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THE VOS VOICE

"BECAUSE ACCOUNTING MATTERS AND WE KNOW IT"

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INSIDE THIS ISSUE

DEMYSTIFYING THE AUDIT PROCESS

Independent auditors provide many benefits to business owners and management: They can help uncover errors in your financials, identify material weaknesses in your internal controls, and increase the level of confidence lenders and other stakeholders have in your financial reporting.

But many companies are unclear about what to expect during a financial statement audit. Here's an overview of the five-step process.

1. Accepting the engagement
Once your company has selected an audit firm, you must sign an engagement letter. Then your auditor will assemble your audit team, develop a timeline, and explain the scope of the audit inquiries and onsite "fieldwork."

2. Assessing risk
The primary goal of an audit is to determine whether a company's financial statements are free from "material misstatement." Management, along with third-party stakeholders that rely on your financial statements, count on them to be accurate and conform to U.S. Generally Accepted Accounting Principles (GAAP) or another accepted standard.

Auditing rules require auditors to assess general business risks, as well as industry- and company-specific risks. The assessment helps auditors 1) determine the accounts to focus audit procedures on, and 2) develop audit procedures to minimize potential risks.

3. Planning
Based on the risk assessment, the audit firm develops a detailed audit plan to test the internal control environment and investigate the accuracy of specific line items within the financial statements. The audit partner then assigns audit team members to work on each element of the plan.

4. Gathering evidence
During fieldwork, auditors test and analyze internal controls. For example, they may trace individual transactions to original source documents, such as sales contracts, bank statements or purchase orders. Or they may test a random sample of items reported on the financial statements, such as the prices or number of units listed for a randomly selected sample of inventory items. Auditors also may contact third parties — such as your company's suppliers or customers — to confirm specific transactions or account balances.

5. Communicating the findings
At the end of the audit process, your auditor develops an "opinion" regarding the accuracy and integrity of your company's financial statements. In order to do so, they rely on quantitative data such as the results of their testing, as well as qualitative data, including statements provided by the company's employees and executives. The audit firm then issues a report on whether the financial statements 1) present a fair and accurate representation of the company's financial performance, and 2) comply with applicable financial reporting standards.

Reasonable expectations

Understanding the audit process can help you facilitate it. If your company doesn't issue audited financials, this understanding can be used to evaluate whether your current level of assurance is adequate — or whether it's time to upgrade. Contact us for additional information.

<u>DO YOUR FINANCIAL STATEMENTS CONTAIN HIDDEN MESSAGES?</u>

Over time, many business owners develop a sixth sense: They learn how to "read" a financial statement by computing financial ratios and comparing them to the company's results over time and against those of competitors. Here are some key performance indicators (KPIs) that can help you benchmark your company's performance in three critical areas.

<u>1. Liquidity</u>
"Liquid" companies have sufficient current assets to meet their current obligations. Cash is obviously the most liquid asset, followed by marketable securities, receivables and inventory.
Working capital — the difference between current assets and current liabilities — is one way to measure liquidity. Other KPIs that assess liquidity include working capital as a percentage of total assets and the current ratio (current assets divided by current liabilities). A more rigorous benchmark is the acid (or quick) test, which excludes inventory and prepaid assets from the equation.

<u>2. Profitability</u>
When it comes to measuring profitability, public companies tend to focus on earnings per share. But private firms typically look at profit margin (net income divided by revenue) and gross margin (gross profits divided by revenue).

For meaningful comparisons, you'll need to adjust for nonrecurring items, discretionary spending and related-party transactions. When comparing your business to other companies with different tax strategies, capital structures or depreciation methods, it may be useful to compare earnings before interest, taxes, depreciation and amortization (EBITDA).

<u>3. Asset management</u>
Turnover ratios show how efficiently companies manage their assets. Total asset turnover (sales divided by total assets) estimates how many dollars in revenue a company generates for every dollar invested in assets. In general, the more dollars earned, the more efficiently assets are used.

Turnover ratios also can be measured for each specific category of assets. For example, you can calculate receivables turnover ratios in terms of days. The collection period equals average receivables divided by annual sales multiplied by 365 days. A collection period of 45 days indicates that the company takes an average of one and one-half months to collect invoices.

<u>It's all relative</u>
The amounts reported on a company's financial statements are meaningless without a relevant basis of comparison. Contact us for help identifying KPIs and benchmarking your company's performance over time or against competitors in your industry.

<u>HOW TO PREPARE WIP REPORTS FOR LONG-TERM CONTRACTS</u>

Work-in-progress (WIP) is a major inventory account for manufacturers, media and film companies, construction contractors, and other entities that enter into long-term contracts. WIP reports help management gauge the profit on each long-term project. To maximize profitability, it's essential to regularly monitor these reports.

What should be included?
There are many ways to create WIP reports, including spreadsheet programs and accounting software add-ons. Whichever method you use, the report should track key information for each project in progress, such as:

- Contract price (including approved change orders),
- Estimated job costs,
- Estimated gross profits,
- Costs incurred to date,
- Revenues recognized,
- Percentage of completion,
- Billings to date, and
- Billings in excess of earnings or earnings in excess of billings.

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How To Prepare WIP Reports For Long-Term Contracts

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Most companies with long-term contracts run monthly WIP reports. But proactive managers run them weekly. Warning: The process requires a current and accurate assessment of estimated costs to complete each project. Otherwise, the information will be incorrect and could be misleading.

How can you spot trouble?

