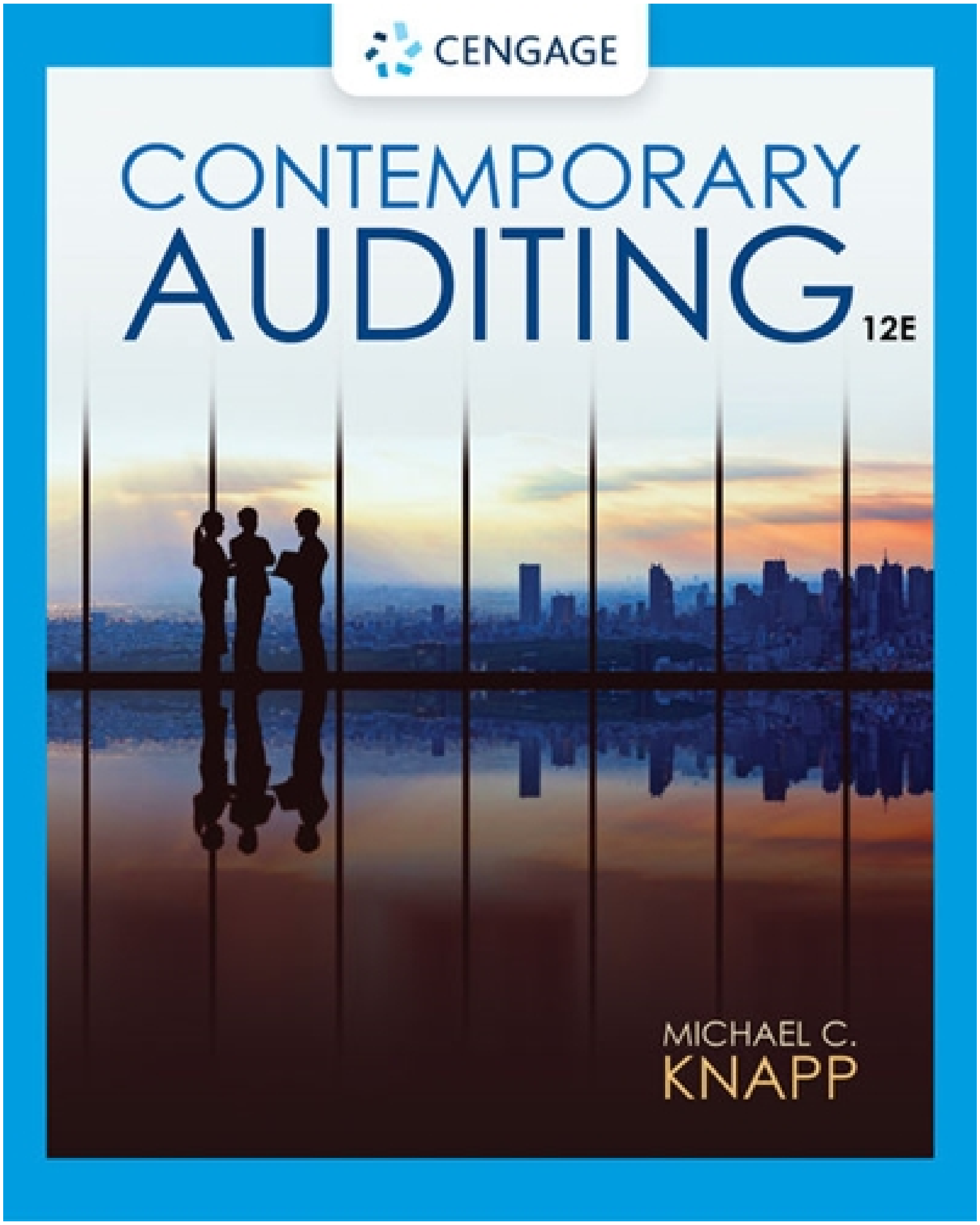
Solutions for Contemporary Auditing 12th Edition by Knapp



Solutions

CASE 1.1

WELLS FARGO & COMPANY

Synopsis

Wells Fargo & Company got its start in 1852 in the midst of the California Gold Rush. The company's two founders raised the capital to finance a new company to be based in the Wild West boomtown of San Francisco after realizing that the Bay Area provided a wealth of business opportunities for investors willing to accept a high risk of failure. The company's founders decided that transportation and banking services were desperately needed in San Francisco so they decided that Wells Fargo would pursue those two unrelated lines of business. The company initially made a "name" for itself by providing rapid and reliable freight, courier, and mail delivery services. But, when the federal government nationalized major freight and transportation lines during World War I, Wells Fargo's management shifted its focus almost exclusively to the banking industry.

Throughout much, if not most, of Wells Fargo's history successive generations of senior executives have embraced the high-risk, "Wild West" mindset around which the company was created. That mindset or company culture triggered a massive, high-profile scandal that surfaced in September 2016 when a federal agency announced that Wells Fargo had been fined nearly $200 million for engaging in improper sales practices on an enormous scale.

Critics of Wells Fargo eventually turned their attention to the company's longtime audit firm, KPMG. Several U.S. senators, in particular, harshly criticized the prominent audit firm. The senators demanded that KPMG explain how it could issue a "clean" opinion each year on Wells Fargo's internal control over financial reporting (ICFR) while the company was involved in the massive fraud involving improper sales practices.

Central to this case are three lengthy letters that are included as exhibits. Exhibit 1 presents a letter sent by four U.S. senators to KPMG in which the senators demand that the audit firm respond to a series of questions including whether the Wells Fargo auditors were aware of the improper sales practices being applied by their client. The senators also demanded to know whether KPMG continued to stand by its opinions that Wells Fargo had maintained "effective internal control over financial reporting" during the timeframe that the sales fraud was ongoing. KPMG's letter in response to the senators is contained in Exhibit 2—in the letter KPMG indicated that it did, in fact, still stand by its earlier opinions that Wells Fargo had maintained effective ICFR. Finally, Exhibit 3 presents a letter that the senators sent to the PCAOB—the senators had been troubled by much of the information conveyed to them by the KPMG letter shown in Exhibit 2. In this final letter, the senators suggested that the PCAOB review KPMG's audits of Wells Fargo's ICFR and that the agency review its "rules and guidance" relevant to public company auditors' consideration of ICFR weaknesses and illegal acts perpetrated by their clients.

Wells Fargo & Company--Key Facts

1. In 1852, Henry Wells and William Fargo organized Wells Fargo & Company because they were convinced that the California Gold Rush provided a wealth of business opportunities in the San Francisco Bay Area.

2. Banking and transportation services were the two lines of business Wells Fargo's founders decided their new company would pursue.

3. After the federal government nationalized major freight and transportation lines during World War I, Wells Fargo's executives focused the company's operations almost exclusively on the banking industry.

4. Beginning in the early twentieth century, successive generations of Wells Fargo senior executives relied on a relentless acquisition strategy and aggressive marketing initiatives to expand the company's banking operations.

5. By 2015, Wells Fargo was the largest global bank in terms of collective market value; at the time, the company operated nearly 9,000 retail branches in 35 countries and had over 70 million customers.

6. In addition to its impressive size, Wells Fargo consistently ranked among the most respected multinational companies in annual surveys by *Barron's*.

7. In September 2016, the Consumer Financial Protection Bureau (CFPB) announced that Wells Fargo had been fined $185 million for improper sales practices between 2011 and 2016; those illegal activities had resulted in the creation of millions of unauthorized customer accounts.

8. In response to the widely-publicized scandal, Wells Fargo's executives typically attributed the illegal practices to self-interested lower-level employees.

9. KPMG, Wells Fargo's longtime audit firm, issued "clean" opinions on the company's internal control over financial reporting (ICFR) throughout the time frame in which the illegal sales practices were being applied.

10. In a letter sent to KPMG in late 2016, four U.S. senators posed a series of questions to the firm, including whether the Wells Fargo auditors had been aware of the illegal sales practices and whether the firm continued to stand by its prior opinions that the company had maintained effective ICFR.

11. KPMG responded to the senators by indicating that the Wells Fargo auditors had been aware of the illegal sales activities but had concluded that they did not involve the company's ICFR and did not have a significant impact on the company's financial statements.

12. After receiving the letter from KPMG, two of the senators wrote the PCAOB and asked the agency to review KPMG's audits of Wells Fargo's ICFR and its "rules and guidance" relevant to auditors' consideration of ICFR weaknesses and illegal acts perpetrated by their clients.

Instructional Objectives

1. To identify the different types or classes of internal controls.

2. To identify the nature and scope of internal controls over financial reporting (ICFR).

3. To define a "material weakness in internal control" and to identify the factors auditors should consider when determining whether a deficiency in internal control qualifies as a material weakness.

4. To define a "material weakness in ICFR" and to identify the factors auditors should consider when determining whether a deficiency in ICFR qualifies as a material weakness in ICFR.

5. To examine the responsibility of public company auditors to search for illegal acts committed by their clients.

6. To identify public company auditors' responsibilities after determining that a client has engaged in an illegal act.

7. To consider how the length of an audit firm's tenure with a public company client may impact its ICFR assessment for that client.

Suggestions for Use

Consider launching this case by requiring your students to either individually or in groups research and report on a recent ICFR material weakness reported by a public company. If you want to ensure that each individual or group reports on a unique material weakness, then use a Google search to identify a sample of material weaknesses to be used for this exercise. After the students have made these presentations, ask them to compare and contrast the material weaknesses they researched with the internal control deficiencies that were evident within Wells Fargo. After completing this exercise, students will be better equipped to provide an informed opinion on whether KPMG should have reported an ICFR material weakness for Wells Fargo.

Suggested Solutions to Case Questions

1. Internal controls can be categorized several different ways. For example, we could classify internal controls by transactions cycles, by cost, or by complexity. The key scheme that the accounting profession has historically used to categorize internal controls is by their overarching objective. According to the COSO's internal control framework, an entity's internal control process is designed to achieve three broad classes of objectives. Those classes of objectives

include "reliability of financial reporting," "effectiveness and efficiency of operations," and "compliance with applicable laws and regulations."

Obviously, the key distinction between internal controls over financial reporting (ICFR) and the other two types or classes of internal controls is the underlying intent or purpose of ICFR. The PCAOB notes that ICFR are intended to "provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance
with GAAP" [AS 2201.A5]. In this same context, the PCAOB auditing standards note that ICFR include those "policies and procedures that—

(1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements." [AS 2201.A5]

The other two classes of internal controls address differing control objectives. For example, the intent or objective of internal controls relating to "effectiveness and efficiency of operations" involve operational issues such minimizing waste on a production line. An example of the final category of internal controls would be ensuring compliance with the Americans with Disabilities Act (ADA).

2. This is a question that has diametrically opposed answers, each of which could be supported with at least somewhat reasonable arguments. In its November 28, 2016, letter to the four U.S. senators, KPMG defended its position that the improper sales practices "did not involve key controls over financial reporting" by arguing that (1) those activities had no significant impact on the company's financial statements and (2) none of the individuals involved in the improper sales practices "worked in financial reporting or had the ability to influence the financial reporting process."

There is certainly a basis for countering KPMG's argument. AS 2201.21 requires auditors to use a "top-down approach" in auditing a client's ICFR: "A top-down approach begins at the financial statement level and with the auditor's understanding of the overall risks to internal control over financial reporting. The auditor then focuses on entity-wide controls and works down to significant accounts and disclosures . . ." (Note the reference to "disclosures." One could certainly argue that Wells Fargo's internal sales "fraud" was a significant disclosure item for users of the company's financial statements.)

AS 2201.23 and 24 identify a variety of entity-wide controls "that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting" [paragraph 23]. One group of such controls are "controls related to the control environment" [paragraph 24]. Following is the complete text of AS 2201.25:

"*Control environment*. Because of its importance to effective internal control over financial reporting, the auditor must evaluate the control environment at the company. As part of evaluating the control environment, the auditor should assess—

- Whether management's philosophy and operating style promote effective internal control over financial reporting;
- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and
- Whether the Board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

Given paragraph 25, a client's overall control environment is linked directly to the entity's ICFR. Now, recognize that the results of the study by Wells Fargo's independent board members indicted or criticized the company's control environment. That is, the overly "decentralized" nature of the company's organizational structure was a direct consequence of a control environment that one could argue was inadequate, at a minimum. So, in summary, the improper sales practices were a consequence of the decentralized organizational structure which, in turn, was a consequence of the company's poor control environment. Bottom line, one could certainly make an argument that Wells Fargo's weak control environment was an issue that should have been considered in KPMG's audit
of the company's ICFR because a company's control environment has a major impact on the reliability or effectiveness of its ICFR.

3. Here is the definition of "material weakness" in internal control that is included in the AICPA's professional auditing standards: "**Material weakness**. A deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis." AU-C 265.07

AS 2201.98.A7 provides the following definition or description of a material weakness in ICFR. "A **material weakness** is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a **reasonable possibility** that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis." AS 2201, paragraph 62 notes that "The auditor must evaluate the severity of each control deficiency that comes to his or her attention to determine whether the deficiencies, individually or in combination, are material weaknesses as of the date of management's assessment." The next several paragraphs then discuss factors that auditors should consider in making that determination. Those factors include, among many others, "the nature of the financial statement accounts, disclosures, and assertions involved;" "the susceptibility of the related asset or liability to loss or fraud;" and the "possible future consequences of the deficiency." [Note: the last item was particularly relevant to the Wells Fargo situation.]

Auditors of public companies have struggled to apply the materiality concept in a new context, namely, in determining whether or not ICFR deficiencies rise to the level of "material." This point was addressed several years ago in a speech made by a PCAOB board member.

"For ICFR purposes, the meanings of 'reasonably possible' and 'material' rely upon established definitions of these same terms that exist with respect to accounting. However, experience gathered during the first year of implementing Section 404 and AS No. 2 demonstrate that auditors and companies both had a difficult time applying these terms in this new context. *Like the generally accepted accounting principles (GAAP) that govern the preparation of financial statements, there are no clear bright-line tests based solely on quantitative measures; qualitative measures must also be considered, and professional judgment is required*." – emphasis added [K. Gillan, "A Layperson's Guide to Internal Control Over Financial Reporting (ICFR)," pcaobus.org/News/Speech/Pages/03312006_GillanCouncilInstitutionalInvestors.aspx, 31 March 2006.

Notice the emphasized text in this quote. In my view, given the nature of ICFR evaluations, one could reasonably argue that, in fact, qualitative considerations may be more important in this context than quantitative considerations. No doubt, applying qualitative benchmarks or criteria are more challenging than applying quantitative guidelines . . . meaning that assessing ICFR deficiencies can be particularly "messy."

4. Notes: This question is closely linked to the two preceding ones. In addition, recognize that there is not a definitive answer to this question. So, instead of assessing the accuracy of a student's answer, I instead evaluate the rigor of the supporting argument for it.

At some point in addressing this question, consider taking a poll of your students to determine whether they believe the decentralized corporate structure of Wells Fargo qualified as a material weakness in ICFR—my students typically vote overwhelmingly that it did. A common justification for a "yes" vote is the fact that the quality of a company's overarching control environment—including how authority is delegated within the organization—has an enormous impact on all dimensions of an organization, particularly its accounting and financial reporting functions. Many of my students point to the metrics identified in Exhibit 3 by the senators to demonstrate how pervasive an impact Wells Fargo's overall poor control environment—including its decentralized management structure—ultimately had on the company.

5. AS 2405, "Illegal Acts by Clients" defines the responsibilities of auditors vis-à-vis illegal acts committed by a public company client. As a sidebar, AS 2405.03 notes that "Whether an act is, in fact, illegal is a determination that is normally beyond the auditor's professional competence." Because of this reality, the paragraph goes on to note that auditors may ultimately have to rely on the "advice of an informed expert" before deciding whether a particular act is illegal.

The degree of responsibility that an audit firm assumes for detecting illegal acts by a public company client depends upon the nature of those acts as discussed by AS 2405. That section of the PCAOB's auditing standards distinguishes between an audit firm's responsibility to detect illegal acts that have a "direct and material" effect on a client's financial statements and illegal acts that have a "material indirect" effect on a client's financial statements.

AS 2405.05 notes that an auditor's responsibility to detect and report "misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for misstatements caused by error or fraud as described in AS 1001, *Responsibilities and Functions of the Independent Auditor*." In turn, AS Section 1001.02

notes that an auditor "has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud."

Auditors generally have much less responsibility to detect illegal acts that have a material indirect effect on a client's financial statements. AS 2405.06 observes that an auditor "ordinarily does not have sufficient basis for recognizing" such violations by clients. AS 2405.07 adds: "If specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred."

When a public company auditor discovers an apparent illegal act that may have a material indirect impact on the client's financial statements, one of his or her first responsibilities is to evaluate the materiality of that item. "In evaluating the materiality of an illegal act [having a potential material indirect effect on a client's financial statements] that has come to his attention, the auditor should consider both the quantitative and qualitative materiality of the act. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue" [AS 2405.13]. Auditors also have a responsibility to assess the "adequacy of disclosure" of illegal acts that apparently have a material indirect impact on a public company's financial statements. "The auditor should evaluate the adequacy of disclosure in the financial statements of the potential effects of an illegal act on the entity's operations. If material revenue or earnings are derived from transactions involving illegal acts, or if illegal acts create unusual risks associated with material revenue or earnings, such as the loss of a significant business relationship, that information should be considered for disclosure" [AS 2405.15]. AS 2405.16 also notes that auditors "should consider the implication of an illegal act [having a potential material indirect effect on the client's financial statements] in relation to other aspects of the audit . . ."

In terms of communication, AS 2405.17 notes that "the auditor should assure himself that the audit committee is adequately informed as soon as practicable" about an illegal act having a material indirect impact on the financial statements. Paragraphs 18-21 of AS 2405 discuss the impact of a "material indirect" illegal act on an auditor's report. Paragraph 18 notes that such an act that "has not been properly accounted for or disclosed" may require the auditor to issue a qualified or an adverse opinion.

6. The key issue in this context is the trade-off between the level of knowledge that an auditor accrues as its tenure with a public company client lengthens versus the corresponding increase in the risk that an auditor may become too "cozy" with the client as the relationship "ages." The existence of a learning curve effect in auditing a client and its ICFR is widely accepted, which means that the periodic rotation of public company auditors would have some clear-cut negative impact on the quality of those services. However, periodically rotating public company auditors would have a countervailing positive impact (at least theoretically) because the *de facto* independence of auditors under a rotation policy regime should be enhanced, that is, auditors who are aware that a client relationship is finite should be less inclined to curry favor with their clients by downplaying "problem" circumstances that they discover.

CASE 1.2

WEATHERFORD INTERNATIONAL

Synopsis

Bernard Duroc-Danner, a native of France, created Weatherford International in 1998 when he merged his oilfield equipment company with Weatherford Services. Under Duroc-Danner's leadership as CEO, the new company adopted a "take no prisoners" approach to competing in the volatile oilfield services industry.

Duroc-Danner relied heavily on Weatherford's stock to finance his growth-by-acquisition strategy. To keep the company's stock price rising and attractive to potential takeover candidates, Duroc-Danner knew that Weatherford needed to post impressive operating results. A key strategic initiative the company implemented to achieve that objective was reducing its income tax expense by a variety of means including reincorporating in low-tax jurisdictions and using hybrid securities to shift revenues from high-tax to low-tax jurisdictions.

In 2006, Duroc-Danner chose Andrew Becnel, an attorney, to serve as Weatherford's CFO. Becnel reorganized the departments under his control. That reorganization included making Weatherford's tax department a "finance function . . . focused on tax strategy and planning, and not tax accounting." Under this new organizational structure, Weatherford's tax department operated independently of the company's accounting and financial reporting function.

In early 2008, two executives in Weatherford's tax department discovered that the company's ETR (effective tax rate) for fiscal 2007 was much higher than expected. That higher tax rate would cause the company to fall short of its 2007 Wall Street earnings forecast, a development that would greatly displease Duroc-Danner and Becnel. To "fix" that problem, the two tax executives prepared a bogus post-closing entry that produced a "plugged tax benefit" of $154 million, an amount that was sufficient to allow Weatherford to surpass its Wall Street earnings forecast. The two men made similar bogus entries in Weatherford's accounting records each of the following three years.

This case focuses primarily upon the trials and tribulations of Weatherford's Ernst & Young auditors. Over the course of the four-year tax accounting fraud, those auditors dealt with severe understaffing issues, time budget constraints, and, most critically, "difficult, intimidating, and stubborn" client personnel, principal among them Weatherford's Vice President of Tax who was the primary architect of the tax accounting fraud and . . . a former Ernst & Young employee. Because of inadequate audit procedures, reliance on inferior audit evidence, and uncooperative client personnel, the auditors never discovered the tax accounting fraud. Following the disclosure of the fraud, Ernst & Young found itself the focus of an SEC investigation that ultimately resulted in the Weatherford scandal being labeled a "significant audit failure" by a senior SEC official.

Weatherford International--Key Facts

1. In 1998, Bernard Duroc-Danner became the CEO of Weatherford International, an oilfield services company; Duroc-Danner created a "take-no-prisoners" corporate culture that was focused on making Weatherford a major player in the volatile oilfield services industry.

2. To grow Weatherford as quickly as possible, Duroc-Danner went on an acquisition spree between 1998 and 2011 that resulted in him acquiring nearly 300 companies.

3. To facilitate his growth-by-acquisition strategy, Duroc-Danner realized that Weatherford had to maintain its stock price at a high level which meant the company had to report impressive earnings.

4. Weatherford relied on aggressive tax avoidance strategies to increase its earnings including using "hybrid instruments" to shift revenues from high-tax countries to low-tax countries.

5. In 2006, Andrew Becnel, an attorney, became Weatherford's CFO; Becnel immediately made the company's tax department a "finance function" focused on tax strategy and tax planning that was independent of the company's accounting and financial reporting function.

6. In early 2008, James Hudgins, Weatherford's Vice President of Tax, realized that the company's ETR (effective tax rate) for 2007 would be much higher than previously estimated; the higher ETR and income tax expense would prevent the company from reaching its 2007 earnings forecast.

7. To allow Weatherford to surpass its consensus Wall Street earnings forecast for 2007, Hudgins and his principal subordinate recorded a $440 million bogus post-closing entry in the company's intercompany accounting records that produced a "plugged tax benefit" of $154 million.

8. Over the next three years, Hudgins and his subordinate recorded similar bogus post-closing adjusting entries to inflate Weatherford's reported earnings; an artifact of Hudgins' tax accounting fraud was a large "phantom income tax receivable."

9. Weatherford was perceived as a "very adversarial" audit client within Ernst & Young's Houston practice office that serviced the company; Hudgins (a former Ernst & Young employee), in particular, was characterized as "difficult, intimidating, stubborn" and untrustworthy.

10. Weatherford's audit engagement team was chronically understaffed, overworked, and unable to obtain sufficient appropriate audit evidence from the client to corroborate the company's income tax-related account balances.

11. Although Weatherford's Ernst & Young auditors never discovered the tax accounting fraud, the attention that the auditors focused on the "phantom income tax receivable" ultimately resulted in the company uncovering the fraud.

12. In 2016, the SEC fined Ernst & Young $11.8 million for its deficient Weatherford audits and interim reviews, suspended two partners involved in those audits, and required the audit firm to implement a "Validation Plan" to improve its audit policies and procedures.

Instructional Objectives

1. To identify the audit objectives for income tax expense and related balance sheet accounts and the audit procedures that should be applied to those accounts.

2. To identify internal control weaknesses and their implications for independent auditors.

3. To identify quality control measures relevant to the staffing of audit engagement teams.

4. To consider measures that auditors can take to cope effectively with uncooperative client personnel.

5. To examine the implications for auditors when they believe that a key client official is not trustworthy.

6. To identify the six ethical principles in the AICPA *Code of Professional Conduct* and their relevance to independent auditors.

7. To examine the enforcement philosophy of the Securities and Exchange Commission.

Suggestions for Use

The Weatherford accounting case is apparently the first major accounting/auditing scandal that revolves almost exclusively around income tax accounting issues. Recognize that this case does not involve tax fraud per se. Weatherford went to extreme lengths to avoid (minimize) its annual income tax payments, but to date, at least, the IRS has apparently not charged the company with improperly avoiding taxes (i.e., tax evasion). Consider assigning this case simultaneously with the Caterpillar case which does involve tax evasion. The key auditing angle in the Caterpillar case is the "scope of services" issue. Caterpillar's Big Four audit firm provided extensive tax consulting services to help the company minimize its taxes. A lynchpin of both the Weatherford and Caterpillar tax strategies involved using artistic legal maneuvers to transfer revenue from high-tax jurisdictions such as the United States to offshore "tax havens" that had minimal or even zero corporate income tax rates. Examples of the latter countries include Luxembourg, Bermuda, Switzerland, and Ireland. A key strength of this case is the insight it provides on the difficult conditions that often characterize the work environment of independent auditors. The Weatherford audit team faced understaffing issues, "severe time constraints," "very adversarial" and uncooperative and untrustworthy client personnel, challenging assignments that exceeded the training level and experience of individual auditors, and superiors who made poor decisions. Empirical research demonstrates that employees who are provided with "realistic job previews" are more likely to have longer tenure with their employers and experience higher levels of job satisfaction. This case by itself provides future auditors with a realistic job preview. Granted, it is important that our students understand that not all audit engagements are as "challenging" as the Weatherford audits. However, those individuals who spend multiple years working as independent auditors will eventually face most, if not all, of the adverse work conditions that were present in this case.

Suggested Solutions to Case Questions

1. For public companies such as Weatherford International, the PCAOB auditing standards identify five management assertions. Specific audit objectives for individual accounts are derived from those assertions: existence/occurrence, completeness, valuation/allocation, rights and obligations, and presentation and disclosure. [See AS 1105.11] This suggested answer provides an overview of key audit tests applied to income tax-related accounts. For a more comprehensive list of such tests refer to online sites that provide representative audit programs for those accounts.

Income tax expense is typically among the largest expenses of big public companies which compounds the importance of properly auditing this financial statement line item. Similar to other expenses, the key audit objective for income tax expense is typically to determine whether the client's reported dollar amount is "complete." Why? Because clients have an incentive to understate expenses, including income tax expense. Unlike most other expenses, income tax expense is determined by applying a volume of complex and ever-changing legal provisos and stipulations. This feature of income tax expense demands that one or more tax specialists be involved in the auditing of this critical account. The starting point in auditing income tax expense is to obtain the client's schedules that demonstrate how the current year figure was determined. Tax specialists can then review this schedule line by line and step by step to ascertain whether the appropriate tax regime has been applied. A particularly important client document in this context is the reconciliation between the client's reported income tax expense for financial accounting purposes and the computation of income tax per the relevant corporate tax returns. Tax specialists will typically spend considerable time and effort reviewing and testing this reconciliation. Other audit tests that will likely be applied to a client's reported income tax expense to corroborate the completeness assertion include investigating unresolved disagreements with taxing authorities that may influence the recorded amount, considering the impact that any newly adopted tax laws or regulations may have on the client's income tax expense, and, of course, testing the clerical accuracy of all relevant mathematical calculations. Note: the audit tests applied to a client's income tax expense typically provide, as well, audit evidence pertinent to the client's current income tax payable/receivable account. Any differences between a client's income tax expense and its current income tax payable/refundable can typically be dealt with by auditors by reviewing the client schedule that reconciles the two amounts.

Deferred (long-term) tax liabilities are more common than deferred (long-term) tax assets. Similar to income tax expense, the key audit objective for deferred tax liabilities is corroborating the completeness assertion, that is, ascertaining that the given item is not understated. Many, if not most, of the audit tests applied to a client's income tax expense relate directly or indirectly to the client's deferred tax liabilities. Again, a key starting point for auditing a deferred tax liability is a client schedule documenting the detail of the given account balance. Since much, if not most, of the tax liability will be carried forward from the prior year, auditors will generally focus on testing the change in the tax liability account from one year to the next—assuming that they audited the prior year balance. Specific items that relate directly to a client's deferred tax liabilities that may need to be addressed by auditors include NOL (net operating loss) carryovers and unused tax credits. In testing a client's deferred tax liabilities, auditors will also need to address the question of whether the client has properly classified its tax liabilities between current and long-term liability accounts.

For current income tax receivable and deferred (long-term) tax asset items, "completeness" is not the principal concern of auditors. For these tax assets, existence and valuation issues would be paramount for auditors. For example, if there is significant doubt that a deferred tax asset will ever be realized, then the client should establish a valuation (allowance) account to reduce the carrying value of that asset. Audit tests will be necessary in such cases to collect sufficient appropriate audit evidence to corroborate the valuation allowance.

Recognize that in the Weatherford case, the company's "phantom income tax receivable" was a current asset account. The SEC pointed out that the auditors should have been particularly suspicious of a "multi-year" current tax asset that grew larger each successive year. The key audit issue should have been the realizability (valuation) of that tax asset. Of course, unknown to the auditors, valuation of that receivable was *not* the key issue. The fact that the receivable was totally bogus, that is, did not exist was the relevant issue. It is instructive to point out how the auditors finally determined the bogus nature of the receivable. They made that determination only after "digging into" the client's intercompany accounting records that was the source of that receivable. The SEC suggested repeatedly in the enforcement release focusing on the Weatherford audits that the auditors would likely have discovered the bogus nature of the receivable if they had insisted on studying the details of the receivable balance and the source of those details that were available in the company's intercompany accounting records. [Granted, even when the auditors' efforts resulted in them determining that the receivable was nonexistent, those efforts did not reveal the fraudulent nature of the receivable.]

Note: Historically, the PCAOB has found frequent deficiencies in the audit procedures applied to income tax-related accounts. The PCAOB's overview of its 2015 "inspection findings" which was released in April 2016, for example, identified "tax-related estimates" as a common cause of audit deficiencies.

2. This is an "easy" question. Hopefully, your students will quickly decide that the absence of an effective control environment was the stark and overriding internal control weakness evident in the Weatherford case. The "go-go" corporate culture created by Bernard Duroc-Danner resulted in an understated degree of control consciousness within his organization. For example, the heavy emphasis on "beating" the quarterly "street estimate" placed significant pressure on his subordinates to take extreme measures to accomplish that goal.

AS 2201.98.A7 defines a "material weakness" as a "deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis." Obviously, determining whether an internal control deficiency qualifies as a "material weakness" is subjective and requires the application of considerable professional judgment on the part of auditors. However, given the pervasive impact of Weatherford's extremely weak control environment on the company's operations, we can probably safely conclude that this internal control deficiency was a material weakness.

What implications did this material weakness have for the Ernst & Young auditors? First, the existence of even one material weakness in internal controls over financial reporting mandates that the given audit team issue an adverse opinion on the client's internal controls. Second, this pervasive material weakness cast doubt on the overall auditability of Weatherford. For example, focus on Adams' suggestion that James Hudgins was not trustworthy. If you explicitly distrust a client official who occupies a key accounting position, then it is virtually impossible to audit the accounts that individual oversees or influences in some way.

3. The PCAOB's Quality Control Standards identify the following five elements of quality control for audit firms: independence, integrity, and objectivity; personnel management; acceptance and continuance of clients and engagements; engagement performance; and monitoring. [QC 20.07] "Engagement performance" is the quality control element most directly relevant to the staffing of specific audit engagements: "Policies and procedures should be established to provide the firm with reasonable assurance that the work performed by engagement personnel meets applicable professional standards, regulatory requirements, and the firm's standards of quality." [QC 20.17]

Craig Fronkiewicz was clearly between the proverbial rock and a hard place. He was in charge of an audit engagement that, to say the least, was not considered a "good" assignment. In fact, according to the SEC, individuals in Ernst & Young's Houston practice office literally "threatened to quit" if assigned to the Weatherford audit engagement team. Making matters even worse was the lack of cooperation provided to the Ernst & Young auditors by client personnel, James Hudgins, in particular. Recall that Sarah Adams went so far as to tell Fronkiewicz that she didn't trust Hudgins and "believed he was misrepresenting the company's ETR and net income." As noted in the case, Fronkiewicz requested that an audit manager "well suited to a difficult, public company like Weatherford" be assigned to the 2009 Weatherford audit team. Of course, that request was denied.

Ex post, it is easy to look back and suggest that Fronkiewicz should "have done more." An extreme measure that he could have taken would have been to refuse to begin the 2009 audit until he was assured that it was properly staffed. Then again, "drawing a line in the sand" in that manner likely would have placed Fronkiewicz in poor stead with his superiors in the Houston office. I believe that is important for students to realize that in the auditing discipline they may very well face such Catch 22 situations where you are "damned if you do and damned if you don't." In addressing this question, I typically allow students to debate and discuss the options that Fronkiewicz had with the hope that they eventually decide that he was in a lose-lose scenario. For what it is worth, from a professional standpoint, the "correct" answer to this question is that he should have stood his ground and insisted on proper staffing of the Weatherford audits before commencing them.

4. Here is another question for which there is not a pristine answer. For lower-level auditors, the proper tactic to apply when dealing with an uncooperative client employee or executive is to bring the matter to the attention of his or her superior. That superior can then hopefully "go over the head" of the uncooperative individual and resolve the matter with a higher-ranking client representative. In this case, Hudgins, the uncooperative individual, was, himself, a relatively high ranking executive. Nevertheless, he did have multiple layers of authority above him in the

Weatherford organization. When he refused to fully cooperate with the auditors, Adams and/or Fronkiewicz should have gone to Becnel, Hudgins' immediate superior. If Becnel refused to resolve the situation, then the partners could have gone to Bernard Duroc-Danner. The SEC did not report whether the Ernst & Young partners made any effort to go over the head of Hudgins. Granted, it seems likely that if they had, the SEC would have reported that fact in one or both of the enforcement releases that were the primary sources for this case.

