Accounting & Audit Advisor

REPORTING ALTERNATIVES: Are you giving financial statement users what *they* really want?

By Guest Columnist J. Scott Hughes, CPA, with Johnson, Price & Sprinkle, PA, a CPAmerica International member firm

These days, practitioners often find themselves preparing financial statements and then doubting that the statements will actually give users what they need to manage their businesses or comply with the requirements of lenders and other outside parties.

The concerns become apparent by the questions users raise. And in most cases, our old friend the "expectation gap" gets in the way of harmonious communication among the client, other users and the accountant.

Practitioners find themselves answering questions such as "What is this 'liability' that has something to do with that interest swap the banker talked me into?" or "Why did you include the related rental LLC in these statements? I didn't want that."

Often, other third parties that require statements presented under generally accepted accounting principles (GAAP) further cloud the conflict between GAAP and users' expectations and preferences. These third parties may have an institutional perception that GAAP financial statements are the fairest presentation of financial position.

Recently, a number of new GAAP requirements include provisions that are particularly complex and have caused users to seek alternative reporting methodologies. These requirements include:

- Consolidation of variable interest entities
- Fair value standards, including the treatment of derivatives such as interest swaps
- Consideration of uncertain tax positions
- Deferred taxes
- Goodwill impairment
- Reporting for employee benefit arrangements

As shown by current deliberations of "private company GAAP versus public company GAAP," standard setters are attempting to deal with the relevance of GAAP to the small-business user and the question of whether private company statement users actually need or want all the information and disclosures required by current GAAP. Until that process runs its course, it is up to practitioners and their clients to explore the options to get specifically what they need to satisfy owners, investors, creditors or bonding companies at an acceptable cost.

For many users, preparing financial statements using an "other comprehensive basis of accounting" (OCBOA) is an alternative to the complexity of GAAP. In other cases, users choose to prepare GAAP statements with exceptions to some GAAP requirements.

These intentional choices, given the right circumstances, can result in meeting a user's needs with less complexity and, in some cases, at a reduced cost. Departures from GAAP usually involve

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Gelman, Rosenberg & Freedman
CERTIFIED PUBLIC ACCOUNTANTS

4550 Montgomery Avenue • Suite 650 North • Bethesda, MD 20814
301/951-9090 • Fax: 301/951-3570 • info@grfcpa.com • www.grfcpa.com

Simplification of goodwill impairment testing planned

By CPAmerica A&A Technical Consultant Thomas A. Ratcliffe, Ph.D., CPA

The recurring cost and complexity of performing the first step of the two-step goodwill impairment test methodology are the driving forces behind planned new guidance.

In April 2011, the Financial Accounting Standards Board (FASB) issued the proposed Accounting Standards Update (ASU), *Testing Goodwill for Impairment*. This update was in response to the feedback the FASB received from private company constituents during October and November 2010 roundtable discussions.

As proposed, the update would amend the guidance in FASB Accounting Standards Codification (ASC) Topic 350, *Intangibles – Goodwill and Other.*

Goodwill impairment occurs when the implied fair value of goodwill declines to an amount that is less than its carrying amount. The current guidance in ASC 350 includes the requirement for reporting entities to use a two-step process to test goodwill for impairment at least annually.

Using the guidance in ASC 350, the first step in the goodwill impairment test, which is used to identify potential impairment, relates to comparing the fair value of the reporting unit with its carrying amount, including goodwill. The second step of the goodwill impairment test, which is used to measure the amount of impairment loss, if any, that needs to be recognized in the financial statements, relates to comparing the implied fair value of reporting unit goodwill with the carrying amount of that goodwill.

The proposed amendments to ASC 350 are intended to have the end result of reducing the complexity and costs incurred by reporting entities by *allowing* the use of a qualitative evaluation about the likelihood of goodwill being impaired in advance of making decisions about whether the fair value of reporting units needs to be calculated. Specifically, reporting entities would have the *option* of first assessing qualitative factors (events and circumstances) to determine whether it is *more likely than not* (i.e., a likelihood of greater than 50 percent) that the fair value of a reporting unit is less than the carrying amount of that reporting unit.

If, after considering all relevant events and circumstances, using the qualitative assessment, a conclusion is reached that it is *not* "more likely than not" that the fair value of a reporting unit is less than its carrying amount, then performing the two-step process would be unnecessary. However, if the converse is true, the requirement to perform the first step in the two-step impairment testing process, as that work is done today, would be retained.

In evaluating whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount, some examples of events and circumstances, among others, that need to be considered include:

- Macroeconomic conditions
- Industry and market considerations
- Cost factors
- Overall financial performance
- Other relevant entity-specific events
- Events affecting a reporting unit
- Where applicable, a sustained decrease, both absolute and relative to peer entities, in share price

It is important to recognize that the above-noted examples of events and circumstances that need to be considered in making the more-likely-than-not qualitative assessment are not intended to be all-inclusive. Essentially, other relevant events and circumstances might be identified that need to be considered in this overall qualitative assessment.

Additionally, none of the individual examples of events and circumstances is intended to represent stand-alone events or circumstances that necessarily would require the performance of the first step in the goodwill impairment testing methodology.

When performing the qualitative assessment using the illustrative events and circumstances – and including other issues that have been identified – it is important to consider positive and mitigating events and circumstances that may affect the determination of whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If reporting entities have a recent fair value calculation for a reporting unit, this information may be useful in considering whether fair value exceeds the carrying amount by a substantial margin. That assessment also would be helpful in determining whether the first step within the goodwill impairment test needs to be performed.

In reading through the illustrative events and circumstances that would be used in the qualitative assessment, it should be noted that the examples differ from the events and circumstances included in the current ASC 350 guidance. These proposed new examples of events and circumstances supersede those current examples so that they would be used even in circumstances in which reporting entities are considering whether goodwill impairment testing is needed between annual tests.

