Managing Difficult Financial Reporting Situations

By P. Woodbridge Wallace, Marco Carducci, Daniel C. Dipillo

Frequently, problems occur as a reporting deadline is imminent.

In recent years, financial news has been filled with a litany of misdeeds, including allegations of inappropriate financial asset valuations, insider trading abuses, financial fraud, bribery allegations of government officials, fraud related to mutual funds, stock option backdating and record levels of financial statement restatements. Any one of these events can not only cause a significant disruption to a bank but also lead to difficult financial reporting situations. In this article, we provide an overview of actions management and audit committees can take to manage these difficult financial reporting situations. We specifically discuss investigating potential accounting errors that may involve misconduct and evaluating materiality when a financial statement error is identified.

Investigations of Potential Accounting Errors That May Involve Misconduct

When a potential accounting error is discovered, the bank needs to assess the nature of the error and whether misconduct was involved. In many instances, this determination is very simple and the error is determined to be inadvertent. In other situations, there may be allegations of management or employee wrongdoing. In those cases, the bank has an obligation to its constituents to determine the veracity, nature and magnitude of any alleged misstatement and to perform appropriate remediation, if necessary. When the process is not managed properly, investigating the alleged wrongdoings can become a long, time-consuming process for the bank and costly for its shareholders.

When an alleged wrongdoing has surfaced, the bank should quickly assess the merits of the allegation to determine the most expeditious means to resolve it. Because not all wrongdoings are created equal, the audit committee, in consultation with general counsel, senior management (when appropriate) and external legal counsel, will need to assess the nature and extent of the allegation in order to conclude what is the most effective approach to resolve the matter. The appropriateness of the type of investigation that will be employed by the audit committee will be based on facts and circumstances; there is no standard response that will fit every situation. The audit committee may elect to conduct its own investigation, using the internal audit function or the office of the general counsel, or it may engage independent external legal counsel to conduct a generic internal investigation or to conduct a full-blown Section 10A investigation. Regardless of the type of investigation selected by the audit committee, the overarching goal is to conduct a sufficiently robust and independent inquiry into the allegation.

The remainder of this segment of the article focuses specifically on those situations where the audit committee undertakes a Section 10A investigation.

P. Woodbridge Wallace is a Partner at PricewaterhouseCoopers, New York, New York. Contact him at woody.wallace@us.pwc.com.

Marco Carducci is a Senior Manager at PricewaterhouseCoopers, Florham Park, New Jersey. Contact him at marco.carducci@us.pwc.com.

Daniel C. DiPillo is a Senior Manager at PricewaterhouseCoopers, Florham Park, New Jersey. Contact him at daniel.c.dipillo@us.pwc.com.

Section 10A of the Securities Exchange Act of 1934 was enacted as part of the Private Securities Litigation Reform Act of 1995.[1] Section 10A broadly defines an illegal act to mean "an act or omission that violates any law, or any rule or regulation having the force of law." Section 10A provides that each audit required by the Securities Exchange Act of 1934 of an issuer's financial statements include audit procedures that will provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts.

Misstatements are not immaterial simply because they may fall below certain quantitative thresholds.

If, during the course of an audit, an auditor finds evidence indicating that an illegal act has occurred or may have occurred or if the auditor is made aware of an alleged illegal act, *regardless of its materiality*, the auditor will need to take certain actions that include determining whether the illegal act was "likely" to have occurred and, if so, determining the possible effect on the financial statements. The auditor is also required to inform management of its findings and must be assured that the board of directors is adequately informed of the alleged illegal act. If, in the auditors' view, the board does not take timely and appropriate remedial action or if the auditor believes the remedial action is not appropriate, the auditor must report this conclusion to the board of directors. At this point, the bank has one business day to notify the Securities and Exchange Commission (SEC) of the auditor's conclusion that senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial actions with respect to the illegal act. Since the enactment of Section 10A, this outcome has been exceedingly rare.

In the typical circumstance, both the bank and the auditor will favor engaging an external law firm to evaluate any potential illegality. That is because not only are auditors not usually trained to investigate and opine on the legality of corporate conduct, but also engaging external counsel will often preserve the confidentiality of certain portions of the inquiry and its results (as a consequence of both the attorney-client communication privilege and the work product doctrine). Because the auditor has ultimate responsibility to express an opinion on the financial statements, the auditor must be well connected throughout the investigation, and due consideration should be given to the views expressed by the auditor throughout the investigation process.

Because Section 10A imposes affirmative investigatory and disclosure requirements directly on auditors, Section 10A is sometimes referred to as the accountants' whistle-blower statute. In today's environment, illegal acts can surface by allegations of a whistle-blower, new information from lawsuit allegations, SEC comment letters, press reports or during the normal course of executing audit procedures.