FYI, an initial tactic for dealing with uncooperative client personnel is to use a "kindler, gentler approach" and try to reason with the individual. (Becoming combative with such an individual is probably a losing strategy from the "get go.")

5. This question is closely linked with the previous question, so you might consider addressing them simultaneously.

The concept of "professional skepticism" is central to this question. Here is the pertinent discussion of that concept that is found in the PCAOB auditing standards at AS 1015, .07-.09, "Due Professional Care in the Performance of Work":

> .07 "Due professional care requires the auditor to exercise *professional skepticism*. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor uses the knowledge, skill, and ability called for by the profession of public accounting to diligently perform, in good faith and with integrity, the gathering and objective evaluation of evidence."
>
> .08 "Gathering and objectively evaluating audit evidence requires the auditor to consider the competency and sufficiency of the evidence. Since evidence is gathered and evaluated throughout the audit, professional skepticism should be exercised throughout the audit process."
>
> .09 "The auditor neither assumes that management is dishonest nor assumes unquestioned honesty. In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest."

Notice that this discussion does not address the set of circumstances present in this case, namely, a situation in which an auditor explicitly *distrusts* a client official. The fact that a key client executive cannot be trusted raises the possibility that the given client may not be "auditable" under any circumstances [as mentioned in the suggested solution to case question No. 2].

Under present PCAOB auditing standards, at a minimum, Adams' distrust of Hudgins would certainly qualify as a "significant risk" of fraud [AS 2110.70]. When a significant fraud risk has been identified, "the auditor should perform substantive procedures, including test of details, that are specifically responsive to the assessed risks" [AS 2301.11]. In the Weatherford case, the significant fraud risk related directly to "significant unusual transactions," i.e., the post-closing "plug" adjustments. AS 2401.66-67 addresses auditors' responsibilities when there is a fraud risk related to significant unusual transactions. Following are examples of specific procedures that auditors should apply to such transactions:

- Determine whether the transaction has been authorized and approved in accordance with the company's established policies and procedures
- Determine whether the transaction lacks commercial or economic substance
- Consider whether the business purpose (or the lack thereof) indicates that the significant unusual transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets
- Assess whether the form of the transaction is overly complex
- Determine whether management has discussed the nature of and accounting for the transaction with the audit committee or another committee of the board of directors or the entire board.
- Evaluate whether significant unusual transactions have been properly accounted for and disclosed in the financial statements

6. Here are the six ethical principles embedded in the AICPA *Code of Professional Conduct*:

- Responsibilities
- The Public Interest
- Integrity
- Objectivity and Independence
- Due Care
- Scope and Nature of Services

AAER No. 3814 specifically indicates that the respondents [Ernst & Young, Fronkiewicz, and Adams] "failed to exercise due professional care." [Of course, keep in mind that none of the "respondents" denied or admitted the charges filed against them.] The "due care" principle in the Code and the "due professional care" concept in the auditing standards are essentially interchangeable—granted, the due professional care concept is restricted to an auditing setting while the due care ethical principle is not. So, one can safely conclude that the SEC ruling in this matter strongly suggests that Fronkiewicz and Adams violated the due care ethical principle. In fact, each of the specific auditing deficiencies listed in Exhibit 3 would constitute a violation of the due care ethical principle. [Due care principle: "A member should observe the profession's technical and ethical standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of the member's ability."]

In addition to due care, did Fronkiewicz and Adams violate other ethical principles? The Responsibilities ethical principle suggests that "in carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities." One could reasonably argue that Fronkiewicz and Adams violated this generic principle. One could argue as well that the two partners violated the public interest ethical principle: "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." Reasonable arguments could also be made that the partners violated the Integrity and Objectivity/Independence principles.

7. Mary Jo White, who served as the SEC Chairwoman from April 2013 through January 2017, addressed the issue of whether individuals who agreed to settlements with her agency should be required to admit guilt for their misdeeds in a speech she made in 2013 to the Council of Institutional Investors (M.J. White, "Deploying the Full Enforcement Arsenal," http://www.sec.gov/, 26 September 2013). Here is an excerpt from that speech:

> Another principle of an effective enforcement program is the recognition that there are some cases where monetary penalties and compliance enhancements are not enough. An added measure of public accountability is necessary, and in those cases we should demand it.
>
> Until recently, the SEC – like most other federal agencies and regulators with civil enforcement powers – settled virtually all of its cases on a no-admit-no deny basis. Generally, a party would pay a hefty penalty and agree to an injunction against future misconduct, but neither admit nor deny the wrongdoing asserted by the SEC in a court complaint or set forth as findings in an order instituting administrative proceedings.
>
> In most cases, that protocol makes very good sense. It makes sense because the SEC can get relief within the range of what we could reasonably expect to achieve after winning at trial. By settling, the agency is able to eliminate all litigation risk, resolve the case, return money to victims more quickly, and preserve our enforcement resources to redeploy to do other investigations – ordinarily, a significant win-win. But sometimes more may be required for a resolution to be, and to be viewed as, a sufficient punishment and strong deterrent message.
>
> In 2012, the SEC changed the no-admit-no-deny language as it applied to settlements with parties that have pled guilty in a related criminal action. In these cases, we now explicitly reference these admissions in the SEC settlement. It was a first step towards greater accountability, and a good one.
>
> But when I started at the SEC, I re-examined our approach and concluded that there are certain other cases not involving any parallel criminal case where there is a special need for public accountability and acceptance of responsibility.
>
> As you might expect, much of my thinking on this issue was shaped by the time I spent in the criminal arena, where courts cannot accept a guilty plea without the defendant first admitting to the unlawful conduct. Anyone who has witnessed a guilty plea understands the power of such admissions – it creates an unambiguous record of the conduct and demonstrates unequivocally the defendant's responsibility for his or her acts.

> But what about resolutions that do not require a guilty plea?
>
> In 1994, when I was a U.S. Attorney, I entered into the first-ever deferred prosecution agreement (DPA) with a company – a tool the Department of Justice frequently uses today. Essentially, a DPA is an agreement that the government will file a criminal charge, but defer its prosecution for a period of time during which the party must demonstrate good behavior and satisfy the other terms of the agreement. These terms can include very significant payments of money, enhanced compliance requirements, and sometimes an outside monitor.
>
> Back in 1994, there was no template for those agreements. Nothing required an admission or confession of wrongdoing. But I decided in that particular case that a public admission of wrongdoing was required for the resolution to have sufficient teeth and public accountability. So considering this history, it should not be surprising that I would follow that same approach in my new role as Chair of the SEC.
>
> Since laying out this new approach, the most frequent question we get is about the types of cases where admissions might be appropriate.
>
> Candidates potentially requiring admissions include:
>
> - Cases where a large number of investors have been harmed or the conduct was otherwise egregious.
> - Cases where the conduct posed a significant risk to the market or investors.
> - Cases where admissions would aid investors deciding whether to deal with a particular party in the future.
> - Cases where reciting unambiguous facts would send an important message to the market about a particular case.
>
> To reiterate, no-admit-no-deny settlements are a very important tool in our enforcement arsenal that we will continue to use when we believe it is in public interest to do so. In other cases, we will be requiring admissions. These decisions are for us to make within our discretion, not decisions for a court to make.

In summary, Chairwoman White suggests that the "no admit-no deny" strategy to resolving enforcement cases is often a matter of expediency and a "win-win" for both the SEC and the party facing SEC charges. In this particular case, one could certainly argue that more than one of the four bulleted circumstances she identified near the end of the above excerpt applied to the Weatherford scandal which would have justified requiring at least some of the "defendants" to admit their guilt. For example, it seems that there were a "large number of investors harmed" by the Weatherford fraud and that the fraud "posed a significant risk to the market or investors."

CASE 1.3

CATERPILLAR INC.

Synopsis

In the late 1990s, PwC tax consultants sold a tax-avoidance plan to Caterpillar Inc., one of PwC's largest audit clients. The linchpin of that plan was the creation of a Swiss subsidiary for Caterpillar. Under Caterpillar's "Swiss tax strategy," the profits from the sale of replacement parts to non-U.S. customers were diverted to the new Swiss subsidiary. In fact, the Swiss subsidiary was not significantly involved in Caterpillar's replacement parts line of business before or after the implementation of the Swiss tax strategy. When marketing the tax plan to Caterpillar, the PwC tax consultants stressed that the plan would involve "relatively simple re-invoicing" of the non-U.S. replacement parts sales and only nominal changes in Caterpillar's operations. From Caterpillar's standpoint, the key feature of the tax avoidance plan was the four percent effective income tax rate negotiated by the company with Swiss taxing authorities. That effective tax rate allowed Caterpillar to realize $2.4 billion in tax savings over approximately one decade.

An anonymous employee in Caterpillar's tax department and Daniel Schlicksup, the company's Global Tax Strategy Manager, warned key company officials on multiple occasions that the PwC-designed tax avoidance plan was improper, if not illegal. Schlicksup maintained that Caterpillar's transactions with the Swiss subsidiary were not "arm's length" and did not have any "economic substance" or "business purpose" other than to reduce the company's corporate income taxes. After being demoted, Schlicksup filed a lawsuit against Caterpillar under the whistleblower provisions of the Sarbanes-Oxley Act of 2002. The lawsuit was settled privately between the two parties.

A Senate subcommittee chaired by Senator Carl Levin investigated Caterpillar's Swiss tax strategy. The resulting report concluded that Caterpillar's Swiss tax strategy involved only "changes . . . made on paper" that did not impact "how the replacement parts business actually functioned." Subsequent to the Senate subcommittee hearing, an IRS investigation resulted in $2.3 billion of additional taxes and penalties being levied against Caterpillar.

The "LuxLeaks" scandal that followed on the heels of Senator Levin's subcommittee hearing revealed hundreds of questionable tax avoidance schemes designed by PwC and the other Big Four accounting firms. These schemes involved "ghost" Luxembourg subsidiaries that were comparable in nature and purpose to the Swiss subsidiary established by Caterpillar. When considered jointly, the LuxLeaks scandal and the U.S. Senate Caterpillar investigation refocused the accounting profession's attention on the longstanding and extremely controversial "scope of services" issue.

Caterpillar Inc.--Key Facts

1. U.S. corporate income tax collections, as a percentage of total federal tax revenue, have been declining for decades.

2. A major factor contributing to declining corporate tax collections has been the efforts of large multinational companies to transfer taxable revenues to "low-tax" countries.

3. In 2014, a Senate subcommittee chaired by Senator Carl Levin investigated a questionable "profit-shifting" tax-avoidance strategy used by Caterpillar Inc. that had resulted in huge tax savings for the prominent multinational corporation.

4. In 1997, tax consultants with PwC, Caterpillar's audit firm, recommended a tax-avoidance plan to client management that would allow the company to achieve its "lowest sustainable tax rate."

5. Caterpillar adopted the PwC tax-avoidance plan and paid the accounting firm $55 million to design and implement it; Senator Levin questioned how PwC could retain its auditor independence when providing aggressive tax-avoidance services to Caterpillar.

6. The key feature of the tax-avoidance plan involved Caterpillar establishing a Swiss subsidiary and then diverting profits from non-U.S. sales of replacement parts to that subsidiary; the 4 percent effective tax rate that Caterpillar negotiated with the Swiss government—versus the 35 percent U.S. corporate income tax rate at the time—resulted in $2.4 billion of tax savings for the company.

7. An anonymous employee of Caterpillar's tax department and Daniel Schlicksup, the company's Global Tax Strategy Manager, warned key company officials that the Swiss tax strategy was improper, if not illegal, because that strategy was "tax-motivated."

8. In particular, Schlicksup maintained that Caterpillar's transactions with the Swiss subsidiary were not "arm's length" and did not have any "economic substance" or "business purpose" other than to reduce the company's corporate income taxes.

9. Schlicksup was ultimately demoted and filed a whistleblower lawsuit against Caterpillar; the lawsuit was settled privately between the two parties.

10. In 2014, the "LuxLeaks" scandal resulted in the public disclosure of 343 tax-avoidance plans designed by PwC for multinational corporations that had established Luxembourg subsidiaries comparable in nature and purpose to the Swiss subsidiary created years earlier by Caterpillar.

11. A second round of leaked documents revealed Luxembourg-based tax-avoidance plans designed by the three other Big Four firms that were similar to the previously disclosed PwC tax-avoidance plans.

12. By 2018, the IRS had assessed additional taxes and penalties of $2.3 billion on Caterpillar linked to its Swiss tax strategy; Caterpillar officials reported that they were "vigorously contesting" that assessment.

Instructional Objectives

1. To identify the ethical "principles" embedded in the AICPA *Code of Professional Conduct*.

2. To identify accounting and financial reporting principles relevant to aggressive tax practices employed by business entities.

3. To identify the professional standards relevant to tax consulting services and the key differences between such services and independent audit services.

4. To identify audit tests that should be applied to financial statement items resulting from, or impacted by, an audit client's aggressive tax practices.

5. To identify the audit risks posed by intercompany transactions.

6. To examine auditor independence issues raised when an accounting firm provides both independent audit and tax consulting services to a company.

Suggestions for Use

The use of "profit-shifting" or "offshore" tax strategies by large multinational corporations has been an extremely "hot button" issue in recent years within the global business community. U.S. critics of such practices have accused some of the nation's largest and most prominent corporations of diverting profits to "low-tax" countries for the sole purpose of avoiding the marginal U.S. corporate income tax rate of 35 percent (of course, the marginal corporate income tax rate has since been reduced). Among those international "tax havens" are members of the European Union, including Luxembourg and Ireland. Similar to the United States, other countries in the EU have directed scathing criticism at those tax havens for effectively "stealing" their tax revenues. Consider opening discussion of this case by identifying recent developments in this ongoing controversy, which is not likely to end soon.

A major focus of this case is the public interest responsibilities of accounting professionals, including independent auditors, tax consultants, and financial accountants of reporting entities. In discussing this case, the exact meaning of the phrase "public interest" will almost certainly become an issue. To prepare you for that issue, here is the definition of "the public interest" included in the AICPA *Code of Professional Conduct*: "The public interest is defined as the collective well-being of the community of people and institutions that the profession serves" [ET 0.300.030.02]. This definition is not as clear-cut as it may initially seem since the individual members of the "community" served by the accounting profession have diverging interests. At some point, the discussion of the meaning of this definition typically centers on the adjective "collective." That adjective implies that a utilitarian perspective should be applied to the term "public interest." Of course, applying a utilitarian mindset is problematic because of the difficulty of measuring "utility" and determining which given decision alternative maximizes the collective utility in a given context.

When covering this case, I am not surprised that many students defend the profit-shifting or offshore tax strategies used by companies such as Caterpillar, but I am surprised how viscerally certain students defend those strategies. These latter students generally express the point of view that the marginal corporate income tax rate in the United States is excessive and that corporations have a right, and a responsibility to their stockholders, to minimize the taxes paid to the federal government—in fact, the 35 percent marginal corporate income tax rate in the United States at the time of this case was among the highest worldwide. During the Senate subcommittee hearing that was a focus of this case, a similar point of view was expressed by certain members of that subcommittee—Senator Rand Paul being the most vocal of those individuals. Consider challenging students who support the profit-shifting tax strategies that are documented in this case to defend their positions and to identify specific examples of tax-reduction strategies, if any, that they would consider immoral or unethical.

Suggested Solutions to Case Questions

1. If your experience is similar to mine, you will have students that come down on "both sides of the ledger" in responding to this question. As I noted in the Suggestions for Use, there was not even consensus among the members of the U.S. Senate subcommittee regarding whether Caterpillar's Swiss tax strategy was inappropriate. Senator Rand Paul defended that strategy because he believed that the U.S. tax rules and regulations were unfair. In particular, he argued that corporate tax rates should be slashed. During his unsuccessful 2016 presidential campaign, Senator Paul proposed a "flat" corporate tax rate of 17 percent. Other members of the Senate subcommittee also chose not to endorse the final subcommittee report because of their belief that the corporate income tax rate in the U.S. was too high.

Here are the six ethical "principles" embedded in the AICPA *Code of Professional Conduct*: Responsibilities, the Public Interest, Integrity, Objectivity and Independence, Due Care, Scope and Nature of Services. Certainly, defensible—but not necessarily "correct"—arguments could be made that the PwC tax consultants violated the Public Interest, Integrity, Objectivity, Due Care, and Scope and Nature of Services. Listed next are brief overviews or summaries of those arguments.

Public Interest: One could argue that by offering Caterpillar a "questionable" tax-avoidance service, PwC was not serving the public interest. That is, PwC was helping Caterpillar avoid its "fair share" of their taxes.

Integrity: "Integrity is measured in terms of what is right and just. In the absence of specific rules, standards, or guidance or in the face of conflicting opinions, a member should test decisions and deeds by asking: 'Am I doing what a person of integrity would do? Have I retained my integrity?'" [ET 0300.040.04] Again, one could make a defensible argument that PwC did not act with integrity by providing tax consulting services that potentially helped Caterpillar improperly avoid taxes; one could also argue that the tax consulting services potentially impaired PwC's auditor independence, which would violate the integrity principle.

Objectivity: Notice that I "split" the fourth ethical principle into two "halves." "A member should maintain objectivity and be free of conflict of interests in discharging professional responsibilities." [ET 0300.050.01] One could argue that PwC's dual roles with Caterpillar impaired the objectivity of the firm's professional employees.

Independence: As suggested in the case, the dual provision of tax-avoidance and audit services placed the PwC Caterpillar auditors in a set of circumstances where, at a minimum, their "appearance" of independence was threatened. I can make this assertion safely since the Senate subcommittee obviously questioned the PwC auditors' apparent independence.

Due Care: I often refer to this as the "catch-all" ethical principle. If an AICPA member violates one of the other five ethical principles, I would argue that he or she has automatically violated this principle.

Scope and Nature of Services: According to ET 0.300.060.04b, a member in public practice should "Determine, in their individual judgments, whether the scope and nature of other services provided to an audit client would create a conflict of interest in the performance of the audit function for that client." One could argue that the tax consulting services provided to Caterpillar created a conflict of interest for PwC since the firm also audited the company.

2. One could argue that the Swiss tax strategy violated the "full and fair disclosure" principle since third parties were apparently not aware of the controversial method being used by Caterpillar to reduce its taxes. As proven by the additional taxes and penalties levied against Caterpillar by the IRS, the Swiss tax strategy exposed the company to significant liabilities. "Comparability" is another accounting/financial reporting principle that the Swiss tax strategy potentially violated since that strategy impacted the ability of third parties to make valid comparisons in Caterpillar's financial statements over time. "Materiality," "completeness," and "freedom from error" are other qualitative characteristics of financial information that the Swiss tax strategy may have adversely impacted.

3. The key difference between tax consulting services and independent audit services: tax consultants are "advocates" of their clients' economic interests while independent auditors are not. "When recommending a tax return position, a member has both a right and the responsibility to be an advocate for the taxpayer . . ." [TS 100.08].

The AICPA Professional Standards include sections devoted to "Consulting Services" and "Tax Services." So, one might conclude that "tax consulting services" would be governed by both of those sections of the professional standards. In fact, the Consulting Services standards specifically state that they do not apply to "tax planning or advice" and related professional tax services [CS 100.05, footnote 1].

TS 100.11 notes that, "In addition to a duty to the taxpayer, a member [CPA] has a duty to the *tax system* (emphasis added)." I believe this statement implicitly imposes a "public interest" obligation or responsibility on tax practitioners since the given "tax system" no doubt is intended to serve the public interest. The next sentence in paragraph 11 observes: "However, it is well established that the taxpayer has no obligation to pay more taxes than are legally owed, and a member has a duty to assist in achieving that result." Subsequent sections of the tax services standards note that as long as a CPA acts in "good faith" in advocating tax policies or positions, then he or she is in compliance with the tax services professional standards—including the implicit "public interest" obligation.

4. The ultimate source of "audit objectives" are "financial statement assertions." In the PCAOB Standards, the assertion regime includes: "existence/occurrence," "completeness," "valuation or allocation," "rights and obligations," and "presentation and disclosure." The key financial statement amounts impacted by a client's tax policies are tax expenses and tax liabilities. In turn, the primary concern of auditors in examining the latter accounts would be "completeness," that is, auditors should consider the possibility that the client has NOT reported all such expenses and liabilities in its financial statements. Another concern would be "valuation," that is, ensuring that a client's tax expenses and liabilities have been included in the financial statements in the appropriate amounts. Finally, for tax expenses and liabilities there may be "presentation and disclosure" issues that a client may need to address in the notes to its financial statements. For example, if a client is applying extremely aggressive tax positions that may be ultimately challenged by the IRS, those positions may need to be discussed in a financial statement note if they have material financial statement implications.

Listed next are selected generic examples of audit tests that could be applied to a client's tax expenses and/or liabilities. For a more complete list of such audit tests, refer to the Internet—numerous websites provide partial or complete "audit programs" for tax-related financial statement items.

- Apply clerical tests to tax-related amounts to ensure that the client has properly computed those amounts.
- Discuss the client's major tax policies with its tax return preparers to ascertain that those policies appear reasonable or defensible.
- Review the client's tax-related disclosures in the financial statement notes to ensure that those disclosures are complete and appropriate.
- Determine that deferred tax amounts have been computed, classified, and disclosed in conformity with GAAP.
- Review and/or test the client's reconciliation of income tax expense per its tax returns to the income tax expense reported in its income statement.

5. If not properly eliminated from a client's accounting records, intercompany transactions can result in significant misstatements in a client's consolidated financial statements. In those circumstances in which intercompany transactions involve an entity whose financial data are not included in the relevant consolidated financial statements, the auditor must consider the possibility that such transactions have been used to materially distort one, or both, of the given entities' financial statements. In the latter circumstances, the given intercompany transactions qualify as "related party transactions." Of course, an overriding concern is that related party transactions

have not been completed at "arm's length," meaning that the transactions may have been influenced, if not dictated, by non-economic considerations.

When intercompany transactions and account balances involve entities whose financial data are included in a consolidated set of financial statements, the auditor will first want to determine what internal control policies and procedures the client has in place to ensure that such items are properly eliminated prior to the preparation of the consolidated financial statements. Once that understanding is achieved—which may involve tests of controls, then the auditor will apply year-end tests to ensure that those policies and procedures were properly applied by the client.

For intercompany transactions and account balances involving an entity whose financial data are not consolidated, the auditor should treat those amounts as related party items. AS 2410, "Related Parties," describes the specific tests that auditors should apply to identify, gain an understanding of, and test a client's related party transactions and account balances. Here's an example of a specific test to consider applying to a related party transaction: "Evaluate the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations." [AS 2410.12d]

For the intercompany transaction described in this case [the "advance payments" made by the Swiss subsidiary to the U.S.-based parent company], the auditors' primary concerns would have been ensuring that the given transaction had been properly eliminated in the consolidated financial statements. Another audit objective would have been to ensure that the transaction complied with all relevant legal and regulatory rules and regulations. For example, the auditors almost certainly addressed the question of whether the given cash transferred to the U.S. parent company qualified as "repatriated" earnings that were subject to being taxed by the IRS and other U.S. taxing authorities. The key audit evidence that should have been collected would have been documentary evidence describing the nature and purpose of the given transaction. In addition, the auditors would almost certainly have discussed the transaction with the relevant Caterpillar personnel and thus have collected "client representations" audit evidence.

6. Regarding James Bowers' dual roles as a tax consultant for Caterpillar and as a participant in Caterpillar's independent audits, I have the same concern as that expressed in the Senate subcommittee report. No doubt, Mr. Bowers believed that he was capable of "independently" analyzing Caterpillar's Swiss tax strategy and the related financial statement implications. However, his dual roles, at a minimum, made third parties (including members of the Senate subcommittee) question whether, in fact, he was objective and independent when participating in the Caterpillar audits. As we all know, the lack of "apparent" independence can be just as damaging to the credibility of independent audit services as the absence of "de facto" auditor independence.

I would suggest that "yes" the Caterpillar workpapers should have included Mr. Bowers' "analysis" and described the purpose, nature, and outcome of that analysis. [See "Objectives of Audit Documentation," AS 1215.02-3, and "Audit Documentation Required, AS 1215.04-09A.] For example, AS 1215.06 notes that, "The auditor must document the procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions. Audit documentation must clearly demonstrate that the work was in fact performed."

CASE 1.4

GEMSTAR

Synopsis

Born in war-torn China in 1948, Henry Yuen, known then as Che-Chuen, fled the country with his family after Communist forces led by Mao Zedung forced large numbers of supposed counter-revolutionaries, including businesspeople such as Henry's father, into exile. The Yuen family escaped with their lives and a few belongings to Hong Kong. Nearly five decades later, Henry Yuen found himself listed in the Forbes 400 with a net worth exceeding one billion dollars.

Quiet and studious by nature, Yuen eventually immigrated to the United States where he earned a doctorate in mathematics and a law degree. At the age of 40, Yuen and a close friend collaborated to develop a simplified method for programming VCRs. The company co-founded by Yuen, Gemstar, eventually acquired almost 100 patents that allowed it to control electronic programming and search technologies that are vital to companies in the broadcasting and electronic communications industries. Gemstar's control of those technologies prompted *U.S. News and World Report* to label Yuen, who was effectively unknown by the general public, as the "Bill Gates of television." In 2000, Yuen acquired TV Guide International and renamed his company Gemstar-TV Guide International, Inc. (GTGI).

Yuen and many other industry insiders were convinced that interactive systems were the wave of the future in television. Since electronic programming technology would be indispensable to creating interactive TV services, many securities analysts believed GTGI would rack up huge profits as those services proliferated. Unfortunately for Yuen, interactive TV did not live up to its expectations. To conceal the discouraging financial performance of GTGI's over-hyped "Interactive Platform" division, Yuen and his key subordinates inflated the division's operating results by applying multiple accounting gimmicks that violated the revenue recognition principle. After facing a litany of civil and criminal charges, Yuen disappeared in 2008 and was subsequently declared a "fugitive from justice" by federal law enforcement authorities.

KPMG audited GTGI's financial statements and, as a result, was caught up in the accounting fraud perpetrated by the company's management team. The SEC berated KPMG for its deficient audits of GTGI which allegedly prevented the firm from uncovering the massive fraud. The SEC's investigation revealed that KPMG auditors often relied on management representations to support questionable revenue amounts when more reliable evidence was available. The SEC sanctioned four KPMG auditors for their roles in the "repeated audit failures" of GTGI—KPMG, as a firm, was slapped with a $10 million fine, which at the time was the largest fine ever imposed on an accounting firm by the SEC.

Gemstar--Key Facts

1. In 1988, Henry Yuen and a close friend developed VCR Plus, a new technology for programming VCRs; this technology became the initial product of Gemstar Development Corporation, a company the two friends founded.

2. During the late 1990s, Gemstar acquired nearly 100 patents; these patents allowed the company to exercise effective control over programming and search technologies vital to many companies in the broadcasting and electronic communications industries.

3. In 2000, Gemstar acquired TV Guide International, creating GTGI (Gemstar-TV Guide International); Yuen and media magnate Rupert Murdoch, who had previously been a major stockholder of TV Guide, were GTGI's two largest stockholders.

4. Yuen, GTGI's CEO, focused his time and energy on promoting the company's new Interactive Platform (IP) Sector that marketed IPG (interactive programming guide) technologies while paying little attention to the company's largest operating unit, the Media and Services Sector.

5. Murdoch, the spokesperson for the GTGI faction made up of former TV Guide executives, believed Yuen's focus on the unproven IPG services was misguided since the company's Media and Services Sector produced the bulk of the company's revenues.

6. Shortly after the 2000 merger that created GTGI, Yuen and several of his subordinates began using a variety of accounting gimmicks to enhance the operating results of the IP Sector, including diverting revenues to that sector from the Media and Services Sector.

7. After the SEC uncovered GTGI's accounting fraud, the federal agency forced the company to restate its prior financial statements and levied fines on Yuen and several of his top subordinates.

8. KPMG, GTGI's audit firm, issued unqualified opinions on the company's financial statements throughout the course of the accounting fraud.

9. In 2004, following a lengthy investigation, the SEC concluded that KPMG was guilty of "repeated audit failures" during its GTGI audits.

10. Among other criticism, the SEC charged that the KPMG audit team failed to uncover abusive revenue recognition policies used by GTGI, failed to consider key qualitative issues in making materiality decisions, and that the audit firm's "consultation" policy was inadequate.

11. In addition to suspending three audit partners and an audit manager who had participated in the GTGI audits, the SEC fined KPMG $10 million.

12. In May 2008, two years after being ordered to pay $22 million to victims of the GTGI accounting fraud, Henry Yuen failed to appear in court to face obstruction of justice charges which prompted federal prosecutors to declare him a "fugitive from justice;" Yuen is presumed to be in hiding outside the United States.

Instructional Objectives

1. To compare and contrast a businessperson's legal and ethical responsibilities.

2. To consider the impact that revisions in a client's business model should have on the entity's subsequent independent audits.

3. To demonstrate the importance of considering qualitative and quantitative factors in making materiality decisions.

4. To identify common causes of "audit failures."

5. To review the key features of the profession's new revenue recognition standard.

Suggestions for Use

This case revolves around a small sliver of everyday life in American culture, namely, the ubiquitous television scroll that many of us check numerous times per day to find a flick, sporting event, or random television program to while away a few mindless minutes . . . or hours. The major technical topic in this case is revenue recognition. The variety of abusive recognition revenue gimmicks used by GTGI provides you an opportunity to comprehensively discuss that topic and examine audit evidence issues relevant to revenue. Because of the focus on revenue recognition, you can also use this case to review the highlights of the profession's new revenue recognition standard—see case question No. 5.

Each semester in my graduate auditing seminar I make a point of engaging my students in a discussion of the meaning of the phrase "audit failure." The SEC charged the GTGI auditors with "repeated audit failures" so this case provides you an opportunity to explore exactly what that term means to your students—of course, "audit failure" is not explicitly defined in the technical literature. Some students will argue that any time an inappropriate audit opinion is issued, an audit failure has occurred. Other students typically define an audit failure as the lack of compliance with professional auditing standards. Dissecting those two alternative definitions of "audit failure" will allow you to touch on a wide array of related auditing topics including, among others, negligence, recklessness, due care, detection risk, and audit risk.

Suggested Solutions to Case Questions

1. No doubt, Yuen's point of view is one that is shared by many businesspeople and professionals. An "anything goes if it is legal" mindset is certainly not consistent with the major ethical paradigms of which I am aware. Consider placing this general issue in a context that your students should be very familiar with: Are "earnings management" techniques or accounting gimmicks "ethical" as long as they are not specifically prohibited by accounting standards? For example, is it ethical for corporate management to defer year-end maintenance expenditures on production equipment so that the company will reach its predetermined earnings goal?

To address this question more directly, a reasonable starting point is to compare the definition of "legal" and "ethical." My dictionary defines "legal" as something that is permitted by law, while "ethical" is defined as being in accordance with the rules or standards for *right conduct* or practice. Laws are intended to provide for, or, at least, contribute to, social order. As such, laws are not necessarily intended to define or enforce "right conduct." A brief review of U.S. history will identify many instances of laws that were clearly intended for some purpose other than enforcing "right conduct" on the part of U.S. citizens.

I would suggest that even today practically every U.S. citizen if asked would identify at least one law that they believe to be "unethical." In fact, if you want to prompt a lively discussion among your students, ask them to identify a law that they consider to be unethical—instruct them to be ready to defend that choice. Or, if you want, start with an example of your own drawn from the accounting and financial reporting domain, namely, the Foreign Corrupt Practices Act of 1977. That law specifically prohibits U.S. companies from paying bribes to officials of foreign governments to establish business relationships. Although most U.S. citizens may believe that law enforces "right conduct," certainly a large number of businesspeople believe that it is unjust or unfair (unethical?) to hold U.S. companies to higher standards of moral conduct than many, if not most, of their foreign competitors.

Several years ago, an empirical study reported in the *California Management Review* compared and contrasted U.S. and Russian business ethics. That study found that whistleblowing is generally, but not always, considered ethical in the U.S., while that practice is generally, but not always, considered unethical in Russia. Likewise, a large disparity in salaries within corporations (from low-level employees to top corporate executives) was considered ethical by a majority of U.S. businesspeople, while a majority of Russian businesspeople considered that phenomenon unethical. The point here is even if we all agreed that laws should be designed to provide for social order and to enforce "right conduct," differences of opinion on what is considered proper or right conduct would make accomplishing that goal very difficult.

In summary, I would answer "no" to this question. Just because someone is complying with all applicable laws and regulations does not suggest, necessarily, that he or she is behaving ethically.

2. The central issue in this case question is audit planning. Considering the "viability of new and untested business segments" is clearly a responsibility imposed on auditors by the PCAOB audit planning standards, assuming that the new business segments have a material impact on the company's operations, which the Interactive Platform Sector certainly did in the case of GTGI.

To properly perform an audit, the audit team must, by definition, have a thorough understanding of the client's business model and any recent changes, particularly major changes, that have been made to that business model. AS 2101.07 notes that "The nature and extent of planning activities that are necessary depend on the size and complexity of the company, the auditor's previous experience with the company, and changes in circumstances that occur during the audit." That same paragraph goes on to identify a dozen "matters" that may "affect the auditor's procedures" on a particular engagement including the following:

- Matters relating to the company's business, including its organization, operating characteristics, and capital structure.
- *The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting.* [emphasis added]

- Knowledge about risks related to the company evaluated as part of the auditor's client acceptance and retention evaluation.
- The relative complexity of the company's operations.

