

NAVIGATING A CHANGING LANDSCAPE AS AUDIT PORTION BECOMES MORE COMPLEX



The audit portion of financial reporting has become more critical and more “cerebral” in nature over the past few years. At the center of these changes is the Sarbanes-Oxley Act of 2002. Other factors include the increasing complexity of documents such as FIN 46R (disclosure rules related to a “variable interest entity”) and FAS 43 (accrual of liability for employees’ rights to receive compensation for future absences). Reporting companies must factor these changes into their audit preparation processes or risk facing potentially negative consequences.

THE EXPANDING ROLE OF AUDIT TEAMS

“The audit portion of financial reporting has become more critical in that the information auditors look at is being examined in much greater depth than it was just a couple of years ago,” says Mark Davis, a managing partner of Deloitte & Touche LLP’s technology and venture-backed practice in the Northeast region.

“We as a firm have always supplemented our audit teams with people who have other specialized expertise in areas such as tax compliance and ongoing evaluation of goodwill and intangibles,” Davis says. “The audit team has morphed from a group of audit specialists to one which includes a broader spectrum of knowledge, skills and expertise. We are getting the right answers in areas such as merger and acquisition activity, FIN 46R and FAS 43 by relying on experts with specific skills in those areas.”

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This new environment for the audit function raises financial reporting challenges for companies, says Michael Bernstein, managing director of Geller & Company’s Emerging Business Group in New York City. “A need has arisen for audit firms to work in a different way with clients. There is stricter separation between the accounting and auditing functions, and there is the possibility that legitimate differences of opinion over some accounting issues could lead to problems,” he says.

ROADBLOCKS TO REACHING SIMILAR POSITIONS

Most companies want to do the right thing when it comes to financial reporting, and the auditor does too, Bernstein says. “But the way the rules are structured and enforced makes it difficult and awkward for the two parties to have the kind of collaborative, productive conversations that in many cases might make it easier to reach a right conclusion.”

In some cases, companies are hesitant to take a position on certain issues, especially in areas such as business combinations and valuation. “If they take the wrong position, it can be seen as a material weakness,” Bernstein explains. “But they have to take a

position, because if the auditors are asked to work with something other than a final product, that can be interpreted as them having crossed over the line.”

WALKING THE LINE BETWEEN BALANCED RESPONSIBILITIES

That “line” is the pivot point in the “appropriate balance between the responsibilities of management to design, oversee and obtain reasonable assurance about internal controls over financial reporting and the auditor’s responsibilities to test and report independently on those controls in connection with the annual financial statement audit,” according to an April 2005 report from Deloitte in response to a request by the Securities and Exchange Commission (SEC) for comments on its experiences with implementation of the auditing and reporting requirements of Section 404 of Sarbanes-Oxley.

Among the fundamental principles affirmed in Auditing Standard No. 2 and emphasized or strengthened in Section 404 of Sarbanes-Oxley and related SEC rules is that external auditors must perform sufficient testing themselves to obtain the principal evidence to achieve their own reasonable assurance regarding the accuracy of items included in an audited company’s financial statement.

“The most important thing clients can do to adjust to the new environment is to gain access to more specialized expertise, either by adding it in-house or by turning to an outside expert firm, such as Geller,” says Davis. Prior research and preparation can help ensure that the positions a company takes on material issues, such as business combinations and valuation, will turn out to match the conclusions reached by the auditor, thus avoiding the potential downsides of higher fees, a lengthened audit process and delays in releasing information to the public.

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