North face

Assignment 2: North Face Auditors are faced with the very difficult task of insuring the public, that in their opinion, the financial statements of their clients are accurate and free of any material misstatements. The problem is that materiality is a subjective figure. In the North Face case an immaterial revenue recognition entry ended up being material when compounded with additional misstatements. North Face was the perpetrator of the intentional misstatements but they were concealed by the Deloitte audit advisor, Richard Fiedelman.

Fiedelman allowed additional non-recognizable revenue to be posted and altered/replaced the original working papers that reported the original material misstatement. (Knapp, Rittenberg, Johnstone, & Gramling, 2012) Several generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS) were violated (In the Matter of Richard Fiedelman, 2003) resulting in declining stock prices and Security and Exchange Commission (SEC) sanctions. SEC Sanctioned Richard Fiedelman The SEC requires the all registrant working papers be reviewed by a partner that is not assigned to the engagement.

When the Deloitte concurring partner found the discrepancies and misstated revenue they investigated further leading to the review and the ultimate discovery of the altered working papers. North Face’s audit committee then retained a second accounting firm to investigate the accounting records which led to the SEC sanctioning Fiedelman. (Knapp, Rittenberg, Johnstone, & Gramling, 2012) 1. The SEC sanctioned Richard Fiedelman for failing to document the changes that his subordinates had made in 1997 North Face work papers and for failing to exercise due professional care.

Explain the SEC’s rational in making each of these allegations. The SEC found that Fiedelman violated GAAP by allowing recognition of profit margin on the second barter transition and violated GAAS 150, 230, 326, and 338. (In the Matter of Richard Fiedelman, 2003) Failing to Document Work Paper Changes Per the several GAAS violations the SEC was right to sanction Fiedelman for failing to document the changes made to North Face working papers. AU 338 (339A) directs auditors on the importance of working papers.

Working papers are the “ principal record of the work that the auditor has done and the conclusions that are reached concerning significant matters. ” (Public Company Accounitng Oversight Board, 1982) The working papers help insure that the audit engagement has been properly planned and adequately supervised. It is also the record of the audit evidence and procedures applied to the audit. Fiedelman also violated Auditing Standard No. 3 which is very clear that any changes must be documented. “ Circumstances may require additions to audit documentation after the report release date.

Audit documentation must not be deleted or discarded after the documentation completion date, however, information may be added. Any documentation added must indicate the date the information was added, the name of the person who prepared the additional documentation, and the reason for adding it. ” (Public Accounting Oversight Board, 2004-06) When Fiedelman revised the 1997 work papers without the proper documentation he violated Standard No. 3 justifying the SEC sanction. Failing to Exercise Due Professional Care Fiedelman violated AU 150 and AU 326, failing to execute due professional care.

AU 150 states that “ due professional care is to be exercised in the performance of the audit and the preparation of the report. ” (Public Accounitng Oversight Board, 2001) AU 230 explains that due professional care is “ employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and if his pretentions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. ” It does state however that no one is free of error.

Due professional care does not intend work to be free of error but free of negligence. (Public Accouniting Oversighe Board, 1972) Fiedelman violated the due professional care standard when he allowed the misstatement and margin recognition to be posted. The misstatement was already noted but he himself should have been aware that the margin was not permitted and that the misstatement should have been corrected. It is also concerning that the increased sales from $90, 000 to $3. 9 million was not investigated more thoroughly, again indicating Fiedelmans lack of due professional care.

Fiedelman also violated AU 326 Evidential Matter. With the violations of so many auditing standards the SEC had no other choice but to sanction Fiedelman. (Knapp, Rittenberg, Johnstone, & Gramling, 2012) If there is no punishment for altering working papers auditors would fear no repercussions and they would alter the papers whenever they wanted reducing the public’s assurance offinancial statementaccuracy SEC’s Punishment The SEC punished Fiedelman by suspending him from being involved with audits of SEC clients for three years. 2.