Each of the previous items was relevant to the GTGI KPMG audit team following the merger that created that company and, which in turn, resulted in the creation of the new Interactive Platform Sector. Regarding that new division, KPMG should have considered, at a minimum, bringing in an expert—either an external or an in-house expert—who clearly understood the business model of that division and the overall implications it had for GTGI's operations. Obtaining such an understanding would have allowed KPMG to develop a more thorough and appropriate audit strategy for the Interactive Platform Sector.

3. AS 2105.02 addresses the concept of materiality in the context of audits of public companies. This paragraph effectively adopts the Supreme Court's definition of that concept.

> In interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences 'a reasonable investor' would draw from a set of facts and the significance of the inferences to him."

The following paragraph notes that auditors should be "alert . . . for misstatements that could be due to quantitative or qualitative factors" [AS 2105.03]. So, bottom line, auditors must consider both qualitative and quantitative issues/factors in reaching materiality judgments.

Arriving at "good" materiality decisions is still more of an art than a science, to make use of a timeworn cliché. Broad guidelines or rules of thumb derived or borrowed from the auditing standards, however, can be extremely useful to auditors in "framing" their materiality decisions. I would suggest, for example, that auditors should place particular importance on qualitative issues when there appears to be a higher than normal risk of intentional misstatement. When fraud risk is elevated, auditors should recognize that the given financial data may have been sculpted to achieve a given purpose, one of which may be to mislead or deceive the auditors. In addition, during the final review of a client's financial statement data, the audit review partner would be well served to place a particularly heavy emphasis on qualitative, "big picture" issues that may have been given short shrift by field work auditors who for expediency and efficiency purposes placed a disproportionate emphasis on easy-to-apply quantitative materiality measures. (That is, field work auditors may be disinclined to take a "big picture view" of the client's financial data when they are focusing exclusively on inventory, receivables, or some other financial statement line item that they have been assigned to audit.)

It seems reasonable to suggest that quantitative measures may be most useful to auditors when fraud risk is low. Likewise, quantitative measures are particularly appropriate when auditors are making "first pass" audit planning decisions to identify financial statement items that may demand more attention than others.

In any case, regardless of the auditing context, auditors should not focus exclusively on quantitative measures or qualitative factors in arriving at audit judgments. With experience, auditors hopefully gain the insight to ascertain what "mix" of the two materiality considerations are most important in each unique client situation.

4. If you study a sample of audit failures or breakdowns, I believe you will find that a fairly small set of factors or circumstances are responsible for most deficient audits. The following list is not intended to be comprehensive, but, nevertheless, I believe these items are easily among the most common antecedents to audit failures. [As a sidebar: students are better equipped to address this question if they have studied several problem audits. If your students have studied several such audits, then you might require them to defend the items they list with references to specific cases in which those factors were present. If your students have not studied several problem audits, consider focusing this question on the Gemstar case alone. That is, instruct your students to identify the key factors that contributed to the deficient audits of GTGI.]

--An aggressive client management team committed to fulfilling their company's revenue and profit forecasts.
--A client experiencing declining profitability or recurring losses.
--A client that needs to raise additional debt or equity capital.
--Highly competitive conditions in a client's market.
--A client that has engaged in a series of large and unusual transactions, particularly near the end of a financial reporting period.
--Weak internal controls that can be easily overridden by client personnel.
--An audit engagement team lacking the proper degree of professional skepticism.
--One or more members of the audit engagement team lack the proper training to carry out their assigned responsibilities and/or are not supervised properly by their superiors.
--Lack of a proper degree of auditor independence. This condition is likely a product of other factors, such as the existence of a high-profile client that the audit firm is intent on retaining. (Before the passage of the Sarbanes-Oxley Act, a common precursor to audit failures for large public companies was the provision of a large amount of non-audit services by the given company's audit firm.)

You may have recognized the first several items on this list as "fraud risk factors" discussed in the professional auditing standards. No doubt, when such factors are present, the likelihood of an audit failure or breakdown increases significantly. The final three items relate to auditors themselves. Audit failures are much more likely when members of the audit engagement team lack a proper degree of professional skepticism, competence (including adequate familiarity with the client's business and industry), or independence. When the two sets of "audit failure" factors intersect, then the risk of a defective audit soars.

Hopefully students recognize that the "quality control mechanisms" that are the most effective in preventing audit failures are the profession's auditing standards and ethical mandates. Of course, the profession has also established explicit "quality control" standards that address broader quality control issues facing audit practitioners such as "leadership responsibilities" and "human resources" policies and procedures.

Consider asking your students to identify specific measures audit firms and auditors can use to avoid audit failures. After listing these items on the blackboard or overhead, relate each item on that list to one or more specific auditing standards. You will almost certainly find that each of the items listed in some way correlates with one or more explicit requirements in the professional auditing standards. For example, one of your students will almost certainly identify the preparation of detailed audit workpapers as an important measure to prevent audit failures. That quality control mechanism relates directly to the profession's "audit documentation" standards.

5. Here is the FASB's "core revenue recognition principle*:"* *Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.* Organizations apply the following five steps to invoke that principle:

1. Identify the contract with a customer
2. Identify the performance obligations (promises) in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations in the contract
5. Recognize revenue when (or as) the reporting organization satisfies a performance obligation.

Now, let's apply these five steps to the four transactions (highlighted in the case) in which GTGI improperly recognized revenue:

Licensing agreement with Scientific-Atlanta: No contract! Gemstar/GTGI would not have been entitled to recognize revenue under the new revenue recognition rules because there was no express contract with the other party.
Licensing agreement with AOL: There was definitely a contract in this case, however, Step No. 5 above was clearly violated by GTGI because the company did not recognize the revenue as the "performance obligations" were completed. Instead of recording the revenue on an annual basis prorated over the eight-year contract, GTGI "front-loaded" the revenue in the initial year of the contract.
Barter transaction with Fantasy Sports: In this case, Steps No. 3 and No. 4 would have been violated by GTGI. In fact, the fair value of the "future advertising credits" was grossly inflated by GTGI. Under the new revenue recognition standard (and under the "old rules" for that matter!) GTGI would have a responsibility to determine the proper fair value to assign to the advertising credits. Once that determination was made, then Step No. 4 would have been quite simple. That is, as the other party used the advertising credits, GTGI's Interactive Platform Sector would have been entitled to record the proper dollar amount of revenue.
Multiple-element transactions with Motorola and Tribune Company: Here again, the major issue would have been with Step No. 3, "determine the transaction price." GTGI would be required under the new revenue recognition rules to ascertain the proper transaction price or value to ascribe to the future advertising credits that were exchanged for the assets acquired. Under the circumstances, the fair value of the assets being sold by Motorola and the Tribune Company probably provided the most reliable basis for determining the fair value of the advertising credits exchanged for those assets.

CASE 1.5

ENRON CORPORATION

Synopsis

Arthur Edward Andersen built his firm, Arthur Andersen & Company, into one of the largest and most respected accounting firms in the world through his reputation for honesty and integrity. "Think straight, talk straight" was his motto and he insisted that his clients adopt that same attitude when preparing and issuing their periodic financial statements. Arthur Andersen's auditing philosophy was not rule-based, that is, he did not stress the importance of clients complying with specific accounting rules because in the early days of the U.S. accounting profession there were few formal rules and guidelines for accountants and auditors to follow. Instead, Andersen invoked a substance-over-form approach to auditing and accounting issues. He passionately believed that the primary role of the auditor was to ensure that clients reported fully and honestly to the public, regardless of the consequences for those clients.

Ironically, Arthur Andersen & Co.'s dramatic fall from prominence resulted from its association with a client known for aggressive and innovative uses of "accounting gimmicks" to window dress its financial statements. Enron Corporation, Andersen's second largest client, was involved in large, complex transactions with hundreds of special purpose entities (SPEs) that it used to obscure its true financial condition and operating results. Among other uses, these SPEs allowed Enron to download underperforming assets from its balance sheet and to conceal large operating losses. During 2001, a series of circumstances, including a sharp decline in the price of Enron's stock, forced the company to assume control and ownership of many of its troubled SPEs. As a result, Enron was forced to report a large loss in October 2001, restate its earnings for the previous five years, and, ultimately, file for bankruptcy in December 2001.

During the early months of 2002, Andersen became the focal point of attention among law enforcement authorities searching for the parties responsible for Enron's sudden collapse. The accusations directed at Andersen centered on three key issues. The first issue had to do with the scope of professional services that Andersen provided to Enron. Critics charged that the enormous consulting fees Enron paid Andersen impaired the audit firm's independence. The second issue stemmed from Andersen's alleged role in Enron's aggressive accounting and financial reporting treatments for its SPE-related transactions. Finally, the most embarrassing issue was the massive effort of Andersen's Houston office to shred Enron audit documents, which eventually led to the demise of the firm.

Enron Corporation--Key Facts

1. Throughout Arthur E. Andersen's life, "Think Straight, talk straight" served as a guiding principle for himself and Arthur Andersen & Co., the accounting firm that he founded.

2. Arthur Andersen's reputation for honesty and integrity resulted in Arthur Andersen & Co. gaining stature in the business community and growing into one of the nation's leading accounting firms by the time of his death in 1947.

3. Leonard Spacek succeeded Arthur Andersen as managing partner of Arthur Andersen & Co. in 1947 and continued Andersen's legacy of lobbying for more rigorous accounting, auditing, and ethical standards for the public accounting profession.

4. When Spacek retired in 1973, Arthur Andersen & Co. was one of the largest and, arguably, the most prominent accounting firm worldwide

5. The predecessor of Enron Corporation was an Omaha-based natural gas company created in 1930; steady growth in profits and sales and numerous acquisitions allowed Enron to become the largest natural gas company in the United States by the mid-1980s.

6. During the 1990s, Kenneth Lay, Enron's CEO, and his top subordinate, Jeffrey Skilling, transformed the company from a conventional natural gas supplier into an energy trading company.

7. Lay and Skilling placed a heavy emphasis on "strong earnings performance" and on increasing Enron's stature in the business world.

8. Enron executives used hundreds of SPEs (special purpose entities) to arrange large and complex related party transactions that served to strengthen Enron's reported financial condition and operating results.

9. During 2001, Enron's financial condition deteriorated rapidly after many of the company's SPE transactions unraveled; in December 2001, Enron filed for bankruptcy.

10. Following Enron's collapse, the business press and other critics began searching for parties to hold responsible for what, at the time, was the nation's largest corporate bankruptcy.

11. Criticism of Andersen's role in the Enron debacle focused on three key issues: the large amount of consulting revenue the firm earned from Enron, the firm's role in many of Enron's SPE transactions, and the efforts of Andersen personnel to destroy Enron audit documents.

12. Andersen's felony conviction in June 2002 effectively ended the firm's long and proud history in the public accounting profession.

Instructional Objectives

1. To provide students with a brief overview of the history and development of the public accounting profession in the United States.

2. To examine the "scope of services" issue, that is, the threats to auditor independence posed by audit firms providing consulting services to their audit clients.

3. To examine the extent to which independent auditors should be involved in their clients' decisions regarding important accounting and financial reporting issues.

4. To review recent recommendations made to strengthen the independent audit function.

5. To review auditors' responsibilities regarding the preparation and retention of audit workpapers.

Suggestions for Use

I typically begin an auditing course by discussing a major and widely publicized audit case. Clearly, the Enron case satisfies those criteria. The purpose of presenting such a case early in the semester is not only to acquaint students with the nature of auditing but also to make them aware of why the independent audit function is so important. Many accounting students are not well acquainted with the nature of the independent auditor's work environment, nor are they generally familiar with the critical role the independent audit function plays in our national economy. Hopefully, cases such as this one provide students with a "reality jolt" that will stimulate their interest in auditing and, possibly, make them more inclined to pursue a career in the auditing field.

The Enron case also serves as a good starting point for an auditing course since it provides students with an overview of how the auditing profession developed and evolved in the United States over the past century. The vehicle used to present this overview is the history of Arthur Andersen & Co. You will find that the case attempts to contrast the "Think straight, talk straight" philosophy of Arthur E. Andersen, the founder of the Andersen firm, with the more business-oriented approach to auditing that his predecessors adopted in the latter decades of the twentieth century.

Consider asking one or more of your students to interview former Andersen personnel who are graduates of your school. I have found that many former Andersen partners and employees are more than willing to discuss their former employer and the series of events that led to the firm's sudden collapse. These individuals typically suggest that federal prosecutors' efforts to "bring down" the entire Andersen firm as a result of the document-shredding incident was not only unnecessary but also inequitable, an argument that many members of the accounting profession—including academics—find difficult to refute.

Suggested Solutions to Case Questions

1. A large number of parties bore some degree of responsibility for the problems that the Enron fiasco ultimately posed for the public accounting profession and the independent audit function. The following bullet items identify several of these parties [see bold-facing] and the role they played in the Enron drama.

- The **leadership of the Andersen firm** that allegedly focused too much attention on practice development activities at the expense of the public service ideal embraced by Arthur E. Andersen and other early leaders of the profession.
- Impertinent **corporate executives** who insisted on aggressive, if not illegal, accounting and financial reporting treatments.
- **Individual auditors** who made shortsighted and/or unprofessional decisions that tainted the perceived integrity of all auditors.
- **Regulatory authorities** that failed to take proactive measures to limit the ability of rogue corporate executives, accountants, and auditors to circumvent their professional responsibilities.

2. One approach to answering this question is to review with your students the eight specific types of non-audit services that the Sarbanes-Oxley Act of 2002 prohibited auditors of public companies from providing to their clients. Listed next are those eight non-audit services.

- Bookkeeping or other services related to the accounting records or financial statements of the audit client
- Financial information systems design and implementation
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports
- Actuarial services
- Internal audit outsourcing services
- Management functions or human resources functions
- Broker or dealer, investment adviser, or investment banking services
- Legal services and expert services unrelated to the audit

Many of these services would eventually place auditors in situations in which they had to effectively audit their own work. For example, auditors providing "financial information systems design services" could be forced to evaluate the integrity of an accounting system they had designed for an audit client. Likewise, providing "human resources" functions, such as executive search services, to audit clients could threaten auditors' independence by causing them to evaluate the work product of high-ranking client employees who they had recommended that a client hire.

3. Given the assumption that the Powers Report excerpts included in Exhibit 3 are accurate, one could plausibly argue that Andersen's involvement in Enron's accounting and financial reporting decisions violated several of the ten generally accepted auditing standards that were in effect at the time. The specific standards violated would have included, at a minimum, those involving, independence, due professional care, planning and supervision, audit evidence, and audit

reporting. Each of the latter standards are now integrated into the PCAOB's auditing standards. Next, I list these standards, indicating parenthetically where they can be found in the PCAOB's auditing standards, and then briefly review how each was likely or possibly violated by the Andersen auditors.

- Independence (AS 1005): by becoming too involved in Enron's decisions for important accounting and financial reporting treatments, the Andersen auditors may have forfeited some degree of objectivity when they reviewed those decisions during the course of subsequent audits.
- Due professional care (AS 1015): any violation of another auditing standard, by definition, results in a violation of this broad-brush standard.
- Planning (AS 2101) and supervision (AS 1201): a reliable quality control function, including proper audit planning decisions and effective supervision/review during an audit, should result in the identification of problematic situations in which auditors have become too involved in client accounting and financial reporting decisions.
- Audit evidence (AS 1105): many critics suggest that Andersen's deep involvement in Enron's aggressive accounting and financial reporting treatments may have precluded the firm from collecting sufficient appropriate evidence to support the audit opinions issued on the company's financial statements (that is, the Andersen auditors may have been less than objective in reviewing/corroborating the client's aggressive accounting and financial reporting treatments).
- Reporting (AS 3101): If Andersen did not maintain its independence and objectivity while auditing Enron, the audit firm should have issued a disclaimer of opinion on the company's periodic financial statements.

4. Note: The PCAOB has established the documentation requirements for the audits of publicly owned companies in AS 1215, "Audit Documentation." The documentation requirements that pertain to audits of other organizations can be found in AU-C Section 230, "Audit Documentation," of the AICPA Professional Standards.

AU-C Section 230:

Paragraph .08 of AU-C Section 230 provides the following general guidance to independent auditors regarding audit workpapers or "audit documentation."

> "The auditor should prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand
>
> a. the nature, timing and extent of the audit procedures performed to comply with GAAS and applicable legal and regulatory requirements;
> b. the results of the audit procedures performed, and the audit evidence obtained; and
> c. significant findings or issues arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions."

Paragraphs 15-19 of AU-C Section 230 discuss the "assembly" and "retention" of audit workpapers. For example, paragraph 17 notes that the "retention period" for audit documentation "should not be shorter than five years from the report release date."

AS 1215:

This standard defines audit documentation as "the written record of the basis for the auditor's conclusions that provides the support for the auditor's representations, whether those representations are contained in the auditor's report or otherwise" (para. .02). "Examples of audit documentation include memoranda, confirmations, correspondence, schedules, audit programs, and letters of representation. Audit documentation may be in the form of paper, electronic files, or other media" (para. .04).

AS 1215 notes that there are three key objectives of audit documentation: "demonstrate that the engagement complied with the standards of the PCAOB, support the basis for the auditor's conclusions concerning every major relevant financial statement assertion, and demonstrate that the underlying accounting records agreed or reconciled with the financial statements" (para. .05).

Similar to AU-C Section 230, AS 1215 establishes an explicit benchmark that auditors can use to determine whether audit documentation is "sufficient." "Audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement: a) to understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached, and b) to determine who performed the work and the date such work was completed as well as the person who reviewed the work and the date of such review" (para. .06). AS 1215 generally requires auditors to retain audit documentation for seven years from the date the auditor gave the client permission to use the relevant audit report in connection with the issuance of a set of financial statements.

Regardless of whether an audit client is a publicly owned company or another type of organization, the audit workpapers are the property of the audit firm.

5. During and following the Enron debacle, wide-ranging recommendations were made by many parties to strengthen the independent audit function. Listed next are several of these recommendations, including certain measures that were incorporated in the Sarbanes-Oxley Act of 2002.

- Establish an independent audit agency. Some critics have suggested that to "cure" the paradoxical nature of the auditor-client relationship (that is, to eliminate the economic leverage that clients have on their auditors), the independent audit function should be performed by a government agency comparable to the Internal Revenue Service.
- Permit audit firms to provide only audit, reviews, compilations, and other "pure" attestation services to their clients, that is, prohibit the provision of all non-audit services to audit clients. (As mentioned in the suggested solution to Question 2, Sarbanes-Oxley prohibits audit firms from providing eight specific consulting services to their audit clients.)
- Require that audit clients periodically rotate or change their independent audit firms. (Sarbanes-Oxley requires that engagement and review partners be rotated every five years on audit engagements involving public companies.)

- Establish an independent board to oversee the audits of public companies. (Sarbanes-Oxley resulted in the creation of the Public Company Accounting Oversight Board "to oversee the audit of public companies that are subject to the securities laws . . .")
- Require independent auditors to work more closely with their clients' audit committees. (Section 204 of Sarbanes-Oxley is entitled "Auditor Reports to Audit Committees" and delineates the information that auditors should exchange with a client's audit committee, including any alternative accounting treatments "preferred" by the auditors.)
- Establish more explicit statutory requirements that prohibit client executives from interfering with the work of their independent auditors. (Section 303 of Sarbanes-Oxley is entitled "Improper Influence on Conduct of Audits." This section of the federal law makes it unlawful for corporate executives "to fraudulently influence, coerce, manipulate, or mislead" their company's independent auditors.")

6. Many critics of our profession suggest that beginning in the latter part of the twentieth century certain accounting firms gradually turned away from the public service ideal embraced by Arthur E. Andersen and other early pioneers within the profession and, instead, adopted a somewhat mercenary attitude toward the independent audit function. A key factor that certainly accelerated this trend was the profession's decision in the 1970s, with the goading of the Federal Trade Commission and the courts, to drop bans on competitive bidding, client solicitation, and other ethical rules that effectively restrained competition among audit firms. The elimination of those rules enticed audit firms to begin competing against each other for the finite number of large corporate audits. Practices such as "lowballing" to gain such clients allegedly resulted in audit firms "cutting corners" on audits. Likewise, audit firms began vigorously marketing non-audit services to supplement their suddenly low-margin audit services.

A related factor that allegedly contributed to the move away from the public service ideal was the growing tendency for large audit firms to consider marketing skills, as opposed to technical skills, as the key criterion in determining which individuals would be promoted to partner. Finally, pure and simple greed is a factor that motivates most of us. The large and lucrative market for business consulting services over the past few decades may have enticed audit firms to focus more on becoming "strategic business advisers" to their clients rather than placing an unrelenting emphasis on the quality of their audits of those clients' financial statements.

7. In the spring of 2000, the SEC began requiring public companies to have their quarterly financial reports (typically included in Form 10-Q filings) reviewed by their independent auditors. Should quarterly reports be audited? In fact, many parties have advocated an even more extreme measure, namely, that independent auditors continually monitor and report on the integrity of their clients' financial disclosures. In the current environment when information is distributed so readily and widely to millions of investors and other decision makers, the validity or utility of independent audits that focus on discrete time periods has been challenged. As recent history has proven, by the time that auditors issue their reports on a client's financial statements for some discrete period, the "horse may already be out of the barn"—the "horse" in this case being the damage to investors and other parties resulting from oversights and other misrepresentations in the given financial statements. This problem could be cured, or, at least, mitigated to some extent, by requiring auditors to provide real-time disclosures of potential problems in their clients' financial records.

CASE 1.6

LEHMAN BROTHERS HOLDINGS INC.

Synopsis

Wall Street was stunned in September 2008 when this iconic investment banking firm filed for bankruptcy. Two years later, there was a similar reaction within the investment community when Lehman's court-appointed bankruptcy examiner released his 2200-page report, the purpose of which was to identify the parties that could possibly be held civilly liable for the enormous losses suffered by Lehman's investors and creditors.

The focus of the bankruptcy examiner's report was hundreds of billions of dollars of allegedly "accounting-motivated" transactions that Lehman had used to enhance its apparent financial condition. Lehman's Repo 105s were short-term repurchase agreements that the company had chosen to record as "true sales" of securities under the auspices of the relevant accounting standard, namely, *SFAS No. 140*. The normal accounting treatment for repos is for the "seller" to record them as short-term loans. Why? Because most repos are, in substance, short-term loans in which the securities being "sold" are, in reality, simply the collateral for the given loan.

An exception to *SFAS No. 140* permits repo borrowers (sellers) to record these transactions as true sales of securities if they can demonstrate that they have "surrendered" control of the securities involved in the transactions. Lehman's management used this "loophole" in *SFAS No. 140* to significantly reduce its "net leverage ratio" and its reported liabilities near the end of financial reporting periods by engaging in a huge volume of Repo 105 transactions. At the time, the most important metric that analysts used in monitoring the financial health of large investment banks was their degree of financial leverage—Lehman touted its net leverage ratio as the best measure of its financial leverage.

This case provides a brief historical overview of Lehman Brothers and then dissects the accounting and financial reporting issues related to the company's controversial use of Repo 105s. Of course, the principal purpose of this case is to examine the auditing issues raised by the Lehman debacle. The company's audit firm, Ernst & Young, was among the parties most criticized by Lehman's bankruptcy examiner. The bankruptcy examiner identified three "colorable claims" involving professional malpractice or negligence that could potentially be pursued in lawsuits filed against Ernst & Young. This case examines the auditing issues embedded in each of those claims.

Lehman Brothers Holdings, Inc.--Key Facts

1. Lehman Brothers, one of Wall Street's most prominent investment banking firms, became the largest corporate failure in U.S. history when it filed for bankruptcy in September 2008.

2. The release in March 2010 of a report by Lehman's court-appointed bankruptcy examiner prompted a public outcry when it revealed that Lehman had used multi-billion dollar "accounting-motivated" transactions to embellish its apparent financial condition during 2007 and 2008.

3. Similar to other investment banks, a key business risk factor for Lehman was the high degree of financial leverage that it employed; Lehman management persuaded financial analysts and other third parties that its "net leverage ratio" was the best measure of its degree of financial leverage.

4. The business risk faced by Lehman and the other major investment banks was amplified during the 1990s and beyond when they became heavily involved in the rapidly evolving and high-risk financial derivatives markets.

5. When housing prices began plummeting in the U.S. in 2007, Lehman's financial condition worsened dramatically since it had large investments in RMBS (residential mortgage-backed securities).

6. To enhance its reported financial condition and its net leverage ratio, Lehman developed a plan to engage in a large volume of Repo 105s, which were repurchase agreements accounted for as sales of securities (the customary accounting treatment for repos was to record them as short-term loans).

7. Accounting for repos as sales of securities was permitted under certain restrictive conditions identified by the relevant accounting standard at the time, *SFAS No. 140*; however, Lehman could not find a U.S. law firm that would issue an opinion confirming that Repo 105s could be treated as sales.

8. Lehman executed the Repo 105s in Great Britain after finding a British law firm that would issue an opinion that they qualified as sales of securities; the Repo 105s allowed Lehman to reduce its net leverage ratio by as much as 10 percent and its reported liabilities by as much as $50 billion at the end of financial reporting periods.

9. Among the parties that were most heavily criticized by Lehman's bankruptcy examiner in his report was the company's audit firm, Ernst & Young.

10. The bankruptcy examiner concluded that E&Y could potentially be held liable for failing to properly investigate a whistleblower's allegations that Lehman's financial statements were materially misstated and for allegedly failing to properly investigate the impact of Repo 105s on Lehman's quarterly and annual financial statements.

11. Numerous lawsuits stemming from Lehman's collapse named E&Y as a defendant or co-defendant; E&Y made more than $100 million in payments to settle such lawsuits.

Instructional Objectives

1. To examine the responsibility of auditors when a client implements a new and controversial accounting policy that has significant financial statement implications.

2. To examine the responsibility of auditors when clients have engaged in significant "accounting-motivated" transactions.

3. To identify auditors' responsibility to review or otherwise evaluate important "other information" that accompanies a client's audited financial statements.

4. To identify factors that should influence key materiality decisions made by auditors.

5. To identify the responsibilities of auditors when the integrity of a client's financial statements is challenged by a whistleblower.

6. To examine auditors' differing legal exposure in lawsuits filed in state courts versus federal courts.

Suggestions for Use

Here's another case that you could use as a launching pad for an undergraduate or graduate auditing course. This case will readily demonstrate to your students the huge challenges that auditors can face in carrying out their responsibilities and the critical importance of independent audits for not only individual companies but the national economy as well. Ernst & Young's audits of Lehman Brothers literally had economic implications for practically every U.S. citizen. In sum, I believe a case such as this can be used as an "attention grabber" for auditing students by conveying to them the importance of the professional responsibilities that they will soon be assuming.

The focal point of this case involves a critically important issue for accountants and auditors alike, namely, the bottom-line objective of accounting and financial reporting standards. Lehman Brothers engaged in hundreds of billions of dollars of complex transactions that apparently had no express business purpose. Instead, the transactions were used ostensibly to window dress the company's financial statements, that is, to improve Lehman's critical net leverage ratio at a point in time when the company was literally coming apart at the seams. Although there is still some disagreement on this matter, there seems to be a general consensus that the "accounting loophole" that Lehman used to "pull off" this accounting charade was "legal" or permissible under *SFAS No. 140*, which was the relevant accounting standard at the time. In fact, I tell my students to make that assumption prior to addressing the following question, which I use to kickoff the discussion of this case: *Is it permissible for reporting entities to use accounting standards to intentionally misrepresent their financial statements?* It is surprising to me that there is not complete consensus within the profession or even among academics within our profession on this issue—as pointed out in the case. In fact, I have found that the majority of my students typically express the view that entities should be allowed to apply a given accounting or financial reporting rule even if their express intent is to use that rule to embellish their apparent financial condition and/or operating results.

You may want to point out to your students that U.S. accounting standards do not currently include a rule equivalent to the "true and fair override" rule embedded in IFRS—that rule requires reporting entities to *not* apply an accounting standard if it would result in the given financial statements being misleading. However, the AICPA *Code of Professional Conduct*, "Accounting Principles," effectively includes such an "override" rule—see "Accounting Principles Rule," ET 1.320.001.

Suggested Solutions to Case Questions

1. No, auditors do not have an explicit responsibility to be involved in an audit client's process of developing new accounting policies. In the PCAOB's auditing standards, AS 1001.03 notes that "The financial statements are management's responsibility . . . [and] that management is responsible for adopting sound accounting policies. . ." AS 2110.07 requires auditors to obtain an understanding of "the company's selection and application of accounting principles." AU-C 315.12 of the AICPA Professional Standards observes that "The auditor should obtain an understanding of the . . . entity's selection and application of accounting policies, including the reasons for changes thereto." In addition to obtaining an understanding of a client's accounting policies, auditors should consider whether each accounting policy is "appropriate" as noted by AS 2110.12 and AU-C 315.12.

Recognize that auditors' need to obtain an understanding of a given accounting policy is enhanced when the policy involves "unusual" transactions or when a "significant" accounting policy involves "controversial" or "emerging" areas for which there is a lack of authoritative guidance or consensus [see AS 2110.13]. These circumstances certainly seem to apply to the situation that existed when Lehman was developing its Repo 105 accounting policy.

2. Again, for me, this question or issue is the focal point of the case—from both an accounting/financial reporting point of view and from an auditing perspective. In my view, the economic reality of a given transaction should be reflected in the accounting treatment applied to it. That is, I believe that "intent does matter" and that the underlying intent of the accounting treatment applied to a given transaction should be to ensure that the economic substance of the transaction is properly reflected in the given entity's financial statements and accompanying notes.

The principal conceptual basis for the argument outlined in the previous paragraph is the FASB's conceptual framework, that is, the Statement of Financial Accounting Concepts, in particular, *SFAC No. 8, "Conceptual Framework for Financial Reporting."* For example, *SFAC No. 8* notes that "To be useful, financial information not only must represent relevant phenomena, but it also must faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, a depiction would have three characteristics. It would be complete, neutral, and free from bias." [para. QC12] Of course, as pointed out by E&Y's legal counsel in lawsuits filed against the firm, the conceptual framework is not considered a component of GAAP. So, a violation of the "faithful representation" requirement is technically not considered a GAAP violation. [Note: *SFAC No. 8* was issued in September 2010. *SFAC No. 8* replaced *SFAC No. 2* which included a discussion of "representational faithfulness" that paralleled the "faithful representation" concept presented in *SFAC No. 8*.]

3. Recall that the SEC has specifically defined "accounting-motivated structured transactions" as follows:

> 'Accounting-motivated structured transactions' are 'transactions that are structured in an attempt to achieve reporting results that are not consistent with the economics of the transaction, and thereby impair the transparency of financial reports.' [Attempts] to portray the transactions differently from their substance do not operate in the interests of investors, and may be in violation of the securities laws.

Auditors have an explicit responsibility to investigate whether the key management assertions underlying a given account balance, transaction, or financial disclosure is consistent with the presentation of that item in the relevant financial statements. By definition, accounting-motivated transactions would almost definitely violate one or more of those management assertions. For example, the classification assertion mandates that transactions and events be recorded in the proper accounts. You can imagine that a large proportion of accounting-motivated transactions would result in violations of the classification assertion.

So, my answer to this case question would be that auditors do have a responsibility to investigate whether client transactions are accounting-motivated. However, that responsibility is simply a by-product of applying an assertion-based audit strategy.

4. There was not a specific auditing standard that mandated that Schlich or one of his subordinates review the legal opinion issued by the British law firm. Having said that, given the critical importance of the Repo 105 transactions to Lehman's financial statements, it certainly seems that doing so would have been a "good idea." Reviewing that legal opinion would certainly have provided Ernst & Young with an enhanced "understanding" of the Repo 105 transactions [see answer to Question No. 1]. Granted, this observation is being made ex post. Recognize that Lehman developed the Repo 105 accounting policy shortly after *SFAS No. 140* was adopted in 2000. The company didn't begin engaging in a large volume of the Repo 105 transactions until several years later. So, even though it may not have seemed imperative for Ernst & Young to have reviewed the Linklaters' legal opinion when it was originally issued, years later when the volume of the Repo 105s increased dramatically, it seems reasonable to suggest that Ernst & Young should have at least considered reviewing that document.

On a large engagement involving multiple practice offices of an accounting firm, the engagement audit partner has the responsibility for overseeing the division of responsibilities on that engagement. In this case, that individual would have been William Schlich. Of course, on a large audit the engagement partner may delegate that administrative task to a subordinate. Nevertheless, the key point here is that the ultimate responsibility for administering the 2007 Lehman audit, including the allocation of the specific audit procedures to the practice offices involved in that audit, apparently rested with Schlich.

Notes: AU-C 600, "Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)" is relevant for audits of non-public companies. That auditing standard discusses the division of responsibilities on audits of "group financial statements," including the overarching responsibilities of the "group engagement partner." In the PCAOB's auditing standards, AS 1205, "Part of the Audit Performed by Other Independent Auditors," addresses circumstances in which multiple accounting firms are involved in an audit of an SEC registrant. AI 10 of the PCAOB's auditing standards includes "Interpretations" of AS 1205.

5. The relevant section of the PCAOB's auditing standards in this context is AS 2710, "Other Information in Documents Containing Audited Financial Statements."

AS 2710.04: "Other information in a document may be relevant to an audit performed by an independent auditor or to the continuing propriety of his report. The auditor's responsibility with respect to information in a document does not extend beyond the financial information identified in his report, and the auditor has no obligation to perform any procedures to corroborate other information contained in a document. However, he should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements. If the auditor concludes that there is a material inconsistency, he should determine whether the financial statements, his report, or both require revision."

AS 2710 goes on to discuss additional responsibilities that auditors have for "other information." For example, paragraph .05 discusses an auditor's responsibility when he or she discovers a "material misstatement" in "other information."

