

Accounting *focus*

* **Accounting focus is published by faculty of the University of Arizona Department of Accounting**

* **Our goal is to keep our students up-to-date on current events in the accounting world, including FASB, IASB and SEC happenings.**

Focus on Going Concern

Extraordinary Measures in Extraordinary Times

Back to the Future

Please take a moment to consider the role of time in financial reporting. In the form of a multiple-choice question, what is the time orientation of the income statement? (a) past, (b) present, (c) future, or (d) all of the above. The best answer is (d). The income statement has a *past* orientation in that it looks back at net income for last quarter or last year, but it also looks forward to *future* events given *presently* available information. To measure revenue, expenses, gains and losses on an accrual basis, an accountant must take into account not just past cash flows but also expectations about future cash flows. Will customers pay for credit sales as they promise? Will long-term assets provide future benefits as expected? An accountant cannot measure income on an accrual basis without looking forward as well as back in time. Like the movie title, it's back to the future.

To form expectations about future events, an accountant makes an assumption about the reporting entity. Absent

significant information to the contrary, an accountant assumes that the entity will continue as a going concern. The entity will be able to pay its debts without taking extreme actions such as liquidating long-term assets or arranging new and unusual financing. Consider the calculation of depreciation expense. Assuming that the entity is a going concern, an accountant can systematically allocate an asset's cost over its useful life. But if the entity must liquidate long-term assets to pay current debts, this calculation of depreciation expense make no sense.

When the independent auditor performs a financial-statement audit, it is necessary to consider the reporting entity's ability to continue as a going concern (AU Section 341). The auditor has a responsibility to evaluate whether there is "substantial doubt" about whether the entity will continue as a going concern for a reasonable period of time not to exceed one year beyond the balance-sheet date. The auditor's evaluation takes into

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FASB Relaxes Fair Value Accounting Rules

In response to pressure from Congress, the FASB on April 9 issued three new Staff Positions (FSPs) intended to provide application and disclosure guidance regarding fair value measurements and impairments of securities. Under the new FSPs, values will be based on what the assets would sell for in an "orderly" transaction in a non-distressed environment.

Under FASB Statement 115 and FASB Statement 133, both derivative instruments and investments other than held-to-maturity debt are required to be marked to fair market value at the end of each accounting period. Held-to-maturity debt is marked to market when an "other-than-temporary" impairment occurs. FASB 157 standardized the definition of fair market value to measure "exit

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Going Concern

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account available information as of the date of the auditor's report, which in many cases is a month or more after the balance-sheet date.

The auditor forms a conclusion about whether the entity will continue as a going concern, considering conditions that raise doubt (for example, net operating losses) and conditions mitigate doubt (for example, corporate restructuring). If the auditor tentatively concludes that there is substantial doubt, then the auditor finds out what the entity's management plans to do about the problem and the auditor assesses the likely effectiveness of those plans. If the auditor believes that management's plans are unlikely to be effective, then the auditor is left with the conclusion that there is substantial doubt about the entity as a going concern. In such cases, the auditor must add an explanatory paragraph to the audit report that clearly states the auditor's conclusion. This extra paragraph alerts investors and other users that the normal going-concern assumption is questionable for the entity.

Going, Going, Gone

General Motors, Inc. (GM), is a large corporation with a proud history. GM originated 100 years ago as a holding company for several brands including Buick, Cadillac, and later Chevrolet, among others. GM successfully competed against its rival, Ford Motor

Company (Henry Ford: "Any customer can have a car painted any colour that he wants so long as it is black"), by offering customers a diverse product line and by implementing innovative organizational principles. These principles included many of the things that you learn in your managerial accounting course, such as profit planning and return on investment analysis. GM's success persisted into the 1970s. In the 1980s, flaws in GM's business model became apparent as foreign companies like Toyota offered higher-quality products at competitive prices. GM eventually adapted its designs and manufacturing operations, but faced lingering problems such as excess capacity, high labor costs, and commitments for retiree benefits. As you probably have read in the newspaper, GM is in deep financial crisis. The federal government provided billions of dollars in aid, forced a change in top management, and set a June 1 deadline for the company to come up with a viable plan for avoiding bankruptcy.

Deloitte & Touche LLP is GM's independent auditor. Its latest audit report, dated March 4, 2009, included the following paragraph:

"The accompanying financial statements for the year ended December 31, 2008, have been prepared assuming that the Corporation will continue as a going concern. As discussed in Note 2 to the con-

solidated financial statements, the Corporation's recurring losses from operations, stockholders' deficit, and inability to generate sufficient cash flow to meet its obligations and sustain its operations raise substantial doubt about its ability to continue as a going concern. Management's plans concerning these matters are also discussed in Note 2 to the consolidated financial statements. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty."