Over the past several years, the term "10A investigation" has struck fear into the minds of management, directors and shareholders as a result of the time-consuming and costly process for investigating an alleged illegal act. Additionally, 10A investigations can distract valuable senior management resources from effectively managing the business and may delay the issuance of financial statements, which may limit a bank from accessing the capital markets. For these reasons, when a full-blown 10A investigation is determined to be necessary, the first step in the process is to have the independent directors of the audit committee take responsibility for assessing the merits of the allegation. The audit committee should take a great deal of care in determining the appropriate strategy for timely resolution. The audit committee will need to be actively engaged in managing and overseeing the 10A investigation process from beginning to end.

During a 10A investigation, care must be taken to ensure the investigation is carried out effectively and is not ultimately rendered unreliable to the auditors or the regulator(s). As a result of the auditor's professional responsibility under both Section 10A and relevant audit standards, an important step in the planning phase of an investigation should be for the audit committee to obtain and consider the views of its independent auditor. As previously noted, because the auditor has ultimate responsibility to express an opinion on the financial statements, this critical step is needed early in the planning phase of the investigation to ensure that the auditors are comfortable with the identity of the proposed investigators, the planned scope of the investigation, the conclusions reached and any remedial actions undertaken in response. To avoid the appearance that the investigation is biased and not objective, the investigators assigned to the engagement should generally be independent. The external law firm, when deemed necessary, should usually be engaged by the audit committee, have no prior history of reporting to the bank nor plan to represent the bank in defense of future litigation or government investigation related to the matter. A competent investigation team may be enhanced by involving specialists to provide accounting, forensic and other expert (for example, actuarial) assistance.

A critical function of the audit committee is to ensure the investigation does not become tainted or unreliable. A common pitfall occurs when the scope is not adequate (either too broad or too narrow) or is intentionally and inappropriately limited. Once the initial scope is set and agreed to with the bank's independent auditor, periodic discussions should be held between the audit committee, the investigator and the auditor to determine whether the scope remains adequate or whether the scope needs to be reduced or expanded.

An effective investigatory scope typically gives the investigative team latitude to address any evidence of potential improprieties discovered during the investigation, no matter where it may lead. At the same time, the audit committee should ensure the investigation team remains within the parameters of the defined scope of the investigation and manage against unnecessary "scope creep." As the investigation progresses, the audit committee may need to manage against any unwarranted management interference in the investigation process so as not to compromise any conclusions reached. The audit committee should also ensure that executives or employees potentially involved in the alleged wrongdoing are not informed as to the investigative process or tentative results. As an investigation may become time-consuming, the audit committee should ensure that the investigation is not compromised by management pressure, upcoming reporting deadlines or other limiting factors. In addition, throughout the investigative process, the audit committee will need to carefully monitor the results of the investigation for possible required public disclosures.

As a result of the auditor's professional responsibility under both Section 10A and relevant audit standards, an important step in the planning phase of an investigation should be for the audit committee to obtain and consider the views of its independent auditor.

The overarching goal at the completion of an investigation is to ensure that results/findings are supported by the facts and that the remedial actions contained in the investigation report are clear and not ambiguous.

At the completion of the investigation, the results will need to be reviewed with the bank's independent auditor. As part of an auditor's professional responsibility, the auditor will need to perform procedures to evaluate the quality and effectiveness of the investigation, including ensuring the conclusions reached and remediation plans identified are appropriate and that reports/findings are consistent with the results of the work performed.

As a result of the breadth and depth of a 10A investigation, banks must remain focused in order to eliminate or minimize distractions to its business. The audit committee overseeing the investigation plays a pivotal role in navigating a 10A investigation to a successful completion, thus allowing senior management to focus on running the business.

Evaluating Materiality of Financial Statement Errors

Even when Section 10A investigations identify an error in the bank's financial statements, errors are often not the result of misconduct but instead often reflect inadvertent misapplication of generally accepted accounting principles (GAAP) or a clerical error. Over the past several years, the complexity of financial reporting has grown in tandem with the evolving complexity of the business environment.

When an error is identified, management is required to determine if the error is "material" to the previously issued financial statements. Materiality is a highly subjective matter, and the determination of whether an item is material requires management to exercise significant judgment. The U.S. Supreme Court has stated that an item is generally considered to be material if there is a substantial likelihood that a reasonable investor would view it as significantly altering the "total mix" of available information.

To guide a bank in reaching its conclusion regarding the materiality of an error, the SEC issued Staff Accounting Bulletin No. 99 (SAB-99). SAB-99 expresses the views of the staff that exclusive reliance on certain quantitative benchmarks (that is, five percent of pretax income in the absence of particularly egregious circumstances, such as self-dealing or misappropriation by senior management) to assess materiality in preparing financial statements is inappropriate; misstatements are not immaterial simply because they fall beneath a numerical threshold. An evaluation of an error requires thoughtful, robust and contemporaneous documentation by management of the facts and circumstances surrounding the error. Management must consider all relevant quantitative and qualitative circumstances resulting in the misstatement.