In the AICPA Professional Standards, AU-C Section 720, "Other Information in Documents Containing Audited Financial Statements," would be relevant to this question in the context of audits of entities other than public companies. AU-C Section 720 imposes responsibilities on auditors that are very similar to those included in AS 2710.

6. Since there isn't a "definitive" answer to this question, one objective you may want to accomplish in addressing it is to acquaint your students with the principal materiality "rules" or guidelines in (current and past) technical literature. Following are multiple viewpoints on materiality.

NOTE: *SFAC No. 2* was in effect when the key events in the Lehman case transpired. Included below is the FASB's reference to materiality in *SFAC No. 2* and in *SFAC No. 8*, which superseded *SFAC No. 2*. Finally, recognize that in 2018, the FASB shifted to a more legalistic definition of materiality, that is, one consistent with U.S. Supreme Court rulings. Of course, the SEC's views on materiality parallel those of the Supreme Court.

FASB, SFAC No. 2: *Statement of Financial Accounting Concepts No. 2* defines materiality as follows: "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."

FASB, SFAC No. 8: "Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity's financial report."

SEC: The SEC's principal statement regarding materiality can be found in *Staff Accounting Bulletin No. 99* issued in 1999. From the SEC's standpoint, an item is generally material if there is a "substantial likelihood" that a "reasonable investor" would "attach importance" to it in deciding whether or not to purchase a given security. Here's a key excerpt from *SAB No. 99*.

> An assessment of materiality requires that one views the facts in the context of the "surrounding circumstances," as the accounting literature puts it, or the "total mix" of information in the words of the Supreme Court. In the context of a misstatement of a financial statement item, while the "total mix" includes the size in numerical percentage terms of the misstatement, it also includes the factual context in which the user of the financial statements would view the financial statement item. The shorthand in the accounting and auditing literature for this analysis is that financial management and the auditor must consider both "quantitative" and "qualitative" factors in assessing an item's materiality.

PCAOB auditing standards: In AS 2105.02, the PCAOB embraces the Supreme Court and the SEC's definition of materiality (which, again, was effectively adopted as well by the FASB in 2018).

AICPA Professional Standards: AU-C Section 320, "Materiality in Planning and Performing an Audit," notes that "misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users made on the basis of the financial statements" (paragraph .02). [Note: In 2019, the Auditing Standards Board of the AICPA announced that it would be aligning its definition of materiality with those used by the SEC, the PCAOB, and the FASB.]

For Lehman Brothers, there was no doubt that the company's apparent degree of leverage was a key issue being monitored closely by the parties tracking that company's financial data. So, it certainly seems reasonable for E&Y to have placed a disproportionate focus on that facet of Lehman's financial condition in arriving at key materiality benchmarks—apparently, the E&Y auditors did just that since they had an explicit materiality threshold related to Lehman's net leverage ratio.

7. Allegations of financial statement misrepresentations by a whistleblower are not one of the "standard" types of audit evidence identified professional auditing standards. Nevertheless, such allegations will nearly always relate to one or more of the management assertions around which auditors design their audit program or audit plan. For example, in this case, the whistleblower's allegations challenged the reliability of the "accuracy" assertion for total assets and liabilities as well as several other management assertions identified in the PCAOB's auditing standards and the

AICPA Professional Standards. When whistleblower allegations challenge the reliability of management assertions for a given audit client, then certainly auditors have a responsibility to investigate those allegations.

No doubt, the first task of the auditor in this type of scenario will be to "consider the source." It may well be that the individual making the allegation is not credible and/or does not have access to information on which to base such an allegation. In such cases, the auditor will likely expend little time and effort investigating the given allegation. (By the way, the whistleblower in the Lehman case was very credible and had access to the company's accounting records since he was a member of the company's accounting staff.)

8. Most elements of proof do not vary between civil lawsuits filed against audit firms in the state and federal courts. For example, in either level of the court system, the plaintiff has to prove "damages," otherwise there is no basis for a lawsuit. The key factor that influences the legal exposure that audit firms face in state versus federal courts is the level of misconduct or malfeasance that the plaintiff must prove in order to prevail in a civil lawsuit filed against such a firm. When suing an audit firm under the Securities Exchange Act of 1934, the plaintiff has to prove that the audit firm was more than negligent in performing the given audit. Federal courts require a plaintiff to establish that the defendant audit firm was either reckless or that scienter (intent to deceive) was present (this element of proof varies across individual federal courts—approximately one-half of the federal district courts require plaintiffs to establish at least recklessness, while the other one-half invoke the higher "scienter" standard).

The level of misconduct that plaintiffs must establish in the state courts to prevail in a civil lawsuit against an audit firm varies. For example, in some state courts, only primary beneficiaries (of a given audit) can sue an audit firm for negligence, while in other state court systems primary, foreseen, and reasonably foreseeable beneficiaries can sue auditors for negligence. If a state court system does not allow a plaintiff to sue an audit firm for negligence, then the plaintiff must file such a lawsuit predicated on gross negligence, recklessness, or fraud. As you can imagine, plaintiff legal counsel often engage in so-called "venue shopping" to find a court where their client is most likely to prevail.

Notes: recognize that very few civil lawsuits against audit firms are tried in the federal courts under the Securities Act of 1933. Why? Because that statute imposes a severe level of legal liability on third parties, such as auditors, associated with S-1 registration statements that contain material misrepresentations. So, audit firms nearly always settle such lawsuits out of court. (Of course, the 1933 Act doesn't apply in this case since that statute deals with initial SEC registration statements for companies going public.)

CASE 1.7

JUST FOR FEET, INC.

Synopsis

Harold Ruttenberg emigrated to the United States from South Africa in 1976. In his early thirties at the time and the father of three small children, Ruttenberg wanted to escape the political and economic troubles brewing in South Africa. Over the previous decade, Ruttenberg had created a successful retail business in his home country. However, South Africa's emigration laws allowed the young businessmen to take only $30,000 of his considerable net worth with him to the U.S. Not to be deterred, the industrious Ruttenberg quickly resurrected his business career in his new homeland.

In 1988, Ruttenberg sold his existing business and founded Just for Feet, Inc., a retail "superstore" that sold principally athletic shoes. Over the next decade, Just for Feet opened more than 300 retail outlets across the United States and became the second largest retailer of athletic shoes in the nation. Ruttenberg took his company public in 1994. During the late 1990s, Just for Feet's common stock was one of the "hottest" securities on Wall Street, thanks to the company's impressive operating results, which included 21 straight quarterly increases in same-store sales. Those operating results were even more impressive when one considers the fact that the athletic shoe "sub-industry" was suffering from severe over-saturation during that time frame.

Just for Feet shocked Wall Street in mid-1999 by announcing that it would post its first-ever quarterly loss and that it might default on the interest payment that was coming due on its outstanding bonds. The potential default was particularly stunning since the company had just sold the bonds two months earlier. When Harold Ruttenberg resigned as the company's CEO in July 1999, Just for Feet's board hired a corporate turnaround specialist. Unfortunately, there was no turnaround in the company's future. In November 1999, the company filed for bankruptcy and was eventually liquidated.

Federal and state law enforcement authorities who investigated Just for Feet's sudden collapse discovered that management had orchestrated a large scale accounting fraud to conceal the company's deteriorating financial condition in the late 1990s. The principal features of the fraud included improper accounting for so-called vendor allowances, the company's refusal to provide an appropriate reserve for inventory obsolescence, and the recording of millions of dollars of fictitious "booth" income. Eventually, regulatory authorities turned their attention to Just for Feet's independent audit firm, Deloitte & Touche. Investigations of Deloitte's audits of Just for Feet revealed serious deficiencies in those audits that resulted in the prominent audit firm being sanctioned by the SEC and being named as a defendant in multiple civil lawsuits.

Just for Feet, Inc.--Key Facts

1. In 1976, Harold Ruttenberg, a successful entrepreneur in South Africa, chose to emigrate to the U.S. because of the economic and political turmoil in his home country.

2. Ruttenberg, who was forced to leave nearly all of his net worth in South Africa, quickly created a thriving retail business in Birmingham, Alabama.

3. In 1988, Ruttenberg founded Just for Feet, Inc., a retail company that marketed sports apparel, principally athletic shoes, from large "superstores."

4. From 1988 through 1998, Just for Feet's revenues and profits grew dramatically; by 1998, the company operated 300 retail outlets in the U.S. and was the nation's second largest retailer of athletic shoes.

5. In mid-1999, Just for Feet shocked the investing public by announcing that it would report its first-ever quarterly loss and that it might default on the interest payment coming due on its outstanding bonds.

6. Just for Feet's financial condition continued to deteriorate, causing the firm to file for bankruptcy in November 1999.

7. A series of investigations by state and federal authorities revealed that Just for Feet's impressive operating results during the 1990s had been the product of a large-scale accounting fraud.

8. The three principal elements of the accounting fraud were improper accounting for vendor allowances, refusing to record an appropriate reserve for inventory obsolescence, and booking millions of dollars of fictitious "booth" income.

9. An SEC investigation revealed numerous deficiencies in Deloitte & Touche's audits of Just for Feet during the late 1990s.

10. The principal criticisms of Deloitte's audits included the improper application of confirmation procedures, failure to properly audit Just for Feet's inventory valuation reserve, and the failure to thoroughly investigate the company's suspicious booth income transactions.

11. Deloitte was fined $375,000 by the SEC for its deficient Just for Feet audits; the SEC suspended the 1998 audit engagement partner for two years and the audit manager for one year.

12. At the same time that the SEC announced the sanctions imposed on Deloitte for its Just for Feet audits, the federal agency revealed that it was fining the accounting firm $50 million for its flawed audits of the scandal-ridden telecommunications company, Adelphia Communications.

Instructional Objectives

1. To demonstrate the need for auditors to employ analytical procedures during the planning phase of an audit to identify high-risk accounts.

2. To help students identify key inherent and control risk factors present during an audit.

3. To understand the nature and purpose of audit confirmations.

4. To demonstrate the importance of auditors thoroughly investigating unusual and suspicious circumstances uncovered during an audit.

5. To understand the SEC's oversight role for the financial reporting and independent audit functions.

Suggestions for Use

This case can be integrated with the coverage of several different topics in an undergraduate or graduate auditing course. Exhibits in this case present Just for Feet's financial statements for the final three years that it was fully operational, namely, fiscal 1996 through fiscal 1998. Instructors can use those financial statements as the basis for a major analytical procedures assignment—see the first case question. The second and third case questions provide an opportunity for instructors to introduce the audit risk model and/or to provide a real-world application of that model. Finally, since much of the criticism of Deloitte in this case involved the confirmation procedures that firm applied to Just for Feet's receivables, you could integrate this case with your coverage of that important topic.

You might consider making the fourth case question a group assignment. After each group has completed the ranking exercise, collect the resulting lists and post them on the board or overhead. Then, identify the "outliers" in those rankings and ask the given groups to justify/explain those items.

Suggested Solutions to Case Questions

1. Common-sized balance sheets for Just for Feet's 1996-1998 fiscal years: [Note: each fiscal year ended on January 31 of the following year. For example, fiscal 1998 ended on January 31, 1999.]

	1998	1997	1996
Current assets:			
Cash	.02	.19	.37
Marketable securities	.00	.00	.09
Accounts receivable	.03	.04	.02
Inventory	.58	.46	.35
Other current assets	.03	.01	.01
Total current assets	.66	.70	.84
Property and equipment	.23	.21	.14
Goodwill, net	.10	.08	.00
Other	.01	.01	.02
Total assets	1.00	1.00	1.00
Current liabilities:			
Short-term borrowings	.00	.20	.27
Accounts payable	.14	.12	.10
Accrued expenses	.04	.02	.01
Income taxes payable	.00	.00	.00
Current maturities of LT debt	.01	.01	.01
Total current liabilities	.19	.35	.39
Long-term debt and obligations	.34	.05	.03
Total liabilities	.53	.40	.42
Shareholders' equity:			
Common stock	.00	.00	.00
Paid-in capital	.36	.49	.51
Retained earnings	.11	.11	.07
Total shareholders' equity	.47	.60	.58
Total liabilities and shareholders' equity	1.00	1.00	1.00

Common-sized income statements for Just for Feet:

	1998	1997	1996
Net sales	1.00	1.00	1.00
Cost of sales	.58	.58	.58
Gross profit	.42	.42	.42
Operating expenses:			
Store operating	.30	.30	.27
Store opening costs	.02	.01	.04
Amortization of intangibles	.00	.00	.00
General and administrative	.03	.04	.03
Total operating expenses	.35	.35	.34
Operating income	.07	.07	.08
Interest expense	(.01)	.00	.00
Interest income	.00	.00	.01
Earnings before income taxes and cumulative effect	.06	.07	.09
Provision for income taxes	.02	.03	.03
Earnings before cumulative effect	.04	.04	.06
Cumulative effect	--	--	(.01)
Net earnings	.04	.04	.05

Financial Ratios for Just for Feet:

	1998	1997
Liquidity:		
Current	3.39	2.00
Quick	.37	.67
Solvency:		
Debt to assets	.53	.40
Times interest earned	6.38	24.67
Long-term debt to equity	.71	.09
Activity:		
Inventory turnover	1.49	1.65
Age of inventory	242 days	218 days
Accounts receivable turnover	44.6	42.75
Age of accounts receivable	8.1 days	8.4 days
Total asset turnover	1.36	1.26
Profitability:		
Gross margin	41.6%	41.5%
Profit margin on sales	3.4%	4.5%
Return on total assets	6.1%	5.5%
Return on equity	9.0%	8.8%

Equations:

Current ratio: current assets / current liabilities
Quick ratio: (current assets - inventory) / current liabilities
Debt to assets: total debt / total assets
Times interest earned: earnings before interest and taxes / interest charges
Long-term debt to equity: long term debt / shareholders' equity
Inventory turnover: cost of goods sold / avg. inventory
Age of inventory: 360 days / inventory turnover
A/R turnover: net sales / average accounts receivable
Age of A/R: 360 days / accounts receivable turnover
Total asset turnover: net sales / average total assets
Gross margin: total gross margin / net sales
Profit margin on sales: net income / net sales
Return on total assets: (net income + interest expense) / avg. total assets
Return on equity: net income / avg. shareholders' equity

Selected industry norms as of 1998 (these norms were taken from a Dun & Bradstreet publication; each industry norm is a mean for the given ratio):

Current ratio:	3.0
Quick ratio:	.75
Debt to assets:	.37
L-T debt to equity:	.14
Inventory turnover:	2.15
Age of inventory:	167 days
A/R turnover:	52.7
Age of A/R:	6.8 days
Total asset turnover:	2.11
Gross margin:	36.7%
Profit margin on sales:	4.6%
Return on total assets:	9.7%
Return on equity:	15.3%

Following, in bullet form, are the key financial statement items and other issues that are "brought to the surface" by the common-size financial statements, financial ratios, and other available information regarding Just for Feet as of the end of fiscal 1998.

1. Clearly, inventory had to be a major focus of the fiscal 1998 audit. At January 31, 1999, inventory was easily Just for Feet's largest asset, accounting for almost 60% of the company's total assets. In addition, inventory was growing at a rapid pace relative to other financial statement items. Notice that at the end of fiscal 1996 inventory accounted for only 35% of the company's total assets. Given the increasing age of inventory, proper valuation of that asset should have been a major concern at the end of 1998. This concern should have been heightened by the fact that the average age of Just for Feet's inventory

was approximately 45% higher than the average age of inventory in the industry.

2. Cash is a financial statement item that is not particularly challenging to audit; however, auditors must closely monitor a client's cash and near-cash assets to assess the entity's liquidity. A client that has limited cash resources may pose a going-concern issue for its auditors. Notice the dramatic decline in Just for Feet's cash resources, both on an absolute and relative basis, from the end of fiscal 1996 through the end of fiscal 1998. More insight on Just for Feet's liquidity can be obtained by reviewing the company's statements of cash flows, which are included in Exhibit 2 of this case. Notice that over the three-year period in question, Just for Feet's operations were producing negative cash flows. In fact, in fiscal 1998, the company's negative operating cash flows were more than three times greater than its reported net income. The major source of cash for Just for Feet from 1996 through 1998 was borrowed funds. Recall that shortly after the end of fiscal 1998, the company borrowed an additional $200 million by selling "junk" bonds. Another indication that Just for Feet's liquidity was substandard at the end of fiscal 1998 was its quick ratio of .37, which had declined from .67 at the end of fiscal 1997. Notice that the average quick ratio in Just for Feet's industry at the time was .75.

3. Related to the previous item was the sharp increase in Just for Feet's long-term debt during 1998. Notice that the company's long-term debt to equity ratio spiked from .09 at the end of fiscal 1997 to .71 at the end of fiscal 1998. Although the company's interest coverage ratio was at a reasonable level at the end of fiscal 1998, the auditors should have been aware that it was unlikely that Just for Feet's operations would "fund" the interest payments on that debt during the following year.

4. Just for Feet's financial data suggest that accounts payable may have merited more attention than normal at the end of fiscal 1998. As a general rule, the growth rates of inventory and accounts payable should parallel each other. That was not true with Just for Feet. Inventory increased by approximately 200% from the end of fiscal 1996 through the end of fiscal 1998, while accounts payable increased approximately 157% over that time frame. [Note: of course the "netting" of the questionable vendor allowances reduced Just for Feet's reported accounts payable.]

5. A final issue that is raised by an analysis of Just for Feet's 1996-1998 financial data is the seemingly improbable consistency of certain of the company's key financial ratios. In particular, notice how stable the company's gross margin (profit) percentage was over that period. Likewise, the company's operating margin percentage (operating income / net sales) was effectively unchanged over that period. Executives in the retail industry are aware that analysts pay particular attention to certain financial statistics. Among these latter items are the year-over-year percentage change in same store sales, the gross profit percentage, and the operating margin percentage. In many financial frauds, executives have "sculpted" their financial data to produce impressive appearing trend lines for those items. Finally, notice that Just for Feet's gross margin percentage was considerably higher than that of the industry during fiscal 1998, which should have raised some level of concern on the part of Deloitte.

2. (The second part of this question will be addressed first.) The audit risk model suggests that there is a direct relationship between control risk and audit risk. That is, as the level of control risk posed by a client increases, *ceteris paribus*, there is a greater chance that an auditor will issue a "clean" opinion when some other type of audit report is appropriate in the circumstances. Thus, as assessed control risk increases, auditors typically counterbalance that increased risk by increasing the overall rigor of their audit NET (nature, extent, and timing of their audit tests), thereby reducing detection risk.

Listed next are examples of specific control risk factors that are common to companies such as Just for Feet.

--A significant amount of cash changes hands daily.
--Inventory is exposed to a high risk of customer and employee theft.
--The large volume of transactions increases the likelihood that some transactions will be processed incorrectly.
--The decentralized nature of the organization's operations increases the likelihood that mid- or lower-level managers may attempt to take advantage of the organization.
--The decentralized nature of the organization increases the difficulty of monitoring its control functions.
--The high degree of employee turnover typically experienced by such organizations tends to diminish the effectiveness of their internal controls.

3. This is a "sister" question to Question #2. Again, there is a direct correlation between inherent risk and overall audit risk. As assessed inherent risk increases, *ceteris paribus*, overall audit risk increases as well. To mitigate an increased level of inherent risk, auditors will typically increase the rigor of their audit NET (nature, extent, and timing of their audit tests), thereby reducing detection risk.

Listed next are examples of specific inherent risk factors that are common to companies operating in a highly competitive industry.

--Rapid changes in products and customer preferences for those products increase the risk of obsolete inventory.
--Price competition due to companies "chasing" a finite set of customers may undermine operating results.
--Declining or negative operating cash flows may induce management to begin "window-dressing" their financial statements to increase the likelihood of obtaining additional debt and equity capital.
--Declining or negative operating cash flows may increase the likelihood of violating debt covenants, which, in turn, may induce window-dressing behavior on the part of management.
--Subtle or overt pressure exerted by financial analysts to maintain revenue and profit trends may induce window-dressing behavior on the part of management.
--Unusually high turnover within management due to competitors "raiding" each other's talent pool may result in a higher frequency of inadvertent errors in a company's accounting records due to a "learning curve" effect.

4. As a point of information, the phrase "audit risk factor" is apparently never explicitly defined

in the professional standards. A related phrase, "fraud risk factors" is defined in AU-C 240.A28 of the AICPA Professional Standards: ". . . the auditor may identify events or conditions that indicate an incentive or pressure to commit fraud or provide opportunity to commit fraud (fraud risk factors), such as . . ." In this context, the phrase "audit risk factor" is intended to be more inconclusive. For example, certain of the items identified in the suggested solutions to Questions #2 and #3 may qualify as "generic" audit risk factors but not necessarily fraud risk factors.

The following list identifies key audit risk factors evident during the 1998 Just for Feet audit. This list is not intended to be all-inconclusive, nor are these factors ranked in order of importance. Finally, recognize that many of these factors overlap. As a statistician would say, these factors are not "orthogonal."

--the high-risk business strategies applied by management
--the "significant" emphasis that management placed on achieving earnings goals
--management's aggressive application of accounting standards
--management's "excessive" interest in maintaining the company's stock price at a high level
--"unique and highly complex" transactions engaged in by the company near year-end
--the domineering management style of Harold Ruttenberg
--the large increase in vendor allowance receivables from the end of 1997 to the end of 1998
--the large increase in the company's inventory from the end of 1997 to the end of 1998
--the over-saturation and thus extremely competitive nature of the athletic shoe segment of the shoe industry
--the dwindling cash resources of the company
--the consistent trend of negative operating cash flows
--the large increase in long-term debt in 1998 and the resulting increase in financial leverage
--the disproportionately slow growth rate of accounts payable (vis-à-vis inventory)
--the unusually steady gross margin and operating margin percentages from 1996 through 1998
--the considerable risk of inventory and cash theft given the nature of the company's operations
--the decentralized nature of the company's operations
--the large volume of transactions processed daily
--the complex nature of the vendor allowance transactions (for example, Just for Feet's vendors had considerable discretion in determining the timing and size of the allowances)
--the unusual, if not unique, nature of the booth income transactions

As suggested previously, you might consider having your students complete Question #4 as a group exercise. After each group has developed its "top five" list, collect those lists and make each of them available to the entire class. Next, challenge individual groups to defend obvious "outliers" and/or obvious omissions in their individual rankings.

Did the Deloitte auditors identify and respond appropriately to the audit risk factors just listed? First of all, the Deloitte auditors apparently identified most, if not all, of these factors. Granted, the information available in the public domain does not explicitly confirm this assertion. For example, the sources that were the basis for the development of this case do not indicate that Deloitte explicitly considered the potential implications for the 1998 audit of Just for Feet's negative operating cash flows. However, almost certainly Deloitte recognized this issue since it was so blatantly obvious. Second, it seems apparent that Deloitte did not respond appropriately to these risk factors. Certainly, that was the conclusion of the SEC. In the course of addressing this case question, you might ask your students what other audit procedures Deloitte should have applied or should have considered applying in responding to the audit risk factors present during the 1998 audit.

5. There was a wide range of parties who stood to be affected by the decision of Thomas Shine regarding whether or not to send a false confirmation to Deloitte & Touche. These parties included, among others, Just for Feet's stockholders and potential stockholders, Just for Feet's lenders and potential lenders, Just for Feet's independent auditors, Shine's own company and the stakeholders in that organization, his family, and, of course, himself.

A common feature of the various ethical decision-making models that can be applied to ethical dilemmas, such as that faced by Thomas Shine, is identifying the alternatives that are available to the given individual. Too often, individuals facing an ethical dilemma succumb to tunnel vision, that is, they become focused on only one or two possible decision alternatives without taking the time to consider the full range of such alternatives that are available to them. Another common mistake that individuals face in such situations is to act too hastily. This is a natural reaction, of course. By definition, an ethical dilemma imposes some degree of pressure or stress on the given individual. One strategy for eliminating that stress is to make a hasty decision that resolves the dilemma. Finally, another common oversight in such situations is to place too much weight on the short-term consequences that the given individual will face following his or her decision. In these situations, individuals should force themselves to "look" well into the future and consider how each decision alternative, if chosen, may eventually affect their careers, their feelings of self-worth, and other stakeholders.

An effective approach to addressing this question is to ask students to suggest different ways that Thomas Shine could have responded to the ethical dilemma he faced. Then, you can engage students in an open discussion or debate regarding the advantages and disadvantages, propriety and impropriety of each given suggestion. Too often when faced with this type of question, students will suggest that the given individual should have "stood his or her ground" and simply refused to cooperate in any way with the party who was pressuring him or her to behave unethically. That simplistic suggestion ignores the complexity of most ethical dilemmas that arise in a business context. So, before asking students to respond to this question, consider requiring them to identify specific contextual factors that may have complicated Thomas Shine's decision. These factors may have included . . . Shine was aware that Just for Feet had numerous vendors and may have been able to reduce or even eliminate purchases from any one vendor; Shine was in the process of attempting to sell his company to a larger shoe manufacturer (in fact, that is exactly what happened); or, Shine was aware that many of his colleagues with other vendors routinely signed audit confirmations without considering the accuracy of the amounts reported in them.

CASE 1.8

HEALTH MANAGEMENT, INC.

Synopsis

This case profiles an imaginative accounting fraud orchestrated by two top executives of Health Management, Inc. (HMI), a New York-based pharmaceuticals distributor. The HMI fraud is noteworthy because it led to the first major test of an important federal statute, the Private Securities Litigation Reform Act of 1995 (PSLRA), that was intended to alleviate the growing burden of class-action lawsuits filed against accounting firms and other third parties under the Securities Exchange Act of 1934. (The PSLRA amended key provisions of the 1934 Act.) The PSLRA made it more difficult for plaintiffs to successfully "plead" a case under the 1934 Act, that is, to have such a lawsuit proceed to trial. Among other provisions in the PSLRA is a proportionate liability rule. Under this liability standard, a defendant that is guilty of no more than "recklessness" is generally responsible for only a percentage of a plaintiff's losses, the percentage of those losses produced by the defendant's reckless behavior.

HMI's former stockholders filed a class-action lawsuit against BDO Seidman, HMI's former audit firm. The plaintiff attorneys attempted to prove that the BDO Seidman auditors had been reckless during the 1995 HMI audit, which prevented them from discovering the large inventory fraud carried out by Clifford Hotte, HMI's CEO, and Drew Bergman, the company's CFO. The plaintiff attorneys repeatedly pointed to a series of red flags that the BDO Seidman auditors had allegedly overlooked or discounted during the 1995 audit. Additionally, the plaintiff attorneys insisted that a close relationship between Bergman and Mei-ya Tsai, the audit manager assigned to the 1995 HMI audit engagement team, had impaired BDO Seidman's independence during the 1995 audit. Bergman had previously been employed by BDO Seidman and had served as the audit manager on prior HMI audits.

Following a jury trial in federal court, BDO Seidman was absolved of any responsibility for the large losses that HMI's stockholders had suffered as a result of the 1995 inventory fraud. BDO Seidman's lead attorney attributed that outcome of the case to the PSLRA. Absent the proportionate liability rule incorporated in the PSLRA, the attorney suggested that BDO Seidman would likely have chosen to pay a sizable settlement to resolve the lawsuit rather than contest it in the federal courts.

Health Management, Inc.--Key Facts

1. Clifford Hotte and Drew Bergman engineered an accounting fraud to allow HMI to reach its 1995 earnings target.

2. The key element of the HMI fraud was an elaborate in-transit inventory sham that resulted in a material overstatement of HMI's year-end inventory.

3. The HMI fraud triggered the first major test of an important federal statute, the Private Securities Litigation Reform Act (PSLRA) of 1995, which amended the Securities Exchange Act of 1934.

4. Congress intended the PSLRA to alleviate the burdensome legal liability that accounting firms and other defendants faced under the 1934 Act by raising the "pleading standard" for lawsuits filed under that law and by establishing proportionate liability for defendants found liable in such lawsuits.

5. The key objective of the plaintiff attorneys in the HMI lawsuit filed by the company's former stockholders against BDO Seidman was to convince the jury that the BDO Seidman auditors, at a minimum, had been reckless during the 1995 HMI audit.

6. BDO Seidman's attorneys used a three-pronged defense strategy: (1) insisting that the auditors were victims of the fraud, (2) arguing that there was no evidence of specific violations of auditing standards by the auditors, and (3) contending that the auditors had made a good faith effort to investigate HMI's suspicious financial statement items.

7. A key issue during the trial was whether the BDO Seidman auditors should have performed an inventory rollback to corroborate the year-end in-transit inventory.

8. Another key issue that arose during the trial was whether a relationship between Bergman and the audit manager assigned to the HMI engagement, who was his former co-worker at BDO Seidman, had undermined BDO Seidman's independence.

9. Eventually, the jurors ruled in favor of BDO Seidman after deciding that the auditors had not been reckless.

10. BDO Seidman's lead attorney suggested that the PSLRA's proportionate liability rule was a key factor that gave his client the courage to contest and ultimately defeat the HMI lawsuit.

Instructional Objectives

1. To examine the implications that the Private Securities Litigation Reform Act of 1995 has had, and is expected to have, for the public accounting profession.

2. To illustrate key strategies that plaintiff and defense attorneys use in lawsuits filed against auditors.

3. To define "recklessness" as it relates to audit-related lawsuits filed under the Securities Exchange Act of 1934.

4. To examine the impact that close relationships between auditors and client personnel can have on independent audits.

5. To demonstrate that auditor judgment is the ultimate determinant of the specific audit procedures applied during an audit engagement.

Suggestions for Use

This case includes dialogue excerpted from the transcripts of the HMI trial in late 1999. When possible, I attempt to incorporate such dialogue into cases because it results in a heightened sense of realism. The dialogue in the case also provides an opportunity for instructors to set up realistic role-playing exercises. For example, you might consider having one student assume the role of the plaintiff attorney who interrogated Jill Karnick, the BDO Seidman semi-senior who audited HMI's inventory, while another student "steps into the shoes" of Ms. Karnick. Instruct the attorney to quiz Ms. Karnick regarding the audit procedures she applied to inventory, in particular her aborted effort to complete an inventory rollforward. Likewise, you could use role-playing to recreate some of the testy exchanges that took place between Michael Young, BDO's lead attorney, and Mr. Moore, the plaintiff's expert witness. Although many students are hesitant at first to participate in such exercises, I have found that most of them quickly "warm" to the role they are asked to assume.

A feature of this case that typically spawns considerable discussion is the close friendship that existed between Drew Bergman and Mei-ya Tsai. The professional auditing standards do not prohibit auditors from being friends with client personnel, but such friendships can be very problematic. To extend Question 1, you might ask students to develop a set of general rules or guidelines that audit firms should include in their policy and procedures manual to ensure that auditor-client relationships do not jeopardize the independence of an audit team or the independence/ objectivity of individual auditors.

Suggested Solutions to Case Questions

1. The two dimensions of auditor independence are relevant to this context: appearance of independence and de facto independence. A close friendship between an auditor and a client

employee can jeopardize the auditor's appearance of independence (and that of the entire audit team) even though the auditor scrupulously protects his or her de facto independence. If third parties lose confidence in an auditor's independence, then the purpose of the audit is undermined, period.

I would suggest that the de facto independence of an auditor has been compromised by a relationship with a client employee when that relationship begins to influence important decisions of the auditor. For example, if an auditor decides not to fully investigate a suspicious transaction or other item because doing so might result in negative consequences for his or her friend, clearly the actual independence of the auditor has been compromised. Likewise, loss of independence may result in an auditor failing to gain a proper understanding of a client's internal controls, ignoring pertinent fraud risk factors that are present, or even issuing an inappropriate audit opinion for the given client.

2. Interpretation 1.279.010, "Considering Employment or Association with an Attest Client," of the AICPA *Code of Professional Conduct* addresses the situation in which an auditor is considering the possibility of employment with an audit client during the course of an audit engagement. In such situations, the given individual faces an unacceptable threat of violating his or her independence. To mitigate that threat, four "safeguard" conditions have to be met:

a. "The individual promptly reports such consideration or offer to an appropriate person in the firm.
b. The individual immediately ceases participation in the engagement and does not provide any services to the attest client until the employment or offer is rejected or employment is no longer sought.
c. If a covered member becomes aware that an individual is considering employment or association with an attest client, the covered member should notify an appropriate person in the firm.
d. The appropriate person in the firm should consider whether, based on the nature of the engagement and the individual involved, the firm should perform any additional procedures to provide reasonable assurance that any work that the individual performed for the attest client was performed in compliance with the 'Integrity and Objectivity Rule.'" [ET 1.279.010.02]

3. The most common situation in which an inventory rollback is performed is when an audit firm has been retained to audit a company following that company's year-end physical inventory. If the inventory is a material item in the client's financial statements, the audit firm must devise a test or series of tests to corroborate the key management assertions for that inventory. Since re-taking the physical inventory may not be feasible or may be too costly, auditors in such situations will typically use the client's purchases and sales documentation during the intervening period since the physical inventory to "rollback" the existing inventory quantities and dollar amounts to the corresponding amounts on the inventory date.

AS 1105.08 of the PCAOB auditing standards discusses the factors that impact the reliability or validity of audit evidence. Following is a brief excerpt from that discussion. "Evidence obtained from a knowledgeable source that is independent of the company is more reliable than evidence obtained only from internal company sources." (A similar statement is found in AU-C Section 500.A8 of the AICPA Professional Standards.) This observation would suggest that the documentary evidence provided by an inventory rollback is not as persuasive as the physical evidence that auditors obtain by observing a client's physical inventory.

