By Gary Zeune, CPA

warning!

Reading this article will be painful

Are clean opinions materially misstated?

Have you ever asked yourself, "Why do we even do audits?" Most CPAs will say, "Because they are required?" But why are audits required? Audited financial statements are valuable because they reduce the client's cost of capital. How? Because audited statements reduce the user's assessed risk. Assume a bank has a loan request from two companies, identical in every respect, except that one has audited statements and the other doesn't. All things being equal, the bank will charge a lower rate of interest, and maybe impose fewer or less onerous covenants, to the company with audited statements.

So where does audited financial statement value come from? There are two sources. The first source is that the numbers are fairly presented, not materially misstated. To most users fairly presented means the numbers are "right" or "accurate." The second source of value is that users believe the numbers are right. Even if the financial statements have a "clean" opinion, if the user, bank loan officer, donor, vendor, customer, taxpayer, doesn't believe it, the statements have no value.

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So how do you create "believability" value? We all know that the second general standard in SAS No. 1 requires auditors to be independent. To be qualified to issue an opinion you must be independent. If you're not independent you have disqualified yourself from issuing and opinion, even if the numbers are "right." Here are four requirements in SAS No. 1 that you must comply with to qualify to issue an opinion:

- For dependability of his findings…auditors must be without bias…not a prosecutor but judicial impartiality and an obligation for fairness on those who rely.
- To be independent, an auditor must be intellectually honest.
- Auditors should avoid situations that may lead outsiders to doubt their independence.
- Our code of conduct has precepts to guard against presumption of loss of independence.

Unfortunately, there are a whole host of structural defects and behaviors that make if nearly impossible to comply with the independence requirement.

So is the solution!

Auditors must be without bias

The first problem is that our profession's model is fundamentally flawed. Who pays for the work? The client. What's the flaw? No one can be truly independent of someone who pays for the work.

Think about this: Would it be a good idea for restaurant inspectors, building inspectors, power plant inspectors, OHSA inspectors, FDIC inspectors, or meat packing plant inspectors to be paid by the companies they inspect? Why not? Because doing this would impair their judgment and independence.

Why don't we have the restaurants pay for the inspections, but have a code of professional conduct requiring the inspectors to be independent? Because we all know such a system would not work. So how are auditors independent when they are paid by the client? That's the system we're stuck with. So until the profession develops another payment mechanism, our independence will always be suspect. No amount of rules or punishment is as powerful a motivator as getting paid. If people followed the rules, no one would cook the books, and Arthur Andersen would still be around.

An auditor must be intellectually honest

Are you an ethical CPA? "Of course," you say to yourself. But have you ever had a client who treats the company (could be a private or public company, government or non-profit entity) as his or her own personal piggy bank? Yep. If you knowingly let your client take a clearly personal expense through the entity, it's a violation of SAS No. 1. Why? Because you've knowingly allowed your client to violate his or her own internal controls. Please explain how it's intellectually honest to knowingly let a client violate internal controls to take an illegal tax deduction.

Furthermore, paragraph 10 of SAS 107, "Audit Risk and Materiality in Conducting an Audit" in part states: "When the auditor encounters evidence of potential fraud, regardless of its materiality, the auditor should consider the implications for the integrity of management or employees and the possible effect on other aspects of the audit."

Just because the deduction is immaterial for financial reporting does not mean it's legally OK. In other words, legality and materiality are two different things. How can auditors render a clean opinion knowing the financial statements are misstated by an illegal amount? It's willful because you see the deduction and do nothing about it, for example, by putting the illegal deductions on your "passed adjustments" list. Doesn't "willful blindness" of illegal activities by its nature render the auditor not independent? In other words, if an auditor is truly independent, he or she would stand up to the client and force proper accounting. Issue a 1099, repay the money and set up a receivable. Do anything for proper accounting.

Avoid situations that may lead outsiders to doubt their independence

SAS 107 defines materiality as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement." Note that there is no percentage or amount in the definition.

Thus, if users would make a different decision, then the amount/ transaction / event are material. Note the definition says "reasonable person." It does not say "reasonable accountant or reasonable auditor." Who are these "reasonable persons?" Think bank loan officer, nonprofit donor, taxpayer, regulator, or newspaper reporter. If you were required to disclose every personal expense taken as a corporate deduction in the opinion, would you allow them? If not, on what basis is it to look the other way now?

Furthermore, paragraph 14 of SAS 107 and Policy 2 of Statement on Quality Control Standards No. 7, Establishing and Maintaining a System of Quality Control for a Firm's Accounting and Auditing Practice, both require the firm to have the expertise necessary to properly perform the engagement. If you don't have the expertise, you're not independent. For example, Bernard Madoff has admitted to a $50 billion Ponzi scheme. The auditor was a three-person firm? Thus, the situation rendered the firm unqualified to issue an opinion.

Guard against presumption of loss of independence

I can't tell you how many times I've had people in class say, "If we didn't let clients run small personal expenses through the company, we wouldn't have any clients." My reply is, "In other words, if you don't let your clients cheat on their income tax returns, you wouldn't have an accounting firm?"

Think about this, if you aren't willing to walk away, lose the client, and refuse to let a client cheat on the tax return, even if completely insignificant, how can you sign the opinion saying you're independent? Using this standard, are you or your partners or is your firm independent? It's a scary thought for the reliability of financial statements.

So what might be a solution?

The only real solution is to structure a system where the client does not pay for the audit. But the system will change only after there is another round of audit failures. And we find, again, that the current system does not work, and Congress mandates change in how audits are paid for (those options require another article).

Because of recent scandals about the reliability of drug testing, medical journal publishers have instituted strict disclosure of financial interests or other conflicts between scientists testing the drugs and the pharmaceutical manufacturers.

Do you think full and fair disclosure of drug testing conflicts is a good idea so that users, doctors, hospitals, the public, have independent test results? If so, why don't the AICPA and SEC require firms disclose in the opinion that the client paid for the audit? If we are so confident of our independence, why do we hide our relationship?

Will you do the right thing?

I know much of this conflicts with what has for some firms become acceptable practice. It's no different than breaking the law when you speed when driving. You rationalize your behavior. "I'm just keeping up with traffic. There aren't many cops around. I'm a really good driver. If I drive the speed limit I'll get run over." All those may be true. But it doesn't make speeding legal. And just because many clients do it doesn't make it legal.

It's that simple. You won't like this: If you have clients that will leave if you don't allow past behaviors, which puts the firm at risk? Whose fault is that?

What's the solution? Simply comply with our profession's requirement to be independent. If you don't, you've disqualified yourself from rendering an opinion, even if the numbers are right.

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