

## **PRESSURE TO BREACH FUNDAMENTAL PRINCIPLES**

In this KLiP, we will discuss how a Chief Financial Officer is pressured into breaching the fundamental principles and what actions he needs to take to address this threat.

### **Facts of the case:**

Mr. Nova is a Chief Financial Officer of Best Limited, a large private company. Best Limited had already established the accounting policy for the treatment of internally generated intangible assets in the previous years. It spends an average of S\$1m to S\$2m on R&D each year. The company's policy effectively splits expenditure on intangible assets into one of two categories.

- (i) Activities aiming at obtaining new knowledge, design, evaluation, and selection of alternatives for new and enhanced product; and
- (ii) Activities relating to design, construction and testing new products or enhance existing products which is reasonably expected to result in material revenue streams in the future.

In the former case, this is budgeted and recognised as an expense each year. In the latter case, the process has been successful in the recent years and the auditors concur with the company's accounting policy, to capitalise the relevant expenditure on the balance sheet as intangible assets and to then subsequently amortise it (usually over a period of 2 to 3 years) against the associated revenue stream.

For audit purposes, the auditors would want to see hard evidence of an appropriate business case (with all the relevant assumptions) having been approved by the management team and budgeted for in the new financial year.

Mr. Nova, the CFO became aware that an investment of S\$0.5m was made in each of the last two years in relation to the intangible asset and those were not properly assessed. In aggregate, S\$1m has been committed and spent. Mr. Nova is enquiring on the use or success criteria against the asset purchased. When Mr. Nova challenged the Finance Director, Mr. Xavier on this matter, he was told: "Not to worry, as I would come up with some numbers to keep the auditors happy". Mr. Xavier also warned Mr. Nova, to keep this matter confidential and not to discuss with any member in the board, as his relationship with other members in the board is severely compromised already.

Even though Mr. Nova was aware that the company is unlikely to generate any revenue stream in practice and the fictitious business proposal produced, would be for the purpose of satisfying the auditors. Mr. Nova did not reveal the matter to anybody, as he believed that the financial year-end is only two months away and a S\$1m write-off at this late stage of the financial year would cause real difficulties and the finance team would be answerable to the board regarding the transaction.

What are the likely steps Mr. Nova should take once he becomes aware of the issue?

### **Analysis:**

- Mr. Nova is aware that the balance sheet is compromised but not in a fundamental way and believes that this can be adjusted quietly in the subsequent year.
- Mr. Nova is pressured not to inform any board members.
- The integrity of Mr. Nova and Mr. Xavier is questionable as they never bring the matter to the board's attention.
- Is this matter evidence of a wider breakdown in company internal controls in relation to the correct treatment of expenditure on intangible assets, or is this an isolated incident?

- In this scenario there may be a conflict, if there is any commercial pressure put on Mr. Nova and his team to treat expenses for the year, as deferred expenses

#### **Comments/Recommendations:**

Mr. Nova should take the following steps as safeguards to address the threats to an acceptable level.

- (a) Discuss the matter with Mr. Xavier and explain the implication that exerting pressure creates threat. This would result in Mr. Nova being under undue influence of Mr. Xavier. Mr. Nova could also be liable to the board if the investment is not accounted appropriately.
- (b) Alternatively, he could also discuss with other directors to explain and work together with them in handling the situation before taking the matter to the board.
- (c) Convince and provide appropriate audit evidence to the auditors on the costs as an asset and leave them to adjust or disclose appropriately. This act of Mr. Nova, results in him acting objectively.
- (d) Mr. Nova shall also disclose the matter about investment to the auditors without breaching confidentiality.

He should also ensure that he shows professional behaviour at all times and comply with the *Code*. The company should only recognise assets on the balance sheet which satisfy the requirements of applicable Financial Reporting Standards.

Mr. Nova needs to be honest, not just to himself, but to the rest of the board and the auditors to show integrity despite pressure to breach the fundamental principles.

This brings us to the end of KLiP.