Accounting & Audit Advisor

Offsetting assets and liabilities require new disclosures

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

Some reporting entities must be ready by Jan. 1, 2013, to comply with new disclosure requirements intended to clarify offsetting assets and liabilities for financial statement users.

The Financial Accounting Standards Board issued Accounting Standards Update (ASU) 2011-11, *Disclosures about Offsetting Assets and Liabilities*, in December 2011, amending FASB Accounting Standards Codification (ASC) Topic 210, *Balance Sheet*. This guidance also amends the disclosure requirements in FASB ASC 815, *Derivatives and Hedging*.

In developing the amended disclosure requirements for U.S. generally accepted accounting principles (GAAP), the FASB's goal was to enhance disclosures for users of financial statements. Under the new guidance, users would have available improved information about financial and derivative instruments subject to offsetting, or "netting," in statements of financial position – whether the statements are prepared using U.S. GAAP or International Financial Reporting Standards (IFRS).

Understanding guidance issue and scope

Using these disclosure requirements, reporting entities will provide both net amounts (those that are offset) and gross information (as if amounts are not offset) in notes to the financial statements. In certain circumstances, offsetting assets and liabilities in statements of financial position results in the reporting entities presenting net amounts for the assets and liabilities in those statements.

U.S. GAAP requirements often subject certain derivative instruments, such as interest rate swaps, to legally enforceable master netting arrangements to manage credit risk among counter parties. In the event of default on, or termination of, any one contract, these types of arrangements provide for net settlement of multiple contracts with a single counter party, through a single payment in a single currency.

How financial statements reflect these arrangements depends on whether the financial reporting framework is U.S. GAAP or IFRS. Essentially, entities using U.S. GAAP can "net" amounts in financial statements that must be shown "gross" in statements that are prepared using IFRS.

To illustrate, assume the following:

- ➤ A reporting entity has a derivative asset of $100,000 and a derivative liability of $80,000 with another entity under a legally enforceable master netting arrangement.
- ➤ Given the arrangement, the reporting entity has a net position in the arrangement of $20,000.
- ➤ The reporting entity has $10,000 in cash collateral to put toward the $20,000 net position.

The provisions of U.S. GAAP would permit the reporting entity to offset (net) the derivative asset and the derivative liability, along with the cash collateral, in that these instruments are subject to an enforceable master netting arrangement. In this situation, the reporting entity would report a $10,000 asset position in the statement of financial position.

However, because of differing eligibility requirements in offsetting arrangements, if the reporting entity applied IFRS as the financial reporting framework, it would need to present these amounts gross in the statement of financial position.

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Seeking better communication? Unravel audit-speak

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

Have you ever wondered what your auditor is talking about?

Rest assured you're not alone. While most auditors are diligent in their quest for clarity, the lingo trap can sometimes rear its ugly head.

Here's a bit of a primer on that crazy audit – and accounting – language.

Clarifying Financial Statement Terms

Analytical procedure – This procedure applies analytical analysis as a method of auditing an assertion. Auditors compare financial statement amounts with their expectations.

Audit committee – This group is responsible for oversight of the financial reporting process, selection of the independent auditor and receipt of audit results.

Audit risk – Audit risk is a combination of the risk that material errors will occur in the accounting process and the risk that audit tests won't uncover the errors.

Internal controls

- **Deficiency** – A deficiency is an internal control shortcoming or an opportunity to strengthen internal controls.
  - **Control deficiency** – This deficiency exists when the design or operation of a control does not allow employees, in their assigned functions, to prevent or detect misstatement on a timely basis.
  - **Significant deficiency** – This deficiency in internal control is less severe than a material weakness, yet important enough to merit attention by those charged with governance.
- **Dual-purpose test** – This procedure, or test, provides evidence for both substantive tests and tests of controls.
- **Material weakness** – A deficiency in internal control exists such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and thus corrected on a timely basis.
- **Test of controls** – Auditors use these procedures to evaluate the design of controls and determine whether the controls are in operation – and operating effectively when reliance is going to be placed on controls.

