

Financial Trends Review

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Featured Articles

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Major Changes Loom for Broker Dealer Audits



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Two newsletters ago, when we last discussed the Public Company Accounting Oversight Board (PCAOB), the organization was in the midst of determining what course to take in regards to inspecting public accounting firms that audit broker dealers. As of the beginning of 2012, the PCAOB has begun examination of select auditors who make up the nearly 900 firms that audit

approximately 5,500 broker dealers¹. The two year inspection process will result in one report each year, which, supplemented by recommendations from the Standing Advisory Committee of the PCAOB, will be used as the basis for final recommendations on broker dealer audit standards.

The PCAOB inspections are funded by a support fee on broker dealers whose quarterly tentative net capital exceeded \$5 million in 2010. The PCAOB anticipates 640 of all registered broker dealers (the assessed "Class") will be subject to a percentage fee based upon the individual broker dealer's tentative net capital to the tentative net capital of all those in the Class. Auditors will be required for 2011 audits to verify that these fees have been paid prior to issuance of the auditor's report.

In July, the PCAOB presented to the Securities and Exchange Commission ("SEC") proposed amendments to SEC Rule 17a-5. The proposed changes would provide that audits of broker dealers would be conducted under PCAOB standards, rather than Generally Accepted Auditing Standards (GAAS), which auditors have operated under since the creation of Rule 17a-5. Public companies have been audited under PCAOB standards since 2003. Although the SEC had the authority to make the standards change for the year ended December 31, 2011, it appears that the proposal will take effect sometime in 2012, thereby allowing auditors and broker dealers time to prepare. New reporting requirements, depending on the type of broker dealers (clearing versus non-clearing) will also apply. For clearing brokers, a Compliance Report and an Examination Report will now be required. The Compliance Report is to assert the broker dealers' compliance with the specified rules and internal controls, while the Examination Report, prepared by an independent public accountant, will report on the assertions made by the broker dealer in the Compliance Report. For non-clearing brokers, an Exemption Report and a Review Report will now be required. The Exemption Report is to include an assertion by the broker dealer that they are exempt from the provisions of Rule 15c3-3, and a Review Report, prepared by an independent public accountant, will report on the assertion made by the broker dealer in the Exemption Report.

Auditing Under the PCAOB

What does this all mean and how will it affect your broker dealer? Audits under PCAOB standards will include the following:

1. **Concurring Partner Review** – A second audit partner familiar with audits of broker dealers will need to review the work papers and provide concurring approval of issuance. Presumably smaller accounting firms will need to partner up or have another partner with the experience required to perform the second review.

¹ FINRA Statistics from presentation by PCAOB on October 28, 2011.

2. **Report Writing** – Not only would the financial statements and all required report footnotes need to be prepared by the broker dealer, but the actual report drafting has to be performed by the broker dealer.
3. **Access to Audit Documentation** – Broker dealers will have an additional layer of regulation as the PCAOB periodically examines public accounting firms. The examination frequency is dependent on the size of the accounting firm. The PCAOB will have the ability to not only review the auditor's workpapers but potentially refer to SEC and FINRA matters.
4. **Annual Independence Affirmation** – All members of the audit engagement team will be required to attest to their independence.
5. **Partner Rotation** – If there is no specific exemption proposed by the SEC, partner rotation of potentially five years would be required.
6. **Audit Documentation Standards** – Under PCAOB standards, Audit Documentation Standards are significantly more stringent in some areas. For example, PCAOB auditing requires the completion of a formal document entitled "Engagement Completion Document." This document acts as a roadmap to the audit and requires discussion of facts, evidence and outcome for numerous areas including significant issues, results of procedures and circumstances that caused significant difficulties for the auditor.

Three additional items are possible – a proposal requiring the individual engagement partner to sign his or her name to the audit opinion and, more troublingly, a recent concept release calling for firm rotation. Also, the PCAOB recently released a Request for Comment on rules dealing with the auditor communicating to the audit committee or its equivalent in non-issuer broker dealers. If enacted, this would cause additional burdens on the broker dealer.

