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ACCOUNTANTS & ADVISORS

FIVE PROBLEMS TO BE AWARE OF WHEN PERFORMING ANALYTICAL PROCEDURES

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A key assumption in performing analytical procedures is the belief that the information being examined (current year data) can be benchmarked against measures (ratios, percentages, etc.) that are based on properly formed expectations. Such measures are often derived from company prior years' data, industry results, etc. – **but how reliable is the benchmark data?**

FIVE TYPES OF ADJUSTMENTS

There may be times when either company or industry data needs to be adjusted for known changes in facts or circumstances before a proper measure can be determined. The following five tips highlight the types of adjustments that may be necessary when analytical procedures are performed.

1. Inconsistent Bases of Accounting and Inconsistent Methods of Accounting:

When a company is being compared to another company or to industry data, the bases and methods of accounting should be conformed and consistent. Of what use is comparing liquidity, capitalization and working capital turnover data of a service company's GAAP-basis financial statements (with accounts receivable) to cash-basis industry data?

Conforming the methods of accounting for all years presented can be challenging because GAAP requires retrospective application of a change in accounting principles to prior periods' financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. Ideally, when the company's accounting method differs from industry data (e.g. LIFO v. FIFO), one should adjust either the client company or the other data for conformity purposes.

2. Financial Statement Errors:

PCAOB and AICPA Inspection Reports indicate that financial statement accounting errors frequently occur. Examples of such accounting errors include failure to properly account for (a) revenues, (b) post-employment benefits, (c) non-cash transactions, (d) inventory, and (e) deferred income taxes. Hence, when performing analytical procedures in connection with an audit or review, the accountant should be mindful of the possibility that expectations may have been derived from third party data that is not free of material accounting errors.

3. Year-to-Year Inconsistent Financial Statement Account Classifications:

It is not uncommon to find that similar transactions are classified differently from year to year in a company's financial statements (i.e., shareholder loans, dividends, wages and bonuses). This might occur because of sensitivities to financial covenants, income tax issues, company's accounting personnel turnover, changes in CPA firms, etc.

4. Nonrecurring Events:

Nonrecurring transactions or events that impact the financial statements should be factored into measures utilized. Examples of nonrecurring transactions or events are those that might arise due to an act of nature (such as Hurricane Irene), a terrorist attack (9/11), a lawsuit, a fire or flood, etc. Failure to consider the impact of material nonrecurring transactions may result in an improper expectation of future operations or trends.

5. Changes in Entities comprising the Client Company:

The company may have purchased or sold subsidiary entities during the period under analysis. Failure to consider the implications of different entities comprising the consolidated entity may lead to improper conclusions regarding results of operations and trends.

SET EXPECTATIONS PROPERLY

Improper expectations and measures can destroy the utility of analytical review procedures. Such procedures are an integral part of attest accounting engagements as well as business appraisals.

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