Judgment Frameworks & Applications in Practice

Randall Sogoloff

May 17-18, 2012

Chicago
Judgments in accounting and auditing (cont.)

• Judgment — process of reaching a decision where there are a number of possible alternatives
• Application of judgment is used by:
  – Management in preparing financial statements
  – Auditors in auditing financial statements
  – Regulators in evaluating management and auditor judgments
• Financial statement users rely on good judgments
  – Central to public confidence in our capital markets
Judgments in accounting and auditing (cont.)

• Why the increase in focus?
  – Complexity of transactions
  – More principles-based standards
  – Regulatory environment
  – Increase in use of fair value estimates

• Key judgments used in preparing financial statements
  – Selection and implementation of an accounting standard
  – Accounting for a transaction with no specific standard
  – Determining the appropriate financial statement presentation
  – Estimating the amount to record
  – Evaluating the sufficiency of evidence
Judgments in accounting and auditing (cont.)

• Thought pieces and recommendations issued
  – Committee of Sponsoring Organizations
  – SEC Advisory Committee on Improvements to Financial Reporting
  – Financial Reporting Council
• What makes a good judgment?
  – Made in good faith and unbiased
  – Due care exercised
  – Sufficient evidence obtained
  – Reasonable given the circumstances
Judgments in accounting and auditing (cont.)

• Challenge is removing biases from judgments
  – Too quick to conclude
  – Lack of understanding of facts
  – Overconfidence
  – Common or uncommon information
  – Focus on supporting a specific conclusion

• A judgment framework can help overcome biases
  – a set of principals or guidelines that enable decision makers to consider a situation more holistically and drive more consistent decision making
Judgments in accounting and auditing (cont.)

Why develop a judgment framework?
• More critical thinking and questioning
  – Understand reason and economics of transaction
  – Look at transactions from different points of view
  – Consider alternatives with pros and cons
  – Consider an alternative opposite to a preferred choice
  – Involve a designated expert group
• More consistent, robust, sustained judgments
• Better prepared for discussions with auditors and regulators
Judgments in accounting and auditing (cont.)

• Determining whether a valuation allowance is necessary against the deferred tax assets
• Determining the primary beneficiary of a variable interest entity
• Selecting key assumptions while performing valuations of assets and liabilities (e.g., useful lives, discount rates, cash flows)
• Determining whether a contingent loss should be recognized and measurement of that loss
Judgments in accounting and auditing (cont.)

• Determining whether an arrangement contains a lease
• Determining whether an investor with less than a majority voting interest controls an investee that is not a variable interest entity
• Evaluating indicators of impairment
• Determining the appropriate revenue recognition model for a particular entity or arrangement (e.g., completed performance vs. proportional performance).