The north face inc accounting essay

Financial accountants and independent auditors commonly face challenging technical and ethical dilemmas while carrying out their professional responsibilities. This case profiles an accounting and financial reporting fraud orchestrated by the chief financial officer (CFO) of a major public company and his subordinates. The CFO, who was a CPA, took extreme measures to conceal the fraud from his company’s audit committee and independent auditors. Despite those measures, the independent auditors identified suspicious entries in the company’s accounting records that were a result of the CFO’s fraudulent scheme but did not properly investigate those items. Shortly before the fraud was publicly revealed, a partner of the company’s audit firm instructed his subordinates to alter prior year audit workpapers for the client to conceal improper decisions made by himself and his firm.

History

Hap Klopp founded North Face in the mid-1960s to provide a ready source of hiking and camping gear.

In 1970, North Face began designing and manufacturing its own line of products after opening a small factory in nearby Berkeley.

In 1980, North Face began sponsoring mountain-climbing expeditions across the globe. And North Face became the only supplier in the United States to offer a comprehensive collection of high-performance outerwear, skiwear, sleeping bags, packs and tents.

Challenges

Sales Growth vs. Quality Control

By the mid-1980s, North Face's overburdened manufacturing facilities could not satisfy the steadily growing demand for the company's merchandise or maintain the high quality production standards established by management.

New Era

In July 1996, a new management team took North Face public, listing the company's common stock on the NASDAQ exchange.

The management team established a goal of reaching annual sales of $1 billion by 2003.

Later when the actual revenues and profits of North Face failed to meet management's expectations, the company's chief financial officer (CFO) and vice president of sales booked a series of fraudulent sales transactions.

Barter for Success at North Face

In December 1997, North Face's CFO Christopher Crawford negotiated a $7. 8 million " sale" of excess inventory to a barter company in exchange for trade credits.

Crawford knew that the authoritative accounting literature generally precluded the recognition of revenue on such transactions.

Crawford, however, structured the transaction to recognize a profit on the trade credits.

An Oral " Side Agreement"

Crawford required the barter company to pay a portion of the trade credits in cash.

To further obscure the true nature of the large barter transaction, Crawford split it into two parts.

1. On December 29, 1997, a $5. 15 million sale recorded($3. 51 million in cash & $1. 64 million trade credit)

2. On January 8, 1998, the remaining $2. 65 million portion of the barter transaction was booked.

Consignments

In the third and fourth quarters of fiscal 1998, Todd Katz, North Face's vice president of sales, arranged two large sales to inflate the company's revenues, transactions that were actually consignments rather than consummated sales.

The first of these transactions involved $9. 3 million of merchandise " sold" to a small, apparel wholesaler in Texas.

Katz negotiated a similar $2. 6 million transaction with a small California wholesaler a few months later.

Erasing the Past

Richard Fiedelman served for several years as the " advisory" partner for the North Face audit engagement and during early 1998 served for a brief time as the audit engagement partner.

During the 1997 audit, the Deloitte audit engagement partner proposed an adjustment to reverse the portion of the $7. 8 million barter transaction recorded in December 1997 because he realized that the profit could not be recognized on a barter transaction when the seller is paid exclusively in " trade credits."

The Deloitte audit partner " passed" on the proposed adjustment since it did not have a material effect on North Face's 1997 financial statements.

While supervising the review of North Face's financial statements for the first quarter of 1998, Fiedelman allowed the company to improperly recognize profit on a portion of the $7. 8 million barter transaction booked in January 1998 for which North Face was paid exclusively in trade credits.

During the planning phase of the 1998 audit, Fiedelman convinced the new audit engagement partner that the prior year workpapers were wrong and that the previous audit partner had not concluded that it was not permissible for North Face to recognize profit on the 1997 portion of the barter transaction that involved strictly trade credits.

As a result of Fiedelman's guidance, the new audit partner did not propose an adjustment to reverse the January 1998 portion of the barter transaction that had been approved by Fiedelman.

Fiedelman's subordinates altered the 1997 workpapers to change the conclusion expressed by the 1997 audit engagement partner that North Face was not entitled to record profit on a sales transaction in which it was paid entirely in trade credits.

Consequences

The SEC sanctioned North Face’s CFO, the company’s vice-president of sales, and Richard Fiedelman for their roles in the North Face fraud.

Questions

1. Should auditors insist that their clients accept all proposed audit adjustments, even those that have an “ immaterial” effect on the given set of financial statements? Defend your answer.

No.