The start of any effective analysis of materiality under SAB-99 begins with a summary of the accounting issue in question and why the bank has determined that an error exists. This summary should include a description of the issue as well as the financial data necessary to frame the issue and help in understanding the relevance of the error to the bank's financial information. Management should then fully evaluate the relevant accounting literature surrounding the issue and develop a position regarding the appropriate application of the relevant accounting literature and how this application presents a different result in the bank's financial information.

Once management has determined its accounting position and reached a conclusion that an error exists, management should perform a thorough quantitative analysis in accordance with SEC-issued SAB-108. The quantitative analysis should evaluate the magnitude of the error to each individual financial statement line item and in the aggregate using the "iron curtain" approach and the "rollover approach" as outlined in SAB-108. Management then needs to formulate a judgment as to whether any significant financial statement amounts or disclosures are "materially impacted" by the error. This analysis should consider both the dollar amount and percentage impact of the error.

Generally, a robust quantitative analysis will include, at a minimum, all significant financial statement line items (including amounts in the income statement, balance sheet, cash flow statement, other comprehensive income and earnings per share) reported by the bank, comparing the "as reported" amounts to the "as restated" amounts after consideration of the errors. The quantitative analysis should also consider the impact on any reported segment disclosures, other quantitative disclosures included in the notes to the financial statements and quarterly reported data. Management's analysis should also consider the impact of any errors identified on other publicly disseminated key performance indicators that may be affected by the error identified during the review.

While SAB-99 recognizes that the starting point for assessing materiality is the quantitative impact of misstatements on the financial statements, it also emphasizes that misstatements are not immaterial simply because they may fall below certain quantitative thresholds used by management as a starting point to evaluate materiality. Management must also perform a thorough analysis of qualitative factors as well to determine if the impact of the error may be misleading to a reader or user of the financial statements.

SAB-99 discusses a listing of qualitative materiality considerations that should be addressed by management during the course of its materiality assessment. Among these factors, management should evaluate whether the error masks a change in earnings or other key trends of the bank. A financial statement error that may be quantitatively immaterial may alter a significant trend in the bank's results of operations and therefore be an important consideration to users of the financial statements. In particular, management should carefully evaluate how an error may affect the bank's performance compared to analysts' consensus and/or other financial statement users' expectations, as a bank's performance in relation to these estimates may have an impact on the bank's stock price. Management should also consider whether the error changes a reported profit into a loss or vice versa; whether the error concerns a segment or other portion of the bank's business that has been identified as playing a significant role in the bank's operations or profitability; whether the error affects the bank's compliance with regulatory requirements, debt covenants or contractual agreements; whether the error affects the calculation of management compensation for the period; or whether the error involves the concealment of an unlawful transaction.

The determination of what constitutes a material error is a matter of considerable judgement and may vary based on the specific facts and circumstances of the situation and the error involved. Ultimately, management must evaluate all of the quantitative and qualitative factors outlined above to determine if they believe the impact of the error would alter the "total mix" of available information to an investor or user of the bank's financial statements. Typically, management will review and validate its conclusion with the bank's audit committee and, in some cases, outside counsel. While the ultimate judgment surrounding the materiality conclusion rests with management, the bank's auditors must also review that judgment and concur with it.

While the process outlined above is not an easy one, the importance of a robust and well-documented materiality assessment when evaluating the potential impact of an error cannot be underestimated. The SEC may request further documentation from a bank surrounding its analysis of a particular error and in those cases will expect that the bank provide this analysis in a thorough, well-documented and contemporaneous manner.

Detailed Assessment Is Crucial

Despite the numerous precautions a bank may take, such as significant investment in internal controls over financial reporting and strong management oversight, it can sometimes find itself in the midst of a difficult financial reporting situation. In many instances, these situations can be very stressful as an imminent reporting deadline is approaching. Therefore, management should develop a well-thought-out execution plan in order to work through the issue. This includes a detailed assessment of the situation and the steps necessary to evaluate the facts and circumstances, gaining a deep understanding of the facts, involving the proper individuals (including the board of directors, audit committee and external counsel, as necessary) and communicating both internally and to the investing public effectively throughout the process. Taking these steps when faced with a difficult financial reporting challenge can help to ensure a well-thought-out answer and a successful conclusion to the issue for management, the bank and its constituents.

Endnote

1 Where a Bank is not subject to the requirements of the Securities Exchange Act of 1934, the audit committee will generally want to conduct sufficiently robust and independent inquiry into allegations of wrong doings prior to the issuance of the bank's financial statements.