DECEMBER 1, 2013

CFGINSIGHTS

INDUSTRY TRENDS AND DEVELOPMENTS FROM CFGI

Welcome to the winter edition of CFGInsights. Our goal is to provide you with the most up-to-date accounting and reporting issues that companies face today.

NOW TRENDING IN MATERIAL WEAKNESSES

In December of 2012, the PCAOB issued a report summarizing the findings from their review of the 2010 audits for eight registered accounting firms[1]. The report specifically identified that an area of deficiency among the firms was the testing of internal controls during their audits. In response, auditors have been investing significant effort into performing walkthroughs of the design of processes and testing of the operating effectiveness of controls.

PERSPECTIVES

HEADS UP! NEW LEASE GUIDANCE.

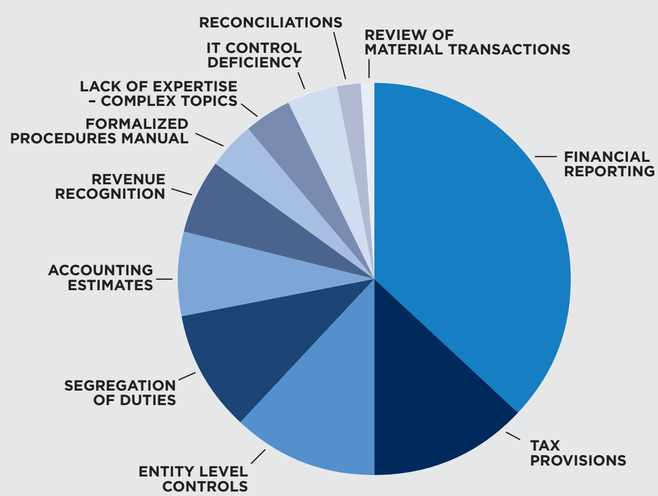
The FASB and IASB issued a revised Leases exposure draft on May 16, 2013, which would mark a significant change to the current accounting for lease transactions. This guidance could potentially have implications that would impact multiple areas of the business, including treasury, operations, tax, regulatory compliance and decisions on how transactions are financed.

READ MORE FOR FULL DETAILS OF OBSERVATIONS ON PAGE 5 >>

TYPES OF MATERIAL WEAKNESSES

CFGI examined filings from January 1, 2013 through July 31, 2013 to identify trends in the types of deficiencies that companies are identifying as material weaknesses.

READ MORE FOR FULL DETAILS OF MATERIAL WEAKNESS DISCLOSURES ON PAGE 2 >>



[1] "Observations from 2010 Inspections of Domestic Annually Inspected Firms Regarding Deficiencies in Audits of Internal Control over Financial Reporting" PCAOB Release Number 2012-006, December 10, 2012.

CFGI

Our team of top-rated former "Big 4" accounting professionals advises clients on complex issues including all aspects of U.S. GAAP accounting, SEC reporting, SOX compliance, business process and financial system redesign and many other areas. We provide expert consultations on technical policy matters, restatements, carve-outs, audit readiness and due diligence, in addition to filling interim accounting, reporting and tax roles. We can also augment your team by providing highly-skilled resources to review policies and procedures, SEC documents and contractual arrangements and highlight areas of focus.

NOW TRENDING IN MATERIAL WEAKNESSES
(CONTINUED)

Given the additional scrutiny on controls from an audit perspective, we examined filings of companies with a market cap between $100 million and $1 billion from January 1, 2013 to July 31, 2013 to identify recent trends in the deficiencies that these companies identified as material weaknesses. The breakdown of these material weaknesses by category is shown in the chart on the preceding page. Two of the top areas where material weaknesses were identified continue to be within financial reporting and tax provision preparation and disclosure.

Key controls within the financial reporting process may include: (1) monthly comparisons of budget and actual results to forecasts for revenues and expenses; (2) comparisons of other metrics, such as profit margins and certain expenses as a percentage of sales; and (3) quarterly balance sheet reviews. These review controls were identified within the PCAOB report as one of the most pervasive deficiencies in public accounting firm's auditing of internal control. As a result of the PCAOB findings, these review controls have received heightened scrutiny during the early part of 2013.

Deficiencies in management review controls typically arise from: (1) insufficient level of precision of review; (2) improper application of judgment; and (3) lack of proper follow up, resolution and documentation for investigated items. Management review is frequently identified as a compensating control in other areas where control deficiencies already exist. Therefore, further stressing the importance of having adequate review controls operating effectively with a sufficient level of precision and documentation is critical to an effective control environment.