4. As Michael Young noted during the HMI trial, the decision of what audit procedures to apply in a given context is ultimately a matter of professional judgment on the part of individual auditors. So, Jill Karnick and the other members of the HMI audit engagement team were well within their rights to decide whether to complete an inventory rollback or rollforward. One troubling aspect of Karnick's decision not to complete the inventory rollforward was that the decision was apparently not approved or even reviewed by her superiors. Given the importance of that decision, it would seem that Karnick's superiors would have been involved in, or, at a minimum, reviewed that decision. [Certainly, it is possible that Tsai and/or Bornstein were involved in that decision and that the trial transcripts simply failed to comment on their involvement.]

AU-C Section 200.A52 of the AICPA Professional Standards notes that cost considerations are a valid issue for auditors to weigh when deciding on the specific audit procedures to apply in a given setting. However, that same paragraph also explicitly states that cost considerations should not be the ultimate factor in such decisions. "The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive. Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost . . . Therefore, there is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and so as to achieve a balance between benefit and cost, recognizing that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is fraudulent or erroneous until proved otherwise." (AS 1105, "Audit Evidence," in the PCAOB auditing standards does *not* contain an equivalent discussion of the tradeoff between the costs and benefits of audit evidence.)

5. AU-C Section 230.A6 of the AICPA Professional Standards includes the following statement: "The auditor need not include in audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents." This statement suggests that the results of inconclusive audit tests do not have to be included in audit workpapers.
Paragraph 230.A17 reinforces this conclusion by noting that auditors do not need to "retain documentation that is incorrect or superseded."

AS 1215, "Audit Documentation," of the PCAOB auditing standards does not include a discussion directly comparable to that just highlighted in AU-C Section 230 of the AICPA Professional Standards. However, AS 1215.06 includes the following blanket statement: "The auditor must document the procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions." AS 1215.12 also observes that audit documentation should include a discussion of "circumstances that cause significant difficulty in applying auditing procedures." This latter statement would certainly have been relevant to Ms. Karnick's aborted attempt to perform an inventory rollforward.

6. The term "red flags" is generally used to refer to various factors, variables, or other items that suggest there is a higher than normal risk that a given audit client's financial statements have been distorted by intentional misstatements. The term "fraud risk factors" is essentially interchangeable with "red flags." The Appendix to AS 2401, "Consideration of Fraud in A Financial Statement Audit," of the PCAOB's auditing standards lists numerous examples of fraud risk factors. Examples of these items include "high degree of competition or market saturation accompanied by declining margins," "high vulnerability to rapid changes . . . in technology . . . or interest rates," "operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent." A comparable list of fraud risk factors can be found in the AICPA Professional Standards at AU-C 240.A75.

During the planning phase of an audit, auditors will consider the existence of red flags in developing the planned nature, extent, and timing of their audit tests. Red flags identified by auditors during the planning phase will typically result in more extensive and rigorous tests applied by auditors during the substantive testing phase of an audit. In the internal control evaluation phase of an audit, auditors should consider whether given red flags have resulted in a client's internal controls being undercut or subverted. Finally, during the "wrap-up" phase of an audit, an audit engagement team must consciously weigh once more the potential impact of existing red flags or fraud risk factors on a client's financial statements. In this final stage of an audit, auditors can step back and make a "big picture" assessment of the given client's financial statements. During the course of an audit, an audit team may overlook individual hints or signals that something is amiss in the client's accounting records and financial statements. Near the end of the audit, however, an audit manager or partner should be able to link such items together to make a more informed judgment regarding the likelihood that fraud has affected the client's financial data.

7. Section 10A, "Audit Requirements," of the Securities Exchange Act of 1934 discusses auditors' responsibilities for investigating and reporting illegal acts by an audit client. Section 10A provides the following cryptic definition of an illegal act: "the term illegal act means an act or omission that violates any law, or any rule or regulation having the force of law." The key issue in this context is that an illegal act discovered by an audit team must have a "material effect on the financial statements" of the given company to trigger required disclosure to the SEC [again, such disclosure is not necessary if the given company informs the SEC of the matter]. Listed next are three (hypothetical) illegal acts and my judgment of whether the given audit team should insist that client management report each item to the SEC.

- A retail company "holds open" its sales records at the end of a fiscal year to ensure that it reaches its sales and earnings target for that year. Analysis: this is an illegal act that almost certainly should be reported to the SEC. Two issues that would be relevant in determining whether SEC disclosure would be necessary are the level of management involved in the fraud and the magnitude of the fraud's impact on the company's sales and earnings. The more important issue is the fraud's impact on sales and earnings. For example, if absent the fraudulent scheme the given company would not have achieved its sales and earnings targets, then it would be difficult to sustain an argument that the scheme did not have a material effect on the company's financial statements, regardless of the absolute magnitude of the amounts involved. In today's capital markets a small revenue or earnings "miss" can result in a company's stock being battered by investors.

- A company admits that a racial discrimination charge filed against a production-line supervisor by a minority worker is valid. Analysis: Unless racial discrimination is seemingly rampant within the given organization, this is an illegal act that likely would not have to be reported to the SEC.
- A manufacturing company violates legally enforceable regulations issued by the Environmental Protection Agency. Analysis: Unless the violation is indicative of a pervasive problem and unless the monetary sanctions to be imposed on the company are material, this item would likely not have to be reported to the SEC.

CASE 1.9

THE LESLIE FAY COMPANIES

Synopsis

Fred Pomerantz founded Leslie Fay in the mid-1940s and built the company into one of the leading firms in the highly competitive women's apparel industry over the next four decades. Fred's son, John, took over the company in 1982 after his father's death. Over the next ten years, the younger Pomerantz added to his father's legacy by maintaining Leslie Fay's prominent position in its industry. In January 1993, John Pomerantz's world was rocked when his company's CFO, Paul Polishan, told him of a large accounting fraud that had inflated Leslie Fay's operating results during the previous few years. Polishan had learned of the fraud from his top subordinate, Donald Kenia, Leslie Fay's controller. Kenia revealed the fraud to Polishan and, at the same time, reportedly confessed that he was the mastermind behind the fraud.

Public disclosure of the large-scale fraud sent Leslie Fay's stock price into a tailspin and prompted the press to allege that Pomerantz and Polishan must have either participated in the various accounting scams or, at a minimum, been aware of them. Within a few months, Leslie Fay was forced to file for protection from its creditors in federal bankruptcy court. In the meantime, investigations by law enforcement authorities corroborated Pomerantz's repeated denials that he was involved in, or aware of, the fraud. However, those same investigations implicated Polishan in the fraud. Another party tainted by the investigations was Leslie Fay's former audit firm, BDO Seidman. One investigative report noted that negligence on the part of the accounting firm had likely prevented it from uncovering the fraud.

In July 1997, BDO Seidman contributed $8 million to a settlement pool to resolve several lawsuits stemming from the Leslie Fay fraud. In the summer of 2000, federal prosecutors obtained an 18-count felony conviction against Paul Polishan. The key witness who sealed Polishan's fate was his former subordinate, Donald Kenia. During the contentious criminal trial, Kenia admitted that Polishan was the true architect of the Leslie Fay fraud. Kenia had initially accepted responsibility for the fraud only after being coerced to do so by Polishan. In early 2002, Polishan began serving a nine-year sentence in a federal prison. Kenia received a two-year sentence for helping his superior perpetrate and conceal the fraud. Leslie Fay emerged from bankruptcy court in 1997 but was bought out by another firm in 2001.

The Leslie Fay Companies--Key Facts

1. Under the leadership of Fred and John Pomerantz, Leslie Fay ranked as one of the leading firms in the very competitive women's apparel industry during the latter decades f the twentieth century.

2. One of John Pomerantz's closest associates was Paul Polishan, Leslie Fay's CFO who ruled the company's accounting function with an iron fist.

3. John Pomerantz insisted on doing business the "old-fashioned way," which meant that the company's accounting function was slow to take advantage of the speed and efficiency of computerized data processing.

4. A growing trend toward more casual fashions eventually created financial problems for Leslie Fay, its principal customers (major department stores), and its leading competitors, problems that were exacerbated by a nationwide recession in the late 1980s and early 1990s.

5. Despite the slowdown experienced by much of the women's apparel industry in the late 1980s and early 1990s, Leslie Fay continued to report impressive sales and earnings during that time frame.

6. In January 1993, Paul Polishan informed John Pomerantz of a large-scale accounting fraud over the previous three years that had materially inflated Leslie Fay's reported sales and earnings, a fraud allegedly masterminded by Donald Kenia.

7. Upon learning of the accounting fraud, BDO Seidman withdrew its unqualified audit opinions on Leslie Fay's 1990 and 1991 financial statements and subsequently resigned as the company's audit firm after being named as a co-defendant in civil lawsuits filed against Leslie Fay's executives.

8. The centerpiece of the Leslie Fay fraud was intentional overstatements of period-ending inventories, although several other financial statement items were also intentionally distorted.

9. John Pomerantz was never directly implicated in the fraud, although many critics, including BDO Seidman, insisted that he had to share some degree of responsibility for it.

10. BDO Seidman ultimately agreed to pay $8 million to a settlement pool to resolve numerous civil lawsuits stemming from the Leslie Fay fraud that named the accounting firm as a defendant.

11. Due principally to Donald Kenia's testimony, Paul Polishan was convicted in 2000 of masterminding the Leslie Fay fraud.

12. Leslie Fay emerged from federal bankruptcy court in 1997 but disappeared a few years later when it was purchased by a large investment firm.

Instructional Objectives

1. To provide students with an opportunity to use analytical procedures as an audit planning tool.

2. To demonstrate the need for auditors to monitor key trends affecting the overall health of a client's industry and to assess the resulting implications for a client's financial condition and operating results.

3. To highlight the internal control issues posed for an audit client when its accounting function is dominated by one individual.

Suggestions for Use

This case contains multi-year financial statement data for The Leslie Fay Companies. These data provide students an opportunity to apply analytical procedures as a planning tool. Although a central theme of this casebook is the "people" aspect of independent audits, I believe it is also important that students be exposed to the more mundane, number-crunching aspects of an independent audit. One way that you can extend Question 1 is to require different groups of students to collect and present (for the same time frame) the financial ratios shown in Exhibit 2 for several of Leslie Fay's key competitors. Quite often, auditors can learn more about the plausibility (or implausibility) of apparent trends in a client's financial data by comparing those data with financial information for a key competitor rather than with industry norms. For example, Leslie Fay's gross margin percentage was generally consistent with that of its overall industry. However, if you compared the company's gross margin percentages over the time frame of the accounting fraud with those of its direct competitors, it would have been apparent that the margins being reported by Leslie Fay were "out of line" with those companies.

A key feature of this case is the impact that Paul Polishan's domineering personality had on the accounting function of Leslie Fay. This "red flag" is among the most common associated with problem audit clients. Published reports never indicated exactly how Polishan was able to psychologically control and manipulate Donald Kenia and his other subordinates in "Poliworld." Apparently, Polishan was one of those individuals who had an innate and enormous ability to impose his will on subordinates. You might ask students how they would deal with such a domineering superior. Since many of our students will have an "opportunity" to work for one or more strong-willed individuals during their careers, they need to have appropriate coping mechanisms to ensure that they do not find themselves in the unfortunate situation that faced Donald Kenia, that is, spending two years in a federal correctional facility. (You might discourage students from taking the "easy way out" by suggesting that they would simply choose not to work for such an individual. Seldom do we have the freedom to choose the disposition and personality traits of our boss.)

Suggested Solutions to Case Questions

1. Following are common-sized financial statements and the requested financial ratios for Leslie Fay for the period 1987-1991.

	1991	1990	1989	1988	1987
Current Assets:					
Cash	1.2	1.1	1.4	1.5	1.3
Receivables (net)	30.0	31.8	30.3	30.3	27.1
Inventories	32.0	33.7	31.3	29.5	27.2
Prepaid Expenses, etc.	5.0	5.1	5.0	4.5	5.2
Total Current Assets	68.2	71.7	68.0	65.8	60.8
PP&E	9.9	6.8	7.0	7.1	7.9
Goodwill	20.5	20.1	23.5	25.9	29.6
Deferred Charges, etc.	1.4	1.4	1.5	1.2	1.7
Total Assets	100.0	100.0	100.0	100.0	100.0
Current Liabilities:					
Notes Payable	8.8	10.9	5.9	8.0	5.1
Current Portion--LTD	0.0	0.0	0.0	0.0	.5
Accounts Payable	8.1	9.9	10.0	12.6	10.3
Acc. Int. Payable	.8	.9	1.1	1.1	1.2
Accrued Compensation	4.3	3.4	5.0	4.6	3.5
Acc. Expenses, etc.	1.1	1.5	1.5	2.0	2.4
Income Taxes Payable	.4	.5	1.3	1.6	.6
Total Curr. Liabs.	23.4	27.1	24.8	29.9	23.6
Long-term Debt	21.3	29.6	33.2	32.0	38.2
Deferred Credits, etc.	.7	.6	.7	1.2	1.6
Stockholders' Equity:					
Common Stock	5.1	4.6	5.2	5.5	6.6
Capital in Excess of PV	20.8	18.7	21.2	22.6	26.9
Retained Earnings	39.6	29.1	25.4	20.1	16.5
Other	(8.7)	(7.2)	(8.3)	(8.8)	(10.4)
Treasury Stock	(2.2)	(2.5)	(2.2)	(2.5)	(3.0)
Total Stock. Equity	54.6	42.7	41.3	36.9	36.6
Total Liab. & SE	100.0	100.0	100.0	100.0	100.0

	1991	1990	1989	1988	1987
Net Sales	100.0	100.0	100.0	100.0	100.0
Cost of Sales	69.9	68.6	68.3	68.3	69.3
Gross Profit	30.1	31.4	31.7	31.7	30.7
Operating Expenses:					
SWG&A	22.3	23.2	23.4	22.9	22.8
Amortization	.3	.3	.3	.5	.6
Total Operating Exp.	22.6	23.5	23.7	23.4	23.4
Operating Income	7.5	7.9	8.0	8.3	7.3
Interest Expense	2.2	2.2	2.4	2.6	2.8
Income Bef. NR Charges	5.3	5.7	5.6	5.7	4.5
Non-recurring Charges	0.0	0.0	0.0	0.0	(.9)
Inc. Before Taxes	5.3	5.7	5.6	5.7	5.4
Income Taxes	1.8	2.3	2.3	2.4	2.0
Net Income	3.5	3.4	3.3	3.3	3.4

Financial Ratios for Leslie Fay:

	1991	1990	1989	1988	1987
Liquidity:					
Current	2.9	2.6	2.7	2.2	2.6
Quick	1.5	1.4	1.5	1.2	1.4
Solvency:					
Debt to Assets	.45	.57	.59	.63	.63
Times Interest Earned	3.4	3.6	3.3	3.1	2.6
Long-term Debt to Equity	.39	.69	.81	.87	1.04
Activity:					
Inventory Turnover	4.26	4.38	4.71	4.91	
Age of Inventory*	84.5	82.2	76.4	73.3	
Accts Receivable Turnover	6.48	6.69	6.92	7.08	
Age of Accts Receivable*	55.5	53.8	52.0	50.8	
Total Asset Turnover	2.1	2.0	2.0	1.9	
Profitability:					
Gross Margin	30.1%	31.4%	31.7%	31.7%	30.7%
Profit Margin on Sales	3.5%	3.4%	3.3%	3.3%	3.4%
Return on Total Assets	12.1%	10.9%	11.6%	11.2%	11.8%
Return on Equity	14.6%	16.8%	17.6%	18.2%	

*In days

Note: Certain ratios were not computed for 1987 given the lack of data.

Equations:

Current Ratio: current assets / current liabilities

Quick Ratio: (current assets - inventory) / current liabilities
Debt to Assets: total debt / total assets
Times Interest Earned: operating income / interest charges
Long-term Debt to Equity: long term debt / stock.equity
Inventory Turnover: cost of goods sold / avg. inventory
Age of Inventory: 360 days / inventory turnover
A/R Turnover: net sales / average accounts receivable
Age of A/R: 360 days / accounts receivable turnover
Total Asset Turnover: net sales / total assets
Gross Margin: gross profit / net sales
Profit Margin on Sales: net income / net sales
Return on Total Assets: (net income + interest expense) / total assets
Return on Equity: net income / avg. stockholders' equity

Discussion:

In comparing Leslie Fay's 1991 financial ratios with the composite industry norms shown in Exhibit 2, we do not find many stark differences. Overall, Leslie Fay's liquidity ratios were stronger than the industry averages, while their solvency ratios were generally a little weaker. Leslie Fay's profitability ratios were also reasonably consistent with the corresponding industry averages. The key differences between the industry norms and Leslie Fay's 1991 financial ratios involve the age of inventory and receivables measures. Leslie Fay's inventory was nearly 60% "older," on average, than the inventory of its competitors, while Leslie Fay's receivables were more than 20% older than those of competitors. These results suggest that the valuation and existence assertions for both inventory and receivables should have been major concerns for the company's auditors.

We can use the common-sized financial statements and financial ratios included in this solution to perform longitudinal analysis on the company's financial data. Here again, the only potential "smoking guns" that we find involve the steadily rising ages of Leslie Fay's inventory and receivables over the period 1988 through 1991. Notice that Leslie Fay's liquidity ratios steadily improved—of course, the "improvement" in the current ratio was largely due to the increasing ages of receivables and inventory, while the improving quick ratio was largely attributable to the increasing age of receivables. Leslie Fay's solvency ratios generally improved during the late 1980s and early 1990s, while most of the company's profitability ratios were remarkably consistent over that time frame.

Leslie Fay's common-sized financial statements for 1987-1991 do not reveal any major structural changes in the company's financial position or operating results over that period. Two accounts that I would mention that had "interesting" profiles in the common-sized balance sheets were accounts payable and accrued expenses. Notice that the relative balances of those two items steadily declined between 1988 and 1991. Since those two items can be fairly easily manipulated by client management, Leslie Fay's auditors might have been well advised to focus more attention on the completeness assertions for those items.

In summary, I would suggest that applying analytical procedures to Leslie Fay's financial data did not reveal any major potential problems, with the exception of inventory and receivables. Then again, Polishan's subordinates were sculpting those data in an attempt to make them reasonably consistent with industry norms. Auditors should recognize when they are performing analytical procedures that they should search for two types of implausible relationships: unexpected relationships apparent in the client's financial data and expected relationships that are not apparent in those data. For example, given the problems facing the women's apparel industry during the late 1980s and early 1990s, Leslie Fay's auditors probably should have expected some deterioration in the company's gross margin and profit margin percentages. The fact that Leslie Fay's profitability ratios were "holding up" very well over that period could have been taken as a "red flag" by the company's auditors. [Note: As pointed out in the Suggestions for Use section, Leslie Fay's gross margin percentages were generally consistent with the industry norm during the time frame of the accounting fraud. However, the company's gross margin percentages during that time frame were considerably more impressive that those being reported by its direct competitors.]

2. Listed next are examples of other financial information, in addition to that shown in Exhibits 1 and 2, that might have been of considerable interest to Leslie Fay's auditors.

- Backlog of orders
- Composition of inventory over the previous several years (that is, did one particular component of inventory, such as, work-in-process or finished goods, account for the increasing age "issue"?)
- Financial ratios and common-sized financial statements for those companies most comparable to Leslie Fay
- Sales data by the company's major product lines (these data might have revealed developing problems for some of the company's product lines)
- Aging schedule for accounts receivable (this schedule might have revealed that the increasing age of Leslie Fay's receivables was due to one type of customer, such as, the company's department store clients)
- Sales forecasts and production cost data

3. Listed next are fraud risk factors that relate to the condition of a given audit client's industry. Each of these factors is included in the Appendix to AS 2401, "Consideration of Fraud in a Financial Statement Audit," of the PCAOB's auditing standards. Similar fraud risk factors are reported in AU-C Section 240.A75 of the AICPA Professional Standards.

- New accounting, statutory, or regulatory requirements: audit clients are more likely to misapply new rules and regulations (having accounting implications) than rules and regulations that have been in effect for some time.
- High degree of competition or market saturation: highly competitive market conditions may induce client management to adopt relatively high-risk strategies, resulting in more volatile operating results. (Significant and/or sudden changes in a client's operating results complicate the selection and application of audit procedures.)
- Declining industry with increasing business failures: by definition, clients in financially distressed industries pose a higher than normal going-concern risk; this higher risk must be

evaluated by auditors and considered when they choose the appropriate type of audit report to issue.
- Rapid changes in the industry, such as changes in technology: sudden technological changes can pose major valuation concerns for a client's inventory and other assets.

4. When one individual dominates a client's accounting and financial reporting, the reliability of those systems depends upon the integrity and competence of that individual. In such circumstances, the inherent risk and control risk posed by a client must be carefully assessed by auditors. Even if the assessments of those risks do not yield any evidence of specific problems, the given audit team should likely apply a more rigorous audit NET (nature, extent, and timing of audit procedures) to the

client's financial statement data. Why? Because an individual who dominates a client's accounting function can readily perpetrate and conceal irregularities.

5. Co-defendants in a lawsuit often have diverging interests that may eventually result in them becoming adversaries as the given case develops (which is exactly what happened in the Leslie Fay case). It is doubtful that auditors can retain their de facto and apparent independence under such circumstances. ET 1.290.010.04-.07, "Litigation Between the Attest Client and Member," of the AICPA *Code of Professional Conduct* addresses this issue.

CASE 1.10

Le-NATURE'S INC.

Synopsis

Gregory Podlucky organized a water-bottling business in 1989. Three years later, the company's product line had expanded to include flavored water, fruit, and tea drinks. Despite operating in the hypercompetitive beverage industry, the company's revenues grew rapidly. By 2005, the company's audited income statement reflected sales of nearly $280 million. That same year, Podlucky rejected a $1.2 billion offer for his company. Podlucky, the company's CEO and sole common stockholder, insisted that figure was too low and decided instead to take the company public the following year.

A common nemesis of a rapidly growing company is a shortage of capital. Throughout Le-Nature's existence, Podlucky relied almost exclusively on debt to finance Le-Nature's expanding operations. During its existence, the company borrowed almost $1 billion via long-term leasing arrangements, high-yield or "junk" bonds, and a large revolving line of credit. Podlucky raised a relatively nominal $30 million of equity capital by selling convertible preferred stock to two investment funds. The conversion feature of the preferred stock effectively gave the investment funds a 45 percent equity interest in Le-Nature's. Each of the two investment funds was allowed to appoint an "outside" member to Le-Nature's board of directors—that body was dominated by Podlucky and his fellow officers who were family members or close friends.

In late 2003, Le-Nature's CFO and two other senior company officials suddenly resigned. Each of them informed the company's Ernst & Young (EY) audit engagement partner that they had serious doubts regarding the reliability of Le-Nature's accounting records. In particular, they doubted the accuracy of the company's reported sales figures. In his resignation letter, the CFO reported that Podlucky had repeatedly refused to provide him with documentation supporting major transactions recorded by the company. The EY audit partner immediately insisted that Le-Nature's retain an external law firm to oversee an independent investigation of its accounting records. Podlucky did just that and the resulting report cleared the company of any wrongdoing.

Three years later, allegations of an accounting fraud surfaced again. The company's outside directors were successful in having a court-appointed custodian placed in charge of Le-Nature's operations. A few days later, the custodian reported that Le-Nature's financial statement data were fraudulent. In 2005, for example, nearly $250 million of the company's reported sales had been fabricated by Podlucky. Subsequent criminal charges resulted in Podlucky and several of his family members and fellow executives receiving prison sentences. In addition to focusing on key corporate governance issues raised by the Le-Nature's scandal, the case questions explore the professional roles and responsibilities of the company's accountants and independent auditors.

Le-Nature's Inc.--Key Facts

1. Gregory Podlucky served as the CEO and sole common stockholder of Le-Nature's Inc., a beverage company with a product line that included flavored water, fruit, and tea drinks.

2. Podlucky faced a recurring need to raise additional capital for his rapidly growing company.

3. In 2000 and 2002, Podlucky sold convertible preferred stock to two investment funds.

4. The convertibility feature of the preferred stock effectively gave the investment funds a 45 percent equity interest in the company; each of the funds also had the right to appoint an "outside" member to the company's board.

5. Despite the sale of the convertible preferred stock, Podlucky relied almost exclusively on borrowed capital to fund his company's expanding operations.

6. Collectively, Le-Nature's borrowed almost $1 billion over its existence; among the methods used to raise those funds were long-term leasing arrangements, the sale of high-yield or "junk" bonds, and a large revolving line of credit.

7. In 2003, three senior company officials, including the CFO, suddenly resigned; the three officials informed Le-Nature's EY audit engagement partner that they doubted the reliability of the company's accounting records, particularly its recorded sales figures.

8. The audit engagement partner immediately insisted that Podlucky retain an outside law firm to investigate the allegations of fraudulent accounting; the resulting report cleared the company of any wrongdoing, allowing Podlucky to refocus his efforts on raising debt capital for the company.

9. In 2005, Podlucky rejected a $1.2 billion offer for his company and decided instead to take it public the following year; the company's preferred stockholders charged that Podlucky sabotaged the sale of the company by refusing to allow the potential buyer to access its accounting records.

10. Allegations of a large-scale accounting fraud surfaced again in 2006; a court-appointed custodian discovered that the company's accounting data were mostly fraudulent which resulted in a federal judge appointing a bankruptcy trustee to liquidate the company.

11. Gregory Podlucky and seven of his co-conspirators pleaded guilty or were convicted of various fraud charges and received prison sentences—Podlucky received the longest sentence of 20 years.

12. Among the parties that made large financial settlements with Le-Nature's bankruptcy trustee was BDO Seidman—the audit firm that replaced EY when it was dismissed by Le-Nature's in 2003, Wachovia—the company's principal lender, and the law firm that had overseen the 2003 fraud investigation.

Instructional Objectives

1. To identify the corporate governance responsibilities of corporate executives.

2. To identify corporate governance safeguards that are mandatory for SEC registrants.

3. To examine the corporate governance-related responsibilities of independent auditors and corporate accountants.

4. To identify safeguards intended to promote the credibility and preserve the integrity of the independent audit function.

5. To examine the key differences between a quarterly review and an independent audit.

6. To identify the professional standards relevant to forensic accounting services.

Suggestions for Use

Corporate governance has been a controversial and "hot" topic in both the front page and business press in recent years. Consider requiring your students to briefly "bone up" on the topic of corporate governance before reading this case. There are several relatively brief overviews or summaries of corporate governance that are available online. In fact, the Wikipedia entry for "corporate governance" provides a reasonable overview of the topic.

This case focuses on Gregory Podlucky who is one of the best examples of what a corporate CEO should not be. Consider asking students to research recent highly publicized accounting frauds and to compare/contrast the CEOs of those organizations with Podlucky. Have them identify the personality traits that those individuals shared with Podlucky as well as apparent differences between them and Podlucky. The more students study major accounting frauds, the more likely it is that they will identify the red flags commonly associated with such frauds. Easily among the most common of those red flags is the presence of a CEO who is brash, bombastic, self-interested, and a self-promoter. You might also consider asking your students to review a series of articles that appeared in major publications which suggested there are a disproportionate number of CEOs who have a psychopathic personality profile. Here are two examples of such articles: C. Chumley, "Top 10 Psychopathic Professions: CEO, Lawyer -- then Media, Twice," *The Washington Times*, 21 March 2014; J. Bercovici, "Why (Some) Psychopaths Make Great CEOs," *Forbes*, 14 June 2011.

Although listed as the third "learning objective," the key goal of this case is to focus students on the critical roles accountants play in an organization's corporate governance system. As noted in the case, Gregory Podlucky, himself, was an accountant by training and a CPA—at some point early in his business career he apparently gave up his certificate. Role playing is an effective way for students to gain a better understanding and appreciation of the challenges they may face in the professional roles that they occupy during their careers. Consider setting up a role playing scenario involving a stormy confrontation between Gregory Podlucky and John Higbee. The confrontation stems from Higbee's insistence that Podlucky provide him access to critical documentation for Le-Nature's major sales transactions. Recall that Higbee, Le-Nature's CFO who resigned in 2003 after being repeatedly "stonewalled" by Podlucky, had 20 years of experience as a prominent audit partner with Arthur Andersen & Co. You could also set up the following role-playing scenarios: Richard Lipovich, the EY audit engagement partner for Le-Nature's, and Gregory Podlucky that involves Lipovich quizzing the CEO regarding the allegations made by John Higbee; Tammy Andrecyak, the apparently browbeaten confidante of Gregory Podlucky who was "in" on the accounting fraud, and a persistent audit senior attempting to pry information out of her regarding some suspicious sales transactions; and Gregory and Jesse Podlucky in a situation that revolves around Jesse's reluctance to record questionable sales transactions for Le-Nature's large tea subsidiary.

Suggested Solutions to Case Questions

1. Investopedia defines corporate governance as "the system of rules, practices and processes by which a company is directed and controlled." As such, corporate governance involves the interests and "balancing the interests" of a wide range of stakeholders. Those stakeholders include management, employees, stockholders, debtholders and other creditors, vendors, relevant government agencies, the business community, and the communities in which a given entity's business operations are located. A major challenge that corporate executives face in carrying out their corporate governance responsibilities is the conflict of interests that exist between and among different classes of those stakeholders. For example, taking actions that are in the best interests of stockholders may disadvantage customers or other stakeholder groups.

Several organizations have published treatises on the topic of corporate governance. Among the most notable of those publications is the "OECD Principles of Corporate Governance" released initially in 1999 by the Organization for Economic Cooperation and Development (OECD). [Note: The OECD is an international organization with 36 member nations. Those member nations include primarily European countries, the United States, Canada, and Australia.]

Typically, the obligation to promote and protect the interests of a company's shareholders is deemed to be the foremost responsibility of corporate executives. Of secondary but still great importance is the obligation of corporate executives to consider the interests of the other classes of stakeholders. In considering and acting on behalf of the interests of these stakeholders, corporate executives have an obligation to conduct themselves with integrity, competence, and transparency.

2. As noted in the suggested solution to the previous question, corporate governance involves "the system of rules, practices and processes by which a company is directed and controlled." Corporate accountants play an essential role in corporate governance by providing the information needed by management to "direct" and "control" their organizations. To properly "direct" their company, corporate executives need a wide range of financial and nonfinancial

information that is collected, processed, formatted, and reported by the entity's accountants. For example, to make informed capital budgeting decisions, corporate executives rely on their accountants to provide a wide range of historical and pro forma information for individual capital budgeting projects that are under consideration. To properly "control" their company, corporate executives rely heavily on the internal control mechanisms developed, implemented, and monitored by their accountants. Accountants are delegated the latter responsibility because they are "experts" when it comes to such issues as the proper segregation of key responsibilities in each accounting cycle.

Independent auditors play a secondary but nevertheless critical role in corporate governance. Similar to corporate accountants, auditors help ensure that critical information needed to exercise effective corporate governance is conveyed to corporate executives, boards of directors, and audit committees. For example, auditors have the responsibility to identify deficiencies in an entity's internal control processes that have been overlooked or discounted by that entity's accounting staff. Plus, auditors have a responsibility to report certain adverse information to the investing and lending public (in their audit opinions) and to regulatory authorities (such as when they discover "illegal acts that client management refuses to report) that effectively keeps corporate executives "on their toes" and serves to enhance the effectiveness of corporate governance.

Forensic accountants are experts in searching for and identifying fraudulent schemes that undermine the operations, accounting systems, and financial reporting functions of organizations. Given their professional training, corporate accountants and independent auditors have some level of forensic expertise but not to the extent of that possessed by professional forensic accountants. So, forensic accountants can buttress corporate governance by "rooting out" fraud and other malfeasance overlooked by an entity's accountants and independent auditors. Forensic accountants also serve to enhance corporate governance by identifying circumstances in which an organization's accountants and/or auditors are complicit in an ongoing fraudulent scheme overseen by corporate executives.

3. The COSO internal control framework identifies five components of a given company's internal control system or structure: control environment, risk assessment, control activities, information and communication, and monitoring. Listed next are examples of corporate governance flaws that were apparent in each of these components of Le-Nature's internal control framework.

Control environment:

The overarching feature of internal control is the control environment which refers to the degree of control consciousness within an organization. An organization's leaders establish the "tone at the top" in terms of control consciousness. If those leaders have little interest in or respect for the importance of internal controls, then their subordinates will almost certainly follow suit. As the dominant executive of Le-Nature's, Gregory Podlucky clearly did not have proper respect for the importance of internal controls and obviously failed to establish a proper degree of control consciousness within the organization.

Related to Podlucky's domination of Le-Nature's is another flaw in the control environment element of the company's corporate governance system, namely, the fact that he nearly always selected family members or close business associates to staff key positions within the company. (A notable exception would be John Higbee.) Another corporate governance flaw that is again related to Podlucky's domination of the company was assigning individuals responsibilities for which they were not competent to perform. Here the perfect example is Tammy Andrecyak who held the position of Director of Accounting when, in fact, she was his personal secretary.

Risk assessment:

COSO defines "risk" as "the possibility that an event will occur and adversely affect the achievement" of one or more entity-level objectives. Risk assessment is a "dynamic and iterative process" intended to ultimately determine how an organization's risks will be managed and controlled. It seems apparent that the major "risk" that Podlucky and his fellow conspirators continually assessed and actively managed was the risk that their massive fraud would be discovered. In fact, Podlucky seemed to pay little attention to such "normal" entity-level objectives as establishing a profitable and growing business, meaning that conventional "risk assessment" activities related to such objectives was effectively a non-issue.