Opinions

- **Adverse opinion** – The presentation is not in accordance with U.S. generally accepted accounting principles (GAAP).
- **Disclaimer of opinion** – The auditor is unable to express an opinion as to the presentation of financial statements in conformity with GAAP.
- **Unqualified opinion** – This is a personal favorite. "Unqualified" does not mean the auditor is lacking the qualifications required to render an opinion. It does mean that the opinion of the independent auditor has not been qualified in any way. This is often referred to as a "clean opinion." Here is a hint: The unqualified opinion is the one you want.
- **Qualified opinion** – In certain circumstances, an auditor cannot render a clean opinion on a portion of the financial statements. When the auditor feels that – except for the effects of the matters to which the qualification relates – the financial statements are fairly presented in conformity with GAAP, a qualified opinion is issued.

Random sample – A random sample is determined under conditions in which each item has an equal chance of being selected.

Relevant assertion – A relevant financial statement assertion has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated.

Segregation of duties – When a company segregates duties, it assigns different people the responsibilities of authorizing transactions, recording transactions and maintaining custody of assets.

Substantive audit procedure – This procedure is a direct test of a financial statement balance.

Those charged with governance – These individuals are responsible for overseeing the entity and obligations related to the accountability of the entity.

Trace – The auditor follows a transaction through the steps of a system.

Deciphering Other Audit Lingo

A discussion of audit terminology would be incomplete without noting a few items that are not limited in applicability to a financial statement audit but are important nonetheless. Read on for more exciting information.

Accounting estimate – Estimates are necessary when amounts are uncertain pending the outcome of future events. An accounting estimate refers to an approximation of a financial statement element, for example, depreciation. The owners of a depreciable asset estimate the useful life of the asset in question. There is no precision involved, although the auditor can assess the reasonableness of the factor considered.

Activities

- **Financing activities** – This refers to borrowing money or repaying amounts borrowed, or otherwise settling obligations.
- **Investing activities** – This refers to making and collecting loans, and acquiring and disposing of debt or equity instruments or property.

Agreed-upon procedures – Not an audit! In this case, the clients or another user, such as a bank, specifies what procedures the accountant will perform.

Basis of accounting

- **Accrual basis of accounting** – An organization recognizes, or records, a transaction when an obligation to pay or be paid arises, not when payment is consummated.

See ***Unravel audit-speak*** *on page 3*

Gauge health of business with internal reviews

By Guest Columnist Cesar Mejia, CPA, with Sol Schwartz & Associates, P.C., a CPAmerica International member firm

Because of the economic woes seen during the past few years, many businesses have seen decreased profits. Some companies that were barely getting by and didn't adjust during these tough times have gone out of business.

Remarks often heard from such businesses are "How could this happen?" and "We didn't see it coming."

While it's true that few people could have predicted the overall downturn in the economy, some business owners simply did not pay attention to the general health of their company. They failed to analyze the financial information available to them, saying, "Things seem to be running just fine," "Why bother?" or "I'm just too busy."

A review of the statement of cash flows could have revealed that operations had been *using* – not providing – cash and that the company had been relying greatly on bank financing to stay afloat. An analysis of the accounts receivable may have alerted business owners and managers that a majority of their receivables were not current and collection issues might arise in the future.

Optimizing business with an internal review

Management, more than any outside user, benefits most from the use of financial statements.

Management should analyze financial information to find ways to improve profitability, identify problems, make projections, cut costs and assist in the decision-making process. Management's review of the financial statements can also help identify and mitigate fraud or theft.

Many small businesses, due to their limited number of employees, usually do not have proper segregation of duties.

To help compensate for the lack of segregation, management should, at a minimum, perform a monthly review of financial statements, compare actual amounts to budgets and prior periods, and investigate any unexpected differences. Management should also review bank reconciliations and bank statements to see who's getting paid and how much.

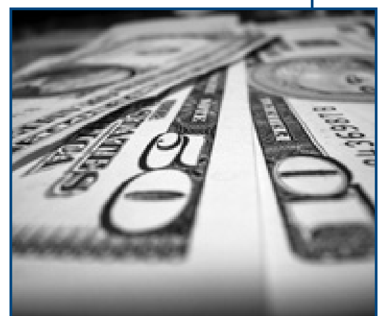
Analyzing financial information

Comparative financial statements

By analyzing financial statements for different periods side by side, a company can see how it has performed over time and identify trends in accounts.

