The Risk to Me if Something Goes Wrong!

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A friend ("George") was fond of relating a story about a golf outing that included he and several colleagues. Among the group were two school superintendents, himself, his boss ("Ed"), and one other person from his place of business. The story goes like this.

Having played with Ed numerous times, and only playing with Ed because it was expected of him, George was aware that Ed had a tendency to "forget" strokes, "find" lost balls, etc. So on this one particular tee, a hole that required your drive to carry about 150 yards of water, George teed up and hit first. His ball cleared the water and Ed teed up next. Ed's ball hit the water about 125 yards out and Ed picked up his tee and walked back to the cart. Thinking Ed was going to the cart to retrieve another ball, everyone else hit and all cleared the water. After the last player hit, they all looked over at Ed and he was sitting in the cart, waiting patiently. George asked him if he was going to hit another ball and Ed said, "no, that one skipped out of the water and came out on the fairway". Of course George didn't say anything, he just got in the cart and drove around the lake.

When they arrived on the other side, they easily found four balls but the fifth, Ed's ball, was nowhere to be found. George recalls, "it really was the strangest feeling, driving back and forth across the fairway, walking, searching for a ball that we all knew wasn't there. We all, except Ed, knew where the ball was. It was at the bottom of the lake. But suddenly, miraculously, there it was, right where it had stopped rolling after skipping out of the water. It didn't matter that the ball had magically changed its number on its flight. What mattered was that we could all relax. The ball had been found."

At a construction industry conference several years ago, a fellow attendee related the following anecdote. As he told the story, I couldn't help but think about George and Ed and the golf ball skipping out of the water. His story has to do with a financial statement audit of a large general contractor. Putting his tale in the first person, it goes like this.

On this particular audit I was the in-charge which meant I was the staffer, the senior, the in-charge, and the supervisor. Of course one partner was responsible for the client.

Earlier that year I had attended an out of state class on IDEA, a data mining software just being implemented by the firm, and because no one else in the firm had ever used it, in fact most of the firm hadn't even heard of it, I was the de facto "expert". So I put it to good use on this new, large construction client.

I used IDEA to run Benford's Law analytics as well as performing an analysis of journal entries and transfers. Using IDEA, I noted numerous large general journal entries that reduced job cost on several completed jobs and increased job cost on several jobs in progress. The transfers were in even amounts such as $250,000, $300,000, etc. Curiously, along with the journal entries, there were corresponding adjustments to Estimated Cost to Complete on the affected jobs in progress that maintained the original estimated gross profit.

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Now, I was well aware of the math involved and quickly realized that the other accounts involved were Job Revenue and Excess Costs and Earnings on Contracts in Progress ("under billings"). After reviewing the entries with the client's controller and not hearing a satisfactory explanation, in fact a somewhat convoluted explanation, I moved the question up the ladder to the owner. Not realizing that the accountant had already made the owner aware of my concerns, I met with the owner to hear his explanation which was quite simple. The transferred costs consisted of payroll costs for project managers, etc., who had worked on the new jobs in progress but had continued to be paid from the completed jobs. Thus, at year end, the company cleaned up all these pending issues and made the transfers. When asked for specifics such as, "Who was the project manager? How many weeks did the project manager work on the new job? Are payroll taxes included in the amounts being transferred?", the owner replied that they didn't keep such detailed records. Finally, the final gross profit on each completed contract, after transfers of job costs to contracts in progress, were all very close and all *very near the original estimated gross profit per the takeoff.*

I was not sold. In fact, as I sat there in the owner's office, hearing his explanation of the issue, I was careful to remain expressionless lest the owner notice my feelings about his story, that it was a complete fabrication. That evening I took all the related workpapers back to the office and discussed the matter with the partner. He was less inclined than I to proclaim the story a fabrication so the next day we both returned to the client's office to discuss the matter with the owner. He related the same explanation and after our meeting, the partner and I met in the conference room and went over our notes. The partner's telling comment was, "he wants his colleagues and others to believe he's an "A" player but he's not. So he arranges it so he looks to be an "A" player." Despite that spot on comment, at the end of our discussion, the partner declared that, to him, the explanation seemed sufficiently reasonable despite the absence of any documentation to support it, we would accept it and document our discussion and conclusions and move on. Furthermore, we discussed the client, the client's year and his results of operations, the strength of the company, and the likelihood that the company would fail or get in trouble, either due to the transfers or some other unknown issue. In the partner's words, "this is a $60 million contractor, his working capital is $1,000,000, and his cash flow is positive. There is no risk."

So, to summarize, we had carefully planned our audit and taken care to complete all our front-of-file work correctly. We had designed our audit procedures using our front-of-file knowledge to identify areas of risk of material misstatement. We had performed our audit using those procedures as well as performing new procedures made possible by the use of our newest tool, IDEA. And the financial statements were materially misstated and everyone, us, the client, and his accountant knew it. Everyone that is except the actual users of the financial statements. Revenue and underbillings were both significantly overstated. Both the completed contracts and contracts in progress schedules were materially misstated, both from a financial standpoint and from a presentation standpoint. And we issued an unqualified opinion on the financial statements. Rather than taking care to issue an unqualified opinion on the financial statements because they truly were, in our opinion, free of material misstatement, we disregarded our own audit work and fell back on, to mollify the client, partner judgment regarding the client's ability to continue as a going concern. And we managed to do the same thing for the subsequent eight to ten years, until finally, because the client had a bad year, his balance sheet was not nearly so strong as before, and he was just so blatant in his reclassifications, we finally had to take a stand. And we lost the client when he managed to hire a firm whose risk tolerance was significantly higher than ours.

This is what is meant by the Risk to Me If Something Goes Wrong. The Risk to Me if Something Goes Wrong can be defined as, "in the partner's opinion, is the client sufficiently financially sound that it can continue operating, at least for the final six months before his next fiscal year end, and if, in the partner's judgment the answer is yes, then we're going to go ahead and issue an unqualified opinion on what we know are materially misstated financial statements. And we're going to do that just to keep the client. And we'll only take a stand when our tolerance for Risk to Me if Something Goes Wrong is exceeded by events on the ground."

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