Another "GAP" in the Accounting Profession:

The Perception of Materiality

In an article entitled " The Ethics of Materiality in Financial Reporting," published in the November/December 2001 issue of *Corporate Finance,* author Marianne M. Jennings appropriately and prophetically explores issues of accepted auditing procedures and the credibility and reliability of audited financial statements. She uses as her central example of abuses not acknowledged by the auditors the case of Sunbeam Corporation.

"Chainsaw Al" Dunlap is the villain of the piece, but he is a hero when the story begins. When he became the CEO of Sunbeam, he had accomplished a remarkable turnaround of Scott Paper Company. He slashed costs, sent the stock prices soaring, and ultimately sold Scott to Kimberly-Clark for a substantial shareholder gain. He was enough of a darling of Wall Street to send the stock price from $12.50 per share to $18 on the day of the announcement of his hiring.

In 1997, on the basis of Sunbeam's financial statements, it appeared that Sunbeam's turnaround had been accomplished. In 1998 Sunbeam began a series of acquisitions of Coleman, Inc., First Alert, Inc., and Mr. Coffee --- all synergistic businesses related to Sunbeam's core businesses. In the first Quarter of 1998 the stock hit its all-time high of $52 per share. Three years later, Sunbeam was in bankruptcy court and by May 2001 "Chainsaw Al" was charged with fraud by the SEC. Dunlap was charged with "orchestrating a fraudulent scheme to create the illusion of the successful restructuring of Sunbeam and facilitate the sale of the Company at an inflated price." How did he go about doing this? Were his auditor's aware of these fraudulent practices?

There are numerous examples of manipulating revenues. For example, Sunbeam warehoused replacement parts for maintenance of its products and support of its warranties. The warehouse was owned by EPI Printers, to whom Sunbeam proposed to sell the inventory for $11,000,000. EPI valued it at $2,000,000, and had no interest in the proposed purchase. Sunbeam then proposed an "agreement to agree," which EPI could and did back out of. In the meantime Sunbeam booked the sale and a profit of $8,000,000.

Sunbeam also engaged in what is known as "channel stuffing," which is when inventory is shipped before delivery is required, so that it can be recognized as sales in the Quarter in which it was shipped.

Did the outside auditor miss the bogus nature of these transactions? No! The partner in charge of the audit engagement asked the executives at Sunbeam to restate earnings reflecting changes that he deemed necessary. Management refused, and he certified the financial statements anyway, using "materiality" as his justification. He knew for instance that the EPI agreement was a sham transaction, but the profits were a relatively small percentage of Sunbeam's income and therefore "immaterial."

Ms. Jennings states that the Audit Engagement Partner from a "Big Five" accounting firm "defined materiality only as a percentage of income, and did not see the disclosure as a reflection of management integrity." In this view, he was supported by another Big Five firm, who reviewed Sunbeam's books and his judgment calls and deemed the financial statements "materially accurate."

From the perspective of the Financial Accounting Standards Board and the American Institute of Certified Public Accountants, these two major firms had a defensible position. The amounts involved of many of the note improprieties were not material in a percentage of income sense, although according to the SEC, collectively they amounted to 16% of Sunbeam's reported profits. According to Jennings there is no definition of materiality for the accounting profession. Her research shows that most auditors use 5 to 10 percent as a threshold of disclosure, such as 5% of income or 10% of assets, or vice versa. Others use a fixed dollar amount or an index of time and trouble in relation to the amounts.

Jennings asserts that there is a 'gap" in the expectations of investors and creditors and the standards employed by corporations and accounting firms. Given the pressures that the auditing firms feel to certify financials, the leadership role on materiality belongs to the financial executives of the company.

To bridge the gap, Jennings proposes that the CEO and CFO of companies, with the support of the Board of Directors and the Audit Committee, should establish clear rules for disclosure that reflect the values of the company.

She proposes seven eminently sensible standards:

1. One standard which is universally accepted by shareholders, courts, executives, and accountants is the need to disclose bribery, regulatory sanctions, and criminal conduct regardless of whether these actions can be quantified and regardless of the amount, if they can. The implication is that such conduct reveals the quality and ethics of management, and is therefore material to investors and creditors.

2. Historically what has happened when these types of disclosures have not been made? The failure to disclose information and other forms of earnings management have not served companies well.

3. What are the financial implications if this item is not disclosed now? If nondisclosure translates into meeting market expectations, projections, budgets, etc., then there is an issue of pressure.

4. What are our motivations for not disclosing this item? Motivation may provide insight into whether the recording or non-recording of the item is ethically correct. Motivations that cloud judgments include bonuses tied to earnings goals, option rights, pending retirements, and other types of personal rewards that according to Jennings "tempt the soul and strain the values."

5. How do we expect this issue to be resolved? If the resolution is to make it up next quarter or hang on until later, there is a problem. That is not a management strategy that will appeal to investors.

6. Is the resolution that is anticipated consistent with the actions taken? In one case, the non-disclosure of a major write down was postponed in the hope that other areas of the company could make up for the loss over time. If the non-disclosure has to be resolved by something unrelated to the issue, it is a fairly good indication that it is material.

7. If I were a shareholder on the outside of the company "Would this be the kind of information I would want to know?" If an investor would view this information as important or relevant to making a decision to buy, hold or sell the stock, then it is material information.

In most cases the issue of materiality is not a black and white issue. For example, AOL capitalized advertising expenditures, because it had a formula for projecting what those expenditures would produce in sales. The SEC disputed this approach and AOL paid a fine. In retrospect AOL's formula proved to be correct, and its advertising expenditures were a form of capital investment. The issue, however, could have been readily resolved by including an explanation of that approach in the notes to the financials, so that investors or prospective investors could accurately interpret the financial situation of the company, and *the assumptions on which that financial report was based.*

In general, Jennings concludes, "If a company has sales, performance and write-down issues, withholding information in the hope that things will get better seems to be the beginning of decline. When truth is withheld, reputational capital is squandered."

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