Impact of the Current Economic and Business Environment on Financial Reporting

The purpose of this document is to provide those with a role in high-quality financial reporting with information relevant to the current financial reporting environment.¹ It includes an assessment of risk factors that may be important for financial statement preparers, auditors, and audit committees to consider during the current reporting cycle. It also offers suggestions as to how each of these major constituencies can contribute to enhancing financial reporting for the benefit of investors.

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The current economic downturn, the unprecedented events of September 11, and recent business failures have combined to create a financial reporting environment unlike any in recent memory. Investor confidence, already shaken by significant volatility in the capital markets, has been further unsettled by highly publicized restatements of financial statements, which have generated questions about the quality of financial reporting, the effectiveness of the independent audit process, and the efficacy of corporate governance. This environment is creating significant challenges for U.S. businesses and their management, boards of directors, audit committees, and auditors.

Always fundamental to the well-being of our capital markets, reliable and transparent financial reporting is particularly important in this troubled environment. Financial reporting cannot forecast the strengths and weaknesses of the economy. However, financial statements and related information, such as Management's Discussion and Analysis (MD&A) can provide useful information that allows users to make informed decisions and facilitates the continued efficient functioning of our capital markets. This requires the attention of management, auditors, and audit committees, who not only must carry out their unique responsibilities in their respective areas, but also must work together to produce the high-quality financial reporting that is vital to our capital markets.

We have summarized the particularly challenging factors affecting financial reporting today, and have identified some of the financial reporting issues that are especially relevant in this difficult business environment. We also have highlighted the actions that management, auditors, and audit committees can take to effectively address these risks and produce reliable financial reporting.

Environmental Factors Affecting Financial Reporting

Difficult Economic Times

The economic slowdown began with a decline in business capital spending and investment. With the burst of the dot.com bubble, businesses took a more pessimistic view of the economic future and curtailed spending on equipment, software, real estate, inventories, and other investments. One of the first sectors to suffer the effects of the reduction in capital spending was the high-tech industry, where earnings and share prices nose-dived.

As the effects of cutbacks in corporate spending rippled through the economy, temporarily soaring energy prices took money out of consumers' pockets and ate into corporate revenues. Earnings sank, borrowing

¹ This document has been prepared and distributed by the five largest accounting firms (Andersen, Deloitte & Touche, Ernst & Young, KPMG, and PricewaterhouseCoopers) and the American Institute of Certified Public Accountants. The five firms and the AICPA recognize the responsibility of our profession to work toward enhanced financial reporting and audit effectiveness and have made significant commitments toward those ends. Preparing and distributing this document is just one of several actions taken to fulfil this commitment.

capacity dwindled, growth slowed, energy prices dropped, and the stock market tumbled. Investor wealth declined by trillions of dollars. Layoffs followed, and with the unemployment rate rising (although still historically low), the surprisingly hardy consumer spending finally started to wane. Companies initiated restructurings, inventory liquidations, and write-offs. The events of September 11 and their aftermath only worsened already deteriorating economic conditions.

These factors put downward pressure on earnings and other performance measures that, for most of the previous decade, had been on an upward trend. This change in direction has created a growing sensitivity in the capital markets to bad news.

Pressures to Perform

Businesses deal with pressures that arise from a variety of sources, both internal and external. External pressures come primarily from the capital markets, with many believing that Wall Street's expectations too often drive inappropriate management behavior. Management often is under pressure to meet short-term performance indicators, such as earnings or revenue growth, financial ratios tied to debt covenants, or other measures. Most often the intentions of management are to follow sound and ethical practices, but pressure may build when analysts and shareholders demand short-term performance and when competitors move closer to the edge of the range of acceptable behavior.

Members of top management also may be pressured to demonstrate that shareholder value has grown as a consequence of their leadership. Boards of directors often create pressure on management to meet financial and other goals. There also is a well-established practice of motivating management with stock options and other equity instruments that attempt to align management and shareholder interests. With their own performance and compensation tied to operating or financial targets, management can in turn push hard on personnel throughout the company, including those in operating business units, to meet what may be overly optimistic goals. This high-pressure environment can create an incentive to adopt practices that may be too aggressive or inconsistently applied in an effort to meet perceived expectations of the capital markets, creditors, or potential investors. At some point, the motivation behind earnings management can become strong enough for individuals with the right opportunity to move beyond acceptable practices, even though they are otherwise honest individuals. The greater the pressures, the more likely individuals will rationalize the acceptability of their actions.