Testing these types of controls presents a challenge, not just for the company, but also for its auditors. Evaluating and assessing the effectiveness of management review and judgments is a complex process given the difficulty involved in corroborating the adequacy of these activities with other evidence.

To reduce the occurrence of deficiencies and address increased audit scrutiny around review controls, companies should implement a process to thoroughly document: (1) control processes; (2) accounting guidance applied; (3) judgments made by management; (4) considerations identified through the review process; (5) items investigated; and (6) the results and conclusions of the review. Companies may implement checklists to assist management in documenting the actions taken, but should avoid a "check the box" mentality that does not adequately investigate key judgments and areas of risk.

Auditing Standard No.5 ("AS No. 5") prescribed a top-down approach to implementing a risk-based control structure. Companies' application of AS No. 5 could increase the risk of not designing controls, specifically management review controls, to a level of precision sufficient to identify misstatements. This exposes companies to control deficiencies. As these controls will become subject to a more detailed level of audit examination, we recommend that all companies, whether subject to the requirements of Sarbanes-Oxley or not, assess whether their management review controls are sufficient to address the applicable risk, specifically with the onset of the year-end process for many companies. ■

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SEC COMMENT LETTERS:
WHAT ARE THE CURRENT HOT TOPICS?

As part of our series on current trends with SEC Reporting, CFGI analyzed over 100 comment letters made available by the SEC between April 1, 2013 and September 30, 2013. The focus of our analysis related to the Financial Statements, footnotes and related disclosures made in Management's Discussion & Analysis filed on Form 10-Q and Form 10-K of companies with a market capitalization between $100 million and $1 billion.

Key trends identified indicate consistency amongst the areas receiving comments when compared to CFGI's prior comment letter analysis, which covered the period from January 1, 2013 to March 31, 2013.

Top 5 Comment Letter topics	Frequency
Management's Discussion and Analysis	26%
Revenue Recognition	17%
Debt	9%
Compensation	8%
Segment Reporting	8%

Our analysis found several key accounting and reporting considerations that registrants should consider in their upcoming filings:

MANAGEMENT'S DISCUSSION AND ANALYSIS. Comments requesting registrants enhance the discussion of underlying reasons for certain changes or emerging trends in a company's business operations continue to be a theme. The SEC staff is looking for registrants to more fully disclose why significant changes occurred by identifying specific drivers of the change to operations in the period. An example of a SEC staff comment follows:

"Please provide a more detailed analysis of the reasons underlying each material quantitative change in operating measures from period to period. For example, fully explain the significant decrease in income from operations attributable to the ABC segment in fiscal 2012. Your discussion should explain the cause of underlying factors which led to material shifts, rather than simply listing factors such as decreased enrollments and higher operating costs. Where acquisitions materially impact financial line item shifts, please quantify that impact. For example, quantify the impact the acquisition of XYZ had on ABC revenues. Finally, more fully explain disproportionate line item shifts."

This example highlights the theme of many of the comments issued in this area, which is a continued focus by the SEC on the depth and quality of the analysis provided by registrants.

REVENUE RECOGNITION. The SEC staff's continued focus on revenue recognition disclosures aims to assist the financial statement user in gaining a deeper understanding of registrants' revenue recognition models. Areas of focus include milestone arrangements, proportional performance models, contingent consideration, extended payment plans with customers, warranty obligations and sales return reserves. These areas require significant judgment and the SEC staff's goal with their comments is to ensure registrants' patterns of revenue recognition are clearly understandable based on the disclosures in these filings.

DEBT. The SEC staff has looked closely at registrants for debt modifications and restructurings. The SEC staff has requested enhanced disclosures regarding gains and losses recorded on extinguishment of debt as well as the accounting for deferred financing costs related to the original debt.

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SEC COMMENT LETTERS:
WHAT ARE THE CURRENT HOT TOPICS? (CONTINUED)

COMPENSATION PROGRAMS. The SEC staff comments have been focused on adequately describing factors that impact variable compensation plans including the description metrics assessed on performance tied plans and the assumptions used to establish the value of compensation programs. An SEC staff comment to a registrant that has a cash bonus award plan is as follows:

"Please advise whether the decision to award cash bonuses is purely discretionary or is triggered by the achievement of performance targets, such as revenue and operating income".

In addition to focusing on providing the financial statement reader with sufficient information to understand the significant compensation programs of the registrant, registrants need to ensure consistency between Financial Statement footnote disclosures and disclosures contained in the Compensation Discussion and Analysis disclosures.