Control activities:

"Control activities" within the COSO internal control framework refer to "actions established through policies and procedures" to mitigate an organization's risks. According to COSO, control activities may be "preventive or detective." Podlucky only made superficial efforts to establish proper control activities for Le-Nature's. For example, he did have in place an accounting system to capture financial data to be used for decision-making purposes and for external reporting purposes, he established a board of directors for the organization and included external or independent members on that board, he hired a competent CFO, and he retained an independent accounting firm to audit Le-Nature's periodic financial statements. However, each of these high-level control activities was, in reality, a smokescreen intended to help Podlucky conceal his fraud rather than to assist him in managing the business-related risks faced by his company. Take the case of the company's accounting system. Le-Nature's actually had *two* accounting systems: one that captured the company's actual financial data and another that included the huge amount of bogus data that he and his conspirators were fabricating. Podlucky used the latter accounting system as the source for Le-Nature's financial statements and only allowed the company's CFO, independent auditors, and independent directors to access data from that system.

Information and communication:

The COSO internal control framework notes that "information is necessary" for an organization to establish and properly carry out its internal control policies and procedures. COSO defines "communication" as the "continual, iterative process of providing, sharing and obtaining necessary information." Again, this element of Le-Nature's internal control was completely flawed. Instead of communicating reliable, useful information, Le-Nature's information and communication systems were designed to deliberately communicate "misinformation" intended to serve the self-interested objectives of Podlucky and his conspirators.

Monitoring:

This component of the COSO framework refers to the need for an organization to continually monitor its internal controls to provide the board of directors and senior management timely information on the status of those controls. Again, the concept of "monitoring" as alluded to by COSO was a non-issue for Le-Nature's since the company's primary objective was to conceal a massive and ongoing fraud. No doubt, Podlucky and his conspirators routinely and vigorously engaged in "monitoring" activities, but the purpose of those activities was driven by those individuals' misdirected self-interests.

Note to Instructors: You may want to point out to your students that Podlucky, given his accounting background (he was formerly a CPA), was particularly well-suited to orchestrate a large-scale accounting fraud. In particular, his accounting background made him aware of all of the "pressure points" that had to be addressed in managing and concealing such an elaborate ruse.

The fraud triangle is discussed in both the AICPA's and the PCAOB's professional auditing standards. The three components or elements of the fraud triangle include incentives/pressures, opportunities, and attitudes/rationalizations. "Incentives/pressures" refer to a given reason to commit fraud; "opportunities" refer to the existence of a set of circumstances that makes the commission of fraud possible; while "attitudes/rationalizations" refer to the ability of a given individual or group of individuals to justify or rationalize fraudulent conduct.

Listed next are specific examples of "fraud risk factors" relevant to each component of the fraud triangle.

Incentives/pressures:

- Need to obtain additional debt or equity capital to remain competitive
- Management has a significant equity interest in the company
- Recurring negative operating cash flows
- Highly competitive industry conditions
- Excessive revenue or profit expectations by third parties

Opportunities:

- Significant related party transactions
- Key financial statement amounts are based on estimates
- Significant, unusual, or highly complex transactions
- Domination of management by a single individual
- High turnover within senior management
- Significant deficiencies or material weaknesses in internal controls

Attitudes/rationalizations:

- History of violations of securities laws or other regulations by management
- Excessive interest by management in company's stock price
- History of management making firm commitments regarding sales or profit forecasts
- Management's failure to remedy known internal control problems
- Frequent auditor-client disputes

In terms of the fraud triangle, Podlucky's apparent personal goal was to become wealthy and influential—he reportedly had political ambitions. That goal gave him a tremendous ***incentive*** to take unfair advantage of his company, its creditors, the preferred stockholders, and other stakeholders of the company. (Note: Consider pointing out to students that simple greed is the most common motive for perpetrating a financial fraud). Podlucky's ability to dictate Le-Nature's internal controls gave him the ***opportunity*** to commit fraud. Even when legitimate controls were in place, he was able to undercut them. For example, he was able to intercept the initial draft version of the Special Committee report and influence its content before it was actually provided to the Special Committee. Finally, Podlucky was obviously able to ***rationalize*** or justify his bad behavior.

4. Many of the corporate governance safeguards for SEC registrants are a direct consequence of the Sarbanes-Oxley Act of 2002. SOX gave more power, authority, and accountability to corporate boards of directors. For example, the audit committee, which is a subset of the corporate board, has a responsibility under SOX to interact directly with a company's independent auditors regarding key internal control and financial reporting matters. SOX effectively mandated or forced companies to establish a corporate code of ethics—if a SEC registrant doesn't have such a code, it must explain and justify that "oversight." SOX resulted in the creation of the PCAOB which serves as a regulatory watchdog for auditors of public companies thereby strengthening the independent audits of those companies and reinforcing their importance. SOX mandated that public companies have their ICFR (internal controls over financial reporting) audited each year, a requirement that has clearly strengthened the internal controls and corporate governance of public companies.

An example of a corporate governance safeguard implemented for public companies prior to the adoption of SOX was the SEC's decision to mandate that SEC registrants report changes in auditors and the circumstances surrounding such changes (such as whether or not an auditor change was preceded by a dispute over accounting or auditing issues). This policy strengthens corporate governance by holding corporate executives accountable for a decision to replace their company's independent auditors.

5. As a sidebar, the information available for this case does not reveal why EY was dismissed in late 2003 by Le-Nature's. Consequently, it is difficult to address the question of whether or not EY was dismissed for a legitimate reason. Having said that, one could safely argue that EY's forceful approach to addressing the fraud allegations was a key factor in that dismissal. If the purpose of the dismissal was to "punish" EY for insisting on a fraud investigation, then that would not have been a proper reason for the auditor change.

Both the AICPA and PCAOB auditing standards mandate predecessor-successor auditor communications. These mandatory communications serve to limit the ability of audit clients to conceal adverse information that their auditors uncover—which, of course, would serve to undermine the credibility and integrity of the independent audit function. As pointed out in the suggested solution to the prior case question, when SEC registrants change audit firms they must file an 8-K statement that discloses the change and the circumstances surrounding it, for example, whether a disagreement over an accounting or auditing issue preceded the change. Again, this requirement promotes the credibility and integrity of the independent audit function.

6. The purpose of a review engagement is to obtain a reasonable basis for providing limited assurance that a given client's financial statements have been prepared in conformity with generally accepted accounting principles. More precisely, a "clean" review report provides negative assurance, that is, it discloses only that the auditor (CPA) did not discover any evidence suggesting that the relevant financial statements are materially misstated. Of course, the objective of an audit is much more affirmative in nature. A full-scope independent audit is designed to provide a reasonable basis for expressing an "opinion" concerning whether or not a client's financial statements have been prepared in accordance with generally accepted accounting principles.

There is also a critical difference between a review and an audit in terms of the scope of work performed. In a review engagement, the primary (mandatory) evidence collection techniques are analytical procedures and inquiries of client personnel. Alternatively, in an audit, the full range of evidence collection techniques available to an auditor is likely to be used including, but not limited to, confirmation procedures, physical observation of assets, and inspection of documents.

7. Pascarella & Wiker's engagement was a non-audit attestation service. (Of course, because all attestation services are also assurance services, the engagement qualified as an assurance service engagement as well.) The attestation standards would be the principal standards that governed P&W's conduct during its Le-Nature's engagement. AT Section 105.01 notes that attestation services generally involve those circumstances in which a CPA is retained to issue a report on "subject matter" or "an assertion about the subject matter" that is "the responsibility of another party." In this case, P&W was hired to investigate and report on whether there was any evidence of an ongoing accounting fraud at Le-Nature's. So, P&W's responsibility was effectively to investigate and report on the assertion by Le-Nature's management team (primarily Gregory Podlucky) that the company wasn't engaging in an accounting fraud.

CASE 1.11

NAVISTAR INTERNATIONAL CORPORATION

Synopsis

Navistar International Corporation traces its roots back to Cyrus McCormick, the famous 19th century American inventor. This case, however, begins in the 21st century when Navistar fired its longtime audit firm, Deloitte, in early 2006. "Longtime" is an understatement since the relationship between the two organizations lasted 98 years.

As Deloitte's 2005 audit of Navistar was nearing completion, the firm suddenly replaced the audit engagement partner. The new engagement partner effectively started the audit over, refusing to accept or rely upon any of the work supervised by his predecessor. Not surprisingly, Navistar management was less than happy with the unpleasant turn of events. In April 2006, well after Navistar had missed its filing deadline for its annual Form 10-K with the SEC, Deloitte was fired and replaced by KPMG. More than 18 months would pass before KPMG completed its audit and Navistar filed its 10-K with the SEC. KPMG's audit was extended by a series of large accounting misstatements and internal control weaknesses discovered by the audit team.

During the midst of Navistar's accounting scandal, the company sued its former audit firm, Deloitte, for $500 million. The harsh allegations included in the 134-page complaint filed against Deloitte included the suggestion that the prominent audit firm was incompetent. Deloitte was less than happy with that allegation and similar statements made by Navistar's attorneys and blamed the company's accounting scandal on the senior executives who were sanctioned by the SEC as a result of it.

Eventually, the PCAOB stepped into the nasty fray involving Navistar and Deloitte and launched a formal investigation of Deloitte's 2003 audit of the company. That probe was the first formal investigation of a Big Four accounting firm by the PCAOB. Ultimately, two Deloitte audit partners who had been assigned to the Navistar engagement were fined and suspended by the PCAOB.

In addition to unraveling the Navistar accounting scandal and Deloitte's role in it, this case focuses on the regulatory role and responsibilities of the PCAOB. The Navistar case was apparently a key factor that prompted the PCAOB to suggest that mandatory audit firm rotation might be necessary to enhance auditor independence. That proposal, as discussed in the epilogue of the case, was rejected by the U.S. Congress.

Navistar International Corporation--Key Facts

1. Deloitte replaced the audit engagement partner on the 2005 Navistar audit as that engagement was nearing completion; the replacement audit partner effectively began the audit over, refusing to “accept any of the work” that had been supervised by the previous audit partner.

2. Five months later, in April 2006, Navistar fired Deloitte and hired KPMG as its audit firm; due to the company’s pervasive “improper accounting practices” and internal control problems, more than 18 months passed before KPMG completed Navistar’s 2005 audit.

3. Navistar ultimately restated its 2003-2004 financial statements and disclosed 15 material weaknesses in internal controls in its 2005 Form 10-K; as a result of Navistar’s accounting scandal, the SEC sanctioned several of the company’s top executives.

4. In 2005, the SEC inadvertently disclosed that the PCAOB was investigating Deloitte’s 2003 Navistar audit; that was the first formal investigation of a Big Four firm by the PCAOB.

5. A few months earlier, the SEC had fined Deloitte $50 million for its audits of Adelphia, a large telecommunications firm that had collapsed into bankruptcy.

6. In addition to investigating alleged audit failures, the PCAOB periodically inspects the audit practices of all accounting firms that audit companies with securities traded on U.S. stock exchanges.

7. The purpose of PCAOB inspections is to “identify and address weaknesses and deficiencies” in how a firm conducts audits.

8. Part I of PCAOB inspection reports identifies deficiencies specific to individual audits, while Part II of those reports identifies quality control defects in accounting firms’ audit practices—only Part 1 is disclosed to the public unless a firm fails to “remediate” the Part II deficiencies within 12 months of the date of the given inspection report.

9. The PCAOB fined and suspended two audit partners involved in the 2003 audit of Navistar; the two partners allegedly worked together to increase a materiality threshold for that audit so that Navistar would not have to adjust its financial statements for a known accounting error.

10. In October 2011, the PCAOB surprised the accounting profession by releasing Part II of Deloitte’s 2007 inspection report; the most serious allegation leveled against Deloitte in that section of the report was that the firm’s “culture” was flawed.

11. Navistar eventually filed a $500 million lawsuit against Deloitte; among other harsh allegations, the lawsuit charged Deloitte with “lying” as to the competency of its audit and accounting services.

12. The Navistar-Deloitte debacle apparently contributed to the PCAOB's decision to propose mandatory audit firm rotation for SEC registrants in 2011.

Instructional Objectives

1. To examine the advantages and disadvantages of mandatory auditor rotation.

2. To consider the nature of material weaknesses in internal control and their impact on independent audits.

3. To examine the nature of the auditor-client relationship and how that relationship may influence the performance of independent audits.

4. To identify factors that influence the materiality thresholds established by auditors.

5. To identify the nature and importance of quality controls for audit firms.

6. To examine the regulatory role and responsibilities of the PCAOB.

Suggestions for Use

This is another case that I have used as an initial assignment for my graduate auditing course. This case provides students who have a limited understanding of the independent audit function in the U.S. with a "big picture" view of independent auditing in a free market economy—I typically have several foreign students in my graduate auditing class from "controlled economy" nations.

The Navistar case provides insight on both the internal and external environments of independent auditing. That is, the case highlights important factors that complicate specific audit engagements, while at the same time demonstrating how the external environment, most notably, legal liability issues and regulatory oversight, impact audit firms and auditors. Given the case's major focus on the PCAOB and its role and responsibilities, in an undergraduate auditing course you might consider assigning this case when you cover the "auditing profession" chapter, which is typically either the first or second chapter of an undergraduate auditing text.

Suggested Solutions to Case Questions

1. The key disadvantage of mandatory auditor rotation is the "learning curve effect." That is, a new audit firm will automatically have less understanding of a client's business practices, internal control system, and accounting methods than the "old" audit firm. Several years may pass before the learning curve "deficit" is overcome and then it may be time to change auditors again. Another disadvantage of mandatory auditor rotation is an alleged increase in audit costs—this is an unsubstantiated argument typically used by opponents of auditor rotation. Empirical researchers have documented so-called "spillover effects" that a client benefits from as

a result of having an experienced auditor. For example, an experienced auditor should be more likely to identify factors that would enhance the operating effectiveness and efficiency of a client's operations. Obviously, these positive spillover effects are lost when a new auditor is appointed.

The principal alleged advantage of mandatory audit firm rotation is that a long-tenured auditor may become somewhat "stale" and/or complacent thus diminishing the likelihood that it will identify material errors in a client's accounting records. Another important advantage of mandatory auditor rotation is an enhanced degree of perceived auditor independence that, in turn, should result in a higher measure of financial statement credibility for the given client.

The Sarbanes-Oxley Act of 2002 mandates a form of auditor rotation in the U.S. The general rule is that the "lead" and "concurring" partners assigned to an audit engagement must be rotated every five years. Another five years must elapse before those individuals can be reassigned to the given audit engagement.

Consider having your students research auditor rotation rules around the world and present their findings in class. Australia, for example, implemented an audit partner rotation rule before the SOX-imposed rule in the U.S.

2. Notes: PCAOB *Auditing Standard No. 2* was the initial internal control standard adopted by the PCAOB (this standard went into effect for large SEC registrants in late 2004). *AS No. 2* introduced the terms "material weakness" and "significant deficiency" in internal controls. In 2007, the PCAOB replaced *AS No. 2* with *AS No. 5*. The title of *AS No. 5* is, "An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements." Earlier in 2007, the SEC had issued new interpretative guidance to streamline and reduce the cost of SOX-mandated assessments of internal control by the management of public companies. The PCAOB followed suit by adopting *AS No. 5*, which was intended to reduce the cost of SOX-mandated internal control audits by a company's auditors. In the reorganized PCAOB auditing standards, *AS No. 5* is integrated into AS 2201. [An excellent summary of *AS No. 5* is included in the following article: S.L. Fogelman, B.H. Peterson, W.G. Heninger, and M.B. Romney, "Opportunity Detected: New SEC Interpretive Guidance and AS5 Give Companies and Auditors A Chance to Make Internal Controls More Efficient," *Journal of Accountancy*, December 2007, 62-65.]

Following are definitions of three key terms that were taken directly from AS 2201.

Internal control deficiency: "A deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis."

Significant deficiency in internal control: "A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting."

Material weakness in internal control: "A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis."

In fact, it appears that Navistar listed the 15 material weaknesses in descending order of importance. That is, the most critical weakness is the initial one, while the second weakness is the next most critical, and so on. Your students almost certainly won't realize that the items are presented in a descending order of importance until they review the entire list. You might consider requiring your students to access Navistar's Form 10-K on the edgar.gov website and review the complete narrative discussion of the 15 internal control weaknesses. Recognize that the excerpts in Exhibit 1 typically represent only a small portion of the narrative discussion for each item.

Certainly, a client can have such inadequate internal controls that it is not "auditable." In such cases, an audit team might be effectively forced to reconstruct the client's accounting records, which means that they would not have the necessary independence to then audit those records. The weaknesses in Navistar's internal controls were so extensive that it does make one wonder how Deloitte was capable of auditing the company's financial statements in the years prior to 2005.

3. Absolutely not. Because of a lack of independence, an accounting firm cannot audit accounting records that it effectively maintained.

Regarding the second question, the point here is to focus students' attention on the fact that both Deloitte and Navistar bore some portion of the responsibility for Deloitte's dismissal in April 2006. In my view, Deloitte clearly had a responsibility to apprise the client earlier than late 2005 that their accounting records were "in a mess" and that a massive reconstruction or refurbishing job would be necessary on those records before they were "auditable." Having said that, Navistar had the ultimate responsibility for maintaining accounting records that were auditable.

4. AS 2105, "Consideration of Materiality in Planning and Performing an Audit," in the PCAOB's auditing standards is the authoritative standard in this context for audits of SEC registrants. The phrase "planning materiality threshold" is not found in AS 2105. The phrase that the PCAOB uses that is most equivalent to "planning materiality threshold" is "materiality level for the financial statements as a whole." AS 2105.06 provides the following discussion of that phrase.

> "To plan the nature, timing, and extent of audit procedures, the auditor should establish a materiality level as a whole that is appropriate in light of particular circumstances. This includes consideration of the company's earnings and other relevant factors. To determine the nature, timing, and extent of audit procedures, the materiality level for the financial statements as a whole needs to be expressed as a specified amount."

Among the factors that may influence the planning materiality level for a given client, according to AS 2105, are the existence of related-party transactions and conflicts of interests.

"Other relevant factors" that may influence planning materiality decisions would include an usually low amount for an important materiality benchmark (such as net income) in a given year, external circumstances that draw particular attention to the given entity's financial statements such as a planned offering of securities, and changes in laws or regulations or industry conditions that impact investors' expectations for the entity.

AS 2105 acknowledges that an auditor may reevaluate the materiality levels he or she has established during the course of an engagement "because of changes in the particular circumstances or additional information that comes to the auditor's attention" (paragraph 11). An example of such a "change in circumstances" provided by AS 2105 is the following: "The materiality level or levels and tolerable misstatement were established initially based on estimated or preliminary financial statement amounts that differ significantly from actual amounts" (paragraph 11).

Clearly, the change in circumstances that prompted the Deloitte partners to revise the planning materiality threshold for the 2003 Navistar audit would not be considered an appropriate justification for a change in a materiality level under AS 2105.

5. The decision not to sanction Deloitte does not seem consistent with the logic of the former PCAOB official (apologies for the double negative). In my view, it appears that there was a "failure of oversight or supervision." No doubt, we can criticize the oversight or supervision that Linden provided to Anderson. Likewise, where was the concurring or review partner? It seems that individual should have "weighed in" on the decision to revise the materiality threshold at the last moment.

In fact, the PCAOB in its 2007 Deloitte inspection report criticized the "consultation" function within the firm (see Exhibit 2). When necessary, auditors, including audit engagement partners, should consult with experts within or outside the firm to ensure that they make the proper decision. Here's a relevant excerpt from the PCAOB's quality control standards: "Policies and procedures should also be established to provide reasonable assurance that personnel refer to authoritative literature or other sources and consult, on a timely basis, with individuals within or outside the firm, when appropriate (for example, when dealing with complex, unusual, or unfamiliar issues)" [QC 20.19]. It is the responsibility of a firm as a whole, not individual partners, to ensure that the firm has proper "consultation" policies and procedures.

6. QC Section 20, "System of Quality Control for a CPA Firm's Accounting and Auditing Practice" in the PCAOB's quality control standards provides an overview of the nature and purpose of a CPA firm's quality control system. (Note: the quality control standards in the AICPA Professional Standards are very similar to the PCAOB's quality control standards.) QC 20.02 notes that CPAs "should practice in firms that have in place internal quality-control procedures to ensure that services are competently delivered and adequately supervised." QC 20.07 identifies the following five elements of quality control for a CPA firm registered with the PCAOB:

a. Independence, Integrity, and Objectivity
b. Personnel Management
c. Acceptance and Continuance of Clients and Engagements

d. Engagement Performance
e. Monitoring

The key factor that influences an accounting firm's culture is the "tone at the top," that is, the overall competence, integrity, and professionalism of the organization's leaders. As noted in the case, the PCAOB reported that Deloitte's "senior leadership" had apparently embraced the need to make changes in the firm's audit practices. For whatever reason, the PCAOB was not convinced that change in attitude had "trickled down" to the rank and file employees of the firm. What this suggests is that the communication element of the firm may need to be improved. [Note: You might draw parallels between the COSO framework for internal control and accounting firms' quality control systems. Of course, in the COSO framework the tone at the top or "control environment" is the most important element of an entity's internal control system. Likewise, adequate "communication" is another necessary element of an entity's internal control system."] The quality of accounting firms' training programs and their overall ability to quickly and thoroughly "acculturate" new employees into the public accounting profession are other key factors that influence the culture of those firms.

7. The PCAOB has faced considerable controversy since it was established in 2003. As you are well aware, a legal challenge to the new agency's constitutionality was ultimately resolved in the federal courts, including a ruling issued in 2010 by the U.S. Supreme Court. As a prologue to discussing this case question, you might provide your students with the PCAOB's "mission" and "vision" statements that are presented on the organization's website:

> "Our Mission: The PCAOB mission is to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports. The PCAOB also oversees the audits of broker-dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection."
>
> "Our Vision: The PCAOB seeks to be a model regulatory organization. Using innovative and cost-effective tools, the PCAOB aims to improve audit quality, reduce the risks of auditing failures in the U.S. public securities market and promote public trust in both the financial reporting process and auditing profession."

Not being an attorney or a governmental affairs expert, I am less than confident in providing affirmative answers to this case question. Then again, even the so-called "experts" quarrel over the proper scope and nature of the PCAOB's regulatory role and responsibilities. The key goal in having students respond to this question is raising their awareness of the PCAOB and the controversy over its regulatory role and responsibilities.

In my view, triggering a dialogue on the topic of mandatory audit firm rotation seems to be well within the purview of the PCAOB's "mission" statement. Then again, it would seem to me that the government agency that would have to make the final decision regarding audit firm rotation would be the SEC. Congressman Garrett would likely challenge that assertion since he is of the opinion, apparently, that important policy issues involving the capital markets, such as audit firm rotation, should be addressed directly by Congress.

8. This question is related to the prior one in that it addresses the nature and scope of the PCAOB's regulatory role and responsibilities. I believe there is a definitive answer to this question, however. In my view, the PCAOB inspection teams have the right, as well as a responsibility, to "second guess" judgments of the professionals whose work they are reviewing. In fact, if the PCAOB did not have that right or responsibility, what purpose would be served in having the regular inspections of audit firms? I also understand the point being made by Deloitte, namely, that two skilled and seasoned professionals may arrive at different decisions when faced with an identical set of circumstances. That fact, however, does not preclude the possibility that one of those "professionals" made a judgment error.

CASE 1.12

LIVENT, INC.

Synopsis

Similar to most financial frauds, the Livent, Inc. fraud was masterminded by a few individuals, primarily Garth Drabinsky and Myron Gottlieb. However, numerous individuals were eventually drawn into Livent's fraudulent schemes by its principal architects, including Maria Messina, the company's chief financial officer (CFO). Messina, a former partner with Deloitte & Touche's Canadian affiliate, had previously served as Livent's audit engagement partner. The fraud unraveled following Livent's takeover by an investment group led by Hollywood mogul Michael Ovitz. The new management team installed by Ovitz soon found that "massive, systematic irregularities" permeated the company's accounting records. Subsequent investigations by various regulatory authorities, including the SEC, resulted in numerous civil lawsuits and criminal indictments being filed against Drabinsky and his former associates.

Two features of the Livent fraud were particularly disturbing to SEC officials. First, Livent's accounting staff helped further the fraud by developing computer software that allowed senior management to track the company's "real" financial data and the data that had been distorted by fraudulent manipulations. The accounting software also allowed Livent's executives to more readily conceal the fraud from the company's Deloitte auditors. The second troubling feature of the Livent fraud was the matter-of-fact manner in which the company's executives organized and carried out the fraud.

Following the collapse of Livent, the company's independent auditors were criticized for failing to discover that the company's financial statements had been grossly misstated. Much of this criticism stemmed from the fact that the Livent fraud had features common to several "classic" financial frauds. These features included an extremely aggressive, growth-oriented management team, a history of prior financial reporting indiscretions by top company officials, a constant and growing need for additional capital, and the existence of related-party transactions. The presence of these "red flags" should cause auditors to recognize that there is a higher than normal risk that the given client's financial statements contain material misstatements.

Livent, Inc.--Key Facts

1. Garth Drabinsky and Myron Gottlieb founded Livent in 1989 after they had been forced to relinquish control of Cineplex Odeon following charges of irregularities in that company's accounting records.

2. Drabinsky was the creative genius behind Livent's impressive string of Tony Award-winning theatrical productions during the 1990s but also dominated, with the help of Gottlieb, every other important facet of Livent's operations.

3. Livent was based in Toronto but the company received SEC approval to begin trading its stock on the NASDAQ stock exchange in 1995.

4. Serious financial problems stemming from huge cost overruns on Livent's extravagant productions forced Drabinsky to allow Michael Ovitz to acquire a controlling interest in the company in 1998.

5. Ovitz's new management team quickly found that Livent's previous financial data had been grossly distorted by pervasive accounting irregularities.

6. Subsequent investigations by the SEC and other law enforcement authorities revealed that Drabinsky and Gottlieb had apparently masterminded a far-reaching and multi-faceted financial fraud to conceal Livent's deteriorating financial health.

7. Livent employees who participated in the fraud included several accountants who had previously served on Deloitte's audit engagement team for the company, most notably Maria Messina, Livent's CFO who had previously been the company's audit engagement partner.

8. The SEC discovered that Livent's accounting staff had developed computer software that tracked the company's "real" and bogus financial data; this software was also used to conceal the fraud from the Deloitte auditors.

9. Another disturbing feature of the fraud was that company executives regularly met with their accounting staff to discuss "adjustments" needed to improve Livent's financial data.

10. The "accounting manipulations" used by Livent officials included simply erasing expenses and liabilities from the company's accounting records, improper deferrals of major production costs, and capitalizing common operating expenses.

11. In August 1998, Messina and four of her subordinates revealed the fraud to a Livent executive who had been appointed by Michael Ovitz.

12. Deloitte was named as a defendant in multiple civil lawsuits stemming from the Livent fraud; to settle one such case, Deloitte reportedly made a multimillion-dollar payment to a restitution fund established for Livent's former creditors.

Instructional Objectives

1. To emphasize the need for auditors to identify the key inherent risk factors posed by an audit client.

2. To illustrate the lengths to which client executives will sometimes go to misrepresent their company's operating results and financial position.

3. To examine the issues raised when independent auditors accept key accounting positions with former clients.

4. To illustrate the difficulty of uncovering financial frauds masterminded by top client executives that involve the collusion of key members of the given entity's accounting staff.

5. To emphasize the need for auditors to thoroughly investigate suspicious circumstances and transactions discovered during an audit engagement.

Suggestions for Use

In responding to Question 1, students are required to identify the audit risk factors posed by companies in the entertainment industry. Consider expanding Question 1 and making it a more comprehensive exercise. After organizing your class into groups of four to six students, require each group to investigate and prepare a five- to ten-minute oral report on the audit risk factors posed by a specific industry. Industries that I have selected for this purpose in similar exercises include gaming (casino), brokerage, trucking, mining, and computer peripherals. The key to this exercise is choosing a set of industries that are quite different in nature. Following this exercise, students should have a better understanding of the risk factors that tend to be common to a wide range of industries and those that are unique to individual industries.

In discussing Maria Messina's plight (while responding to Question 6), some students are prone to suggest that she should have simply reported the fraud to the appropriate officials as soon as she became aware of it. I attempt to goad my students into recognizing that although revealing the fraud would certainly have been the best decision for Messina to make, it certainly would not have been an easy decision. Encourage students to place themselves in Messina's position. The young, single mother faced a classic Catch 22 situation. By revealing the fraud, she would be raising doubts regarding the quality of the prior Livent audits that she had supervised. Making matters worse, she faced the prospect of losing the large salary she received from Livent, forfeiting the comfortable lifestyle that she had enjoyed since becoming a Deloitte partner, and suffering enormous embarrassment. By dissecting historically "bad" decisions made by auditors and accountants in the past, students will hopefully be less prone to make such decisions during their professional careers.

Suggested Solutions to Case Questions

1. The "entertainment industry" is very diverse and fragmented. In fact, there is little consensus among financial analysts on which specific companies belong to this industry. Video game manufacturers, movie production companies, publicly-owned sports franchises, and sporting goods manufacturers are a just a few examples of the types of companies that are involved in "entertaining" the public. Nevertheless, I would suggest that many companies in the entertainment industry pose the following general inherent risk factors:

- Entertainment companies tend to have more volatile operating results than more generic companies. Why? Because most companies in this industry rely heavily on discretionary spending by consumers, which fluctuates with changes in the overall health of the economy.
- Likewise, the demand for products and services of entertainment companies tend to be more subject to sudden changes in the tastes/interests of the consuming public. For example, the most recent "hot" video game may suddenly fall out of favor with teens and pre-teens when a newer, more "hip" game is released by a competing company. In such situations, companies can be "stuck" with a large amount of obsolete inventory.
- Because of the more volatile operating results of entertainment companies, one could certainly argue that their management teams may be more inclined to attempt to "smooth" their periodic earnings by using various earnings management techniques.
- Because of the generally high-risk nature of entertainment companies' business models, I would suggest that the executives who self-select themselves into this industry are prone to be more risk-seeking, or, at least, less conservative, in their business strategies than the executives who enter electric utilities, banking, and other (historically) low-risk industries.

Listed next are a few examples of "non-standard" audit procedures that might be applied during an audit of a company involved in live theatrical productions.

- Internal control tests would be necessary to ensure that cash receipts generated by live shows are being processed properly. Likewise, related tests would be needed to reconcile head counts with cash receipts—to investigate the possibility that ticket-takers/ticker-sellers are being "generous" with their friends and relatives.
- Theatrical companies typically sign contracts with the theatres in which their productions are to appear—which was true of Livent when one of its shows appeared in a theatre that wasn't owned by the company. These contracts have various stipulations that allow the theatre to cancel the show if it is a "bust." Essentially, these contract stipulations are comparable to covenants commonly included in long-term debt agreements. Auditors would need to develop audit tests to make sure that such contractual stipulations are being satisfied and will likely be satisfied in the near future.
- Theatrical companies defer development costs for new productions. These deferred assets can accumulate to material amounts. Auditors would need to develop appropriate

tests to ensure that these deferred costs are, in fact, assets and are properly valued. Such tests might include corresponding with industry experts or analysts to investigate the likelihood that the given shows will ultimately "open" and have a reasonable "run."

- Theatrical companies often have long-term contracts with actors that produce large assets and liabilities in their balance sheets (these long-term contracts are comparable to capital leases).

Auditors would need to develop audit tests to address the key assertions underlying these amounts. For example, a potentially career-ending injury or illness to an actor who has been signed to a long-term contract might have material balance sheet implications for a theatrical company. In such a case, auditors would need to correspond with the appropriate physicians and/or insurance carriers to determine whether the given situation should trigger an accounting adjustment and/or a footnote disclosure in the client's financial statements.

2. The work roles of an audit partner and CFO of a large public company are probably more similar than they are different. Both an audit engagement partner and a CFO have to "sign off" on financial statements. An audit partner attests to the material accuracy of a client's financial statements when he or she signs an audit report. Since the passage of the Sarbanes-Oxley Act in the summer of 2002, the SEC has required CEOs and CFOs to sign an oath attesting to the accuracy of financial statements filed by their companies with the SEC under the Securities Exchange Act of 1934. Both audit partners and CFOs supervise numerous subordinates and assume responsibility for the work product of those subordinates, have an obligation to "stay current" regarding key technical developments within the accounting and financial reporting domain, and face potential civil and criminal sanctions if they fail to carry out their responsibilities. Despite holding high-ranking positions within their organizations, both audit partners and CFOs must "answer" to superiors. An audit partner's performance is regularly reviewed and evaluated by his or her managing partner and/or a committee of peers, while a CFO's performance is typically reviewed by the CEO and/or the board of directors. One responsibility that audit partners assume that CFOs do not is practice development, that is, audit partners typically spend a significant amount of their time attempting to obtain new clients for their firms.

Which role is more stressful? My answer would be that both are stressful and that the specific circumstances faced by individuals occupying those roles dictate how much stress they are forced to absorb. For example, a CFO of a high-profile company that is "treading water" financially almost certainly faces a significant amount of stress, as would the audit engagement partner for such a company. On the other hand, the CFO and audit engagement partner of a financially strong company may seldom feel pressure related to their job roles.

Which job role is more important? Your students' responses will likely vary. One reasonable argument is that the audit partner's role is more important since the individuals occupying that role have some degree of responsibility for ensuring that several companies' financial statements are reliable. CFOs, on the other hand, focus their energy and attention on only one company's financial statements.