The company should make inquiries not only on percentage and dollar changes but also on its expectations based on operations. For example, if the number of plant employees at a manufacturing company doubled from last year, all things being equal, the company should expect revenues – as well as wages, supplies and other direct expenses – to increase.

Budgets



The goal of a budget is to identify specific areas for spending the revenue of the company. Budgets are good for accountability and control of spending. The company should compare budget to actual figures on a regular basis and investigate major variances.

Ratios

Financial ratios are an important part of the financial statement analysis. Ratios generally hold no meaning, unless they are *benchmarked* against past performance or the industry. By benchmarking certain key income statement lines with industry data, an organization can see how it compares to similar companies.

Companies can use ratios when analyzing income statements to make sure the numbers appear reasonable. They can do this by looking at their driving factors and comparing them to revenue for the period. For example, for a medical practice, a direct relationship should exist between the number of patient visits or surgeries and the revenues for a given period.

There are many ratios, so a company should focus on key industry ratios and ratios important to its business – such as ratios required by loan covenants.

Considering the bottom line

Financial statements say a lot about the overall health of a business, which can affect its bottom line. Companies should consider whether they can afford not to do an internal review of their financial statements.

Unravel audit-speak *continued from page 2*

- **Cash basis of accounting** – An organization records transactions when cash is increased or decreased.
- **Comprehensive basis of accounting** – A complete set of rules, other than GAAP, is applied to all items in a set of financial statements, for example, income tax basis or cash basis.

Cash equivalents – Cash equivalents are short-term and highly liquid investments that convert readily to cash and carry little risk of change in value at maturity.

Statements

- **Balance sheet or statement of financial position** – This is an inventory of assets and liabilities at a particular moment in time. Assets represent what an organization owns. Liabilities represent obligations owed to other parties.
- **Income statement or statement of activities** – This statement summarizes revenues and expenses occurring during a given time period.
- **Statement of cash flows** – This statement reconciles changes in cash and cash equivalents with changes in income between two consecutive periods.

Trend analysis – Trend analysis examines the change in something over time, for example, comparisons of one year to another.

If you find yourself still lost in the terminology, have a conversation with your CPA, who is your most valuable resource in achieving financial literacy.

Offsetting assets and liabilities *continued from page 1*

Understanding the disclosures

The ASU 2011-11 amendments to U.S. GAAP disclosure requirements include certain minimum disclosures to be included in notes to financial statements in a tabular format, unless another format is considered more appropriate. Those disclosures include separate amounts (i.e., quantitative disclosures) for financial assets and liabilities, including derivatives, related to the following:

- Gross amounts of recognized financial assets and liabilities
- Gross amounts offset using U.S. GAAP requirements
- Net amounts presented in statements of financial position
- Amounts subject to enforceable master netting arrangements or similar agreements that are not included in gross amounts offset using U.S. GAAP requirements
- Net amounts related to the difference between amounts offset under U.S. GAAP and amounts subject to enforceable master netting arrangements or similar agreements

When considering the disclosures, the net amounts in statements of financial position need to be reconciled to individual line items presented in those statements.

In addition to the quantitative disclosures listed above, reporting entities are required to provide a description of rights of set-off associated with recognized assets and liabilities subject to enforceable master netting arrangements or similar agreements.

Also, in efforts to address stakeholder concerns about lack of transparency in disclosures related to under-collateralized positions when compared to over-collateralized positions, total amounts allowed to be disclosed for particular financial instruments in master netting arrangements or similar agreements are limited to amounts shown as net amounts presented in statements of financial position.

Meeting the effective date

Reporting entities need to comply with the new disclosure requirements in annual reporting periods beginning on or after Jan. 1, 2013, and for interim periods within those annual reporting periods. Importantly, these enhanced disclosures need to be provided retrospectively in all financial statements for all periods presented for comparative purposes.

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