Complexity and Sophistication of Business Structures and Transactions

The increasing sophistication of the capital markets and the creativity of investment bankers and other financial advisers have fostered a wide variety of complex financial instruments and structured financial transactions. Many companies now use complex transactions involving transactions with one another in the form of purchases/sales of assets, derivative transactions, and intricate operating agreements designed to meet a specific reporting objective as well as an economic objective. Some companies have transferred assets off-balance-sheet or arranged for units to be acquired by special purpose entities, joint ventures, limited liability corporations, or partnerships, retaining substantially all the risks and rewards of ownership but without "control." Recent business failures, including the boom-bust cycle of dot.com enterprises, have focused attention on the potential risks of these business structures and transactions and the challenge of reporting them in a way that is easily understood by financial statement users.

Many companies have adopted rapid and innovative forms of business expansion, either through acquisitions and mergers, or internal development. Such rapid expansion may have been necessary to support high price-to-earnings multiples. However, it also creates many challenges, including integrating disparate operations, melding internal control processes, and meeting expanded financing needs. Liquidity crises or financial reporting failures may result.

Complex and Voluminous Standards

Adding to the challenges businesses face are the number of accounting standards, interpretations, SEC staff positions, task force consensuses, statements of position, and so on, that continue to expand the body of technical material that must be understood and applied in the financial reporting process. Understanding this vast body of literature can be a daunting task, even for large sophisticated companies. Furthermore, as transactions become more complex, the accounting rules for them become highly technical and detailed, such as Statements of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities; No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities; No. 141, Business Combinations; No. 142, Goodwill and Other Intangible Assets; and No. 144. Accounting for the Impairment or Disposal of Long-Lived Assets. Complex and detailed rules become selfperpetuating, promising that their complexity will continue to increase. Every new regulation specifying how a certain transaction should be accounted for presents an opportunity for someone to find a way around it by creating an even more complex transaction. This, in turn, creates the need for a new rule to tighten the loophole, and so on. These rules have become so complex that management struggles increasingly to comprehend and apply them. Proper application often requires the attention and involvement of senior financial management and senior technical people in the auditing firms, and even then the decisions are subject to alternative interpretations.

The SEC recently has announced its desire to help registrants "get it right the first time" by discussing and preclearing registrants' proposed accounting for anticipated events, planned transactions, or other unusual accounting matters prior to their inclusion in registrants' financial information. The pre-clearance process should help registrants apply complex accounting standards to unusual situations, helping to ensure that financial statements reflect appropriate accounting policies and disclosures and reducing the risk of subsequent restatements.

Financial Reporting Issues

The fundamental objective of financial reporting is to provide useful information to investors, creditors, and others in making rational decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with appropriate diligence. Financial reporting, including MD&A, should provide investors with management's perspective on the historical and prospective financial condition and results of operations.

A discussion of key financial reporting issues that are especially relevant in the current environment follows.

Liquidity and Viability Issues

The current business environment and market conditions might lead to rapidly deteriorating operating results and liquidity challenges for some companies, particularly those with reduced access to capital. A company particularly sensitive to negative changes in economic conditions can rapidly develop a liquidity crisis and ultimately fail. Certain conditions, considered in the aggregate, may lead management or a company's auditors to question the entity's ability to continue as a going concern. These include negative trends such as recurring operating losses or working capital deficiencies, financial difficulties in the form of loan defaults or denial of credit from suppliers, dependence on the success of a particular product that is not selling well, legal proceedings, loss of a principal customer or supplier, destabilization of a trading partner or contract counterparty, and excessive reliance on external financing rather than funds generated from operations.

Key in evaluating these risk factors is whether:

• Existing conditions and events can be mitigated by management's plans and their effective implementation.

- The company has the ability to control the implementation of mitigating plans rather than being dependent on actions of others.
- The company's assumption about its ability to continue as a going concern is based on realistic, rather than overly optimistic, assessments of its access to needed debt or equity capital or its ability to sell assets in a timely manner.
- Liquidity challenges have been appropriately satisfied and disclosed.