Take a position on the severity of the SEC's punishment of Richard Fiedelman of a three year suspension on being involved in the audits of SEC clients, support your position. The punishment was fair. Theresponsibilityof an auditor is to insure financial statement users that they are free of any material misstatements. In this case Fiedelman made a conscious choice to allow North Face to post margin that should not have been realized, per GAAP. Fiedelman should not be allowed to practice with a public accounting firm until the SEC feels that he will not allow the same misstatements to happen again. In the Matter of Richard Fiedelman, 2003) In order to insure the public that the auditing profession is reliable this kind of punishment is necessary. Each case should be reviewed on an individual basis and if there is any question that the auditor will continue to allow misstatements they should be suspended from being involved with SEC clients. Modify Client Work Papers The PCAOB has very specific instructions that any additions or changes to audit documentation after the release date need to be documented. 3. Assuming that you are an audit manager in a public accounting firm.

The engagement partner asks you to modify client work papers after the financial statements and opinion has been issued. Determine what you would do in this situation. Provide your rationale. If the partner is not asking me to hide the modification and the modification is necessary, per GAAP or audit principals, then I would make the modification. If the client partner is asking to have the papers modified without documentation, or the modification should not be done, I would not modify the work papers. Auditing standard No. 3 clearly states that any modification needs to be documented. Public Accounting Oversight Board, 2004-06) In the North Face case it does not indicate the personnel that altered the work papers were reprimanded, (Knapp, Rittenberg, Johnstone, & Gramling, 2012) however as a manger if it is discovered that you altered work papers without documentation or necessity, even if there were no legal repercussions, it would hurt your reputation and ultimately affect yourcareer. The decision analysis framework could be used in determining if it is necessary to notify another audit partner or the client audit committee about the request.

I would not alter the papers but if no one is made aware of the advisor’s request they may get someone else to alter the work papers. In this case morality and ethics should be enough to prevent a manger from altering work papers, but it helps to have punishments in place to help deter unethical actions. Materiality Public accountants generally use qualitative analysis to determine the appropriate level of material misstatements. 4. Evaluate the practice of “ materiality” used by public accounting firms and how accounting firms should address it with clients. Materiality is based on the assumption a reasonable investor would not be influenced in investment decisions by a fluctuation in net income less than or equal to 5%. This “ 5% rule” remains the fundamental basis for working materiality estimates. ” (Vorhies, 2005) Since materiality is based on the fact that investors would not be influenced when immaterial misstatements are found, if the numbers of immaterial misstatements are small they will not prevent an unqualified audit opinion.

Large misstatements and a large number of small misstatements that could be considered one misstatement need to be corrected before an unqualified opinion can be issued. Since all misstatements are presented to management and the audit committee, how the misstatements need to be addressed should be discussed with them at that time on. If they refuse to make the corrections the auditor should refuse to issue an unqualified audit opinion. (Vorhies, 2005) It is important to remember that every misstatement needs to be analyzed for materiality.

A small misstatement may not seem relevant but may be an indication of a larger aggregate or future misstatement. (Public Coumpany Accounting Oversight Board, 2010) North Face Management Auditors are not required to criticize key decisions made by their clients management team, that does not mean they should not use due professional care when analyzing management behavior. 5. North Face’s management teams were criticized for strategic blunders that they made over the course of the company’s history. Discuss whether auditors have a responsibility to assess the quality of the key decisions made by client executives.

Defend your answer. When auditors are evaluating audit risks there are certain behaviors that should be analyzed. If management is refusing to cooperate, meet with, or puts unusual time constraints on the audit team it could indicate fraud. It is also important for the audit team to monitor management’s tolerance of violations of the company’s code of conduct, inconsistent accounting practices, or frequent changes to estimates for no reason. (Public Compaany Accouning Oversight Board, 2010) These can be key indications of management’s character and ethics.

In the case of North Face since management established a goal to reach $1 billion in sales the audit team should have been more critical of the sales, revenue, and margin that were posted. The audit manager should have used due professional care when analyzing the fact that North Face was having a hard time mainstreaming their product yet implemented this lofty goal. If fraud was going to occur it would likely be in the revenue/sales area. The first auditor engagement partner did catch the material misstatement but had these other considerations been taken into account the misstatement may have been investigated further.

Even though it is not the responsibility of auditors to assess the quality of key decisions, by doing so they can gain valuable insight into how management thinks. Conclusion When auditing firms find financial misstatements it is important that they understand the materiality and reason behind the misstatements. The good thing that came out of this case is that the system worked. When the concurring partner reviewed the audit work papers the misstatement and revision was detected. The SEC sanctioned those responsible and even though the investors were affected they should feel some certainty that the system worked.

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