impact on the financial statements of a company, even an entire industry. For example, banks have struggled with fair value

accounting as their investments plummeted in the throes of the subprime crisis. The write down of collateralized mortgages, credit swaps and various other derivatives have unleashed a sea of red ink, most of which relates to non-cash charges driven by management's best estimate of a true valuation. Valuing these instruments has been made more difficult because firm quotes are hard to come by in a tight market. Similarly, the energy industry has reported very significant losses from hedging contracts designed to protect their core business from the rising commodity prices. Like the banks, these companies must value complex derivatives in a volatile market, with changes in judgment directly impacting the income statement.

More recently in June 2008, the FASB released new guidance on FAS 5, which deals with accounting for contingencies, such as the outcome of legal actions, environmental clean-up, bad debts and other potential losses. While the rules that cover the recognition of losses have not changed, the disclosure has. Under the new guidance, companies must provide a tabular reconciliation; i.e. a rollforward analysis, in the footnotes to their financial statements. Here, too, management must use its best judgment to predict the outcome of future events, which will be prominently disclosed in considerable detail. Disclose too much and management runs the risk of tipping its hand against plaintiffs; disclose too little and risk the wrath of regulators and investors.

With the old and comfortable world of objective rules and historical cost accounting receding, companies need to think about their financial systems in new ways. Most systems are set up to process the hard numbers of the business, such as shipments and payroll. Few systems are equipped to track and document the impact of changes in the outlook of management. With the greater emphasis on these more subjective measures, there is a need for companies to include a formal review of the soft numbers of the business, such as valuations, estimates and projections, in their closing process. Ideally, this review will take place in a structured environment, complete with the appropriate controls and sign-offs, rather than on spreadsheets and e-mails.

There are a number of software vendors who offer Governance, Risk and Compliance ("GRC") products. These products provide an integrated environment where the company can establish internal controls over a broad spectrum of activities. Not too surprisingly, interest in this area has picked up considerably since the passage of Sarbanes-Oxley and many software companies now offer this functionality. As always, the selection of a vendor requires due diligence. But more choices are now available than in previous years.

There are some very practical reasons to consider such a review. Firstly, with more professional judgment comes greater exposure to litigation. It is very easy to second guess the decisions of management and their auditors, especially months and years after the initial estimates were made and the actual results are known. The best defense lies in a controlled environment, where decisions are well documented in a contemporaneous system.

Secondly, under historical costing, the financial statements were somewhat insulated from the impact of volatile markets. Now, a downturn in the economy can compromise many accounts on the balance sheet, such as goodwill, investments, derivatives and various liabilities, all at the same time. This can have a devastating impact on quarterly earnings, which must absorb all such write-downs in the current quarter. A structured environment that supports a sophisticated and detailed analysis of values can restore some measure of control.

Thirdly, this is not going away. If the US moves away from GAAP toward the more principle-based IFRS, the need to document the professional opinions of management will increase, not decrease.

To summarize, Rules-based accounting has been supplemented by new, more subjective measures that rely heavily upon the professional judgment of management and their auditors. Largely by design, these changes have introduced a new element of volatility and risk into the financial statements, particularly the income statement and the footnote disclosures. Companies need to review their accounting procedures to accommodate the increasing importance of “soft” measures, such as estimates, projections and valuations. Since the advent of Sarbanes-Oxley, there are a number of software vendors who offer GRC products that provide internal controls around a wide range of business activities. These products can be tailored to support and document the professional judgments of management in a contemporaneous manner, which is the best defense against second guessing and even litigation. With the ascension of IFRS, a principle-based accounting system that is less dependent upon objective rules, it is likely that subjective measures will become even more critical in the future.

Kevin Brady
CEO
Lexstream, LLC