Changes in Internal Control

Large layoffs, staff reductions, and notifications to employees of impending termination can affect internal control over financial accounting and reporting systems. Remaining employees may feel overwhelmed by their workloads, lack time to complete tasks and consider decisions, and simply be performing too many tasks and functions to meet the required levels of accuracy. In addition, rapid business expansion, changes in business strategies, and integration of different businesses may outstrip the ability of a company's financial systems to remain under effective internal control. Furthermore, controls at business units whose divestiture has been announced may be disrupted. As a result of any of these factors, internal control may become less effective or ineffective.

Relevant considerations are whether:

- The attention to internal control has been maintained in the face of significant changes in the business.
- As a result of unfilled positions, key control procedures are no longer being performed, are being performed less frequently, or are being performed by individuals lacking proper understanding to identify and correct errors.
- Layoffs of information technology (IT) personnel have had a negative effect on the entity's ability to
 initiate, process, or record its transactions, or maintain the integrity of information generated by the IT
 system.
- Key functions that should be segregated are now being performed by one person.
- The impact of changes to the control environment have altered internal control effectiveness and potentially resulted in a material control weakness.
- Changes in internal control caused by past or pending layoffs or staff reductions create an opportunity for fraudulent activities, including misappropriation of assets.

Unusual Transactions

Among the most frequently cited sources of financial reporting risk are significant adjustments or unusual transactions occurring at or near the quarter-end or year-end. Unusual transactions might include sales of assets outside the ordinary course of business, significant or unusual period-end revenues, introduction of new period-end sales promotion programs, and disposal of a segment of a business. These types of transactions and adjustments often occur outside the company's ordinary course of business and, therefore, may not be subject to the checks and balances imposed by the internal control system.

Key points include:

- Recognizing the underlying business purpose for entering into unusual transactions, as well as the resulting financial benefits or obligations.
- Whether unusual transactions particularly those executed close to period-end are subject to effective controls.
- The impact of these types of transactions on annual and quarterly results, and whether they have been appropriately described in the company's financial reports.
- Existence of any "special" or "side" arrangements not considered in determining the appropriate accounting and disclosure for the transactions.

• Whether so-called "non-standard" journal entries, including the adjusting entries made at the end of the closing process, are subject to appropriate review and oversight.

Transactions with Related Parties

Increased pressures on management to maintain or achieve financial targets may heighten the risk of improper accounting or disclosure of related party transactions. Related party transactions lack the independent negotiations as to structure and price that are present in transactions with unrelated parties. Difficult economic times also increase the possibility that the economic substance of certain transactions may be other than their legal form, or that transactions may lack economic substance. Parties that have no independent substance may have no separate ability to carry out transactions or stand behind agreements.

Key to these issues is whether:

- Management has a process in place to identify related parties and related party transactions.
- There is sufficient information available to thoroughly understand and evaluate the relationship of the parties to the transaction.
- The parties have substance and the ability to carry out the transaction.
- The transaction's substance, including any unusual conditions, determines the accounting for the transaction
- The disclosures are complete with respect to the nature and extent of the transaction and relationship among the parties in conformity with FASB and SEC rules.

Transactions Involving Off-Balance Sheet Arrangements including Special Purpose Entities

Some business entities make use of off-balance sheet arrangements to conduct financing or other business activities. These may involve unconsolidated, non-independent, limited purpose entities, often referred to as structured finance or special purpose entities (SPEs). These entities may be used to provide financing, liquidity, or market risk or credit support, or may involve leasing, hedging, or research and development services. These arrangements or entities may result in contractual or other commitments by the company, such as requirements to fund losses, provide additional funding, or purchase capital stock or assets, or may otherwise have financial impacts resulting from the performance or non-performance of the other party.

Transactions with special purpose entities intended to shift assets or liabilities off-balance-sheet require special attention due to the complicated accounting and disclosure rules applicable to many of these transactions. The ownership structure of the entity and the terms of the transactions may be critical to determining whether off-balance sheet treatment is appropriate under generally accepted accounting principles. The adequacy of disclosure also is important since the potential impact of these transactions may not be evident from the basic financial statements.

