Audit Insights
Helping You Succeed
ACCUITY

FEBRUARY 7, 2022

Audit disclosures: Why the fine print is important

Footnotes appear at the end of a company's audited financial statements. These disclosures provide insight into account balances, accounting practices and potential risk factors — knowledge that's vital to making well-informed lending and investing decisions. Here are examples of key risk factors that you might unearth by reading between the lines in a company's footnotes.

Contingent (or unreported) liabilities

A company's balance sheet might not reflect all future obligations. Auditors may find out the details about potential obligations by examining original source documents, such as bank statements, sales contracts and warranty documents. They also send letters to the company's attorney(s), requesting information about pending lawsuits and other contingent claims.

Detailed footnotes may reveal, for example, an IRS inquiry, a wrongful termination lawsuit or an environmental claim. Footnotes may also spell out the details of loan terms, warranties, contingent liabilities and leases. Liabilities may be downplayed to avoid violating loan agreements or admitting financial problems to stakeholders.

Related-party transactions

Companies may give preferential treatment to, or receive it from, related parties. It's important that footnotes disclose all related parties with whom the company — and its management team — conducts business.

For example, say a retailer rents space from its owner's grandparents at below-market rents, saving roughly $240,000 each year. If you're unaware that this favorable related-party deal exists, you might believe that the business is more profitable than it really is. When the owner's grandparents unexpectedly die and the rent increases, the company's stakeholders could be blindsided by the undisclosed related-party risk.

Accounting changes

Footnotes disclose the nature and justification for a change in accounting principle, as well as that change's effect on the financial statements. Valid reasons exist to change an accounting method, such as a regulatory mandate. But dishonest managers can use accounting changes in, say, depreciation or inventory reporting methods to manipulate financial results.

Significant events

Footnotes may even forewarn of a recent event — including something that's happened after the end of the reporting period but *before* the financial statements were issued — that could materially impact future earnings or impair business value. Examples might include the loss of a major customer, a natural disaster or the death of a key manager.

Critical piece of the financial reporting puzzle

Footnotes offer the clues to financial stability that the numbers alone might not. But drafting footnote disclosures requires a delicate balance. While most companies want to be transparent when reporting their results, indiscriminate disclosures and the use of boilerplate language may detract from the information that's most meaningful to your company's stakeholders. Contact us to discuss what's right for your situation.