The Ethics of Accrual Accounting

By Len Griehs

“We’ve got a problem,” said controller Tom Counter to Joe Market, IRO for Polish Pickles, Inc. “I just met with our boss, Bill Numbers (chief financial officer), to let him know that we’ve discovered an under-accrual for marketing expenditures for the just-announced second quarter. Theoretically, it means the EPS for the quarter was overstated by about 3 cents a share. However, I don’t think that’s the case. You’ll be getting a call soon. We’re getting the Disclosure Controls Committee together.” He hung up the phone abruptly.

A knot formed in Joe’s stomach. “Great,” he thought. “We beat analyst estimates for the quarter by 4 cents, and the stock went up almost 15 percent. If we have to disclose an error, we’ll look like we’re a few pickles short of a jar, and the stock could plummet. My stock options will return underwater, and the credibility we’ve built with the new management team the past two years will be shot.”

The next morning, the disclosure committee assembled. It consisted of the controller (who was also chair of the committee), the IRO, chief legal counsel, internal SEC attorney, vice president of corporate audit, corporate secretary and associate general counsel, who kept the minutes and filed the 10-Q’s. The two-year-old committee, formed as a result of Sarbanes-Oxley, was facing its toughest decision.

Everyone knew the situation: The 10-Q was due to be filed in two days. That made the ethical situation even tougher: Would this need to be a “subsequent event” so that investors would know even if there were no restatement? Should the outside auditors and the audit committee of the board be informed?

Joe knew he would bear the brunt of criticism from the investment community. That was part of the job. He also knew the importance that the committee would place on his judgment with regard to the numbers. Although the disclosure issue would be clear to everyone if the numbers were wrong, the ethical judgment swirling around the situation would fall to him and the corporate auditor, both of whom had a high level of financial understanding. They knew the uncertainties surrounding accrual accounting — most things are really estimates that eventually get marked up to reality. However, managers could get aggressive in the estimates, and everyone wants to make his numbers. Joe fought hard to keep Polish Pickles’ conservative reputation intact.

Controller Tom explained that he had met with the CFO, and they agreed that no action should be taken. After the under-accrual was discovered, two other items came to his attention that, if included in the quarter, would have offset almost the entire under-accrued amount.

"It's important to remember that accruals are estimates — and seldom are those estimates 100 percent accurate," the controller said. "If we look at these items together, they offset each other, and there's no impact on the earnings. We're confident that had we seen all these items prior to the quarterly release, it wouldn't have changed the numbers. We don't see any need to put this in the 10-Q or for this situation to be discussed with the outside auditors or the audit committee. I'd like the committee to support that view."

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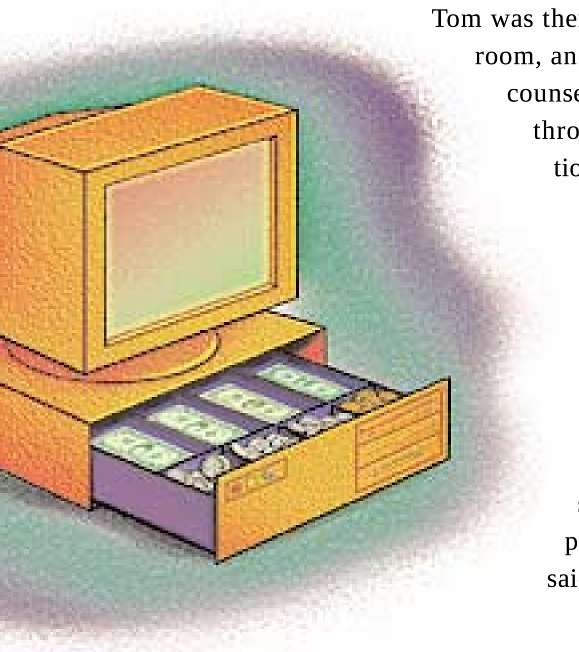
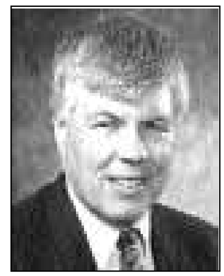
Joe wanted to be sure the controller wasn't putting up a smokescreen. He spoke up: "First, I think Tom should recuse himself from our discussion and ultimate decision. Second, I think we need to call in someone from internal auditing to give this committee an advisory opinion on the severity of the control matter that caused this problem." Committee members agreed.

Audit manager Jayne Checker, sitting in for her boss who was traveling and unavailable, listened to Tom's explanation, asking questions about what had occurred and the subsequent findings of the other accruals that could offset the marketing expense. Tom was then asked to leave the room, and Mary Sumee, general counsel, led the committee through a thorough questioning of Jayne.



Jayne explained the nuances of the accrual system and marketing spending to everyone's satisfaction and finally was asked to offer an opinion. "I think Tom's conclusion is credible and probably accurate," she said. "It appears that this was not a case of inadequate controls. This was a human error — some finance person who should have been looking at things for reasonableness missed this. The person who made the mistake on the accruals was let go this morning. I'm reasonably satisfied there isn't a reportable control problem — just a people problem."

The general counsel wanted to wrap and not to delay the 10-Q filing. Mary was satisfied that the numbers were good. However, she was undecided as to whether the matter should be discussed with the board audit committee or listed as a subsequent event. She asked Joe for his opinion.



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"I think we should let it go as is," Joe replied. "I feel OK about the numbers after our discussion. It doesn't change anything. True, we beat estimates for the quarter, but we didn't raise our guidance for the year, and neither did the analysts. Jayne has told us there was no control issue, so I don't see any need to give this publicity outside of our committee. I'm OK with not notifying the outside auditors or the audit committee, and I don't see any reason to describe the situation as a subsequent event in the 10-Q since we aren't changing anything."

The disclosure controls committee agreed. The minutes of the committee would not be shared with the outside auditors, and no one would call the chair of the audit committee, which had previously reviewed the numbers. Joe went back to his desk drained. His phone rang. His caller ID showed it to be an analyst at Fidelity, Mike Sell. "Boy," came the voice on the other end, "it's sure great to see you guys finally beat the estimates, Joe!" IRU

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