

## CFO Insights

### Financial statements: Framing your judgment calls

CFOs and their teams continually strive to achieve zero material defects in their financial statements. Backed by effective internal controls, the knowledge of the senior officers in their accounting teams, and input from external advisors, they work diligently to avoid last-minute adjustments—or, heaven forbid, a financial statement error, leading to a restatement.

Still, their efforts are not foolproof. In the United States in 2013, 290 accelerated filers (defined as companies with market capitalizations greater than \$75 million, among other criteria) had to restate their financials, up approximately 3% from 2012.<sup>1</sup> Common mistakes included those related to revenue recognition, accounting for income taxes, and measurements of complex financial instruments, all areas that involve a significant degree of judgment.<sup>2</sup>

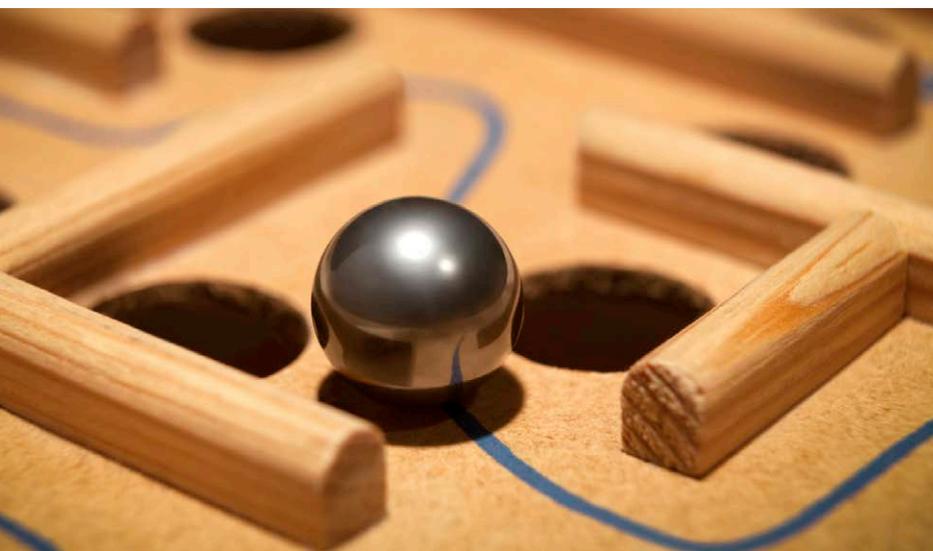
While finance chiefs and their teams typically produce reams of analyses to support their financial statements, errors can still occur—often because of a lack of rigor around accounting judgments. In this issue of *CFO Insights*, we'll examine why companies might consider implementing a formal framework to support accounting and financial reporting judgments, and discuss why they could benefit from a more disciplined approach.

#### Sitting in judgment

Despite what many might believe, accounting is not an exact science. Accounting standards are complex and nuanced, reflecting the nature of the transactions they are designed to capture. A high-tech company's sale of a software package, for example, may have many elements that require separate evaluations as to whether and when to record revenue. Accounting for financial instruments without quoted market prices can involve the selection of appropriate valuation methods and a number of critical assumptions. A corporation operating in multiple tax jurisdictions needs to manage a myriad of judgments, laced with the inherent uncertainty regarding future events.

Current developments in the world of financial reporting are compounding such complexities. For starters, both U.S. GAAP and International Financial Reporting Standards (IFRS) are expected to introduce new judgments into the preparation of financial statements. Notably, the soon-to-be-released accounting standard on revenue recognition, which will be effective on January 1, 2017, will require companies to take a fresh look at how contracts with customers are worded and how associated revenues are recognized (see sidebar, "Judging revenue recognition," page 3).<sup>3</sup>

At the same time, new regulatory requirements are taking aim at disclosures around judgments used in preparing financial statements. In the UK, for example, audit committees are now being asked to discuss, in public company annual reports, the significant issues considered in relation to the financial statements (including management's critical accounting and financial reporting judgments) and articulate how these issues were addressed.<sup>4</sup> While the UK is the first jurisdiction mandating such disclosures, it is not unreasonable to expect similar



requirements to spread to other countries. (In the U.S., audit committees are responsible for overseeing financial reporting and internal controls and upholding the integrity of the financial statements. As part of this role, audit committee members should understand the significant judgments and estimates used by management and their impact on financial statements.)