WIP reports can help you identify problems and take corrective action before the problems spiral out of control. For example, say a job is 25% complete but your costs incurred to date are 40% of budget. That's not good, but thanks to your WIP report, you'll have time to investigate, make adjustments and, one hopes, get the project back on track.

WIP reports also indicate whether a job is underbilled or overbilled. Either situation is a potential red flag of financial trouble. But, in many cases, there's a benign explanation. For example, underbilling (that is, billing that fails to keep pace with a job's progress) may be attributable to cost overruns, inefficient project management or sluggish billing.

WIP reports can also help you spot "profit fade." This is the gradual decline in projected gross profits over the course of a job. There are several potential causes of profit fade, including inaccurate estimates, lax project management and sloppy change order practices. Again, a WIP report can tip you off to project discrepancies before the job gets too far along.

For more on WIP reports

WIP reports may initially seem overwhelming. But once you understand the terminology used and conditions that raise a red flag, the WIP report can be a powerful management tool. We can help you create these reports and teach you how to monitor WIP on a regular basis.

Consider How Tax Reform Would Affect Your Financial Statements

Tax reform legislation might be enacted before year end. If it is, companies following U.S. Generally Accepted Accounting Principles (GAAP) will have to recognize the effects of the changes in 2017 — not when the changes go into effect in 2018 and beyond. Here's what calendar-year businesses need to know as they report their year-end results.

Reporting for income taxes

The effects of a change in tax law must be recognized in the period in which the new legislation is *enacted*, under Accounting Standards Codification (ASC) Topic 740, *Income Taxes*. In the case of U.S. federal income taxes, the enactment date is generally the date the President signs the bill into law.

For interim reporting purposes, the effect of new legislation must be recognized in the interim period in which the legislation is enacted — even if the changes are retroactive. The tax law changes could, for example, require adjustments to current and deferred taxes, as well as any related footnote disclosures.

Tax reform principles

Companies could have very limited time between the date of enactment and the end of their financial reporting period. Therefore, anticipating the financial statement effects of tax reform may be helpful. Tax reform principles that could filter down to your company's financials include:

- Reduced corporate and individual tax rates,
- Greater capital expensing,
- Reduced (or eliminated) business tax breaks,
- Expanded corporate and pass-through business income tax bases,
- Taxes on previously deferred foreign earnings, and
- A potential shift to a territorial tax regime.

Some of these changes might be phased in over several years or expire after a certain number of years. A phase-in of a rate reduction or temporary changes would require additional steps to accurately calculate the impact of a tax rate reduction on a company's deferred tax assets and liabilities.

Income tax disclosures

The FASB also is considering whether it should revise

(See Consider How Tax Reform Would Affect Your Financial Statements continued on page 4)

<u>CONSIDER HOW TAX REFORM WOULD AFFECT YOUR FINANCIAL STATEMENTS</u>

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Proposed Accounting Standards Update (ASU) No. 2016-270, *Income Taxes (Topic 740): Disclosure Framework — Changes to the Disclosure Requirements for Income Taxes*. Issued in July 2016, the tax disclosure proposal would offer more information about taxes on foreign profits, a hot topic as more U.S. companies shift operations abroad. Additionally, it would require companies to separate foreign and domestic taxes, describe changes in tax law and explain the circumstances that cause a change in the assertion about the indefinite reinvestment of undistributed foreign earnings.

For now, however, the proposal is on hold, pending congressional action. The delay provides a temporary reprieve for businesses that expressed concerns about the extra recordkeeping this proposal would require.

<u>PLANNING STRATEGIES</u>

There are still major hurdles that must be overcome for tax reform legislation to be enacted. In the meantime, contact us for guidance on how the proposed changes could affect your financial statements and when those changes must be reported under GAAP.

<u>ACCRUAL BASIS TAX PAYERS: THESE YEAR-END TIPS COULD SAVE YOU TAX</u>

With the possibility that tax law changes could go into effect next year that would significantly reduce income tax rates for many businesses, 2017 may be an especially good year to accelerate deductible expenses. Why? Deductions save more tax when rates are higher.

Timing income and expenses can be a little more challenging for accrual-basis taxpayers than for cash-basis ones. However, being an accrual-basis taxpayer also offers valuable year-end tax planning opportunities when it comes to deductions.

Tracking incurred expenses

The key to saving tax as an accrual-basis taxpayer is to properly record and recognize expenses that were incurred this year but won't be paid until 2018. This will enable you to deduct those expenses on your 2017 federal tax return.

Common examples of such expenses include:

- Commissions, salaries and wages
- Payroll taxes
- Advertising
- Interest
- Utilities
- Insurance
- Property taxes

You can also accelerate deductions into 2017 without actually paying for the expenses in 2017 by charging them on a credit card. (This works for cash-basis taxpayers, too.)

As noted, accelerating deductible expenses into 2017 may be especially beneficial if tax rates go down for 2018.

Prepaid expenses

Also, review all prepaid expense accounts. Then write off any items that have been used up before the end of the year.

If you prepay insurance for a period of time beginning in 2017, you can expense the entire amount this year rather than spreading it between 2017 and 2018, as long as a proper method election is made. This is treated as a tax expense and thus won't affect your internal financials.

And there's more . . .

Here are a few more year-end tax tips to consider:

- Review your outstanding receivables and write off any receivables you can establish as uncollectible.
- Pay interest on all shareholder loans to or from the company.

Update your corporate record book to record decisions and be better prepared for an audit.
To learn more about how these and other year-end tax strategies may help your business reduce its 2017 tax bill, contact us.