FINANCIAL STATEMENT PRESENTATIONS: BY-PASSING DEFICIENCIES

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Course Outline

- Common deficiencies
- Steps you can take to avoid them
- Practical cases and implications

Introduction

"So there is potentially an appetite for auditors to become involved in such a way that we can provide assurance that those numbers that are being relied upon by the markets and are moving stock prices have been, in fact, subject to some form of audit testing. Because of the rigorous standards that govern auditing procedures, it would take a collaborative process to expand auditors' assurance. It's a process that would have to involve regulators, auditors, preparers, and investors. Understanding the information investors would like audited would be one of the most important parts of the process. Once that is determined, professional standards—including those of the PCAOB and the AICPA Auditing Standards Board—may need to be changed to enable auditors to perform new or different procedures. It's going to be critically important for the profession to remain at the heart of attesting to the information that's most important to the markets, and we must have an openness to gravitating our services into those areas" - Ucuzoglu, Chairman and CEO of Deloitte Touche LLP(USA)

Market Perception on CPAs and Financial Statements

- Your accountants report is generally meaningless-Ever read the accountant's report that accompanies your financials? You should. And you'll laugh. Even if the accountant performed a full-blown audit -- and this is unlikely, because, unless you're a public company or have serious obligations, there's no way you're going to pay the fees required -- you'll be amazed at the lack of ownership the accountant assumes. Even the first paragraph says, "these financial statements are the responsibility of the company's management."

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- The auditor at best had “reasonable assurance” and the financials at best are free of “material misstatement.” The whole opinion is made on a “reasonable basis.” You’ll be asked to sign off engagement and representation letters too, which the accountant can fall back on in case there’s a problem. The uptake? You own these financials so you better understand and take ownership of every single line item. Your accountant won’t.

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Your tax return is rarely the same as your financial statements-Separate rules apply. Assets are valued differently. Some expenses are not expenses. Some revenues are accounted for differently. You might show a loss on your financials, but a profit on your tax return. Or the opposite. Make sure to understand how these reconcile.

- **Your assets are lower and your liabilities are higher than you think.** Your bad receivables might be "reserved," but they're not written off. Your "other assets" contain stupid things like "prepaid insurance," which may be an asset for accounting purposes but for a business owner it's already cash out the door for something you'll never get back. Your inventory is probably not worth as much as your financials say and your capital equipment doesn't reflect the annual maintenance and repairs required to keep running.

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- Your income statement doesn’t show the cash you paid out during the year for prior and estimated taxes, inventory you purchased but haven’t sold, machinery bought, loan payments made to the bank or distributions to your partners, which is why you’re scratching your head over the fact that it’s showing profits but you still have no cash in the bank.

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- **Your banker doesn't rely too heavily on your financials.** Banks usually require financial statements from their customers, but they're more interested in getting your monthly reports, aged receivables and accounts payable listing. When they get your financials, they'll quickly go into spreadsheet mode, sticking numbers into the right places so they can confirm compliance with their covenants, checking your debt to equity and making triple-sure you can service your loans. Then they'll tick off "financial statements" from the annual checklist. Every good banker knows that if there's a problem, it won't be found in the financials. It will be found through conversations, site visits and checking more current data. If your banker is just using your financial statements to uncover an issue then he won't be in the banking business for very long.

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- **Your financials have little do to with your company's market value.** Investors don't buy stocks based on a company's past financials. A buyer won't purchase your interest just because you had a good year. The past is not the future, and smart investors put their money into the future. They are interested in your backlog, people, product research, future revenue streams, growth, your customers' growth and a hundred other things. These are not things you will find on your financial statements.

Common Deficiencies

1 80% problem is the auditor's failure to gather sufficient audit evidence. This include inadequate evidence in areas such as:

- asset valuation-Failure to obtain evidence to support key assumptions
- asset ownership –Failure to obtain evidence to indicate the company owned certain assets
- management representations.-Failure to corroborate management responses to inquiries
- Examining a draft instead of a final document, e.g sales contract leading to overstatement of assets(Common fraud technique)

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2 Failure to apply GAAP pronouncements or improper application of the same-e.g violation of GAAP principles on assets with unique accounting valuation issues.

3 Failure by auditors to properly assess:

- inherent risk and adjust the audit program appropriately
- The heightened risk associated with non routine transactions
- An audit program or inappropriately reuse the one from previous year

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4 Failure to exercise due professional care and the appropriate level of professional skepticism

5 Over-reliance on inquiry as a form of audit evidence

6 Deficiency in confirming accounts receivables and other balances and failure to perform alternative procedures on the same.

7 Failure to recognize related party transactions

8 Assuming internal controls exist when they may not.-failing to react to known control deficiencies

Steps to avoid common deficiencies

1 Develop a properly designed and executed quality control system. Such a system encourages all team members to maintain a baseline acceptable level of performance, regardless of perceived day-to-day engagement and firm pressures. firms should reexamine existing quality control procedures to make sure they are detailed enough to assure firm leaders that audit teams are examining appropriate documentation (final documentation, not drafts) and that teams complete all audit program steps. Those procedures should emphasize that auditors should corroborate management representations with additional evidence and not overuse management inquiry as a form of audit evidence.

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2 Firm's tone at the top should:

- Define "client" to include not only mgt but also the entity's BOD, audit committee, stockholders and the investing public to ensure the audit team considers all the affected parties throughout the engagement.
- emphasize the importance of audit quality in training programs and annual performance reviews
- Encourage all personnel to maintain an attitude of professional skepticism that focuses on the importance of the auditor's role in protecting the public interest and maintaining strong capital markets.

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3 Firms should expand the coverage of technical accounting topics in firm sponsored training

4 To remedy audit program deficiencies, partners and managers should be more involved in planning the engagement

5 Review the underlying data in management estimates. For complex, unusual cases, engage an expert

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6 Related party transactions

- Make inquiries regarding existence of the same
- Confirm with the counter-party the nature and existence of material or unusual client transactions, including whether a relationship exists between the counter-party and the client or its management.
- Closely examine the transaction to make sure that it occurred and is correctly valued and ensure the GAAP requirements are satisfied

Probable reforms to increase reliability of audit information

- Modernizing our current reporting and financial disclosure model to supplement historical financial statements.- e.g Kenya Accounting Standards requirements
- Revising current accounting rules for special purpose entities.
- Requiring additional disclosures in company filings with the authorities, including management's discussion and analysis.
- Requiring reporting on a company's internal control system to evaluate its effectiveness and making that report available to investors.

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- Requiring auditors to take additional steps to search for fraud.
- Requiring disclosure of nonfinancial information to highlight what will contribute to the future success of the company.
- Increasing the frequency of reporting.
- Making it illegal for anyone in a publicly held company to lie or withhold material information from their auditor.

Summary:

- No reporting model will protect investors from greed and bad judgment. However, an improved reporting model will provide every investor with better quality information and increase the likelihood of better investment decisions. More information and timely disclosures in plain English are required. The reporting model should also address off-balance-sheet activity, liquidity issues, other risks and uncertainties, forward-looking information, nonfinancial performance indicators, unreported intangibles and other important information. To modernize the model, we must focus on Increasing the frequency of financial reporting so that the delivery of financial information is eventually in "real time," rather than only periodically.

Discussion Question

1. How can the audit profession be turned around in order to be the bedrock of a country's economy?