Clients are not prone to adopting auditor’s proposed audit adjustments, which forces auditors to somehow determine on an aggregate basis the impact that proposed and/or passed audit adjustments have on a client’s financial statements. The most common reason for a client not to make a proposed audit adjustment is that the client disagrees with the need for the given adjustment.

We don’t want to see that audit engagements ultimately become a tug-of-war between client management and auditors over proposed audit adjustments.

2. Should auditors take explicit measures to prevent their clients from discovering or becoming aware of the materiality thresholds used on individual audit engagements? Would it be feasible for auditors to conceal this information from their audit clients?

Yes. To the greatest extent possible, auditors should not provide clients with access to the critical parameters or facets of audit engagements, including materiality limits. According to this case, the CFO used the materiality to subvert the integrity of the entire audit engagement.

It is often not feasible to conceal information such as materiality limits from client personnel.

For example, auditors always have client personnel " pull" documents, prepare various schedules to which audit procedures will be applied, and perform other important audit-related tasks. In completing these tasks, client personnel can often determine the auditor's intent and/or the scope or materiality limit of a given audit test. Likewise, clients have access to the professional auditing literature and professional publications that discuss the general guidelines that auditors use in making important strategic decisions during the course of an audit, including the selection of materiality limits for individual accounts or financial statement items.

3. Identify the general principles or guidelines that dictate when companies are entitled to record revenue. How were these principles or guidelines violated by the $7. 8 million barter transaction and the two consignment sales discussed in this case?

According to FASB 605 Revenue Recognition

Revenues and gains are realized when products (goods or services), merchandise, or other assets are exchanged for cash or claims to cash. Revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues.

Generally, barter transactions in which a company receives trade credits in exchange for merchandise should be recorded at the fair value of the merchandises given up since the ultimate realizability or economic value of the trade credits is typically not determinable at the time of the exchange. So, even though the “ exchange” element of the revenue recognition principle is satisfied by such a transaction, the “ realized” element is not necessarily satisfied, meaning that any profit on the transaction should be deferred. In the case at hand, there was clearly some question as to the fair value of the excess merchandise that was being “ sold” to the barter company. A conservative treatment of the transaction might have dictated that a loss or writedown of the merchandise was actually the most appropriate accounting treatment for the transaction.

FASB 605-15-25 Sales of Product when Right of Return Exists prohibits a seller from recognizing revenue (or profit, of course) when the given customer can return the product and the ultimate payment to be received by the seller hinges on the customer reselling the product. Both features of the revenue recognition rule were violated by the decision of North Face to record the large consignment sales: there was not a true exchange since the two customers did not pay for the merchandise and the given transactions were not finalized until the customers resold the merchandise, meaning that the “ realized” requirement of the revenue recognition rule had not been satisfied.

4. Identify and briefly explain each of the principal objectives that auditors hope to accomplish by preparing audit workpapers. How were these objectives undermined by Deloitte's decision to alter North Face's 1997 workpapers?

According to AICPA AU Section 339. 03, audit documentation serves mainly to:

a. Provide the principal support for the auditor's report, including the representation regarding observance of the standards of fieldwork, which is implicit in the reference to generally accepted auditing standards.

b. Aid the auditor in the conduct and supervision of the audit.

Both of these objectives were undercut by the decision of the Deloitte auditors to alter North Face's 1997 audit workpapers.

First, by modifying the 1997 workpapers and not documenting the given revisions in those workpapers, the Deloitte auditors destroyed audit evidence, evidence that demonstrated that the 1997 audit team had properly investigated the authoritative literature relevant to barter transactions and proposed an audit adjustment consistent with the requirements of that literature.

Second, the alteration of the 1997 workpapers affected the decisions made on the 1998 audit. That is, the auditors during the 1998 audit relied on the apparent decisions made during the 1997 audit and thus reached an improper decision on the accounting treatment that would be appropriate for the barter transaction recorded by North Face in January 1998.

5. North Face’s management teams were criticized for strategic blunders that they made over the course of the company’s history. Do auditors have a responsibility to assess the quality of the key decisions made by client executives? Defend your answer.

Yes.

Major strategic blunders by client management can create an environment in which client executives and their key subordinates have a strong incentive to distort their entity’s accounting records and financial statements. More generally, the overall quality of top management’s decisions affects the “ inherent risk” present during a given audit.

Event though assessing the quality of key decisions made by client executives is not often seen as an explicit audit procedure within an audit program, auditors need to be aware that the competence of top management and the wide-ranging implications of that competence to all facets of an audit.