1-1-1976

Interim financial reporting: A summary of the new SEC requirements;

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Interim Financial Reporting

A Summary of the New SEC Requirements
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Haskins & Sells has prepared this booklet to provide directors and members of management of our clients with an overview of the new Securities and Exchange Commission rules for interim financial reporting and the role of independent auditors.

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Introduction

The Securities and Exchange Commission recently adopted amendments to its regulations concerning interim financial reporting that will expand the disclosure of quarterly financial information and involve independent auditors with reported quarterly operating results.

Expanded quarterly financial information will now be required of all SEC registrants. Also, many registrants will be required to include, in a note to their annual financial statements, summarized operating results for each quarter within the two most recent fiscal years, and independent auditors will be required to review this information. The new rules are effective for reports issued for periods beginning after December 25, 1975.
Overview of New SEC Rules

The significant provisions of the SEC's new rules are described below.¹

Quarterly reports
Registrants are now required to submit quarterly a current income statement, balance sheet and statement of changes in financial position, along with comparative statements for prior periods. Previously, only limited financial information was required. Special rules apply for financial statements for periods beginning before December 26, 1975.

Unlike annual financial statements, these interim statements may be condensed to some extent and may omit the customary note disclosures unless, of course, these disclosures are required to make the interim statements not misleading.

The financial statements are required to be prepared in conformity with the principles of accounting measurement applicable to interim financial information.² In addition, a registrant must state the date of any accounting change, as well as the reasons for making the change, and must furnish to the SEC a letter from its independent auditors indicating whether or not the accounting change is to an alternative principle that, in the auditors' judgment, is preferable under the circumstances.


The registrant is required to provide a narrative analysis of the results of operations, explaining the reasons for material changes in the amount of revenue and expense items from one quarter to the next, from the current quarter to the equivalent quarter of the preceding year, and from the current year to the prior year on a year-to-date basis.

The registrant is not required to have the interim financial information reviewed by its independent auditors; however, if a review has been made in accordance with established professional standards and procedures, the registrant is permitted to state that fact. In this case, the registrant also must indicate whether all adjustments or additional disclosures proposed by the auditors have been reflected in the information presented, and if not, why not.

**Annual financial statements**

For registrants whose securities are actively traded, the SEC requires disclosure in a note to the annual financial statements of net sales, gross profit, income before extraordinary items and cumulative effect of a change in accounting, net income, and income per share data for each quarter of the latest two years. The note may be designated as "unaudited," but certain review procedures are required to be performed by the registrant's independent auditors.

The note disclosure is required in financial statements of registrants whose securities are traded on a national securities exchange or are quoted on the National Association of Securities Dealers Automated Quotation System if the securities meet the Federal Reserve Board's Regulation T requirements for continued inclusion on the list of over-the-counter margin stock and if the registrant (including
consolidated subsidiaries) meets *either* of the following two criteria:

- The registrant had income after taxes but before extraordinary items and cumulative effect of a change in accounting of $250,000 or more for each of the last three fiscal years, or
- The registrant had total assets at the last fiscal year end of $200 million or more.

When the data in the note are different from those previously reported to the SEC, the differences must be reconciled and the reasons for the differences must be described.

**The Role of Independent Auditors**

We have frequently been involved in assisting our clients in their interim financial reporting. Generally, our involvement has been limited to consultation on such matters as accounting principles and disclosure that arise as interim financial information is being prepared. The new SEC requirements do not change our view that the type of service that we traditionally have performed in connection with interim reports has been beneficial to our clients and their shareholders, and we encourage our clients to continue to consult with us about their quarterly reporting practices. The SEC, on the other hand, has prescribed a formal type of auditor involvement with interim financial reporting that has been characterized recently as a *limited review*.3

The remainder of this booklet discusses some frequently asked questions about limited reviews and the auditors’ involvement in the interim reporting process.

**What is a limited review?**
A limited review clearly is not a general audit performed in accordance with generally accepted auditing standards, which has as its objective providing a reasonable basis for expressing an opinion on financial information. A general audit includes comprehensive procedures such as studying and evaluating internal accounting controls, testing accounting records, and obtaining corroborating evidential matter through inspection, observation or confirmation. A limited review, on the other hand, consists mainly of inquiries and analytic procedures concerning significant accounting matters and does not provide a basis for the expression of an opinion on the financial information.

**When is a limited review required?**
The only involvement of the independent auditor in the interim reporting process that the SEC requires is to perform a limited review of the summarized operating results included in the “unaudited” note to the annual financial statements. This may be performed either on a timely basis, i.e., before the quarterly information is issued, or on a retrospective basis in conjunction with the auditor’s examination of the annual financial statements.

**Should the limited review be performed on a timely or a retrospective basis?**
There are three primary factors to be considered before making this decision. First, will a timely re-
view bring to management’s attention significant accounting matters that might otherwise require subsequent adjustment of the quarterly results initially reported? Second, will a timely review unduly delay issuance of quarterly results? Third, will the cost of a timely review be in line with its benefits?

**Early consideration of significant accounting matters.** Because limited review procedures are substantially less comprehensive than audit procedures, there can be no assurance that a timely review will reveal all significant matters that the auditors may conclude, as the result of their year-end audit, should have been treated differently. On the other hand, a timely review will be helpful in minimizing the risk that quarterly results initially issued were erroneous and therefore will require restatement and explanation in the annual report. A timely review may be especially beneficial in those cases where the accounting controls over the preparation of quarterly information are weak, the registrant has a history of large year-end adjustments, significant unusual events occur that require accounting recognition, or new accounting and disclosure rules must be applied. Those registrants that have reliable accounting and interim financial reporting systems may derive little benefit from a timely review.

**Delay in issuing interim information.** The time necessary for the auditor to perform a limited review on a timely basis ordinarily will cause some delay in the issuance of interim financial information, especially for registrants with diversified or multinational operations. Accordingly, since timeliness is important in the issuance of quarterly information,
we would endeavor to perform as many review procedures as possible before the end of the quarter in order to minimize the delay in issuing interim information.

**Cost of a timely review.** The cost of a timely review will depend, among other things, on the size and nature of the registrant’s operations, the effectiveness of the interim reporting process, and the time required to resolve various issues. In general, we believe that a timely review will increase total audit cost more than a retrospective review made in connection with the annual audit. There are, however, some potentially offsetting cost savings in having a timely review, because some of the procedures performed on a timely basis would not need to be repeated in connection with the annual audit. Because each client’s situation is unique, the best approach is to obtain an estimate of the incremental cost of performing a timely review from the partner directly responsible for our services.

**Conclusion**

While the concept of an independent auditor’s involvement with interim financial reporting is not new, the formal type of involvement required by the SEC is new. We encourage each of our clients to discuss with us the implications of these new rules and the effect they will have on their financial reporting procedures. We will also be glad to assist on possible improvements that can be made in the overall financial reporting process so that clients can prepare and issue interim reports quickly and efficiently.