Fair Value Accounting and Revenue Recognition

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The Sarbanes-Oxley Act of 2002 (the “Act”) created the Public Company Accounting Oversight Board (PCAOB) and established specific rules related to audit committees of public companies. Title I of the Act established the PCAOB, which is responsible for conducting inspections of registered public accounting firms and the audit work they perform. Specifically, the PCAOB’s mission is to “oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports.”\(^1\)

The Act also requires the identification of “financial experts” on public company audit committees and recommends that at least one member of each audit committee qualify as a financial expert.

The PCAOB conducts inspections of audit firms that issue audit reports on the financial statements of SEC registrants, on an annual or triennial basis, depending upon the number of reports that a firm issues. In 2011, the PCAOB released reports related to its inspections of the Big Four accounting firms. The reports reveal some noteworthy trends. For the period beginning September 2009 through February 2011 the PCAOB reviewed 242 U.S. Big Four audits and identified 79, or one-third, as having “audit deficiencies.” The two areas with the most deficiencies: valuation and revenue recognition.

VALUATION

Nearly 80% of the deficiencies involved audits of accounts, the valuations of which are highly dependent on management judgment. Most of the audit deficiencies were associated with accounts that have a fair value and/or impairment component, including long-lived assets, securities/financial instruments, intangible assets, and pension reserves. In addition, the PCAOB identified deficiencies related to audits of inventory valuation and bad debt provisions. The PCAOB’s overarching conclusion in instances of valuation audit deficiencies was that the auditors failed to perform sufficient substantive procedures to test the valuations. Among the specific issues cited were the:

- **Failure to evaluate** appropriateness of financial models used for hard-to-value financial instruments;

- **Failure to perform** sufficient substantive procedures to test the valuation of pension plan assets due to an excessive level of reliance on internal controls;

\(^1\) PCAOB Mission Statement, http://pcaobus.org/About/History/Pages/default.aspx
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• **Failure to address** the fact that discounted cash flow models: (i) did not include terminal values, (ii) used discount rates that were not developed based on observable inputs, and (iii) were based on cash flow assumptions as of the wrong measurement date;

• **Failure to obtain** sufficient appropriate audit evidence related to private debt securities, auction-rate securities, asset-backed securities, collateralized debt obligations (“CDOs”), collateralized mortgage obligations, and other mortgage-backed securities.

To be sure, fair value is more than just an audit issue. It also has been a significant focus of SEC enforcement activity. In 2011, for example, the Commission issued numerous comment letters related to fair value. While many of them resulted in amended disclosures, others led to restatements in situations ranging from acquisition accounting to valuing derivatives and other complex financial instruments such as CDOs.

**REVENUE RECOGNITION**

Twenty-eight percent of the audit deficiencies in the reports involved revenue recognition. In many cases, the issues cited were not related to a material misstatement, but rather to a failure to test revenue recognition controls. This is not surprising. For years, the SEC has devoted significant resources to the enforcement of revenue recognition accounting and disclosures.

Audit committees may be able to reduce the risks associated with financial misstatements. To do so, they should ensure that financial management has the appropriate training, experience, rationale, and processes in place to develop valuations that are compliant with GAAP. At a time when markets remain volatile, it is critical for assumptions, such as expected rate of return and discount rate, to be well reasoned. Slight changes in assumptions can lead to material changes to a company’s financial results. For example, in the case of calculating pension liabilities, a relatively small change in a projected rate of return assumption can transform a loss into a profit. In some cases, a third-party independent expert may be needed to review management’s methodologies and assumptions and to value certain assets.

Similarly, audit committees should ensure that their auditors have the requisite experience to audit the accounts in their company’s financial statements. Those auditors should have a well-developed plan that can serve to minimize the risk of failing to identify a material misstatement.
and in 2011, it issued more than 400 comment letters that addressed revenue recognition in some fashion. In this environment, audit committees should consider whether they have the necessary understanding of their company’s revenue recognition policies and disclosures to adequately perform their oversight roles.

Proactive audit committees may be able to identify accounting issues earlier and thereby reduce the risks of SEC compliance issues at their companies. Prudent audit committees perform in-depth, detailed reviews of their company’s policies and disclosures as well as ensure that their independent auditors have an appropriate audit plan in place. Furthermore, since the independence rules of the Act preclude auditors from advising companies on accounting treatment, audit committees may consider retaining an advisor who can provide an unbiased perspective.

Audit committees should play an active role, remain vigilant, and stay knowledgeable about evolving accounting and auditing issues in order provide adequate oversight. As a result they may be able to identify issues earlier and reduce the risks of SEC inquiries, investigations, and financial restatements as well as the related costs and distractions.
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