This audit report did not come as a surprise to many investors. Instead, it reinforced what many investors already believed. This reinforcing effect by itself was significant. On March 5, the stock price of GM fell 15 percent from \$2.20 to \$1.86.

Independent auditors are not in the prediction business. It is not their responsibility to inform investors about good or bad investment opportunities. Nevertheless, independent auditors must form expectations about future events that affect the measurement and reporting of income, assets, and equities. In difficult cases like GM, the independent auditor has a responsibility to notify the public about a client's going-concern problem. Executing this public-interest responsibility requires the auditor to possess considerable professional judgment and personal integrity.

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Fair Value Accounting

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value,” i.e., the price for which these investments and derivatives could be sold. During early 2008, the markets for many financial investments, particularly those backed by residential mortgages, essentially collapsed, resulting in widespread writedowns to market value for financial firms holding those types of securities.

Congress demanded a change in the accounting rules based on concerns about *procyclical* (see sidebar). Bankers argued that in the current credit crisis, fair-value accounting has forced all banks to recognize losses at the same time, impairing their capital (which is subject to regulatory minimums) and triggering sales of securities, which in turn drove down prices and valuations even more. As a result, they argued, market prices did not reflect the true value of the assets. Under the new rules, companies have discretion to assign values to assets based on estimated prices in a non-

distressed market, regardless of actual recent selling prices of the assets.

Banks are now also required to write down only part of an impairment if they plan to hold the impaired asset to maturity. In the traditional mark-to-market rules, a held-to-maturity asset that suffers an other-than-temporary impairment must be written down to fair market value, with the write-down recognized as a reduction of earnings. Under the new rules, the write down is split into two components: an amount related to reduced creditworthiness of the counterparty (“credit loss”) and an amount related to all other factors. Only the amount of the other-than-temporary impairment related to the credit loss is to be recognized in earnings, while the amount of the impairment related to all other factors is recognized in other comprehensive income.

Many critics believe that relaxation of the fair value rules

will result in lower quality financial reporting by banks. Since assets will be carried at higher values than could be realized if the assets were sold, bank net book values will be overstated. This loss of transparency has the potential to reduce the confidence investors have in their assessments of the risks involved in a bank.

Interestingly, this episode is one of the few times Congress has felt it necessary to get involved in accounting regulation. Both the FASB and the SEC have defended the fair value rules as essential for market efficiency. However, Congress chose to ignore the recommendation of both the FASB and the SEC. “If the regulators and standard setters do not act now to improve the standards, then the Congress will have no other option than to act itself,” said Rep. Kanjorski (D-Pennsylvania) on March 12. FASB adopted the new rules less than a month later.

Procyclicality Explained

Banks are subject to minimum capital requirements. Suppose a bank is required to have capital equal to 10 % of total assets. Exemplar Bank has a balance sheet with \$100 million in assets, \$90 million in debt, and \$10 million in equity. Since equity is 10% of assets, regulatory capital requirements are satisfied. Now suppose that the value of some of the assets (e.g. mortgage securities) falls by \$1 million, also resulting in a reduction in equity of \$1 million. The bank’s new balance sheet has \$99 million in assets, \$90 million in debt, and \$9 million in equity. Capital is only 9.1% of assets, causing a violation of the regulatory capital requirement. One way Exemplar can fix this problem is to sell \$1 million of additional common stock, increasing assets and equity by \$1 million and returning the capital ratio to 10%. The bank may find this difficult, however, because investors are reluctant to buy stock in banks that have violated capital regulations. Another way to fix the violation is to reduce assets and debt by selling assets and using the proceeds to pay off debt. Since \$9 million in equity can only support \$90 million in assets, Exemplar must sell \$9 million in assets and pay off \$9 million in debt. Notice that a decline in asset value of only \$1 million has forced the bank to sell \$9 million of assets. Since all banks hold similar assets, they are all likely to have experienced losses at the same time. All the banks try to sell assets at once, causing a market imbalance between sellers and buyers and driving asset prices down or causing the market for those assets to lock up.

Before You Interview, Know IFRS

PriceWaterhouseCoopers, which hires more than 3,000 full time employees and 1,500 interns each year, has announced that its recruiting plan will focus on IFRS readiness of job candidates starting in Fall 2009.

PWC will expect sophomores who have taken at least one accounting course to be able to explain the general uses of GAAP and IFRS and to be able to summarize the importance of IFRS in the future. For juniors, seniors and graduate students, PWC expects those students to be able to articulate the sources of US GAAP and IFRS; describe an example of IFRS financial statements; identify an example of a difference between US GAAP and IFRS; and explain the current status and likely adoption timetable for IFRS.

While these specific 2009 requirements apply to PWC, it is likely that other Big-4 firms will have similar expectations, and that the expectations will be even higher in 2010 and later years. In addition to exposure received in classes, job market candidates will find that making a personal commitment to learning about IFRS will be well worth the effort.