Key considerations in understanding transactions involving SPEs include whether:

- The SPE is a so-called "qualifying special purpose entity" or a non-qualifying SPE, since different accounting standards apply to each.
- The SPE, if it is non-qualifying, is appropriately capitalized to support non-consolidation, including whether a third party has made a substantive investment that is residual equity in legal form, has voting control, and has substantive residual risks and rewards of ownership of the SPE.
- The level of capital in the non-qualifying SPE is adequate, particularly when multi-tiered SPE structures are used.
- The requisite outside investment in the non-qualifying SPE existed at the time of the transaction and continues to exist.
- Any involvement of related parties as investors or otherwise is consistent with non-consolidation.
- Any modifications have been made to an existing SPE in the current period that could affect the accounting determined at the date of the transaction.

• The arrangements are outside the normal course of business.

Materiality

Materiality is a concept that plays a critical role in the judgments of various parties to the financial reporting process. Although generally accepted accounting principles recognize the concept that accounting standards need not be applied to immaterial items, this recognition is more for matters of convenience than for the basic purpose of maintaining accurate books and records. Therefore, while management may consider materiality in selecting the accounting principles to use in the financial statements (including footnotes) and in preparing MD&A, it is generally inappropriate to permit known errors to remain in the financial information based merely on their immateriality.²

Management also may consider materiality in determining the disposition of identified misstatements, including those identified by the auditors. Auditors consider materiality in assessing the application of accounting principles, in planning the audit and designing audit procedures, and in evaluating the significance of misstatements (also referred to as audit differences) identified during the audit if management decides not to record some or all of them.

Both quantitative and qualitative factors should be evaluated when assessing the materiality of misstatements, focusing on:

- Individual and aggregate misstatements and their impact on key financial statement line items, totals, and ratios
- Whether a misstatement increases management's compensation by satisfying requirements for the award of bonuses or other incentives.
- Whether a misstatement masks a change in earnings or other trends or hides a failure to meet analysts' consensus expectations.
- A misstatement's impact on compliance with financial statement-related debt covenants.
- A misstatement indicative of intentionally misleading financial reporting or illegal acts.
- A misstatement particularly important to a segment of the business.

Adequacy of Disclosure

In a recent op-ed in the Wall Street Journal, SEC Chairman Pitt summarized actions management, auditors, and audit committees should take to enhance the current financial reporting and disclosure system and reassure and restore investor confidence. Among his recommendations, Chairman Pitt urged public companies and their advisers to identify the three, four, or five critical accounting principles upon which a company's financial status depends, and that involve the most complex, subjective, or ambiguous decisions or assessments. Investors should be told, concisely and clearly, how these principles are applied, and be given information about the range of possible effects from different applications of these principles.

As a follow-up to the Chairman's op-ed, the SEC recently issued cautionary advice regarding disclosure about critical accounting policies, in which it indicated an intention to consider new rules to elicit more precise disclosures about the accounting policies that management believes are most "critical" – that is, that both are most important to the portrayal of the company's financial conditions and results and require management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. The SEC points out that a technically accurate application of the disclosure rules may nonetheless fail to communicate important information if clear analytic disclosures are not included to facilitate an investor's understanding of the company's financial status, and the possibility,

² The SEC staff has expressed their views on the subject of materiality in Staff Accounting Bulletin No. 99, *Materiality*, issued August 12, 1999.

likelihood, and implication of changes in its financial and operating status. The SEC encourages companies to employ a disclosure regimen along the following lines:

- Management and the auditor should bring particular focus to the evaluation of the critical accounting policies used in the financial statements.
- Management should ensure that disclosure in MD&A is balanced and fully responsive.
- Prior to finalizing and filing annual reports, audit committees should review the selection, application, and disclosure of critical accounting policies.
- If companies, management, audit committees, or auditors are uncertain about the application of specific GAAP principles, they should consult with the SEC's accounting staff.

The SEC also has expressed continuing concern that some registrants are simply repeating the financial statement disclosures in their MD&A or merely recalculating the dollar and percentage changes in financial statement captions without providing meaningful information about the underlying reasons for the changes as well as what might happen in the future. MD&A requires disclosure about trends, events, or uncertainties known to management that would have a material impact on reported financial information. The SEC has observed that, even where trends, events, and uncertainties are disclosed, the implications of those matters on the methods, assumptions, and estimates used for recurring and pervasive accounting measurements are not always addressed.