Meanwhile, external auditors in the U.S. may also be asked to disclose more information about their oversight of judgments. In a significant expansion of the information that would be required in the reports of auditors of financial statements, the Public Company Accounting Oversight Board (PCAOB), in 2013, proposed a new auditor reporting standard that would require specific insight into the audit of a company's financial statements.<sup>5</sup> Among other things, the PCAOB has proposed that auditors report matters that involved the most difficult, subjective, or complex auditor judgments. The International Auditing and Assurance Standards Board is considering something similar.<sup>6</sup>

With such changes on the horizon, this may be a good time to revisit controls over your company's judgment calls. While many companies have designed their internal controls to be compliant with the Committee of Sponsoring Organizations' (COSO) framework, few have formal *judgment frameworks* as part of that infrastructure.<sup>7</sup> Moreover, while COSO directs companies to identify risks to financial reporting and implement controls to address risks of noncompliance, it does not explicitly address the need for specific controls over the processes involved in making accounting judgments.<sup>8</sup> That means companies seeking a higher degree of comfort about individual judgments may be starting without sufficient guidance.<sup>9</sup>

### A root-cause analysis

Designing an appropriate framework starts with understanding why bad judgments may occur. Assuming you have qualified, talented accountants, errors in judgments typically arise from two factors: inadequate fact-gathering and human biases.

**Inadequate fact-gathering.** A company's accounting and reporting process—for everything from revenue recognition at the top line of the income statement down to income tax expense—may be dependent on hundreds, if not thousands, of pages of legalese or multiple regulations. Take the contracts that underlie today's complex business deals and transactions. Often accountants, who are only peripherally, if at all, involved in negotiations, may simply be sent the final legal documents to decipher after the deal has closed. Although those documents may look like hundreds of previous deals, slight nuances in what is promised to the customer can change everything. Something as simple as the inadvertent omission of an attachment or as innocent as an unwritten traditional industry practice might result in an oversight of a significant liability that should have been recorded on the books.

**Human biases.** Human beings usually have biases that result from life experiences and current circumstances, and accountants are no exception. The following are examples of what your accounting staff might be thinking as they undertake an accounting judgment—all biases that may result in a flawed judgment:



- ***“My conclusion is best for the company and for me.”*** The bottom-line effect of an accounting judgment can be significant either for the entity or for the individual. Many times mistakes are made because of a bias toward a result that is favorable to one or both. While the bias may be unintentional, it typically involves the accountant rationalizing the most desirable outcome, rather than seeking and evaluating alternatives. An accountant, due to this bias, may be inclined to just follow the path of least resistance: If he or she knows that conclusion A will meet with wide acceptance but conclusion B might result in days of debate, the accountant may be biased toward advocating for conclusion A. For example, if expectations of net income have been set with management (and Wall Street analysts), a company accountant reviewing the elements of a sales contract might unintentionally build a case in line with those expectations, rather than seek information that supports an opposing view.
- ***“Everyone else thinks the answer is right, so the answer must be right.”*** When respected colleagues say the conclusion is A, it might be uncomfortable to say it is B. Similarly, a manager reviewing certain work might assume that because of the significant experience the accountant has had with particular transactions, there is no chance of error.
- ***“I’m smart. I don’t need any help.”*** A long track record rendering accounting conclusions under difficult circumstances might make an accountant feel overconfident. Faced with a new and unfamiliar transaction or set of circumstances (such as a new line of business), he or she may not consider asking for assistance, let alone engaging in a healthy debate and inviting challenge.

### Judging revenue recognition

The soon-to-be-released standard on revenue recognition applies to all contracts with customers, subject to only a few exceptions, and provides a single model that applies to all entities. It also contains a number of new requirements that will require judgment to be exercised.

For example, companies will need to assess their contracts, to identify every performance obligation therein—including implied obligations—to determine whether the promised goods or services should be accounted for as a bundle or separately, considering elements such as warranties, maintenance, and other customer support. In addition, judgment may need to be exercised in estimating the total transaction price, which becomes more complex when a portion of the consideration is variable (for example, discounts, rebates, tiered pricing).

Even the driver of revenue recognition will change to a model under which revenue is recognized when control of the good or service transfers to the customer. For companies such as those in the construction industry, in which the transfer of a “good” takes place over a long period of time, determining when that happens will require judgment to be exercised.



The risk of errors resulting from incomplete fact-gathering and human biases are often exacerbated by extreme time pressures. Given the increased pace of financial reporting, CFOs simply do not have the luxury of leisurely studying their results before reporting them to investors and other stakeholders. Similarly, accountants often have little time to wrap their heads around the complexities of transactions. Unfortunately, last-minute discoveries of facts that could have been uncovered by a more thorough and earlier analysis are more common than a CFO would like to think and taking the steps to avoid them should be a priority.

