The Board of a Public Company Confronts Dysfunction Between the Audit Committee, Management, and the External Auditors.

By George Neble

Diversified Technologies is a Nasdaq listed public company with global operations and annual revenues of over $1 billion. The company’s suite of products is 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.

Its technical products are distributed thru multiple channels (direct, resellers, systems integrators) at wide varying price points. Further 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. Various new entrants in the industry are offering alternative products 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. It underwent several restructurings and consolidations. By 2010, its growth rate was less than the 5% and it was marginally profitable.

In other words, Diversified Technologies is a public company without a great story for investors.

**The Management Team.**

The management teams had gone thru a few 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.

The company’s internal control environment was thought by the Chair of the Audit Committee as barely satisfactory. During the high growth years, the company never invested in the finance team in terms of its systems, people and processes. Its financial closing process was challenging, and the company had numerous 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 this weak internal control group on the “back burner”. Even though there were no formal disagreements, tension started between the company and its outside CPA firm partners over these issues and other matters.

The CPA firm was one of the Big Four. And the CFO expressed frequent concern about the fees charged. A highly qualified regional firm could do a sufficient job while charging less.

In 2007, the Audit Committee reviewed the CFO’s concerns and elected to approve a change in auditors from Big Four A to Big Four B. It rejected the CFO’s idea of a regional CPA firm to do outside audit of a global public company.

The Partner in charge of Big Four B’s audit team to Diversified Industries is Robin Good. Robin and her team are also finding problems with the internal audit team. SEC deadlines are being missed and “old matters” have not been resolved.

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.

Frank Wren Enters the Picture.

Under the SEC independence rules, Robin Good was 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 partners from Big Four B and selected Partner Frank Wren.

Frank 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 services. Each channel had different but also significant accounting implications particularly in revenue recognition.

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.

Frank 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 unresolved issues.

Things remained unresolved. Finally, the audit committee recommended to the CEO that the company required new leadership of the finance function since the CFO had failed to make sufficient progress outstanding audit concerns.

At the Board’s urging, the CEO fired the CFO and hired a new leader named Jennifer Liu.

Jennifer came to Diversified with 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, Jennifer was concerned about the deterioration in the aging of the company’s accounts receivables and spent time with the customer service and implementation team to understand any issues that might be holding up payment from the customers.

It was during these meetings she 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.

She 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.

Jennifer discussed this issue with Audit Partner Frank Wren. They both agreed on a course of action to jointly discuss the issue with the Audit Committee.

The 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. It made an SEC filing to announce that there were errors in the accounting for certain revenue arrangements. Prior year amounts would need to be restated.

You are on the audit committee of Diversified. Jennifer has asked you for a phone call. During the call, she brings up the issue that she does not believe Frank Wren to be the right person to handle the restatement process in an efficient and timely manner.

You cringe. Last night in executive session, Frank Wren expressed concern over the way Jennifer Lin has approached the restatement process. He feels that Jennifer is looking to find a shortcut method to get to answers.

Frank’s position is that the Audit Committee insist that Jennifer insist on a thorough process. The goal is to correct the errors of the past and to ensure the probability of similar errors in the future is reduced.

You are aware that there is escalating tensions between the company and its auditors.

You expect the CEO to back his new CFO. You fear further delays in reporting could cause a Nasdaq delisting and potential shareholder litigation.

How would you handle the situation?