3. Most corporate executives are honest and insist that their accounting subordinates be honest and diligent in maintaining a company's accounting records and in preparing its periodic financial statements. As a result, corporate executives often perceive that an audit contributes

nothing to the quality or reliability of their companies' financial statements. In other words, they conclude that the annual independent audit is effectively a "waste of time." Of course, the reality is that independent audits are necessary. Even scrupulously honest and diligent executives and accountants sometimes make mistakes that result in material financial misstatements. Likewise, there is the occasional dishonest corporate executive whose intent is to mislead and take advantage of investors, creditors, and other third parties who rely on published financial statements to make a wide range of economic decisions.

One effective way for auditors to create a value-added dimension to their audits in the minds of corporate executives is to prepare a management letter or other formal communication at the conclusion of each audit to alert client executives of developing problems in their company's operations, inefficiencies in production processes, emerging human resource issues, and related matters that were discovered during the course of an audit. Likewise, in the post-Enron, post-WorldCom era, auditors should be better equipped to point out to client executives why independent audits—although a potential nuisance to individual companies—are extremely necessary and useful from a society-wide or economy-wide perspective.

4. The relevant technical material in this context is included in AS 6105, "Reports on the Application of Accounting Principles," of the PCAOB's auditing standards. Recognize that when the technical material included in AS 6105 was originally adopted in 1986, the PCAOB did not exist. At that time, that technical material was included in AU Section 625 which was a part of the AICPA Professional Standards. In the "clarified" AICPA Professional Standards, the technical material previously included in AU 625 has been reorganized and placed in AU-C Section 915. AU Section 625 was amended in 2002 well after the key events in the Livent case took place. The key change made to AU 625 in 2002 was to prohibit accountants from issuing reports on "the application of accounting principles to a hypothetical situation." Bottom line, post-2002, the types of reports discussed in AS 6105—and AU-C 915—must now involve specific situations and specific entities.

The simple answer to this question is that the "reporting accountant" must "get the facts" before issuing a report on the given issue. More specifically, AS 6105.08 lists the following four general procedures that a reporting accountant should perform before forming a judgment regarding the given issue.

- Obtain an understanding of the form and substance of the transaction(s)
- Review applicable generally accepted accounting principles
- If appropriate, consult with other professionals or experts
- If appropriate, perform research or other procedures to ascertain and consider the existence of credible precedents or analogies

Note: AS 6105.10 describes in detail the form and content of a "report on the application of accounting principles," while AS 6105.11 provides an example of such a report.

5. At the time, the revenue recognition principle dictated that revenue had to be both "earned" and "realized" before it could be recorded. "Earned" meant that the relevant earnings process was complete or substantially complete, while "realized" meant that an exchange had taken

place. Applying that revenue recognition principle to a generic retail sale was easy to do. But applying the rule to non-standard or unusual revenue transactions was more of a challenge.

In retrospect, the decision to allow Livent to book the full $12.5 million of naming rights revenue seems odd, at a minimum. Particularly troubling was the decision to allow Livent to book naming rights revenue on the yet-to-be-built theatre since one could easily argue that the earnings process for that revenue was not complete. But, in defense of Deloitte's decision, either Ernst & Young or PWC specifically indicated that the $12.5 million should not be recorded.

As a class project, you may want your students to research the "new" revenue recognition standard and have them determine whether the naming rights revenue booked by Livent would be justified under that new standard. I would suggest that the "performance obligations" feature of the new revenue recognition standard would pose a problem for Livent to overcome in justifying the "early" booking of the naming rights revenue.

6. Messina did not feel directly responsible for the accounting irregularities. However, because she had chosen to work for an organization that was replete with fraudulent conduct, she apparently "absorbed" some measure of guilt or responsibility for those irregularities.

After discovering the fraudulent schemes, Messina had several options. These options included, among others, simply ignoring the fraud and hoping that the matter would somehow resolve itself or simply "go away," confronting her superiors who were apparently involved in the fraud, immediately resigning, reporting the fraud to Deloitte officials and/or to law enforcement authorities, and becoming a willing accomplice to the fraud.

One approach to addressing this type of open-ended question is to ask a student to explain what he or she would have done in such circumstances and then immediately ask another student to evaluate the wisdom and morality of that choice. After several rounds of this exercise, a consensus point-of-view among students will likely be evident, namely, that accountants and auditors involved in these types of situations must "bite the bullet" and take aggressive measures, regardless of the personal consequences, to ensure that the fraud is ended.

7. AS 6101 of the PCAOB's auditing standards provides general guidance for accountants to follow when performing a wide range of due diligence engagements, including such engagements that involve common "acquisition transactions." (AS 6101.05). [Note: Since due diligence investigations are not audits, the term "accountants" is used to refer to the individuals completing these engagements.] A key thrust of AS 6101 is that the accountants and the client should reach a firm understanding regarding the nature and scope of the engagement. AS 6101.16 suggests that early in a due diligence investigation the accountants should provide the client with a draft of the report that is expected to be issued at the completion of the engagement. Most importantly, this report should indicate the procedures that the accountants expect to complete during the engagement. After being provided a copy of the draft report, the client should be able to determine whether its objective will be met by the due diligence investigation. In general, the procedures performed during a due diligence investigation will be very similar, in some cases, identical, to the procedures performed during a standard independent audit. (Note: In the "clarified" AICPA Professional Standards, AU-C Section 920 is comparable to AS 6101.)

CASE 1.13

ZZZZ BEST COMPANY, INC.

Synopsis

Barry Minkow founded ZZZZ Best Company, a carpet cleaning concern, in 1982 at the age of 16. Within a matter of months, Minkow was engaging in several fraudulent schemes to raise working capital for his small company, including credit card forgeries and bogus insurance claims. Minkow soon became even bolder and began reporting fictitious revenues from "insurance restoration" contracts in ZZZZ Best's financial statements to induce local banks to grant him loans. Eventually, the revenues from ZZZZ Best's insurance restoration "business" became the dominant line item in the company's financial statements. In fact, by 1987, the insurance restoration contracts accounted for 90% of ZZZZ Best's annual revenues.

In 1986, Minkow took ZZZZ Best public. On the strength of the impressive, but bogus, earnings and revenues figures reported for the company by Minkow, ZZZZ Best's stock price increased dramatically during the first several months it was publicly traded. At one point in early 1987, the collective market value of the company's outstanding stock, approximately one-half of which Minkow owned, exceeded $200,000,000. In July 1987, a few months after ZZZZ Best was exposed as a fraud, the tangible assets of the company were sold for $62,000 at a public auction. In reality, Minkow ran a complex Ponzi scheme for five years. The huge amount of funds ZZZZ Best raised from banks, private investors, and finally through public offerings of stock were squandered by Minkow and his associates on illicit expenditures of all types.

In addition to the investors and creditors that Minkow swindled, among the parties most victimized by his elaborate scam were ZZZZ Best's independent auditors. In a congressional investigation into the collapse of ZZZZ Best, the company's auditors were criticized for their failure to expose Minkow's fraudulent schemes. The investigative subcommittee that sponsored the ZZZZ Best hearings was particularly interested in why the company's auditors failed to discover that the numerous multimillion-dollar insurance restoration contracts reported by Minkow were totally bogus. ZZZZ Best's auditors were also questioned extensively regarding their decision to sign a confidentiality agreement that precluded them from obtaining evidence from independent third parties to corroborate the insurance restoration contracts. Among the other auditing-related issues raised during the course of the hearings was the subject of predecessor-successor auditor communications. Members of the congressional subcommittee were concerned that there had been a lack of candor in the communications between ZZZZ Best's predecessor and successor auditors following both changes in auditors made by the company.

ZZZZ Best Company--Key Facts

1. ZZZZ Best Company, which was initially a small rug-cleaning business, was founded by Barry Minkow when he was 16-years-old.

2. Minkow transformed ZZZZ Best into a leading company in the small and highly fragmented insurance restoration industry by including bogus insurance restoration revenues in ZZZZ Best's financial statements.

3. The daring and resourceful Minkow eventually took ZZZZ Best public.

4. Despite the fact that the company effectively existed only on paper, ZZZZ Best's market capitalization at one point exceeded $200 million.

5. Minkow spent huge sums to conceal his fraud from third parties, including ZZZZ Best's independent auditors, Ernst & Whinney.

6. Ernst & Whinney eventually insisted on visiting some of ZZZZ Best's insurance restoration job sites.

7. Minkow carried out elaborate and expensive "sting" operations to convince the auditors that the job restoration sites actually existed.

8. Minkow demanded that Ernst & Whinney representatives sign a confidentiality agreement prior to visiting the bogus insurance restoration sites; these agreements prevented the auditors from properly investigating the insurance restoration contracts.

9. Because the auditors were not familiar with the insurance restoration industry, they failed to discover that the company's gross profit margins greatly exceeded the industry norm and that the number and size of ZZZZ Best's insurance restoration contracts were unrealistically large.

10. Ernst & Whinney avoided being held civilly liable for the losses resulting from the ZZZZ Best fraud because the accounting firm never completed an audit of the company.

Instructional Objectives

1. To stress the importance of professional skepticism on the part of independent auditors.

2. To demonstrate to students the importance of "assertion-based" auditing.

3. To emphasize the hazards of allowing a client to impose significant constraints on the scope of an audit.

4. To emphasize the importance and necessity of candid communications between predecessor and successor auditors.

5. To introduce students to the SEC's auditor-change disclosure requirements.

6. To acquaint students with the form and content of audit engagement letters.

7. To contrast the nature of audits with that of review engagements.

Suggestions for Use

I often assign the ZZZZ Best case during the first week of the semester, using it as an introduction to the auditing profession for my students. The outrageousness of Minkow's scam and the lengths to which he went to deceive his company's auditors impress upon students the need for auditors to enter each audit engagement with a high degree of skepticism. The case also serves as good introductory material for an auditing course because it illustrates to students that the independent audit function plays a critical role in our economy and society. I stress to students in presenting this case that auditors are often the most (if not only) effective defense that investors and creditors have against massive fraudulent schemes similar to Minkow's. If students are convinced early in the semester that auditing is an important activity, it has been my experience that they are more likely to approach the subject with a high level of interest and enthusiasm.

This case can also be integrated into an auditing course during the coverage of the AICPA's *Code of Professional Conduct*. Most of the ethical issues raised in the case involve the conduct or misconduct of Minkow and his subordinates. However, the case also raises ethical issues directly relevant to the independent auditor's role, such as, client confidentiality and the collegial responsibilities of auditors. The case could also be assigned during coverage of the following topics: client acceptance and continuance, evaluation of audit evidence, and reviews and compilations.

At some point in the presentation of this case, the instructor will want to emphasize that Ernst & Whinney, the audit firm that is the focus of much of this case, never completed an audit of ZZZZ Best. The audit firm did complete a review of the company's quarterly financial statements for the three months ending July 31, 1986; however, the firm resigned in the late spring of 1987 prior to completing its audit of ZZZZ Best's fiscal 1987 financial statements.

One final pedagogical suggestion concerns the exhibits incorporated in this case. Unlike many auditing cases, the ZZZZ Best case provides an opportunity for students to review actual audit documents since certain of Ernst & Whinney's audit workpapers became public domain material during the course of the congressional investigation. Included in the exhibits, for example, are the memorandum that an audit partner wrote following his visit to one of ZZZZ Best's bogus restoration sites and the actual engagement letter obtained by Ernst & Whinney from ZZZZ Best.

Suggested Solutions to Case Questions

1. The purpose of a review engagement is to obtain a reasonable basis for providing "limited assurance" that a given client's financial statements have been prepared in conformity with generally accepted accounting principles. Essentially, a “clean” review report provides negative assurance, that is, it discloses only that the auditor (CPA) did not discover any evidence suggesting that the financial statements are materially misstated. The objective of an audit is much more affirmative in nature. A full-scope independent audit is designed to provide a reasonable basis for expressing an "opinion" concerning whether or not a client's financial statements have been prepared in accordance with generally accepted accounting principles.

There is also a critical difference between a review and an audit in terms of the scope of work performed. In a review engagement, the primary evidence collection techniques are analytical procedures and inquiries of client personnel. Alternatively, in an audit, the full range of evidence collection techniques available to an auditor is likely to be used including, but not limited to, confirmation procedures, physical observation of assets, and inspection of source documents. Because reviews are generally not as rigorous as audits, considerably less evidence is typically collected in a review engagement than in a comparable audit engagement.

2. Third party confirmations, in most cases, yield reliable evidence in support of the occurrence assertion. However, the quality of such evidence is largely dependent upon the nature of the relationship, if any, that exists between the client and the third party providing the confirmation. Confirmations provide the highest quality evidence when the third party is independent of the client. Unfortunately, in the ZZZZ Best case, the individuals who confirmed that the company’s insurance restoration transactions had “occurred” were not independent of the client. In fact, unknown to Ernst & Whinney, the parties who returned the confirmations were confederates of Minkow. [Note: The second stipulation of the confidentiality agreement signed by Ernst & Whinney precluded the audit firm from obtaining written confirmations from certain key parties allegedly associated with the job sites visited by Ernst & Whinney. However, the auditors did obtain confirmations from the two bogus companies, Assured Property Management and Interstate Appraisal Services, regarding insurance restoration jobs that these companies had allegedly contracted out to ZZZZ Best. It is these latter confirmations that are referred to in this question.]

In evaluating the competence of documentary evidence, such as the contracts ZZZZ Best furnished Ernst & Whinney in support of the company's insurance restoration revenues, an auditor should consider whether the documents are internally or externally prepared. Documents prepared external to the client's internal control system by an independent third party are generally considered to provide a high quality of audit evidence. However, externally prepared documents in the possession of the client, which was the case with the ZZZZ Best insurance restoration contracts, provide a lower quality of audit evidence than documents that originate and remain outside a client's internal control system. Internally prepared documents nearly always yield a lower quality of evidence than either type of externally prepared documents.

The evidence provided by analytical procedures is generally considered to be somewhat tenuous in nature, regardless of which assertion is being tested, and should be corroborated with other audit procedures if possible. For instance, the results of analytical tests may suggest that there is a proper relationship between bad debts and credit sales. However, one or both of the account balances may be materially misstated, meaning that any conclusions drawn from such a comparison are invalid.

Physical evidence is generally considered to be a very reliable source of audit evidence since it involves the auditor actually observing and/or inspecting a given asset—of course, in this case, the auditors were observing the job restoration sites to confirm the occurrence assertion for the insurance restoration revenues. Nevertheless, auditors should realize that even physical evidence has limitations. For example, auditors may not have the proper experience or expertise to gather or interpret physical evidence. Likewise, similar to other forms of audit evidence, physical evidence may be fabricated by dishonest client personnel.

3. Payments received by a client on an account receivable do not establish, necessarily, that the receivable actually existed at some point in time. A client with sufficient funds can easily create what appears to be a normal operating cycle on paper even though no arm's length transactions are taking place. In ZZZZ Best's fraudulent scheme, management generated fake receivables and then arranged for payments on those receivables to make it appear that a normal cycle of transactions was occurring. Of course, the absence of a normal operating cycle would have been an immediate tip-off to the auditors that something was awry. Again, an instructor can comment on the need for auditors to maintain a skeptical attitude even when faced with a seemingly "normal" set of circumstances.

4. Note: At the time the key events in this case transpired, *SAS No. 7*, "Communications between Predecessor and Successor Auditors," was in effect. In 1998, *SAS 7* was superseded by *SAS No. 84*, which has the same title. There are only minor differences between these two standards. *SAS No. 84* is now integrated into AU-C Sections 210 and 510 of the AICPA's "clarified" Professional Standards. In the PCAOB's auditing standards, *SAS No. 84* is integrated into AS 2610.

Predecessor-successor auditor communications are intended to help ensure that successor auditors receive all relevant information they need to make a client acceptance decision and to help them design an appropriate audit for the new client following that decision. The prospective successor auditor is responsible for initiating predecessor-successor auditor communications. Prior to accepting a client, the successor auditor should request permission from the prospective client to communicate with the former auditor. Additionally, the successor auditor should ask the client to authorize the former auditor to respond fully to that request.

A successor auditor should request from the predecessor auditor: 1) information that might bear on the integrity of management, 2) disagreements with management as to accounting principles, auditing procedures, or other similar matters, 3) communications with the client's audit committee (or other parties with similar authority) regarding fraud, illegal acts, and internal control-related matters, 4) the predecessor auditor's understanding as to the reasons for the change in auditors, and 5) the predecessor's understanding of the client's related party relationships and transactions and significant unusual transactions (Item #5 applies only to public company clients.) (Note: AU-C 210.A31 and AS 2610.09 of the AICPA Professional Standards and the PCAOB's auditing standards, respectively, are the relevant sources in this context.) Following the acceptance of the client by the successor auditor, the latter should ask the client to authorize the predecessor to allow it (the successor) to review the predecessor's workpapers. It is customary for the predecessor auditor to provide the successor auditor with copies of key workpapers prepared during the prior year's audit.

According to the congressional testimony of ZZZZ Best's initial auditor, George Greenspan, Ernst & Whinney did not attempt to communicate with him either prior to or after that firm accepted ZZZZ Best as an audit client. If that testimony was correct, Ernst & Whinney failed to comply with the existing provisions of *SAS 7* since it was the successor auditor and thus had the responsibility to initiate contact with Greenspan. (Of course, theoretically, Minkow could have denied Ernst & Whinney permission to make the standard *SAS 7* inquiries of Greenspan.) As pointed out in the case,

Ernst & Whinney representatives subsequently disputed Greenspan's testimony by reporting that they, in fact, had communicated with him prior to accepting ZZZZ Best as a client. However, the Ernst & Whinney representatives did not testify as to the content or results of those communications.

Following the resignation of Ernst & Whinney, Price Waterhouse contacted that firm and apparently made the standard inquiries suggested by *SAS 7* prior to accepting ZZZZ Best as an audit client. The congressional testimony documents that Congressman Wyden was concerned that Ernst & Whinney failed to respond candidly to Price Waterhouse's request for information regarding ZZZZ Best. In responding to Price Waterhouse's *SAS 7* inquiries, Ernst & Whinney reported no prior disagreements with ZZZZ Best management. Regarding the reason for the auditor change, Ernst & Whinney representatives simply informed Price Waterhouse that their firm did not want to be associated with the ZZZZ Best financial statements. Finally, Ernst & Whinney reported to Price Waterhouse that it had no concerns regarding the integrity of management, pending the results of an ongoing board of directors' investigation. Despite this latter communication, the transcripts of the congressional hearings suggest that, at the time of its resignation, Ernst & Whinney did appear to have concerns regarding the integrity of ZZZZ Best management. Ernst & Whinney apparently did not believe it was appropriate to disclose those concerns to Price Waterhouse prior to the conclusion of the board of directors' investigation (which was intended to determine whether allegations of fraudulent conduct involving Minkow were true).

5. The confidentiality agreement certainly imposed restrictions on the ability of Ernst & Whinney to corroborate the evidence collected during the site visitations. The second stipulation of that agreement, shown in Exhibit 3, was particularly limiting. The inability of Ernst & Whinney to contact the building owner, the insurance company, and other companies or individuals allegedly involved in, or associated with, the restoration projects precluded the

auditors from obtaining evidence from independent third parties to resolve any questions or issues raised as a result of the site visitations. Whether the confidentiality agreement improperly limited the scope of Ernst & Whinney's audit is a matter of professional judgment. Apparently, members of the audit engagement team did not believe that the scope of the ZZZZ Best audit was improperly restricted by the agreement, otherwise they would not have complied with it.

Many companies are concerned that confidential information may be leaked to external parties, competitors, in particular, as a result of an independent audit. For example, following the merger of Ernst & Whinney and Arthur Young & Company in 1989, Coca-Cola executives insisted that the merged firm retain only their company or PepsiCo as an audit client. Prior to the merger, Coca-Cola had been a client of Ernst & Whinney, while PepsiCo had been a client of Arthur Young. Coca-Cola officials were reportedly concerned that key operating data might be inadvertently passed to their major competitor if Ernst & Young audited both companies. When an audit firm serves competing companies, one obvious precaution that can be taken is to have different audit teams assigned to the engagements.

Another situation in which confidentiality concerns on the part of a client may affect an independent audit is when the client has new products or services in development. Although auditors are bound by the *Code of Professional Conduct* to not disclose such information to third parties, the client may still be concerned about the possible leakage of information. In such cases, the client may insist that a limited number of auditors be given access to the confidential information. In addition, the client may insist that only partners or managers assigned to the audit be provided that information.

When constraints imposed by a client prevent auditors from complying in material respects with the relevant auditing standards, a scope limitation has occurred. Most often, the standard affected in such cases is the auditor’s responsibility to obtain sufficient appropriate evidence to support the opinion rendered on the client's financial statements. If the auditor decides that a client's confidentiality concerns have resulted in a scope limitation, then client management should be informed that the auditor will be required to issue either a disclaimer of opinion or a qualified opinion on the company's financial statements. At that point, client management can decide whether to modify the constraints that they have chosen to impose on the audit or to accept the impact of those constraints on the auditor's report.

6. Professional standards do not require that auditors attest to the material accuracy of pre-audit earnings press releases that many public companies make. However, it is customary that client executives consult with their independent auditors before making such announcements. Typically, the pre-audit earnings release is not made until the net income number is considered "firm" by both parties.

CASE 1.14

DHB INDUSTRIES, INC.

NOTE: This case was published initially in *Issues in Accounting Education*, a publication of the American Accounting Association. The original title was "Of Hurricanes and Horse Racing: The Accounting Fraud at DHB Industries, Inc." (February 2013, pp. 131-152). The AAA has requested that AAA members access the Teaching Notes for this case on its website: https://aaapubs.org/loi/tnae.

CASE 1.15

NEW CENTURY FINANCIAL CORPORATION

Synopsis

New Century Financial Corporation's bankruptcy filing in April 2007 was the initial incident in a series of events that would eventually plunge the U.S. and global economies into full-fledged panics. Within a few years of its founding in 1995, New Century had become one of the largest subprime mortgage lenders in the U.S. New Century and other major subprime lenders such as Wells Fargo, Countrywide, and HSBC catered to potential home buyers who had poor or "subprime" credit histories. The subprime lenders prospered throughout the late 1990s and following the turn of the century because of steadily rising housing prices. Those rising prices allowed large numbers of subprime mortgagees to routinely refinance their homes to raise the cash needed to make their monthly mortgage payments. Other subprime borrowers purchased homes with the intention of "flipping" them in a few years that is, selling them at a significant gain and then using a portion of the proceeds to purchase a larger home— with an even larger mortgage than their previous home.

This new age, real estate Ponzi scheme came to a screeching halt when housing prices began declining. Suddenly, subprime lenders were flooded with loan repurchase requests. These repurchase requests came primarily from institutional investors that had purchased large blocks of mortgage-backed securities or MBS that the subprime lenders had sold "upstream" via the securitization process. As one observer noted, securitization effectively spread the "cancer" of subprime mortgages around the globe. The resulting worldwide financial crisis imposed huge losses on investors and claimed many former stalwarts of the financial services industries including Merrill Lynch, Bear Stearns, Lehman Brothers, Fannie Mae, and Freddie Mac.

This case provides a brief history of the subprime sector of the mortgage industry and the massive financial crisis triggered by the collapse of that industry. The bulk of this case examines allegations that independent auditors played a major role in the subprime lending fiasco. In early 2008, the court-appointed bankruptcy examiner for New Century Financial Corporation released a nearly 600-page autopsy of that company. Much of that report focused on the alleged malfeasance of New Century's audit firm, KPMG. Among other charges, the bankruptcy examiner maintained that the New Century audits were not properly staffed, that KPMG failed to adequately consider pervasive weaknesses in the company's internal controls, and that the audit firm failed to properly audit New Century's critical loan repurchase loss reserve.

New Century Financial Corporation--Key Facts

1. New Century Financial Corporation was one of the leading firms in the subprime sector of the mortgage industry until it suddenly collapsed into bankruptcy in April 2007; New Century's collapse contributed to the onset of a worldwide financial crisis in late 2008.

2. New Century's financial health was undermined by rapidly declining housing prices that resulted in a large number of subprime mortgagees defaulting on their loans.

3. Despite its deteriorating financial condition and operating results, New Century continued to insist that it was financially healthy until late 2006.

4. KPMG served as New Century's audit firm from the company's inception in 1995.

5. New Century's court-appointed bankruptcy examiner maintained that because KPMG failed to comply with "professional standards," investors and other third parties failed to learn of the company's deteriorating financial condition and operating results.

6. The bankruptcy examiner alleged that the New Century audit engagements were improperly staffed and that the independence of certain KPMG auditors may have been impaired.

7. The bankruptcy examiner also charged that the KPMG auditors failed to adequately consider serious internal control problems within New Century's accounting system and that the auditors failed to properly audit the company's critically important loan repurchase loss reserve.

8. Among other allegations, the bankruptcy examiner maintained that a KPMG senior manager recommended an improper accounting change for New Century's loan repurchases that resulted in large understatements of the company's loan repurchase loss reserve.

9. KPMG officials insisted that their firm properly audited New Century and that the bankruptcy examiner's report was unfair and "one-sided."

10. Other parties also came to the defense of KPMG, including an accounting professor who suggested that New Century's high-risk business model doomed the company to bankruptcy and "not anything that KPMG did."

11. At a minimum, the New Century bankruptcy report added to a series of embarrassing public relations incidents experienced by KPMG.

12. In response to the massive financial crisis triggered at least partially by the huge losses in the subprime sector of the mortgage industry, the U.S. Congress passed a $700 billion bailout plan in October 2008 to shore up the nation's crumbling financial infrastructure.

Instructional Objectives

1. To illustrate the critical importance of independent auditing to the proper functioning of a free market economy.

2. To examine the importance of proper staffing of an audit engagement team.

3. To demonstrate how auditors' perceived independence can be impaired when significant auditor-client conflicts arise.

4. To examine key responsibilities of independent auditors under Section 404 of the Sarbanes-Oxley Act.

5. To identify the general principles auditors should employ when auditing important "accounting estimates" of a client.

Suggestions for Use

This case clearly establishes that independent auditors play a critical, if underappreciated, role in the nation's economy. Likewise, the case documents that auditors of high-profile clients may find themselves involuntarily thrust into the spotlight and be asked to justify, in minute detail, key decisions that they made on previous engagements for such a client. You can use these observations to convince your students of 1) the critical importance of the professional role that many of them are about to assume and 2) the need for them to take their professional responsibilities as independent auditors very seriously.

During the 2004 through 2006 New Century audit engagements, PCAOB *Auditing Standard No. 2* was in effect. As you are probably aware, *AS No. 2* was very controversial and was replaced in short order by *PCAOB AS No. 5*—which was subsequently integrated into AS 2201 of the PCAOB auditing standards. Consider having a group of your students report on why the PCAOB chose to replace *AS No. 2* with *AS No. 5*. You might also have the students briefly discuss the key differences between those two standards. (In fact, the SEC issued a statement profiling those differences.) Finally, consider asking another group of students to provide an in-class summary of the technical requirements of Section 404 of the Sarbanes-Oxley Act that are in addition to those that are the subject of case question No. 3

Suggested Solutions to Case Questions

1. Several academic studies have found that the major international accounting firms have historically specialized, that is, have had heavy concentrations of clients, in certain industries. For example, Arthur Edward Andersen built his namesake firm into a powerhouse in large part by focusing on the electric utility industry.

The obvious advantage of having client concentrations in certain industries is economies of scale. An accounting firm that has a sizable market share of a given industry can justify devoting significant resources to developing a customized audit model for companies in that industry and intensive training programs intended to develop expertise in auditing such companies. Because those costs can be "amortized" over a large number of clients, the accounting firm in question should be able to establish itself as the "low cost" supplier of audit services for that industry. Even more important, that accounting firm should develop a reputation for being the highest quality auditor for the industry.

An obvious disadvantage of establishing an audit practice that specializes in certain industries is the difficulty that such a firm may have obtaining clients outside of those industries. For example, earning a reputation as the "banking industry's auditor" would probably diminish the chances of "picking up" clients that become available in lines of business unrelated to banking. Another disadvantage of specialization is that a large portion of a firm's clientele may be lost if the industry or sub-industry in which it specializes is undermined by foreign competition, regulatory or legislative changes, or unexpected economic conditions—similar to what happened to the subprime sector of the mortgage industry in recent years.

2. The PCAOB's quality control standards provide broad guidelines and recommendations that accounting firms can use to ensure that the professional services they provide are competent. QC 20.01 mandates that a CPA firm "shall have a system of quality control for its accounting and auditing practice." QC 20.07 notes that an accounting firm's quality control system should include policies and procedures that address the following five elements: independence, integrity, and objectivity; personnel management; acceptance and continuance of clients and engagements; engagement performance; and monitoring." (Note: the quality control standards included in the AICPA Professional Standards are closely related to those of the PCAOB. There are differences, however. For example, the AICPA's quality control standards identify the following six elements that should be integrated into an accounting firm's quality control system: leadership responsibilities within the firm, relevant ethical requirements, acceptance and continuance of client relationships and specific engagements, human resources, engagement performance, and monitoring. See the "QC" sections of the AICPA Professional Standards.)

The quality control element of "Engagement Performance" is discussed at QC 20.17-19. These paragraphs identify general principles that accounting firms should invoke in performing audits and other professional service engagements. Arguably the principle most relevant in the present context is "consultation." For example, QC 20.19 observes that, "Policies and procedures should also be established to provide reasonable assurance that personnel refer to authoritative literature or other sources and consult, on a timely basis, with individuals within or outside the firm, when appropriate (for example, when dealing with complex, unusual, or unfamiliar issues)." Given the almost complete turnover of the New Century audit engagement team from the 2004 audit to the 2005 audit and the lack of experience that certain members of the new team had with the client's industry, it seems reasonable to suggest that KPMG should have emphasized the need for the 2005 engagement team to make full use of the large firm's considerable "consultation" resources. In fact, as pointed out in the case, certain "specialists" were brought in to review some of New Century's most complex transactions.

Other quality control measures that could be implemented when there is a large turnover in the members of an audit engagement team would include a more rigorous review of audit workpapers and more input from a "concurring" or "review" partner who has experience with the given client's industry.

No doubt, some of your students will also suggest that audit firms should simply avoid such situations altogether—that is, situations in which there is wholesale turnover of an audit engagement team from one year to the next. You may want to remind your students that in the "real world" such simple solutions are not always feasible. In fact, during the time frame that the 2004 and 2005 New Century audits were being performed, the major international accounting firms were facing large personnel shortages. The huge amount of SOX Section 404 work that was necessary beginning with calendar-year 2004 audits consumed an enormous amount of those firms' manpower and other resources. In addition to requiring their employees to work an inordinate amount of overtime, the major firms implemented other unconventional measures in an effort to provide at least minimal staffing for all audit engagements. These latter measures included tracking down former employees and offering them attractive salaries to return to work and "borrowing" staff from international affiliates. KPMG used both of these latter measures to staff the 2005 New Century audit. As indicated in the case, Debbie Biddle, who oversaw the 2005 SOX internal control audit, was recruited from KPMG's UK affiliate. Mark Kim, the senior manager assigned to the 2005 New Century audit, was a former KPMG auditor who had left the firm several years earlier.

3. As pointed out in the Suggestions for Use, PCAOB *Auditing Standard No. 2* was in effect during the time frame that the 2004 through 2006 New Century audits were being performed by KPMG. In 2007, the PCAOB replaced *AS No. 2* with *AS No. 5*, which was subsequently integrated into AS 2201 of the PCAOB auditing standards. The title of *AS No. 5* and AS 2201 is, "An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements." [Sidebar: You may want to point out that in 2007 the SEC issued new interpretative guidance to streamline and reduce the cost of SOX-mandated assessments of internal control by the management of public companies. PCAOB followed suit by adopting *AS No. 5*, which was intended to streamline and reduce the cost of SOX-mandated internal control audits.]

Following are definitions of three key terms that were taken directly from Appendix A of AS 2201.

Internal control deficiency: "A deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis."

Significant deficiency in internal control: "A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting."

Material weakness in internal control: "A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis."

AS 2201.03 notes that "The auditor's objective in an audit of internal control over financial reporting is to express an opinion on the effectiveness of the company's internal control over financial reporting." This paragraph goes on to indicate that "a company's internal control cannot be considered effective if one or more material weaknesses exist." As a result of this latter premise, "the auditor must plan and perform the audit to obtain reasonable assurance about whether material weaknesses exist as of the date specified in management's assessment [of internal control]." (AS 2201.62 indicates expressly that "the auditor is not required to search for deficiencies that, individually or in combination, are less severe than a material weakness.") In summary, if an auditor discovers one or more material weaknesses in internal control, then he or she cannot issue an unqualified or "clean" opinion on the given client's internal controls. So, in a nutshell, the key operational responsibility of auditors under AS 2201 is to "plan and perform the [internal control] audit to obtain reasonable assurance about whether material weaknesses exist." Likewise, the key reporting responsibility of auditors is to disclose whether or not material weaknesses are present in the client's internal control over financial reporting.

AS 2201.78-84 address the "communication" responsibilities of auditors, other than the overall opinion that an auditor must issue on the client's internal controls over financial reporting. Listed next are these responsibilities:

- "The auditor must communicate, in writing, to management and the audit committee all material weaknesses identified during the audit."
- "If the auditor concludes that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that conclusion in writing to the board of directors."
- "The auditor also should consider whether there are any deficiencies, or combinations of deficiencies, that have been identified during the audit that are significant deficiencies and must communicate such deficiencies, in writing, to the audit committee."
- "The auditor should also communicate to management, in writing, all deficiencies in internal control over financial reporting (i.e., those deficiencies in internal control over financial reporting that are of a lesser magnitude than material weaknesses) identified during the audit and inform the audit committee when such a communication has been made."

4. For audits of SEC registrants, AS 2501, "Auditing Accounting Estimates," of the PCAOB's auditing standards is the authoritative source most relevant to this question. AS 2501.03 summarizes the "macro" level responsibility of auditors regarding client accounting estimates.