The SEC informally has suggested that the following matters be considered for MD&A disclosure in the current environment: loss of a significant customer; impairments of long-lived assets; business restructurings; factors affecting the cost or availability of insurance coverage or energy; declines in the value of investment securities or pension plan assets; violations, amendments or waivers of debt covenants; credit or market risks; and effects of related party transactions.

On another matter, over the past few years, companies increasingly have presented earnings and results of operations on the basis of methodologies other than GAAP, sometimes referred to as "pro forma earnings." Such information may be presented to provide a meaningful comparison to results in prior years, to emphasize the results of core operations, or for other purposes. While there is no prohibition against public companies publishing interpretations of their results or summaries of GAAP financial statements, there is a growing concern that pro forma financial information can mislead investors if it obscures GAAP results.

The SEC recently issued cautionary advice to preparers, as well as an alert to investors, about the use of pro forma financial information in earnings releases. The SEC staff cautioned that earnings releases are subject to the antifraud provisions of the federal securities laws and should not be used to mislead investors through the inclusion of such pro forma information. Earnings releases that contain pro forma and other non-GAAP information without a plain English reconciliation to GAAP, including amounts and appropriate explanations, may be viewed as misleading.

Furthermore, the SEC suggests that companies:

- Provide an accurate description of the controlling principles that underlie the pro forma presentation. For example, when a company purports to announce earnings before "unusual or nonrecurring transactions," it should describe the particular transactions and the kind of transactions that are omitted and apply the methodology described when presenting purportedly comparable information about other periods.
- Consider the materiality of the information that is omitted from a pro forma presentation. Statements about
 a company's financial results that are literally true nonetheless may be misleading if they obscure GAAP
 results or omit material information otherwise included in GAAP financial statements. For example,
 investors are likely to be deceived if a company uses a pro forma presentation to change a loss to a profit, or
 to hide a significant fact, without clear and comprehensible explanations of the nature and size of the
 omissions.
- Consider the guidelines jointly developed by the Financial Executives International and the National Investors Relations Institute before determining whether to issue pro forma results, and before deciding how

to structure a proposed pro forma statement. A presentation of financial results that is addressed to a limited feature of financial results or that sets forth calculations of financial results on a basis other than GAAP generally will not be deemed to be misleading merely due to its deviation from GAAP if the company in the same public statement discloses in plain English how it has deviated from GAAP and the amounts of each of those deviations.

As an overall matter, clear and complete disclosure is key. In particular, complex transactions such as those with related parties, special purpose entities, off-balance-sheet vehicles, or situations that involve contingent obligations, derivatives, financial guarantees, and liquidity, among others, heighten the importance of financial disclosures to present a complete picture of a company and its risks. Therefore, it is important not only to assess whether the technical disclosure requirements of GAAP and MD&A have been met, but also to consider the depth and transparency of the disclosures with a focus on helping the reader more fully understand the substance of the company's risks and rewards.

Specific Financial Statement Risks

In these difficult times, new risks directed at specific financial statement areas can arise, among them:

Long-lived assets, goodwill, and other intangible assets

- Are there events or changes in circumstances indicating that a long-lived asset's carrying amount may not be recoverable, triggering an impairment consideration?
- Are the assumptions underlying the calculation of fair values of hard-to-value assets reasonable and based
 on current information? Are they based on assumptions that are difficult to determine, such as occurrences
 over long periods of time? Do the disclosures adequately portray the methods for calculating fair value and
 the related degree of uncertainty?

Impairment of inventory

• Are there events or changes in the demand or price indicating that carrying amounts of inventory may be too high?

Revenue recognition

- What are the significant judgment areas and estimates underlying the company's revenue accounting?
- Do the company's revenues meet required standards, including, where applicable, the four criteria in SEC Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements*: (1) persuasive evidence of an arrangement; (2) delivery occurred or services rendered; (3) price fixed or determinable, and (4) collectibility reasonably assured?
- Have any "special" or "side" arrangements been appropriately considered in determining reportable revenues?
- Are the company's revenue recognition policies adequately disclosed in the financial statements?
- Are there unusual seasonal trends or period-end "spikes" in revenue?

Accounting estimates

- What are the most significant estimates and judgments management makes in preparing the financial statements?
- Is enough attention resources, rigor of process, level of review given to these estimates?
- Are underlying assumptions based on reliable, up-to-date information?
- Is there appropriate disclosure regarding significant assumptions, changes in assumptions, and uncertainty in estimates?