SEGMENT REPORTING. The SEC staff showed a consistent theme of requesting that registrants discuss the qualitative and quantitative factors considered when aggregating product lines and/or reporting units into a single operating segment in accordance with the characteristics established by Accounting Standards Codification ("ASC") Topic 280. Additionally, the Staff inquired about changes to the Chief Operating Decision Maker (CODM), as registrants experienced significant business changes including significant organic growth as well as acquisitions.

RESPONSE CONSIDERATIONS. The SEC's focus continues to be on the depth, completeness and adequacy of disclosures. To minimize the burden and likelihood of receiving follow-up comments, consider the following strategies:

1. Pay particular attention to these SEC focus areas and ensure your company's relevant reporting and disclosures are adequate and thorough. The SEC's National Conference on Current SEC & PCAOB developments is scheduled for the week of December 9, 2013, which typically produces a "*Frequent Areas of Comment*" presentation. Focus areas noted at the 2012 conference were consistent with the top 5 comment letter topics noted in our independent analysis;
2. Anticipate potential SEC comments about key judgments and be ready to answer questions before they come by preparing internal documentation in a manner that can be easily converted into a formal response to a comment letter. Companies with an established process to document key judgments contemporaneously with their filings will benefit if the SEC staff were to comment on that area;
3. Track recent SEC releases and other resources to keep your organization abreast of the latest guidance; and
4. Identify an internal plan for comment letter response, including resources that will assist when comment letters are received as a typical comment letter provides for a ten day response period. ■

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PERSPECTIVES:
HEADS UP! NEW LEASE GUIDANCE

WHAT ARE THE PROPOSED CHANGES? Under the revised Leases exposure draft, virtually all leases will have to be recognized on the balance sheet. Companies will no longer be able to recognize operating leases off-balance sheet.

When entering into a lease arrangement, or upon adoption of the new guidance, lessees will be required to recognize a right-to-use asset and a liability measured at the present value of future lease payments. As a concession, the FASB will allow companies to make an accounting policy election for short-term leases (less than one year) to be accounted for in a manner consistent with the current accounting for an operating lease.

Leased assets will be bifurcated into "property assets" (defined as land, buildings and part of a building) and "non-property assets" (which could be anything that is not land and buildings, such as machinery).

The lessor will derecognize a non-property leased asset and in its place will recognize a receivable and a residual asset. Most property assets will continue to be recognized by the lessor. It will not be uncommon for both the lessee and the lessor to have a leased asset, especially property leases, recognized on both companies' balance sheets.

The lessee will recognize non-property lease expense using the dual expense recognition method, which requires recognition of interest expense for the unwinding of the present value discount and depreciation of the right-of-use asset as separate line items on the income statement. The lessor will recognize a portion of the profit from the "sale" of the non-property lease at commencement and recognize interest income over the lease term. Property lease expense/income would be straight-lined over the lease term.

After the initial lease assessment, companies will have to reassess and remeasure the lease assets and liabilities to reflect revisions in estimated lease terms and variable lease payments.

WHAT SHOULD COMPANIES BE DOING TO PREPARE? Companies should begin to develop accounting policies for analyzing whether existing and new leases would be classified as either a non-property or property lease. For entities with large numbers of leases this could be a significant undertaking. Additionally, companies should develop models to calculate the present value of lease payments for their identified leases. From a controls perspective, companies should begin to develop controls to monitor changes in estimates and begin to develop processes to remeasure the assets and liabilities.

Any arrangement that is affected by a Company's balance sheet should be reviewed for the impact of this new guidance. For example, companies should begin to evaluate debt with covenants that relate to debt-to-equity ratios or total debt amounts and develop a plan to model the impact of this proposed guidance to creditors.

Keep an eye on the news! FASB and IASB deliberations are ongoing so changes to the exposure draft could come at any time. While an effective date is unlikely before 2017, now is the time to start thinking about these potentially widespread and long-lasting effects. ■

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WHY CFGI?

At CFGI, we define our success by the quality of our work and the satisfaction of our clients. Through our deep knowledge base, industry expertise and passion for client service, we provide value add solutions to address client needs. We have built a reputation as the go-to solution for all – critical finance and accounting projects and continue to build our business by attracting the industry's best professionals and supporting them with the cumulative expertise of our firm. When you partner with CFGI, you gain access to a full-service financial consulting and corporate finance team. Through our well-rounded operational and technical expertise, our team is ready to deliver the services and support needed to achieve your goals quickly, efficiently and effectively.

Whether it is assistance evaluating and documenting complex technical accounting issues, or assistance with your financial close process, financial reporting and tax process, or assistance with your SOX process and documentation, we are uniquely positioned to help you with those needs. ■

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