Seidman Business Review

Volume 6 | Issue 1 Article 6

4-1-2000

Is Your Auditor More Demanding This Year?

Joseph Godwin
Grand Valley State University

Is Your Auditor More Demanding This Year?

Joseph Godwin, Ph.D.
Department of Accounting and Taxation
Seidman School of Business

Securities and Exchange Commission (SEC) efforts to curtail inappropriate earnings management over the past year could affect companies in West Michigan. While SEC efforts affect public companies most, changes in generally accepted accounting principles (GAAP) and changes in the way audit firms conduct business will also affect audited, non-public companies. These changes should not alter most planned transactions, but financial managers may want to consider the reduced accounting flexibility and the effects on financial statements for some transactions they may be contemplating.

The SEC staff focused on several key topics, including materiality, auditor independence, restructuring reserves, and the allowance for loan losses. Here is a brief discussion of these topics and how they might affect West Michigan companies, particularly during interactions between the companies and their auditors.

Materiality

Most companies execute thousands of transactions over the course of a year. For one reason or another, those transactions may not be entered into the accounting records, or they may be entered in a manner that is inconsistent with GAAP, with the result that net assets are either overstated or understated. For example, the monthly invoice from the company's law firm may be temporarily mislaid, or a machine that will provide benefits for several years may be incorrectly written off as a current period expense.

During the annual audit, many of these issues will come to light. The monthly invoice may be found or the errant machine entry observed. Typically, the auditor will develop a list of such items, both positive and negative, and propose record adjustments to management. Management either accepts or rejects the auditor's proposed adjustments. However, an auditor may render a clean audit opinion if, in the aggregate, unaccepted proposed adjustments do not have a "material" effect on the financial statements.

In many cases, auditors have defined "material" as some percentage of income or assets, such as five percent, and have based their determination on the net effect of proposed adjustments. In many cases, items affecting income millions of dollars in one direction were offset with items going millions of dollars in the other direction, and both were swept off the financial statements.

A recent SEC Staff Accounting Bulletin (SAB 99) attacks this practice and requires auditors to consider factors other than the percentage relationship to income or assets in assessing materiality. As a result, auditors will need to assess whether the incorrectly recorded item is such that a reasonable investor would want to know about it. Auditors should take a harder line regarding netting positive and negative items before assessing materiality. Many companies, both public and non-public, will feel more pressure to book transactions according to GAAP.

Auditor Independence

Some of the largest audit firms have come under fire for lack of independence with respect to their audit clients. As a result, audit firms are taking a fresh look at relationships between members (partners and engagement staff) of their firm and clients. Audit clients who are required to provide an independent audit to the SEC or to lenders, regulatory agencies, and others should also be concerned lest lack of independence cause their financial reports to be rejected by others for failure of independence. Such a determination could jeopardize a stock offering, borrowing, debt covenants, or compliance with other regulatory requirements. Such a result could lead to a re-audit, costly delays, or other problems.

Space does not allow a discussion here of all of the ways that independence can be impaired. The most common ways include auditors having direct financial interests in their clients. Such an interest could be a direct investment, such as owning shares of the client, or it could be a creditor-debtor relationship between the auditor and the client. In some cases, unpaid audit fees have been deemed to impair independence. Companies should also be cognizant of non-financial relationships that could impair independence. Family relationships or provision of some non-audit services can also create independence problems. For example, if a company employs a spouse or close relative of a member of an audit firm in a position where that individual can influence financial reporting, the audit firm will not be considered independent. And, if the audit firm prepares some of the numbers to be reported, it may not be independent. This situation has arisen where the audit firm "keeps the books" for the client or provides valuation services for items like pension liabilities, in-process R&D write-offs, or asset valuations. Audit firms cannot independently audit their own work.

Managers should be aware that even though auditors may be disciplined for undertaking audits where they lack independence, it is the manager's responsibility to provide the independent audit. Managers will want to have a frank discussion with their auditors about financial arrangements or other matters that could impair independence.

Restructuring Reserves

We have been blessed in West Michigan with a dynamic, growing economy. However, sometimes things do not go as planned and a company is confronted with the need to lay off employees, curtail operations, or sell plant and equipment. GAAP generally requires a company to recognize a loss and a liability (reserve) for such activities when it appears probable that a liability has been incurred and the costs can be reasonably estimated. The loss and liability recorded would relate to future costs to be paid regarding employees to be terminated or shortfalls that will be incurred on the sale of plant and equipment.

Some managers have taken such losses before they fully understood the economic realities of a situation. As a result, reserves appeared to be used for ordinary operating costs rather than a planned restructuring. Some observers expressed concerns that managers were reducing income during good times by creating cookie jar reserves that could be used to reduce operating costs during bad times. In such cases, financial statement users may not be able to observe as fully as they should the underlying economics of a company.

Late last year, the SEC staff issued another SAB to clarify practice about restructuring charges. Managers will want to be sure they comply with GAAP when taking restructuring charges and using the reserves set aside for such purposes.

Allowance for Loan Losses

Companies with significant receivables can expect increased scrutiny of their allowance for loan losses by auditors this year. Historically, auditors question whether the allowance is large enough to cover expected credit losses. Last year, however, the SEC caused a stir by questioning whether several banks' allowances were too large and were thus providing cookie jar reserves for some institutions in a manner similar to restructuring charges.

Confusion among financial institutions about appropriate methodologies to determine the allowance led to the creation of an AICPA sponsored panel to develop guidance. In the meantime, managers can expect their auditors to make extra efforts to be sure that allowances are neither too large nor too small. Instead, they should be *just right.*

The Bottom Line

One of the things I learned working at the SEC is that there is good reason to have confidence in the financial reports of U.S. companies. The vast majority of the business community, by far, is working hard and diligently to produce high quality financial statements and disclosures. Most professionals, whether in public accounting or in financial management, are performing their jobs with great integrity and rigor.

West Michigan companies are known for using conservative accounting practices so that users of their financial statements have reason to believe that assets and income are not overstated. Auditors may challenge conservative accounting practices, however, especially if they are being applied in areas where the SEC has been active. The topics I describe in this article are several areas in which the Commission is currently active. Such activities could explain why your auditor is more demanding than in past years.