Case 8: Balancing Client Interests and Ethical Accounting Practice

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Part I: February 21, 2005

John Smith, an auditor and partner for Smith & Jones Accounting Firm, was sitting in his office contemplating what course of action he should take regarding the audit of Alpha Corp. Located in California, Alpha Corp. is a publicly held company that distributes textbooks to colleges and universities. In December 2004, Alpha Corp. hired Smith & Jones to audit their financial statements as required by the Security and Exchange Commission. Smith & Jones is a small, regional accounting firm, and Alpha Corp. is one of its largest clients. Alpha Corp. requested that Smith & Jones complete the audit by February 28, 2005 so that the results of the audit could be presented at their annual stockholders' meeting scheduled for March 15.

John Smith was the principal auditor for the Alpha Corp. audit. He was very aware of the deadline and scheduled all work in a way that would let them complete the audit on time. Of course, John was also responsible to ensure that the audit be performed according to generally accepted auditing standards to provide sufficient evidence to issue an unqualified opinion. Thus, John did not want to perform a substandard audit just to satisfy the client's interests. As of February 21 the audit was still unfinished due to a series of unexpected issues that had surfaced since the December 31 closing date. The following discussion occurred during the most recent meeting on February 18 with Alpha Corp.'s chief financial officer, Paul Roberts.

John: Paul, I've been looking over several financial events that transpired since December 31 of last year. I believe they are going to have a significant impact on the audit.

Paul: Sure, John, feel free to ask me anything. I know the audit deadline is rapidly approaching, and I want the audit completed by then. In fact, it is imperative that it be finished.

John: I recently became aware that one of your major customers, XYZ University, recently filed for bankruptcy. I checked your accounting records from the December 31, 2004 trial balances that you gave us to determine if there were any implications for Alpha Corp. Your accounts receivables show that XYZ University currently owes you $250,000. I also found several mentions in the press that XYZ University was having problems as early as October of last year. What have you done to account for the bankruptcy?

Paul: Unfortunately, the bankruptcy of XYZ University hit at a very bad time since we were closing the books at year's end. Since the university declared bankruptcy, it's highly unlikely we will collect any of the $250,000. However, since XYZ University only declared bankruptcy in 2005, I don't see any reason to account for this in our 2004 report.

John: Actually, there are some issues related to disclosure. However, that is not the only problem. I also have a question about another major customer of yours.

Paul: Oh, I bet I know who that is. Are you referring to the Smalltown College account?

John: Yes. According to the final records, Smalltown College represents $100,000 of your company's accounts receivables. Last month, a fire destroyed one of its buildings. The casualty caused Smalltown to default on all debts that became due in January because the college did not have sufficient cash on hand to pay for the losses from the fire as well as additional obligations on the building. Have you revised your books to reflect this issue?

Paul: Unfortunately, we may take a big hit. It's not the best way to start out the year, is it? Smalltown has told us that they are strapped for cash. It's doubtful we will see any payments for a long time while Smalltown gets back on its feet. I hope to recoup part of the debt, but I am uncertain how much or when we'll receive any payments.

John: So shouldn't this amount be written off as an uncollectible account?

Paul: John, I just don't think it's warranted right now. Besides, two big hits in a row just might cause our shareholders to get nervous and divest their holdings. We really don't need any negative news that might affect stock prices right before our annual meeting.

John: I understand your position, Paul, but based on your comments, the loss may have to be disclosed. I will give you one more week to assess the situation. We'll need to resolve it at our next meeting. I see in the last board meeting report dated January 14, 2005 that Alpha Corp. intends to issue a stock split the day before the annual meeting where it will be announced.

Paul: Yes, we have 1,000,000 shares authorized and outstanding of our $10 par value stock. The stock split will be two for one. The board feels that the increase in shares would positively influence the number of shares being traded and would raise the stock price.

John: Sounds like a good strategy to me. Have you disclosed this information in your financial statements that will be issued upon completion of the audit?

Paul: Since it will happen in 2005, I don't think it's necessary to disclose it in the 2004 audit.

John: OK, Paul. I understand your position, but auditing standards may require disclosure. I'll research each issue and give you my recommendation next week. One more issue – my legal representative provided an update on the litigation that Alpha Corp. has been under from Deermont University. Refresh my memory. Did Deermont University claim that Alpha Corp. had conspired in price-fixing agreements?

Paul: Yes, Deermont University brought the suit against Alpha Corp. in June 2004. As of December 31, 2004, the litigation had yet to be decided; however, our legal counsel advised that we be prepared to lose the case, and we accrued a liability of $500,000. I personally felt the case had no merit, but I am not a lawyer or judge. Unfortunately, on February 5, the lawsuit was settled with a verdict of $700,000 against Alpha Corp. Can you believe that we have suffered three major hits in just the first two months of 2005?

John: I know that must be tough. Have you made the necessary accounting adjustments?

