Fire This CPA Partner!

For the last six years, you are a member of the Board of Diversified Technologies and also are on the Audit Committee. You have just left a meeting with the Audit Partner of the company’s CPA firm and your head is spinning. The CFO wants an answer. The Audit Partner wants an answer.

Your first instinct is to review your D&O insurance policy.

Your second instinct is to not want to think about the problem at all.

**Overview:**

Diversified Technologies is a Nasdaq listed public company with global operations and annual revenues of over $1 billion. The company’s suite of products are widely recognized as “best of class” serving all facets of the audio visual and media production industry-from large broadcast and media companies to individual artists.

Products are distributed thru multiple channels (direct, resellers, systems integrators) at wide varying price points.

The pace of change in the industry requires a large continued investment in the technology for the company to keep its “best of class” status. New entrants in the industry are offering alternative products (ie cloud based) and solutions that are putting pressure on the company’s revenues, margins and growth.

The company went public in the late 1990’s and was viewed favorably by investors as a high growth, attractive stock which enabled it to grow thru acquisitions and organically while attracting a strong management team.

The company began to see its growth taper off beginning in 2005 such that it underwent several restructurings and consolidations. By 2010, its growth rate was less than the 5% and it was marginally profitable.

The management teams had gone through changes from its original management team and the last team had more of a financial and operational restructuring background.

The board of directors had morphed from its original founders and investors to more professional members although none had deep industry related skills. They were principally engaged with the company thru quarterly board meetings but did not spend significant time with the management team throughout the year.

During the high growth years, the company focused on R&D. The finance function was under-invested and “good enough” was good enough.

This philosophy is catching up with the company.

As a public company, auditors have identified weaknesses in internal controls by its auditors in the area of revenue recognition, inventory, stock options, income taxes and consolidations. Constant changes in the management team and the prioritization of other more pressing business issues always kept addressing these items on the “back burner”.

**The Board Replaces the CPA Firm:**

Even though there were no formal disagreements, tension started between the company and its auditors over these issues and other matters including the level of fees such that the company recommended. The Audit Committee approved a change in auditors in 2007 from one big 4 firm to another.

None of these internal control issues were completely addressed.

Diversified Technologies and its new auditors were still challenged by the impact they had on meeting SEC reporting deadlines and the constant impact of “old matters”. Each year end audit identified at least one matter that caused significant concern over the possibility of a restatement of previously reported results for an accounting error. The impact was always on the edge of being material but fortunately the company and its auditors were able to fix the impact of the error without restating prior year reported results. The audit committee was frustrated that these items kept coming up and tried to get management to get ahead of the items. However, the priorities of the company along with constant changes in the accounting and finance team never seem to get them caught up.

Under the SEC independence rules, the audit partner is required to rotate off after performing audit services for the company for 5 years. The company was going thru another restructuring in 2012 and the audit committee did not want to create more challenges by switching audit firms after the current partner rotated off. They interviewed two candidates from the existing firm and agreed on the firm’s choice of one of the candidates.

The new audit partner worked a year in transition and then began to serve as the lead partner. As noted previously, the company had numerous channels of distribution for its products and service.

There were numerous judgments that were made in concluding on the appropriate revenue recognition model to be utilized and the auditors tested and relied on those key assumptions in performing their work. Certain of these judgments required input from people outside of the accounting and finance team to understand how significant the impact could be of various customer deliverables or obligations on the ultimate timing of recognizing revenue. The audit partner increased the awareness of the audit committee to the sensitivity of these judgments in each of the quarterly and annual meetings along with emphasizing the need for the company to put more focus on the lingering issues. The audit committee recommended to the CEO that a new CFO might be needed given that the existing CFO had not made much progress in the process and systems over the past 5 years and thus, a new CFO was hired.

**New CFO Arrives:**

This year, the company hired a new CFO, the third in six years. This CFO has deep accounting skills and was more used to the complex judgments that were inherent in the company’s revenue recognition model. As part of the quarterly close process, he expressed concern to the Audit Committee about the deterioration in the aging of the company’s accounts receivables.

CFO became aware that the company had committed to various large customers product upgrades that were expected but not likely to be delivered until the next year at the earliest. He also discovered that the company had a practice of calling these upgrades “extended warranty” vs. an upgrade which had the impact of the company not having to defer any of the revenue upon the initial sale for this undelivered element. This practice had evolved over the years and had not been revisited as the company’s product offerings became more complicated, the customers became more insistent on deliverables under the product roadmap and the constant changeover in personnel.

All parties all agreed that there had been an error in the accounting and its impact was material and impacted prior year reported information. The audit committee was informed, and the company issued a press release and made an SEC filing to announce that there were errors in the accounting for certain revenue arrangements, that the matters were still under review but that prior year amounts would need to be restated.

You are on the audit committee of Diversified and the CFO has brought up that he does not trust that the audit partner is the right person to handle the restatement process in an efficient and timely manner.

**The Audit Partner Meets the Audit Committee in Executive Session:**

In executive session, the audit partner has expressed concern over the way in which the CFO has approached the restatement process. He feels that the CFO is looking to find a shortcut method to get to answers. He wants the audit committee to support his recommended approach.

How would you handle the situation? What questions would you ask?