> "The objective of the auditor is to obtain sufficient appropriate evidence to determine whether accounting estimates in significant accounts and disclosures are properly accounted for and disclosed in the financial statements."

AS 2501.07 describes the general testing approaches that auditors should use in examining a client's material accounting estimates—auditors may choose to apply a combination of these approaches.

a. "Test the process used to develop the accounting estimate."
b. "Develop an independent expectation for comparison to the company's estimate."
c. "Evaluate audit evidence from events or transactions occurring after the measurement date related to the accounting estimate for comparison to the company's estimate."

The remaining three sections of AS 2501 provide guidance to auditors on how to apply the above three approaches to testing accounting estimates. Listed next are examples of a few of the many procedures that AS 2501 recommends auditors use in evaluating the reasonableness of management accounting estimates.

- ”The auditor should evaluate the reasonableness of the significant assumptions used by the company to develop the estimate."
- "If the auditor uses data or assumptions obtained from a third party in developing an independent expectation, the auditor should evaluate the relevance and reliability of the data and assumptions . . ."
- "When the auditor obtains audit evidence from events or transactions that occur after the measurement date, the auditor should evaluate whether the audit evidence is sufficient, reliable, and relevant to the company's accounting estimate and whether the evidence supports or contradicts the company's estimate."

Note: the AICPA Professional Standards discuss the topic of auditing accounting estimates within AU-C Section 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures."

5. The most effective way to address this question is to simply "walk through" the various sections of the PCAOB auditing standards and identify apparent oversights made by the KPMG auditors of New Century. The following list is not intended to be all-inclusive. Instead, what I have done is focus on the overarching or "macro" auditing principles or standards slighted by the KPMG auditors. [Note: Realize, of course, that the following PCAOB auditing standards were not in effect when the New Century audits were performed. Nevertheless, the auditing standards that were in effect at that time included the principles underlying the following list of PCAOB auditing standards.]

1. AS 1005, "Independence." As mentioned in the case, the bankruptcy examiner "speculated" that the 2005 10-K "incident" impaired the independence of Donovan and Kim. After that awkward and embarrassing incident for KPMG, the two senior members of the audit team may have attempted to "bend over backwards" to get back "in the good graces" of client management.

2. AS 1010, "Training and Proficiency of the Independent Auditor." Certainly, the bankruptcy examiner's report raised legitimate concerns regarding the issue of whether the 2005 New Century audit engagement team was properly staffed. As noted in the case, even New Century management questioned the appointment of Donovan as the new audit engagement partner given his lack of familiarity with the mortgage industry. Likewise, the appointment of Debbie Biddle to oversee the 2005 SOX internal control audit seemed to be a questionable decision since she had no prior SOX experience and "virtually no experience auditing U.S. clients." Making matters worse was the fact that nearly all of the subordinate members of the audit team were new to the New Century engagement.
3. AS 1015, "Due Professional Care in the Performance of Work." This standard is a "catch-all" professional standard. If it is proven that an auditor violated another auditing standard, then it would be easy to maintain that this standard was violated as well.
4. AS 1105, "Audit evidence." Whether KPMG obtained sufficient appropriate audit evidence to support the period-ending balances of the loan repurchase loss reserve is a question that will likely be debated *ad nauseam* in coming years. Based upon the information available in the bankruptcy examiner's report, it is easy to question the adequacy and propriety of that evidence.
5. AS 2101, "Audit planning." The bankruptcy examiner alleged that the 2005 audit team did not properly review the prior year workpapers, at least with regard to the internal control deficiencies discovered by the 2004 audit team. AS 2201 ("An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements") notes specifically that "In subsequent years' audits, the auditor should incorporate knowledge obtained during past audits he or she performed of the company's internal control over financial reporting into the decision-making process for determining the nature, timing, and extent of testing necessary" (AS 2201.57). Again, this general audit planning principle was apparently not invoked by the KPMG auditors.

6. You can find a slag pile of articles in recent years that have debated the role that mark-to-market accounting played in the serious financial crisis that engulfed the national and global economies in late 2008. The principal (pre-codification) technical standard relevant to mark-to-market accounting is *Statement of Financial Accounting Standard No. 157*, "Fair Value Measurement." That standard defines "fair value" as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." [Note: In the FASB's codification of accounting standards, "Fair Value Measurement" is Topic 820.]

Critics of the mark-to-market rule insist that it is disruptive to the capital markets because it introduces more uncertainty and volatility into those markets. Many financial institutions were "trapped" with large investments in MBS and other more exotic financial instruments when the financial crisis erupted in 2008. The mark-to-market rule forced those institutions to take large, if not massive, write-downs on those investments. Critics of the rule maintained that those involuntary write-downs created more havoc in the markets by panicking investors, which, in turn, forced more mark-to-market write-downs. These same critics argued that many, if not most, of the write-downs being taken were unnecessary and inappropriate since it was difficult, if not impossible, to determine the true fair value of the given investments given the illiquid and sometimes "disorderly" nature of the markets in question. To calm the capital markets, many parties, including respected members of the investment community, called for the mark-to-market rule to be repealed or at least temporarily suspended. One critic of the rule succinctly summarized his position by stating that, "SFAS 157 Is Worse than Al Qaeda."

Prominent members of the accounting profession forcefully defended the mark-to-market rule and insisted that critics of the rule had adopted a "kill-the-messenger" attitude. Among the most vocal defenders of the rule were former SEC Chairman Arthur Levitt and former SEC Chief Accountant Lynn Turner who addressed the need to retain the rule in an editorial appearing in the *Wall Street Journal* (September 26, 2008).

> Ultimately, those who blame fair-value accounting for the current crisis are guilty of the financial equivalent of shooting the messenger. Fair value does not make markets more volatile; it just makes the risk profile more transparent. We should be pointing our fingers at those at Lehman Brothers, AIG, Fannie Mae, Freddie Mac, and other institutions who made poor investment and strategic decisions and took on dangerous risks. Blame should not be placed on the process by which the markets learned about them.

7. I commonly conclude the discussion of a case by asking students to identify the key "take-aways" for that case. In fact, in pre-coverage, in-class quizzes I frequently ask students to list and rank the most important take-aways for the cases to be discussed in the given class and require them to defend their choices. Listed next is a sample of what I consider to be important take-aways for this case.

- The independent audit function is critically important to the proper functioning of a free market economy.
- When planning an audit, auditors should pay extremely close attention to important industry developments that may impact the integrity of the client's financial statements.
- Accounting estimates that are critical to the reported health of the client should be audited rigorously.
- Companies with high-risk business models generally make high-risk audit clients.
- To properly plan an audit, auditors must review prior year workpapers and identify key accounts, internal control deficiencies, and other factors or circumstances that could potentially influence the outcome of the audit.
- Auditors should consider internal control deficiencies when determining the nature, extent, and timing of substantive audit procedures.
- Proper staffing of an audit engagement is critical to the performance of a high quality audit.
- Perceived auditor independence can be just as important as *de facto* auditor independence.
- Poor relationships between auditors and client personnel, particularly high-level accounting personnel, can have an adverse impact on the quality of an audit.
- Client representations are a weak form of audit evidence.

CASE 1.16

MADOFF SECURITIES

Synopsis

A childhood friend summed up the driving force in Bernie Madoff's life: "Bernie wanted to be rich." As a youngster growing up in New York City, Bernie realized that Wall Street was the greatest wealth creation machine the world had ever known. So, after graduating from college in 1960, he set his sights on joining the exclusive fraternity that ran Wall Street by organizing his own one-man brokerage firm, Madoff Securities.

Madoff was one of the first individuals to recognize that computer technology provided the means to "democratize" Wall Street by establishing a system that made securities trading much more efficient and much cheaper. In the early 1970s, Madoff and several other individuals organized the NASDAQ exchange, which was destined to become the world's largest electronic stock market. Years later, the NYSE would be forced to follow suit and switch to electronic securities trading. Literally hundreds of millions of investors have benefitted from the lower transaction costs of electronic securities trading that were in large part a result of the pioneering efforts of Bernie Madoff.

Unfortunately, Bernie Madoff will not be remembered as a pioneer of electronic securities trading. Instead, the word "Madoff" will always be associated with the phrase "Ponzi scheme." Although his stock brokerage firm was extremely lucrative, Madoff eventually established a parallel business, investment advisory services. Over a period of several decades, Madoff became known as the "Wizard of Wall Street" for the incredibly consistent and impressive returns that he earned on the billions of dollars entrusted to him by investors. However, those returns and Madoff's secretive investment strategy that produced them were fraudulent.

This case documents the Madoff fraud with a particular focus on its implications for the nation's financial reporting system. Many critics have insisted that the ineffectiveness of the SEC was a major factor that allowed Madoff to sustain his fraud for so long. Likewise, those critics insist that Madoff's independent auditor played a major role in allowing the fraud to go unchecked for decades. Throughout most of its existence, Madoff Securities was audited by a small accounting firm with one professional accountant. That accountant, David Friehling, would become the second individual arrested by federal prosecutors investigating Madoff's massive fraud. Friehling was charged with "flouting" the accounting profession's auditor independence rules and with performing "sham audits" of Madoff Securities.

Madoff Securities--Key Facts

1. The driving force in Bernie Madoff's life was his desire to become wealthy.

2. Madoff founded Madoff Securities, which was one of the first brokerage firms to employ computer technology to reduce the cost of securities transactions; Madoff is also credited as one of the founders of the NASDAQ, the world's largest electronic stock exchange.

3. The investment advisory division of Madoff Securities grew dramatically over the life of the firm due to the incredibly consistent and impressive rates of return that it earned for investors.

4. In early December 2008, Madoff confessed to family members that his firm's impressive investment results were fraudulent, the product of a massive Ponzi scheme that he had carried out over decades.

5. News of the massive fraud prompted an angry public to question why the nation's "watchdogs" for the capital markets, particularly the independent audit function, had failed once again.

6. Madoff's auditor had been a tiny CPA firm, Friehling & Horowitz, with one professional accountant, David Friehling.

7. Accounting and auditing experts insisted that it was "preposterous" that one person could audit a firm the size of Madoff Securities.

8. In March 2009, Friehling was arrested and charged with securities fraud and aiding and abetting an investment fraud due to his allegedly "sham audits" of Madoff Securities; federal prosecutors also revealed that Friehling and his firm had a large amount of funds invested with Madoff Securities.

9. The SEC was the target of harsh criticism when it was revealed that Harry Markopolos, a Boston-based financial analyst, had repeatedly told the federal agency that Madoff was operating the "world's largest Ponzi scheme" and had provided evidence apparently proving that allegation.

10. In March 2009, Madoff pleaded guilty to eleven counts of fraud, money laundering, perjury, and theft; in June 2009, Madoff was sentenced to 150 years in federal prison.

11. KPMG became the first of the Big Four firms to be sued as a result of the Madoff fraud; the lawsuit alleged that KPMG failed to properly investigate Friehling & Horowitz while auditing the financial statements of a large "feeder firm" in which the plaintiff was an investor.

12. The SEC announced a series of reforms to prevent or detect future frauds similar to Madoff's; one of those measures subjects investment advisers to annual "surprise audits" to ensure that customer funds are properly safeguarded.

Instructional Objectives

1. To identify the principal precursors of financial fraud.

2. To identify "red flags" or risk factors typically indicative or symptomatic of fraud.

3. To demonstrate the critical importance of a vigorous independent audit function for a free market economy.

4. To examine the regulatory role and responsibilities of the Securities and Exchange Commission.

5. To identify the nature and purpose of peer reviews.

Suggestions for Use

This case is well suited to "kick off" an auditing course, particularly an undergraduate auditing course. The case is high profile, fairly brief, not highly technical, and most importantly documents how vital the independent audit function is to our economy. After studying this case, students should have a crystal clear understanding of why it is so necessary that every large company, both private and public, undergo a truly independent and vigorous financial statement audit each year. No doubt, almost every business in the United States was affected directly or indirectly by Bernie Madoff's massive fraud. The "sham audits" that David Friehling performed on Madoff Securities' financial statements played a central role in allowing Madoff to sustain his fraud for as long as he did.

If you don't choose to launch your auditing course with this case, you could use it to compliment your coverage of several important auditing topics including internal controls, auditor independence, and fraud. This case also provides an opportunity to discuss a technical topic that doesn't arise in many alleged audit failures, namely, the audit procedures that should be applied to a client's major stock market investments. Another technical topic in this case that is seldom addressed in other audit cases is peer reviews.

Suggested Solutions to Case Questions

1. The principal authoritative source in the PCAOB's auditing standards vis-à-vis the auditing of investments was AS 2503, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities" until late 2020. Effective for audits of financial statements for fiscal years ending on or after December 15, 2020, AS 2503 was replaced by AS 2501, "Auditing Accounting Estimates, Including Fair Value Measurements," as the primary authoritative source for the auditing of investments. The comparable technical material in the AICPA Professional

Standards can be found in AU-C Section 501, "Audit Evidence—Specific Considerations for Selected Items." The AICPA has also issued an accounting and audit guide for investment companies. Understandably, the increasing complexity of securities investments in recent years has greatly complicated the auditing of investments, particularly investments involving options and other "exotic" transactions—as noted in the case, the buying and selling of put and call options was a central feature of Bernie Madoff's alleged investment strategy.

Listed next are a few examples of specific audit procedures that can be applied to a client's "investments." Students will likely identify many other such procedures by referencing their undergraduate auditing texts.

- Confirmation of settled transactions with the broker-dealer or counterparty.
- Confirmation of unsettled transactions with the broker-dealer or counterparty.
- Inspecting underlying agreements and other forms of supporting documentation, in paper or electronic form that describe the key features of the given investment.
- Inspecting supporting documentation for subsequent realization or settlement after the end of the reporting period.
- Performing analytical procedures to determine, for example, whether recorded interest revenue on given investments is reasonable.
- Inspecting documentation in paper or electronic form for investment activity subsequent to the reporting period, particularly any unusual such activity.
- Assessing the reasonableness and appropriateness of the fair value model used to determine the reported value of a given security investment.

Arguably, the most important of the procedures listed is the final one. Determining the propriety of a client's recorded values for given investments can be a time consuming and challenging task. Were these and other audit procedures performed by the auditors of Madoff's "feeder firms"? Unfortunately, to date, there has been no public disclosure of the specific audit procedures applied by those feeder firms to their clients' Madoff-held investments. As a point of information, there has also been no public disclosure regarding specific details of the Friehling & Horowitz's "sham audits" of Madoff Securities.

2. A "peer review" is an examination of an accounting firm's quality control system and its compliance with the requirements of that system by one or more accounting professionals. You may want to point out to your students that the PCAOB has established its own inspection program to ensure that auditors of public companies have established and are applying appropriate quality control policies and procedures. Of course, the PCAOB inspection program is technically not a "peer" review program but it serves the same general purpose.

Assuming that Friehling & Horowitz's audits of Madoff Securities were, in fact, "sham audits" as alleged by federal prosecutors, then it seems reasonable to conclude that a thorough peer review would have revealed that those audits were substandard. The resulting peer review report filed with the relevant regulatory or oversight body would very likely have resulted in Friehling & Horowitz being disqualified as Madoff's audit firm.

As discussed in the case, the state of New York adopted a peer review requirement following the Madoff fraud. However, as pointed out in a footnote to the case, a firm the size of Friehling & Horowitz would be exempt from that requirement!

3. AS 2401, "Consideration of Fraud in a Financial Statement Audit" in the PCAOB's auditing standards, is an authoritative source to refer to in responding to this question. (The corresponding section in the "clarified" AICPA Professional Standards is AU-C Section 240.) AS 2401.07 lists the three "angles" of the so-called fraud triangle: the existence of an incentive and/or pressure to commit a fraud, the opportunity to commit a fraud is present (typically due to ineffective internal controls), and the ability to rationalize fraudulent conduct on the part of the given or potential fraudster. These three "conditions" are effectively precursors to fraud. The presence of these factors does not necessarily mean that fraud will occur but an environment in which these conditions are present is much more likely to spawn fraud.

AS 2110.65 notes that "fraud risk factors" are "events or conditions that indicate" that one or more of the three elements of the fraud triangle are present. [The use of the term "conditions" within the professional auditing standards to refer to both the precursors of fraud and the symptoms or indicators of those precursors is somewhat problematic.] Appendix A of AS 2401 identifies dozens of individual "fraud risk factors." A few examples: a high degree of competition or market saturation in a client's industry (incentive/pressure), negative cash flows (incentive/pressure), need to obtain additional debt or equity capital (incentive/pressure), significant related party transactions (opportunity), and known history of violating securities laws or other laws (ability to rationalize).

Each of the three elements of the fraud triangle were present in the Madoff scandal. The principal incentive for Bernie Madoff to commit the fraud was apparently his need to "be somebody," that is, to become a prominent member of the Wall Street community. Madoff developed an organization that he apparently exercised almost complete control over, which gave him the opportunity to perpetrate and conceal his massive fraud. Finally, Madoff testified ex post that he expected that his scheme would be short-lived and that he would eventually be able to "extricate" himself from it. That "storyline" is among the most common that fraudsters use to justify or rationalize their misconduct.

Listed next are fraud risk factors that were present during the Madoff scandal:

- Excessive pressure exists to meet the requirements or expectations of third parties
- Management has a significant financial interest in the given entity
- Domination of management by a single person
- Ineffective oversight over the financial reporting process and internal control by those charged with governance
- Ineffective accounting and information control systems
- A practice by management of committing to third parties to achieve aggressive or unrealistic financial results
- Domineering management behavior in dealing with external auditor

4. Financial fraud, including fraudulent accounting, has plagued our nation in recent decades. This question provides your students with an opportunity to come up with their own "answers" to this perplexing problem—maybe their solutions would be more effective than the preventative measures implemented in recent years by so-called experts. Consider placing your students in groups to come up with their recommendations and then have each group present and defend their choices.

Listed next are a few random reforms that regulatory authorities could consider adopting to address the fraud "problem":

--Requiring independent auditors to immediately report suspected fraud to regulatory and/or law enforcement authorities. (This measure has been implemented in South Africa.)

--Establishing a government audit agency to "take over" the independent audit function. In the 1930s, Congress initially considered creating a government agency to perform the independent audit function when it passed the federal securities laws.

--More rigorous training programs to ensure that government regulators, such as SEC personnel, have the proper background to carry out their oversight responsibilities.

--Educational programs intended to help investors spot investment opportunities that are "too good to be true."

--Longer prison sentences for convicted fraudsters to serve as a deterrent for potential fraudsters.

CASE 1.17

AA CAPITAL PARTNERS, INC.

Synopsis

In February 2002, John Orecchio and Paul Oliver teamed together to establish an investment advisory firm, AA Capital Partners, Inc. The two Chicago businessmen had all of the necessary credentials for their new venture. Orecchio had helped manage a $5 billion private equity fund for Bank of America, while Oliver had served as the chief financial officer of a large bank, ABN AMRO. The two men used their network of connections in Chicago to quickly attract $200 million of customer accounts that represented the pension funds of six labor unions.

Unfortunately, AA Capital proved to be a less than trustworthy steward of its customers' funds. Within four years, Orecchio was responsible for his customers losing nearly one-fourth of their investments due to embezzlement and mismanagement. Orecchio, who was married with three children, squandered a large portion of the $24 million that he embezzled on his mistress, a young exotic dancer.

This case focuses on Ernst & Young's 2004 audits of AA Capital Partners and the four private equity funds organized by that firm. During those audits, the Ernst & Young audit team discovered $1.92 million of suspicious cash payments made to John Orecchio that were characterized as "tax transfers" or "tax loans" by the client. In fact, those payments represented a small slice of the $24 million of funds that Orecchio had embezzled. Both the SEC and a federal judge concluded that inadequate audit procedures prevented the AA Capital audit team from discovering the true nature of the alleged "tax transfers." Surprisingly, the federal judge who issued a 41-page opinion in this case ruled that the AA Capital audit engagement partner was not culpable because the audit manager on the engagement had failed to properly inform him of the suspicious "tax transfers." After dismissing the sanctions that the SEC had recommended for the audit partner, the judge suspended the audit manager from practicing before the SEC for one year.

AA Capital Partners, Inc.--Key Facts

1. John Orecchio and Paul Oliver founded AA Capital Partners in 2002; due to Orecchio's strong credentials in investment management, he took responsibility for the firm's day-to-day operations.

2. By the end of 2004, Orecchio had persuaded six labor unions to place their collective $200 million of pension fund assets under the management of AA Capital.

3. The Chicago office of Ernst & Young audited AA Capital and the four private equity funds that it established; during the 2004 AA Capital audits, Gerard Oprins served as the audit engagement partner, while Wendy McNeely served as the audit manager.

4. McNeeley and her subordinates discovered $1.92 million of unusual cash payments made to John Orecchio during 2004; AA Capital's chief accounting officer told the auditors that the cash payments were "tax transfers" made to Orecchio to allow him to pay taxes levied in error on him by the IRS.

5. McNeeley attempted to obtain more information regarding the suspicious payments but the chief accounting officer would not cooperate; ultimately, McNeeley relied on the client's journal entries and other internal audit evidence in deciding that the payments had been accounted for properly.

6. McNeeley discovered additional suspicious payments to Orecchio during the subsequent period review; however, she did not mention those payments or the original $1.92 million of payments in the Summary Review Memorandum (SRM) prepared for the 2004 AA Capital engagement.

7. The client's 2004 financial statements and accompanying financial statement footnotes failed to adequately disclose the "related party" nature of the $1.92 million of payments made to Orecchio.

8. During the 2005 AA Capital audits, the audit manager who replaced McNeeley discovered the $5.7 million of "tax transfers" that had been made to Orecchio during 2004 and 2005; the audit manager refused to "sign off" on those items because she "didn't have anything to audit."

9. In February 2010, John Orecchio pleaded guilty to embezzling approximately $24 million from his clients' funds, which included the bogus $5.7 million of alleged tax transfer payments made to him; Orecchio had spent a large portion of the stolen funds on his mistress.

10. The SEC identified numerous oversights that the auditors had made during the 2004 AA Capital audits; those oversights included failing to properly investigate the suspicious tax transfers and failing to ensure that the client made appropriate related-party disclosures for those transactions.

11. A federal judge ultimately ruled that Gerard Oprins was not responsible for the audit "failures"

during the 2004 engagement because Wendy McNeeley had not properly apprised him of the suspicious tax transfers; McNeeley received a one-year suspension from practicing before the SEC.

12. John Orecchio received a prison sentence of nine years and four months for his indiscretions; his sentence was significantly shortened because he agreed to cooperate in a "sting operation" intended to implicate other parties allegedly involved in his fraudulent scheme.

Instructional Objectives

1. To examine the responsibility of auditors to thoroughly investigate large and unusual client transactions.

2. To identify the audit procedures that should be applied to related-party transactions.

3. To determine the nature and purpose of "subsequent period" audit procedures.

4. To understand the division of responsibilities on an audit engagement team.

5. To determine the circumstances under which auditors can choose not to rely on a client's internal controls.

Suggestions for Use

An instructional case is only as "good" as the sources from which it is developed. For this case, there was an excellent source of insightful and "inside" information regarding Ernst & Young's AA Capital audits. This latter source was the 41-page opinion written by Judge Robert Mahony. That opinion was effectively a summary of the two-week hearing presided over by Judge Mahony that was intended to determine whether the sanctions recommended by the SEC for Gerard Oprins (AA Capital's audit engagement partner) and Wendy McNeeley (the audit manager on the 2004 AA Capital audits) were appropriate. If you are using this case in a graduate class, you might consider having your students read that opinion and/or have a group of students provide an in-class report on it. Judge Mahony does an excellent job of summarizing the "nitty-gritty" details of the 2004 AA Capital engagement. Just as intriguing in his opinion are the views expressed by the expert witnesses regarding key technical issues that arose during the AA Capital audits. No doubt, your students will find it surprising that two "big time" experts could have such divergent views on major auditing issues. The divergence between the experts' opinions serves to confirm that independent auditing is much more an "art" than a "science."

Suggested Solutions to Case Questions

1. A) The fact that both McNeeley and Oprins were "new" to the AA Capital engagement almost certainly resulted in a learning curve effect for each of them. For example, because

McNeeley didn't have a "history" with Mary Beth Stevens, she did not have a baseline against which to evaluate Stevens' competence, candor, and willingness to cooperate.

B) The fact that Ernst & Young was auditing five entities (AA Capital and its four private equity funds) simultaneously, no doubt, complicated matters for McNeeley and her subordinates. [Note: In fact, Ernst & Young performed ten audits simultaneously! Although not pointed out in the case, the 2003 and 2004 audits (five each) were conducted during the same time frame in early 2005. I didn't address this aspect of the case because it wasn't a major issue raised by either the SEC or Judge Mahony. To keep my cases to a reasonable length, I have to eliminate as many marginal issues/facts as possible.]

C) As suggested in the case, the lack of client cooperation was a critical factor in determining the outcome of the 2004 audits.

D) Because the audit team "busted" the assigned budget of 600 hours by 200 hours, McNeeley may have felt pressure near the end of the engagement to "wrap it up" as quickly as possible—in other words, she may have felt the need to give the "tax transfers" issue the short shrift.

E) During the time frame that the 2004 audits was being performed, AA Capital was still in its infancy—recall that it was organized in February 2002. Most likely, the firm was still getting its "legs underneath itself," meaning that there was probably some degree of confusion, if not chaos, in the firm's operations.

F) Related to the previous item was the horrific "tone at the top" established by John Orecchio for this audit client. The available sources for this case suggest that Orecchio spent most of his time "on the road" attempting to attract new customers and pursuing various prurient interests. This lack of leadership for AA Capital, no doubt, created, or added to, the confusion and chaos within the organization.

QC Section 20, "System of Quality Control for a CPA Firm's Accounting and Auditing Practice" in the PCAOB's quality control standards provides an overview of the nature and purpose of a CPA firm's quality control system. (Note: the quality control standards in the AICPA Professional Standards are very similar to the PCAOB's quality control standards.) QC 20.02 notes that CPAs "should practice in firms that have in place internal quality-control procedures to ensure that services are competently delivered and adequately supervised." QC 20.07 identifies the following five elements of quality control for a CPA firm registered with the PCAOB:

a. Independence, Integrity, and Objectivity
b. Personnel Management
c. Acceptance and Continuance of Clients and Engagements
d. Engagement Performance
e. Monitoring

In the AA Capital case, the two quality control elements that were particularly relevant were "acceptance and continuance of clients and engagements" and "engagement performance." Given Mary Beth Stevens' failure to cooperate with Wendy McNeeley (when the latter was investigating the tax transfers) one could certainly suggest that Ernst & Young should have considered ending, or at least suspending, the 2004 audits. Of course, during the 2005 engagement, Ernst & Young did suspend the AA Capital audits after the new audit manager (Jennifer Aquino) suggested that sufficient information had not been provided by the client to audit the suspicious tax transfers.

In terms of engagement performance, there are several measures that might have mitigated the impact of the six "problem" facets of the 2004 AA Capital audits listed previously. For example, given that long list of problems, it seems reasonable to suggest that the 600-hour time budget for the 2004 AA Capital engagement *should not* have been considered a major constraint for the auditors. Here was a situation where the auditors were probably justified in taking as much time as necessary to complete the audits and saying "to heck" with the time budget. (Note: another facet of the case that I didn't mention in the case narrative was the fact that AA Capital was pressuring Ernst & Young to complete the audits—quite possibly, the client was hoping that if the auditors were "rushed," they would be less likely to uncover the fraud.) Another quality control measure that could have been implemented by Ernst & Young, given the "problem" nature of the 2004 AA Capital engagement, was to have had more frequent and timely involvement of Oprins (the audit partner) in the engagement. In fact, one of the expert witnesses complained of the disproportionately few hours that Oprins spent working on the engagement.

2. Both the AICPA and PCAOB auditing standards mandate that auditors obtain an understanding of an audit client's internal controls and then document that understanding in their workpapers. However, in either an audit of a private entity or a public company, auditors may decide not to rely on the client's internal controls. What circumstances would justify such a decision? One obvious example would be that the auditors determine that a client's internal controls are not reliable. Likewise, auditors may decide that it is not cost-effective to rely on a client's internal controls, that is, it would be more efficient to use a strictly substantive testing audit strategy for the given client.

3. Note: AS 2410, "Related Parties," presents the PCAOB's auditing standards for related parties and related-party relationships and transactions. AU-C Section 550, "Related Parties," includes the comparable auditing standards of the AICPA. [Note: AS 2410 did not become effective until late 2014, well after the events documented in this case took place. At the time of the AA debacle, the organization's auditors were subject to the related-party auditing rules included in AU-C Section 550. However, going forward, the auditors of an organization such as AA Capital would be subject to the related-party audit requirements included in AS 2410, consequently, this solution will focus on those requirements.]

The overall audit objective for a client's related parties, related party relationships, and transactions with related parties is expressed in AS 2410.02: "The objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements."

Auditors must first identify and obtain an understanding of a client's related parties and the relationships and transactions with those parties. To achieve this goal, auditors should study the client's "process" for identifying those items, inquire of management regarding the existence of related parties (and consequent relationships and transactions), and make the members of the audit engagement team aware of the client's related parties.

Among other procedures, auditors must also "identify and assess" the "risks of material misstatements" stemming from the client's related parties, related party relationships, and related party transactions [AS 2410.10]. AS 2410.12 identifies five specific measures that auditors should apply "for each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk." These five measures are summarized below:

a. "Read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or lack thereof) of the transaction."
b. "Determine whether the transaction has been authorized and approved in accordance with the company's established policies and procedures . . ."
c. "Determine whether any exceptions to the company's established policies or procedures were granted."
d. "Evaluate the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any."
e. "Perform other procedures as necessary to address the identified and assessed risks of material misstatement."

Would any of the above audit procedures if applied to Orecchio's "tax transfers" have resulted in the auditors discovering that the transactions were fraudulent? Probably—if not almost certainly. For example, the auditors obviously did not "read the underlying documentation" for the alleged tax transfers—granted, given the nature of those transactions it is unlikely that there was extensive "documentation" of them. In fact, because of a lack of client cooperation, the Ernst & Young auditors never obtained a complete understanding of the transactions. If auditors fail to obtain a thorough understanding of related party transactions or potential related party transactions, then the usefulness of any subsequent audit procedures [including items "a" through "e" listed above] applied to such transactions is severely diminished if not undercut completely. (For whatever reason, recall that the auditors never directly inquired of Orecchio regarding the nature and purpose of the alleged tax transfers. In retrospect, that appears to be a major oversight since he was the party most knowledgeable of those suspicious transactions.) A full investigation of the transactions would have also revealed that they were not "in accordance with the company's established policies and procedures." McNeeley reported having reviewed the "partnership agreement" for AA Capital early in the 2004 audit and she recalled that the agreement permitted "tax distributions and tax advances" to the two partners. However, the funds transferred to Orecchio were not "tax distributions," "tax advances," or "tax transfers" for that matter—a fact that almost certainly would have been revealed by a rigorous investigation of the transactions. Likewise, as indicated in the SEC enforcement release, the auditors did not take any steps to determine the "financial capability" of Orecchio to repay the alleged loans. That investigation would likely have revealed that Orecchio could not repay the amounts.

4. Note: AS 2801, "Subsequent Events," includes the PCAOB's technical audit requirements for subsequent events. AU-C Section 560, "Subsequent Events and Subsequently Discovered Facts," presents the AICPA Professional Standards for "subsequent period" audit procedures. These two sets of requirements are very similar.

The key audit objective associated with subsequent period audit procedures is to identify any events, circumstances, or other information that may reflect on the integrity of the management assertions embedded in the given client's audited financial statements. Once such information is identified, then the auditor must take steps to determine its impact, if any, on the client's financial statements.

Among other procedures applied to identify relevant subsequent period "information," auditors may review minutes of post-balance sheet board of directors meetings, inquire of client legal counsel regarding such information, determine whether there have been any "significant new" related party transactions since the balance sheet date, and simply scan the accounting records for evidence of such information. Once important subsequent period information is identified, then the auditors must assess its potential financial statement impact. In some circumstances, the new information may dictate adjustments to the audited financial statements and/or disclosure in the accompanying financial statement footnotes.

In the case at hand, McNeeley discovered the additional "tax transfers" made to Orecchio during the first few months of 2005. However, for whatever reason, she apparently didn't consider that information important since she didn't characterize those transactions as unusual or comment on them in the Summary Review Memorandum.

5. When I first read that statement, I was surprised because I had always assumed that audit engagement partners had such a responsibility. However, after some reflection, Ellingsen's assertion seems reasonable (recall that he was Deloitte's senior audit technical partner and that he served on the Auditing Standards Board for several years).

Given the fact that the audit engagement partner is not "in the trenches" and in many cases is only deeply involved in an audit on the "front end" and "back end," it is not reasonable to hold him or her responsible for every decision made during the course of an audit. In truth, the responsibility for many audit decisions is delegated by the audit partner to his or her key subordinates, principally, the lead audit manager and lead audit senior assigned to the given engagement. Of course, an accounting firm must have appropriate controls in place to ensure that the "field lieutenants" on each audit engagement have the proper training and experience to make "good" decisions and to ensure that they communicate all critical decisions to the audit engagement partner. Likewise, a rigorous workpaper review process should increase the likelihood that subpar decisions by the field lieutenants—which were not communicated on a real-time basis to the audit engagement partner—are ultimately brought to the attention of, or discovered by, the audit engagement partner or independent review partner. Nevertheless, there is always some residual risk that certain "bad" decisions by an audit partner's subordinates will not be detected.