Deferred taxes

• Have there been cumulative losses in recent years or other conditions that may require a valuation allowance for net deferred tax assets?

Restructuring charges

• Does the company's initial and ongoing accounting and disclosure for restructuring provisions meet the requirements of EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*, and SEC Staff Accounting Bulletin No. 100, *Restructuring and Impairment Charges*?

Debt covenants

- Is or has the company been in violation of debt covenants, possibly requiring disclosure and reclassification of long-term debt to a current liability?
- Are there cross-default provisions that could be triggered by a single debt covenant violation?
- Are there debt covenants relating to unspecified "material adverse changes"?

Other than temporary declines in value of marketable debt and equity securities, and investments

- Has there been an "other than temporary" decline in investment securities classified as held-to-maturity or available for-sale, or in equity- or cost-basis investments, requiring loss recognition?
- Is there a need to disclose an "early warning sign" related to a decline that has been experienced but not yet deemed other than temporary?

Pensions and other post-retirement benefits

• Do factors such as falling securities market values, significant drops in interest rates, and projected increases in health care costs require that management revise key assumptions underlying accounting estimates related to pension and other post-retirement plans?

Employee stock options

• Has the company made changes to its options plans, such as repricings or extending the term of outstanding options, that require expense recognition and disclosure?

Other risks and uncertainties

- Is the company exposed to credit/default risk of a significant supplier/customer, service provider, lessor/lessee, debtor, financial guarantor, investor/investee, joint venture partner, derivative counterparty, and/or trading partner due to financial problems or bankruptcy?
- Have credit and default risks been adequately disclosed?
- Have contingent liabilities been adequately identified and, as appropriate, disclosed?

Newly issued standards

 Have newly issued standards, such as Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, been fully addressed and disclosed?

Changes to accounting principles and methods

• Have all discretionary changes to accounting principles and methods that, individually or collectively, materially affect reported results of operations for an interim or annual period been disclosed?

The risks described above are general in nature. Further information on financial statement risks related to specific industries can be obtained by reading the industry-specific risk alerts produced by the American Institute of Certified Public Accountants.

A Call to Action

Management, auditors, and audit committees each have their separate roles and responsibilities. Still, their goal must be the same – making sure that a company's financial reporting is of the highest quality.

Following are the most important actions that should be taken to achieve this common goal.

Management

- Ensure the proper tone at the top and an expectation that only the highest-quality financial reporting is acceptable.
- Review all elements of the company's internal control control environment, risk assessment, control activities, information and communication, and monitoring in light of changes in the company's business environment and with particular attention to significant financial statement areas.
- Ensure that appropriate levels of management involvement and review exist over key accounting policy and financial reporting decisions.
- Establish a framework for open, timely communication with the auditors and the audit committee on all significant matters.
- Strive for the highest quality, most transparent accounting and disclosure not just what is acceptable in both financial statements and MD&A.
- Make sure estimates and judgments are supported by reliable information and the most reasonable
 assumptions in the circumstances, and that processes are in place to ensure consistent application from
 period to period.
- Record identified audit differences.
- Base business decisions on economic reality rather than accounting goals.
- Expand the depth and disclosure surrounding subjective measurements used in preparing the financial statements, including the likelihood and ramific ations of subsequent changes.
- When faced with a "gray" area, consult with others, consider the need for SEC pre-clearance, and focus on the transparency of financial reporting.

Auditors

- Understand how a company is affected by changes in the current business environment.
- Understand the stresses on the company's internal control over financial reporting, and how they may impact its effectiveness.
- Identify key risk areas, particularly those involving significant estimates and judgments.
- Approach the audit with objectivity and skepticism, notwithstanding prior experiences with or belief in management's integrity.
- Pay special attention to complex transactions, especially those presenting difficult issues of form versus substance.
- Consider whether additional specialized knowledge is needed on the audit team.
- Make management aware of identified audit differences on a timely basis.
- Question the unusual and challenge anything that doesn't make sense.
- Foster open, ongoing communications with management and the audit committee, including discussions about the quality of financial reporting and any pressure to accept less than high-quality financial reporting.
- When faced with a "gray" area, perform appropriate procedures to test and corroborate management's explanations and representations, and consult with others as needed.