Industry-Wide Changes On the Horizon

In late October 2011, the PCAOB, along with FINRA, presented to 300 auditors at a forum in Jersey City, New Jersey. Tim Gustafson, Associate Director for Policy Support of the PCAOB's Office of Research and Analysis, noted some interesting findings:

- 53% of all FINRA firms are made up of less than 10 employees.
- Excluding the Madoff claims, 82% of all Securities Investor Protection Corporation liquidations and 65% of customer advances were for non-clearing broker dealers.

These findings may make it extremely difficult for decision makers to exclude smaller broker dealers from the PCAOB requirements due to size or type of business. Additionally, this two-year inspection program of public accounting firms may not give support to any broker dealer firms.

Barring unforeseen circumstances, broker dealer auditing and reporting is slated to change dramatically in 2012. As it stands, it is likely that the entire sector could fall under the PCAOB rubric within a few years' time. Adjusting to the changes could prove to be difficult for unprepared firms. As a PCAOB-registered firm since 2003, WeiserMazars has many engagements which have been subject to PCAOB auditing standards and we are aware of the challenges that such audits can present. Those firms which may be subject to these new standards are well-advised to begin preparing as soon as possible, even before the SEC signs off on the proposal.

SSAP No. 101, *Income Taxes*, Effective January 1, 2012



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During the National Association of Insurance Commissioners (“NAIC”) 2011 National Meeting in November, Statement of Statutory Accounting Principles No. 101 (“SSAP 101”), *Income Taxes, A Replacement of SSAP No. 10R and SSAP No. 10*, was finally approved and effective on January 1, 2012. This was the culmination of several years work to modify and replace SSAP 10R, *Income Taxes, A Temporary Replacement of SSAP No. 10*. (“SSAP 10R”), which was slated to sunset on December 31, 2011 (the result of which would have reverted the accounting for income taxes back to SSAP 10). A Q&A addressing new issues in SSAP 101 is slated to be issued during the first quarter of 2012.

Background

Since the codification of statutory accounting in 2001, accounting for income taxes had remained unchanged until 2009 when changes were made in reaction to the financial crisis of 2008, specifically a renewed focus on SSAP 10’s highly conservative deferred tax asset (“DTA”) admittance test. After much debate, the NAIC issued SSAP 10R, which permitted the election, if certain ratios were met, expanded DTA admissibility (from one to three-year reversal period and from 10% to 15% surplus limit).

Additionally, there was concern by the regulators of the lack of statutory consistency with generally accepted accounting principles (“GAAP”) accounting for tax contingencies (FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes — An Interpretation of FASB Statement No. 109*, (“FIN 48”) as well as regulator concern over unwarranted admittance of DTAs on weak companies.

Key Revision Elements

The following areas contain key revisions to SSAP 10R:

- Tax Loss Contingency
- DTA Admissibility
- Disclosures

Tax Loss Contingencies

Federal and foreign income tax contingencies will now be computed in accordance with Statement of Statutory Accounting Principles No. 5R, *Liabilities, Contingencies and Impairments of Assets* (“SSAP 5R”), making them subject to a more conservative *more-likely-than-not* standard, replacing the *probable* standard for non-tax contingencies. SSAP 101 specifically rejects adoption of FIN 48, however it has adopted conservative aspects which appealed to the regulators while reducing some of its complexity (no probability analysis) which appealed to the industry. Differences from FIN 48 include:

- Measurement (see below)
- No unit of account concept
- Eliminates two-step recognition & measurement process
- Tax positions evaluated in aggregate (i.e. offsetting available)
- Applies to federal and foreign income taxes only (not state income taxes)

Like FIN 48, full tax authority knowledge of tax positions is presumed. Tax contingencies related to temporary items (such as a redundant loss reserve) need not be recorded unless an “event” has occurred (e.g., issuance of Form 5701, notice of proposed audit adjustment). At such time, the tax contingency would be recorded with an offsetting DTA, subject to admittance tests. This is consistent with paragraph 3.c. from SSAP No. 10 Q&A 9.6. Even if a gross up is not required, it is presumed that any interest or penalties related to the tax contingency would still have to be recorded. If an event causes a gross up to occur, surplus may be adversely impacted as the DTA may not be admitted. Proper planning and advice to management is necessary to avoid an unexpected result.