Areas of interest may trigger higher chance of IRS audit

By Guest Columnist Gail M. Kinsella, CPA, with Testone, Marshall & Discenza, LLP, a CPAmerica International member firm

The dreaded Internal Revenue Service audit is one of the universal concerns for companies everywhere. While there is no guaranteed method to avoid an audit, a variety of situations may increase the chance for examination.

IRS officials are naturally reluctant to share details of the audit selection process. But it makes sense to direct attention to the areas where the Service has focused attention with "Market Segmentation Specialization Program" (MSSP) efforts.

The IRS has developed literally dozens of industry guides to assist auditors in their pursuit of enforcement. These audit technique guides are highly detailed, and they reveal considerable investment by the IRS. The documents are public and available on the IRS website (www.IRS.gov).

While the Service won't provide a road map for avoiding an audit, there is certainly adequate information about "areas of interest" and therefore, seemingly, audit risk. The MSSP process aims to develop highly trained examiners in specific areas with the objective of ensuring taxpayer compliance.

Common wisdom and the IRS website advise us that returns have a higher likelihood of being selected for examination if the reporting entity has involvement, or potential involvement, in abusive tax avoidance transactions.

In other words, returns may be selected for audit based on information obtained by the IRS through efforts to identify promoters and participants in these sorts of transactions. Returns are often selected when a company is involved as a related party or a party to general transactions with other businesses, partners or investors whose returns were selected for examination.

The IRS uses a Discriminate Function System (DIF) to correlate return statistics based on a company's return with past IRS experience or similar returns using the Unreported Income DIF. A return's DIF indicates the potential for questionable issues. The highest-scoring returns are often subject to selection for evaluation of items requiring review.

Local compliance projects may increase the likelihood for audit, as may the sheer size of the company. Many large corporate returns are examined annually, and there seems to be an indication that the cash basis of accounting could bring Uncle Sam around for a sniff at the substantive reasons for selecting the cash method.

Like so many rules and regulations, there are always exceptions. But if the IRS is talking about it, then you should be thinking about it.

Taxable income in foreign accounts is a key initiative of the Service. The recent Offshore Voluntary Disclosure Initiative was designed to bring offshore money back into the U.S. tax system, and it likely provides additional data for the IRS selection matrix.

A reputable CPA is a key component to your overall business strategy and could have an impact on audit exposure as well. If the IRS believes a preparer is claiming inappropriate deductions or taking other fraudulent steps on client returns, the preparer's clients are at risk for an audit.

And it isn't only the federal return. The IRS has information-sharing agreements with the states. If you are audited at the state level and you owe additional taxes, your state will share that information with the IRS. Receiving notification from the state may prompt the IRS to contact you to ask for additional information or to audit your return in depth.

Recent accounting pronouncements have many businesses concerned about providing an unintended road map for tax examiners relative to "uncertain tax positions." The Internal Revenue Code includes provisions for compensating informants and whistle-blowers that provide specific and credible information to the IRS if the information results in the collection of taxes, penalties, interest or other amounts from the noncompliant taxpayer. Check out IRC Section 7623 and the "Whistleblower – Informant Award" on the IRS website if you are curious about this initiative.

Taxpaying entities should avoid claiming deductions that are inappropriate or unsupported. But if a business is entitled to a tax deduction – even if "high" compared to the amount of income – it should claim the deduction.

The 2012 federal budget calls for expanding the IRS auditor ranks in an effort to shrink the nation's "tax gap." The IRS has estimated this gap at nearly $300 billion.

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With revenue of this magnitude at stake, rest assured that enforcement and collection initiatives will remain at a high level of interest for the IRS. As with many things, the best offense is often a good defense.

This brings us back to the reputable CPA: Be sure to consult with one soon.

Reporting alternatives *continued from the front*

recognition of the specific departures from GAAP in the report attached and in the financial statements being prepared.

Reporting under OCBOA, however, is defined as "a definite set of criteria other than accounting principles generally accepted in the United States of America, having substantial support underlying the preparation of financial statements prepared under that basis."

Typically, standards recognize accepted OCBOA methods as the pure cash method, the modified cash method, the tax basis, the regulatory basis or an "other" basis that includes a definite set of criteria applied to all material items appearing in the financial statements.

A key component of a successful engagement includes making sure that all the users of the statements are in agreement with the basis of presentation, including the reasons for the change. Communicating with third-party users is paramount. In some cases, communication may require some education as to the differences between GAAP and the basis used to prepare the statements before users will agree to accept an alternative presentation.

For instance, often a debt agreement requires a financial statement to be submitted in the first place. Upon inquiry of the lender, a client may learn that this third-party user may actually prefer the less complicated OCBOA presentation.

Many technical issues must be considered in making this important presentation decision, including that:

- Professional standards still apply to OCBOA statements.
- OCBOA statements may be audited, compiled or reviewed.
- A statement of cash flows is not required in OCBOA statements.
- The basis of accounting used must be disclosed, and all statements must be titled in a manner that is distinguishable from GAAP basis titles.
- Disclosures should be comparable to those of a GAAP basis statement and, accordingly, should provide either the relevant disclosures required by GAAP or information that communicates the substance of those required disclosures.
- If modifying an OCBOA basis, modifications cannot be so extensive as to effectively result in a GAAP basis statement with departures.

The use of an alternative presentation can effectively provide meaningful data at a more reasonable cost for financial statement users. However, all the users should carefully consider the benefits and limitations before implementing this option.

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GELMAN, ROSENBERG & FREEDMAN
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4550 Montgomery Avenue
Suite 650 North
Bethesda, MD 20814

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