### Elements of a judgment framework

Given the multiple factors that can sabotage financial statements, what can a CFO do to create the foundation for sound accounting judgments? To start, develop a strong judgment framework incorporating the following:

- 1. Ensure that your team is properly armed.** Having a qualified and experienced staff is table stakes, and forms the foundation of a solid judgment framework. Remember to:
  - **Keep your accounting staff current.** Having a qualified staff doesn't just mean collecting smart people with impressive résumés. Your team should be driven to remain current with developments in your business, as well as with their continuing professional education requirements—especially important given the constant evolution of accounting standards and shifts in regulatory focus.
  - **Recognize limitations.** Consider establishing a policy under which nonroutine transactions that meet certain criteria are subjected to an objective assessment. If the information required to support certain judgments is in a specialized area, such as the valuation of a complex financial instrument or a one-off complex leasing transaction, you may want to involve external specialists who can either take an active role in making the accounting judgment or provide an independent challenge.

- **Consider designating a judgment arbiter.** Your company may have an efficient process around the review of accounting judgments and your finance team may be top-notch, but even the best of us fall prey to bias from time-to-time. One possible solution to guard against this natural human tendency is to designate an independent reviewer of judgments—a “judgment arbiter,” for want of a better title. The arbiter's role would be to ensure that the company's predefined steps in material judgment areas have been applied in a thorough fashion and that the judgments have been made objectively and reviewed following due process (see sidebar, “Who could be your judgment arbiter?” page 5).

### 2. Instill a culture of comprehensive fact-gathering and documentation.

Documentation provides discipline over accounting judgments. Often the process of documenting a transaction will cause a more careful examination of the facts and highlight issues or questions that would otherwise be left at risk of last-minute discovery.

- **Gather all the facts.** Performing a thorough analysis of all relevant facts is critical to making an appropriate judgment. Once facts are gathered, it is then possible to determine which accounting standards apply, and then to review the transaction in light of the applicable standards. The process of documenting a transaction in the context of the accounting guidance may necessitate digging deeper into the facts. One task of the arbiter could be to determine how much information is adequate in each circumstance.
- **Cast a broad net.** While finance obviously takes the lead in the financial reporting process, operations, tax, and legal are also often involved in making accounting judgments. The judgment arbiter could help ensure that the finance team is coordinating with the appropriate individuals throughout the organization to determine if facts are fully understood and conclusions thoroughly vetted.

### Who could be your judgment arbiter?

On the surface, appointing a “judgment arbiter” may appear to be a drastic measure, but the added assurance benefits and enhanced capability could help avoid errors that might result in restatements. The question then becomes, who should be the arbiter?

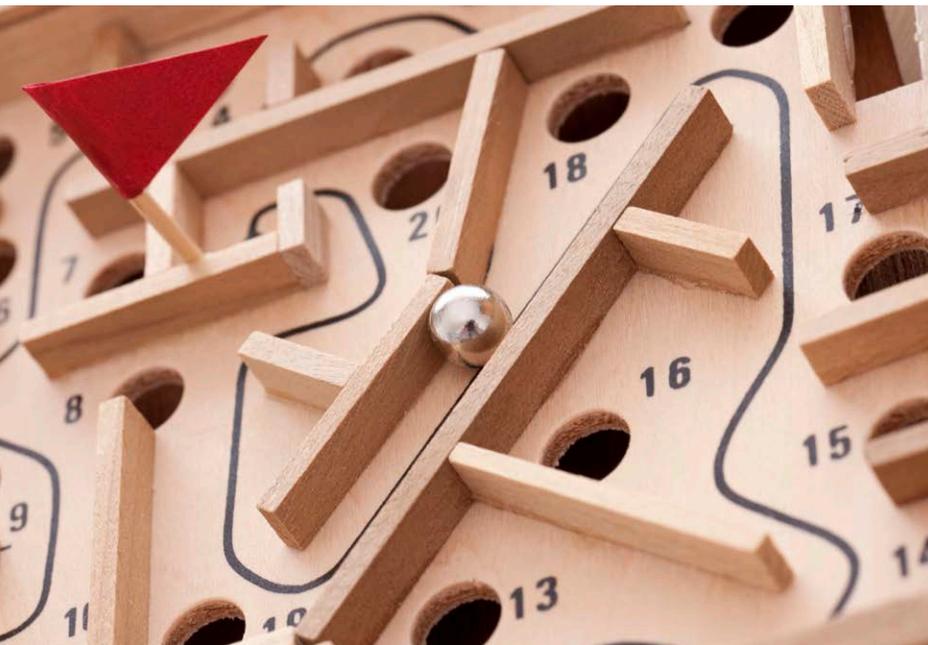
There may be several possible candidates already on staff in the following areas:

- **Finance.** Appointing someone from finance may sound logical, but the team may not be large enough to allow for a review that is truly independent.
- **Internal audit.** Given that its role is already somewhat independent, internal audit may be the ideal team from which to choose an impartial arbiter.
- **Legal department.** A legal background that trains practitioners to weigh all the facts—for example, in a court case—would be relevant, irrespective of a lack of accounting knowledge.
- **Disclosure committee.** A member of your disclosure committee, or maybe even the committee itself, could serve as the judgment arbiter in addition to existing responsibilities.