Measurement

The tax contingency is measured at management’s best estimate. The recording of a tax contingency is subject to a “more-likely than not” threshold or a cliff test. A 100% tax loss contingency is recorded when the estimated tax loss contingency is greater than 50% of the tax benefits originally recognized. If the estimated tax loss contingency is 50% or less of the original benefit recorded, then a tax contingency for the estimated amount only is recorded.

Example:

Current Tax Benefit	\$100	\$100
Estimated Liability	\$60	\$20
Percentage of Tax Loss Contingency	60%	20%
Tax Loss Contingency Recorded	<\$100>	<\$20>

Deferred Tax Asset Admissibility

The adjusted gross DTA (after application of a valuation allowance) is subject to a revised three prong test net admitted DTA under SSAP 101 which is calculated as the sum of the following:

1st Test – Hypothetical Loss Carryback

Federal income taxes paid (including any tax contingencies) in prior years that can be recovered through a hypothetical loss carryback for existing temporary differences that reverse in the timeframe consistent with the IRS loss carryback provisions, not to exceed three years.

Character of loss and type of insurance company matter. Life companies can carry ordinary losses back three years, while non-life insurers are limited to a two year net operating loss carryback. Capital losses may be carried back three years.

2nd Test – Expected Future Realization Subject to Guardrails

The remaining amount, after application of the 1st test, of adjusted gross DTA expected to be realized during the “applicable time period” (ranging from zero to three years reversals) not to exceed the “applicable percentage”, which is no longer elective, (ranging from zero to 15%) of the current period adjusted statutory surplus (as opposed to prior period surplus per SSAP 10R). This requires computation of a company’s current period authorized control level (ACL) RBC level. See the below table for applicable guardrails, exclusive of financial and mortgage insurers and non-RBC insures:

	<u>3 year and 15%</u>	<u>1 year and 10%</u>	<u>No Admittance</u>
ACL RBC (ex-DTA) *	>300%	200% - 300%	<200%

* ex-DTA = excluding deferred tax assets.

Note: The guardrails referred to above are based on the current reporting period. As a result, it's imperative that tax departments be prepared to obtain this information and note that this will be subject to external financial reporting auditor scrutiny. Computations on the quarter are slightly different. Strong companies which did not elect to admit additional DTA under SSAP 10R will most likely have a surplus boost in the first quarter of 2012.

3rd Test – Offsetting Against DTLs

The remaining amount of adjusted gross DTA that can be offset by existing DTLs. When applying the offsetting criteria, companies must consider the tax character (ordinary vs. capital) and the reversal patterns of temporary differences. It should be noted that the scheduling exercise should be consistent with the determination of a valuation allowance before the admissibility test.

Use of tax-planning strategies has been officially codified within SSAP 101 for use in determining the valuation allowance and in determining realization of DTAs.

Disclosures

SSAP 101 has eliminated the additional admitted DTA election, thereby eliminating this disclosure. New disclosures include: if a tax-planning strategy was used in determining the admissibility of DTAs whether the tax-planning strategy takes into account reinsurance transactions. For any tax contingency for which it is reasonably possible that the total liability will significantly increase within 12 months of the reporting date, the reporting entity shall disclose an estimate of the range of the reasonably possible increase or a statement that an estimate of the range cannot be made.

Effective Date and Transition

SSAP 101 becomes effective January 1, 2012. Any change resulting from the adoption of the Exposure Draft is to be accounted for as a change in accounting principle in accordance with SSAP No.3 — *Accounting Changes and Corrections of Errors*, in the first quarter of 2012. Companies should begin to analyze the impact of SSAP 101 on surplus, revise their tax provision, forecast admissibility models and procedures and plan accordingly.

What Do Boards and CFOs Really Need From Each Other in 2012?

