

Transparency in Financial Reporting – An Expectation Gap Problem

Professional standards (SAS 32) require that financial statement disclosures should be “adequate” – whatever that means. SAS-32 is a perfect example of where significant expectation gap problems can arise in an engagement failure circumstance. What might seem “adequate” to one might seem completely inadequate to another – and will likely seem inadequate to any plaintiff’s attorney. In most of the malpractice cases that we have personally consulted on, the “inadequacy” of the note disclosures has been a major factor. Several major pitfalls exist for the practitioner in determining what constitutes adequate disclosure including:



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1. “Adequate”, is in the eye of the beholder. To properly assess adequacy of financial disclosures, the auditor has to put himself in the shoes of at least the major stakeholders.
2. The auditor does not typically draft the financial statements or the notes. If an auditor does not like a particular disclosure, he is left with threatening to qualify his opinion. As a result, he is likely to give great leeway to a client, or possibly minimize the perceived impact of “inadequate” disclosure because the cost of qualifying an opinion is so high.
3. An adverse selection process applies to “inadequate” note disclosures. Inadequate disclosures are more likely to occur in circumstances where an engagement failure is possible. For example, a client may not want to “red flag” potential problems for creditors or investors to see. Precisely the circumstances where these parties should be provided with the information that will allow them to identify red flags.
4. Client lawyers who review the note disclosures typically want only the minimum amount of disclosures necessary to comply with the letter of the applicable requirements.
5. The concept of materiality cannot readily be applied to financial statement notes disclosures. One might be able to describe a contingency circumstance in one way that is technically true, but at the same time such disclosures could be completely misleading.

What the Standard (SAS – 32) Requires

Put simply, the standard says that an auditor should use his professional judgment to determine whether the disclosure in the financial statement is adequate. This judgment is to take into account the format of the statements, how items are arranged, specific disclosure content, the terminology used, and the classification of the items within the financial statements. In other words, there exists little guidance other than what is specifically required by individual sections of GAAS and GAAP.

What Practitioners Need to Think About

We would recommend practitioners voluntarily use a higher and broader standard than “adequate”. A higher and broader standard would be more consistent with the ethical principles that guide the profession. For example, Article II of the Code of Professional Conduct states that, “Members should accept the obligation to act in a way that will serve the public interest, honor the public trust and demonstrate a commitment to professionalism”. We would suggest a standard that embodies these principles. The disclosures taken together should serve the public interest and honor the public trust. In many cases this will mean evaluating disclosures from the perspective of someone who is a financial statement reader. Any auditor that takes this approach to financial statement disclosures will find little difficulty in evaluating such disclosures.

Mark L. Cheffers, CPA, ABV, is the founder of www.AccountingMalpractice.com, a specialty education and research service that provides “next generation” loss prevention resources and alerts to more than 20,000 practitioners. He is a former PWC manager, Harvard MBA and highly experienced litigation consultant. He can be reached by phone at (508) 476-7007 ext 23 or by email at mcheffers@ivesinc.com

Jeffrey R. Bourassa is the Chief Research Analyst at www.AccountingMalpractice.com. He can be reached by phone at (508) 467-7007 ext 31 or by email at Jbourassa@ivesinc.com.