Audit Committees

- Evaluate whether management exhibits the proper tone at the top and fosters a culture and environment that promotes high-quality financial reporting, including addressing internal control issues.
- Question management and auditors about how they assess the risk of material misstatement, what the major risk areas are, and how they respond to identified risks.
- Challenge management and the auditors to identify the difficult areas (e.g., significant estimates and judgments) and explain fully how they each made their judgments in those areas.
- Probe how management and the auditors have reacted to changes in the company's business environment.
- Understand why critical accounting principles were chosen and how they were applied and changed, and consider the quality of financial reporting and the transparency of disclosures about accounting principles.
- Challenge management for explanations of any identified audit differences not recorded.
- Understand the extent to which related parties exist and consider the transparency of the related disclosures.
- Read the financial statements and MD&A to see if anything is inconsistent with your own knowledge.
- Consider whether the readers of the financial statements and MD&A will be able to understand the disclosures and risks of the company without the access to management that the committee enjoys.
- Ask the auditors about pressure by management to accept less than high-quality financial reporting.
- When faced with a "gray" area, increase the level of communication with management and the auditors.

Management, auditors, and audit committees each must diligently fulfil its own role and effectively work together with the others through proactive communication and information sharing. In working together, we can collectively improve the financial reporting process. This requires a renewed commitment by each of the parties to the needs of financial statement users.

CPAs Issue Assessment of Risk Factors for 2001 Financial Statements

Financial statement preparers, audit committees and auditors urged to consider risk factors in current financial reporting environment

Andersen KPMG

Deloitte & Touche PricewaterhouseCoopers

Ernst & Young American Institute of Certified Public Accountants

(January 9) - The five largest accounting firms and the American Institute of Certified Public Accountants (AICPA) today released a detailed list of "risk factors" that should be considered as companies prepare their 2001 financial statements.

The current economic downturn, events of September 11, and recent business failures have combined to create a troubled financial reporting environment that poses significant challenges for U.S. business and management, boards of directors, audit committees, and auditors. The five firms and the AICPA have identified the specific financial reporting issues that are especially relevant in these times, and recommend actions that can be taken to address such financial reporting risks.

Key Financial Reporting Issues

- Liquidity and Viability In the current environment, the presence of certain conditions, in the aggregate, may create questions about a company's ability to continue as a going concern. These conditions are detailed in the report.
- Changes in Internal Control In addition, the presence of certain other conditions may compromise internal control over financial accounting and reporting systems. These are also detailed in the report.
- *Unusual Transactions* Among the most frequently cited sources of financial reporting risk are significant adjustments or unusual transactions occurring at or near the quarter-end or year-end.
- Related Parties Increased pressure on management to hit financial targets has heightened the risk of improper treatment of related party transactions, which lack the independent qualities that are intrinsic in transactions with unrelated parties.
- Off-balance Sheet Arrangements Transactions intended to shift assets or liabilities off the balance sheet, including those with special purpose entities, require special attention because of the complicated accounting and disclosure rules applicable to many of those transactions.
- Materiality Management may consider materiality in preparing a company's
 financial statements, but it is generally inappropriate to permit known errors to
 remain in the statements based merely on their immateriality. Both
 quantitative and qualitative factors should be considered when assessing the
 materiality of misstatements.
- Adequacy of Disclosure It is important to assess not only whether the technical accounting and disclosure requirements have been met in a company's financial reports, but also the depth, nature and transparency of the disclosures. In addition, while the presentation of pro forma earnings has

- become relatively common, there is a growing concern that such financial information can mislead investors if it obscures GAAP results.
- Specific Financial Statement Risks The profession has outlined additional financial statement areas that merit consideration in the current environment.

Recommended Action

Company management, audit committees and auditors have separate roles and responsibilities, but share a common goal: financial reporting of the highest quality. To achieve this goal, they must commit fully to execute their own responsibilities and work together by sharing information through ongoing communication. The profession has outlined thirty actions to be taken by management, auditors, and audit committees to achieve high quality financial reporting in the 2001 reporting year.

[THE FULL RISK ASSESSMENT DOCUMENT IS AVAILABLE AT WWW.AICPA.ORG]

For More Information:

Geoff Pickard, AICPA 202-596-6299