Tapping someone internally, of course, offers the added benefit of cost savings. However, asking more of an already overstretched team might not go over well. One possible step: backed with the appropriate level of authority and executive support, launch a trial run with existing resources and assess the benefits in relation to the costs. You may be surprised at what you find.

**3. Take steps to mitigate bias.** While biases cannot be completely eliminated, you should consider creating mechanisms to recognize and mitigate them. Again, this is an area where a judgment arbiter could offer oversight.

- **Inventory employee incentives.** In order to keep talented people, you need competitive compensation arrangements. But have you considered whether your practices could lead to biased outcomes? If the potential for biases exists—such as offering bonuses based on earnings per share—an added element of oversight of material judgments might be prudent.
- **Embrace the contrarian view.** In many cases, a conclusion might be vastly different using a different assumption or a different accounting standard. A judgment arbiter could help ensure that all reasonably possible alternatives were appropriately considered and documented. For certain high-risk transactions, the arbiter could also ask for a “devil’s advocate” to research and assert an alternative viewpoint that challenges the conclusion.
- **Stress-test, and stress-test again.** Assumptions are an important component of the judgment process. While you might be comfortable with the result, a small tweak to an assumption underlying a conclusion might yield a different result. In fact, if you run the calculations using different scenarios, you might be surprised at the result(s). At a minimum, assumptions in the accounting process should be evaluated against those used elsewhere. For example, if you are assuming a certain interest rate for your pension estimates, how does it compare with the assumption used in your analysis of long-lived assets for potential impairment?
- **Track and report your performance.** Over the course of a year, there are often hundreds of judgments that have a material impact on financial statements. Senior management and audit committees should take steps to ensure that critical judgment areas are identified and addressed objectively. A judgment arbiter could ensure that an honest self-assessment is taking place, including identification of breakdowns in the framework, and could be responsible for reporting failures to you, the audit committee, and others charged with governance.



- **Limit the risk of a rush to judgment.** While a formal judgment framework will help guard against last-minute adjustments, 11th-hour fire drills will not be totally eliminated. At these times, CFOs should consider relying on the judgment arbiter to guard against the snap judgments that are often made shortly before an earnings release or other financial reporting deadline.

### No pain, no gain

The steps outlined above are only some a CFO can take to mitigate the risk of errors in financial statements. Every company's circumstances are different, and there is no one-size-fits-all solution, and, of course, nothing is foolproof. However, designing and implementing a formal judgment framework of the kind proposed herein, including implementing the role of a judgment arbiter, can provide CFOs and audit committees with a comfort level that may otherwise be out of reach. Granted, it requires a change in the corporate mind-set and may provoke pushback from the accounting staff, who may not appreciate the added challenge and oversight. However, equipped with a formal framework, finance chiefs can help avoid once-in-a-lifetime events that could sideline a company or cost heavily in terms of time, reputation, and, at worst, regulatory scrutiny, fines, and restricted access to capital.

### Endnotes

- <sup>1</sup> "2013 Financial Restatement: A Thirteen Year Comparison," A Restatement Breakdown by Size, page 7; Audit Analytics, 2014.
- <sup>2</sup> "2013 Financial Restatement: A Thirteen Year Comparison," The Top Ten Issues in 2013, page 8; Audit Analytics, 2014.
- <sup>3</sup> Revenue recognition—Joint project of the FASB and the IASB; [http://www.fasb.org/revenue\\_recognition\\_more\\_information.shtml](http://www.fasb.org/revenue_recognition_more_information.shtml).
- <sup>4</sup> Code Provision C.3.8, of the Corporate Governance Code of the United Kingdom.
- <sup>5</sup> *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, Public Company Accounting Oversight Board; [http://pcaobus.org/News/Releases/Pages/08132013\\_OpenMeeting.aspx](http://pcaobus.org/News/Releases/Pages/08132013_OpenMeeting.aspx).
- <sup>6</sup> *Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing (ISAs)*, International Auditing and Assurance Standards Board, July 2013. <http://www.ifac.org/news-events/2013-07/iaasb-proposes-standards-fundamentally-transform-auditors-report-focuses-communi>.
- <sup>7</sup> While both the 1992 and 2013 "Internal Control—Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission recognizes the use of judgment in evaluating internal control, neither explicitly provides a judgment framework.
- <sup>8</sup> Neither the 1992 nor the 2013 "Internal Control—Integrated Framework", issued by the Committee of Sponsoring Organizations of the Treadway Commission address this issue.
- <sup>9</sup> For one alternative, see "A Professional Judgment Framework for Financial Reporting," Technical Policy & Services Board of the Institute of Chartered Accountants of Scotland (ICAS); 2012. <https://www.ifac.org/sites/default/files/uploads/PAODC/A-Professional-Judgement-Framework-for-Financial-Reporting.pdf>.

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