Paul: Actually, since the lawsuit was settled this year, I haven't done anything. I'd really prefer to just forget about it; however, I know I have to figure out a way to explain to the board the additional $200,000 loss and the other negative outcomes.

John: Yes, Paul, I think both of us want my firm to be able to issue an unqualified opinion on the audit. That means that all of these outstanding issues must be resolved according to ethical accounting standards. Thanks for meeting with me, Paul.

Part II: February 23, 2005

John Smith had just finished conferring with the other principal in the firm per normal policy on all audits. Alpha Corp. was a client that the firm could not afford to lose. John knew that the issues raised with Paul had to be resolved. If Alpha Corp. did not receive a favorable audit outcome, matters would not go well at the annual meeting, and it would be likely that Smith & Jones would lose the Alpha Corp. account. John was not looking forward to the upcoming meeting with Paul.

Part III: March 1, 2005

With the Alpha Corp. audit finally complete, John arrived late at his office on Monday morning to discover a bustle of activity. An earthquake had hit in the vicinity of Los Angeles, and John was aware that a significant number of Alpha Corp.'s production plants were located near L.A. John decided that he must call Paul to see if any of Alpha Corp.'s plants were affected by the earthquake. Before he could make the call, Tina Brown entered John's office.

Tina: John, I was performing the final check on the Alpha Corp. audit before filing it, and I discovered that one of Alpha Corp.'s accountants accidentally recorded twice the allowable depreciation on some production equipment. As a result, 2004's net income was understated by $50,000.

John: Thanks Tina. I'll call Paul Roberts and alert him about this issue. *[calls Paul]*

John: Hi, Paul, it's John Smith at Smith & Jones Accounting. I am calling you about two matters. First, did the earthquake cause any problems for your manufacturing plants?

Paul: The earthquake was centered near some of our production facilities. Unfortunately, one of our plants was destroyed. The loss is about $3,000,000. We do have insurance, and we are going to rebuild the plant. In the short term, we will be able to shift some of the scheduled production to other plants, thereby minimizing any lost production, but we will still suffer from a reduced production capability for the next six months.

John: I'm sorry to hear that, Paul. The other issue concerns your depreciation calculations. Apparently, twice the allowable depreciation was recorded for one of your machines. This error caused your 2004's net income to be understated by $50,000.

Paul: I will definitely have to check on that. If it's true, the $50,000 will help to offset all the financial hits we have taken so far this year. Let me get back with you.

John: OK, but we might have to reissue the financial statements and the audit report to account for these events. Goodbye.

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APPENDIX A
Background Information – Subsequent Events and Dual Dating

Subsequent events are those occurrences that happen subsequent to the balance sheet date but prior to the issuance of the financial statements and audit report by the independent auditor (American Institute of Certified Public Accountants Professional Standards AU Section 560, “Subsequent Events”). These occurrences have a material (e.g., relevant and important) effect on the financial statements and require adjustments or additional disclosure so that financial statement users are not misled about the financial condition and situation of a company. Subsequent events are classified into two types of events: Type I and Type II.

Type I events provide additional information to conditions that existed as of the balance sheet date (i.e., the end of the reporting period), and those events require the financial statements to be adjusted for any changes that have occurred. Type II events are those events that did not exist at the balance sheet date but occurred after that date and before the financial statements were issued. Type II events do not require adjustments to the financial statements unless noted as an exception and instead require additional disclosure to keep the event from being misleading on the financial statements. If a Type II event is material, then pro forma financial statements may be issued showing how the financial statements would appear if the event had occurred by the balance sheet date.

Materiality is a concept that is not always easily determined. The Financial Accounting Standards Board in Statement of Financial Accounting Concept No. 2, “Qualitative Characteristics of Accounting Information,” addresses materiality. In general, materiality is quantitative in nature; however, analysis of only the magnitude of a loss is not sufficient. While the amount may be small in magnitude, the circumstances which caused the loss may be considered important. Materiality should be assessed based on the degree to which a loss will make a difference in the decision-making of a financial statement user (e.g., an investor). The relative rather than the absolute size of an item being assessed determines if it qualifies as being material. As the importance of the decision increases, then the screen used to evaluate materiality must become finer.

When an auditor has subsequent events, the date of the audit report may also be affected. If a subsequent event occurs before issuance of the audit report, and if the event is treated appropriately, then the date of the report is the issue date. However, if a subsequent event occurs after the date the report is issued, then a dual dating may be used.

Dual dating may be accomplished in two methods. The first method is to date the report on the date the fieldwork was completed and then date the subsequent event in the note disclosure. This effectively limits the auditor’s responsibility to the specific subsequent event only, not any other events that occur after the date of fieldwork. A second method is to date the audit report using the date that the subsequent event occurs. However, the auditor is responsible for the period up to the date of the subsequent event (American Institute of Certified Public Accountants Professional Standards AU Section 561, “Subsequent Discovery of Facts Existing at the Date of the Auditor’s Report”).