High on the list: solid investment in the finance department's infrastructure.

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Playing the role of GAAP-reporting expert or guru of the regulatory jungle will not be enough for CFOs in the upcoming year. The volatility of the 2012 economy is sure to require innovation and fast decision making. GAAP accounting and regulators do not run your business. Boards of directors want to see some life from their CFOs. Boards want to see a finance department that understands company strategies, not in isolation but in the context of key issues — political, environmental and financial.

However, swift adaptability and comprehensive understanding of the economic environment cannot be based on a foundation of outdated technology or kludged-together operational structures. For a company to be competitive, boards must be willing to support their CFOs with solid investment in the finance department's infrastructure.

It is the finance department that is charged with the critical role of quantifying operational results and assessing risks. The challenge is to convert numbers into knowledge and insights into results. The CFO can play a significant role in translating strategy into action.

Requirements for 2012

The WeiserMazars CFO Leadership Study released last summer found that CFOs in the insurance industry lack the resources needed to effectively analyze the details of their business. They had adequate staff to produce financial information but not to analyze it.

The study also found that many CFOs are hesitant to utilize shared-service models or outsourcing which, while potentially fueling efficiency and/or innovation, can also compromise confidentiality. A temporary workaround has been to utilize a myriad of interlocking Excel spreadsheets that slow down reporting and increase risk. This is a problem because inefficiencies in financial reporting, particularly to support acquired revenue streams, reduce the efficiency of a company as a whole, essentially making the company less profitable.

Patchwork Fixes

Although most CFOs know how to “fix” these problems, such fixes are temporary at best. Current fixes are patches, like duct tape on a leaky pipe. Ultimately, corporate management will face the same situation again a few years down the line, when the financial patches give way; only the magnitude of problem will be greater as successive generations of technology will make existing processes increasingly obsolete.

CFOs are aware of what needs to be changed, but are challenged by lack of support in terms of having little or no budget to make necessary improvements. Wall Street and, ultimately, boards of directors have little fact-driven evidence to support the notion that investing in the finance department will ultimately lead to better results in the form of higher revenue streams or an increase in share price. These factors leave CFOs with aging and

inefficient financial, operational, and technological infrastructures. Improvements could be substantial, yet few companies can perceive a return on investment that isn't reflected in next quarter's earnings per share.

Here are some important points to think about.

1. Preparation for growth: Finance must have an integration strategy

As companies take on new product lines, change geographic locations, and acquire new divisions and/or new companies, it is essential to have a well-thought-out plan for integrating these new reporting events into a standardized system. The rapid growth of the past decade has left many companies with multiple systems that complicate reporting and increase the risk of errors, resulting in slow responses that weaken forecasts. A strategy for simplification/standardization is a must for 2012 to keep infrastructure meeting the needs of the growing revenue lines and business opportunities.

2. The need for data architecture planning is imperative

Data architecture describes how data is processed, stored, and utilized in a given system. This is no longer a technology problem. Finance must play a key role in ensuring that critical data is available, reliable, and accessible on a timely basis. Business Intelligence (BI) tools are available to assist and increase the effectiveness of decision making, decrease costs and increase efficiencies throughout the entire company. BI is, however, worthless without valid data. Excel spreadsheets that are patching system deficiencies need to be eliminated and systems repaired. It will ultimately cost less.

3. Looking for the magic bullet? Sorry — it's back to basics in 2012

Companies are looking to reduce head count without impacting customer service and productivity, to improve infrastructure while allocating little money, and to handle a myriad of new tasks while maintaining current responsibilities. They are finding that there is no quick and easy solution. The only answer is to get back to basics. Break projects into smaller pieces. Organize and run efforts using a prescribed methodology. Have a plan and follow it. Fund projects with savings achieved on completed projects.

The financial benefits of infrastructure improvement can be difficult to define. But in today's volatile economic environment, it is imperative that CFOs and boards begin to communicate more effectively about the needs of their companies, and that boards look beyond quarterly earnings statements when making budget allocation decisions. Improved internal processes benefit the entire company, top to bottom.

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