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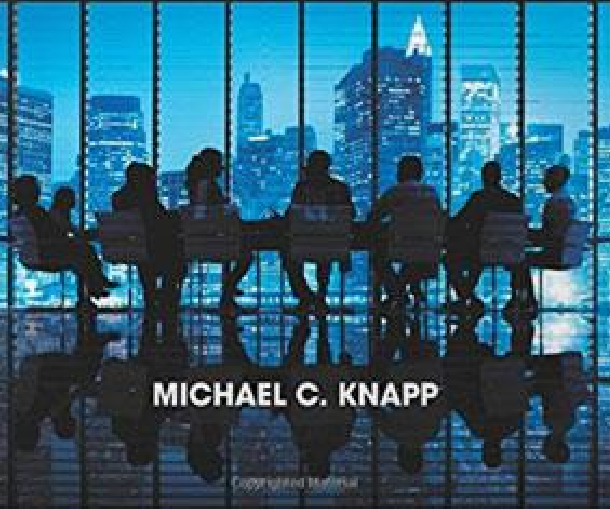

CASE 1.5

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 eighteen-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 of 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. Paul Polishan was convicted in 2000 of engineering the Leslie Fay fraud, principally due to the testimony of Donald Kenia.

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

Several of the Section 1 or Comprehensive cases in this text, including the Leslie Fay case, contain exhibits that present multi-year financial statement data for a given company. 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 of its direct competitors.

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 AU Section 316, "Consideration of Fraud in a Financial Statement Audit," of the PCAOB's Interim 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. Interpretation 101-6 (ET Section 101.8) of the AICPA's *Code of Professional Conduct*, "The Effect of Actual or Threatened Litigation on Independence," addresses this specific situation. [Note: 1.290.010.04-.07, "Litigation Between the Attest Client and Member," of the Proposed Revised *Code of Professional Conduct* addresses this issue and raises the same general concerns as Interpretation 101-6.]

CASE 1.6

NEXTCARD, INC.

Synopsis

In November 2001, Arthur Andersen & Co. employees in that firm's Houston office shredded certain Enron audit workpapers during the midst of a federal investigation of the large energy company. The decision to destroy those workpapers ultimately proved to be the undoing of the prominent accounting firm. A few years later, a felony conviction for obstruction of justice would effectively put Andersen out of business. Ironically, at the same time that the Andersen personnel were shredding Enron workpapers, three senior members of the NextCard, Inc., audit engagement team were altering the fiscal 2000 audit workpapers of that San Francisco-based company.

NextCard was founded during the late 1990s by Jeremy Lent, the former chief financial officer of the large financial services company, Providian Financial Corporation. Lent's business model was simple: use a massive Internet-based marketing campaign to quickly grab a large market share of the intensely competitive credit card industry. By 2000, NextCard, which by then was a public company, had signed up one million credit card customers. Unfortunately, NextCard's customers tended to be high credit risks, which resulted in the company absorbing much higher than normal bad debt losses. When the company's management team attempted to conceal those large credit losses, the SEC and other federal regulatory authorities uncovered the scam. By 2003, the once high-flying Internet company was bankrupt and its former officers were facing a litany of federal charges.

The San Francisco office of Ernst & Young audited NextCard's periodic financial statements. When the news of the federal investigations of NextCard became public in the fall of 2001, Thomas Trauger, the NextCard audit engagement partner, made a poor decision. That decision was to alter the fiscal 2000 audit workpapers for NextCard to make it appear that Ernst & Young had properly considered, investigated, and documented the company's bad debt losses and related allowance for bad debts. During two meetings in November 2001, Trauger and his top two subordinates secretly altered the 2000 NextCard audit workpapers. To conceal the alterations of the electronic workpapers, the three auditors reset an internal computer clock to produce an appropriate electronic time stamp on those revised workpapers.

Trauger realized that the altered workpapers would be given to federal authorities investigating NextCard and the 2000 audit of that company. As a result, Trauger became the first audit partner of a major accounting firm to be prosecuted under the criminal provisions of the Sarbanes-Oxley Act of 2002. In October 2004, Trauger pleaded guilty to one count of impeding a federal investigation and was sentenced to one year in federal prison and two years of supervised release.

NextCard, Inc.--Key Facts

1. Jeremy Lent's business model for NextCard, Inc., was predicated on using Internet advertising as a cost-effective tool to recruit high-quality credit card customers.

2. Initially, Lent's business model for NextCard seemed to be a financial success as the company obtained a large customer base and became recognized as a leader of the e-commerce "revolution."

3. Despite the public perception that NextCard was successful, which was propped up by emphatic statements made by company executives, NextCard's business model was seriously flawed.

4. NextCard effectively became a lender of last resort for individuals who could not obtain credit elsewhere; as a result, the company's credit losses were much higher than the industry norm.

5. NextCard executives attempted to conceal the company's large credit losses by understating its allowance for bad debts and by classifying certain credit losses as losses due to Internet fraud schemes.

6. In the fall of 2001, several federal agencies, among them the SEC, initiated investigations of NextCard's financial affairs, including its prior financial statements.

7. The announcements of the federal investigations prompted Thomas Trauger, the NextCard audit engagement partner, to alter NextCard's 2000 audit workpapers.

8. Trauger's intent was to make it appear that the NextCard engagement team had properly audited the company's accounting records, including its reported credit losses and allowance for bad debts.

9. Trauger and his subordinates manipulated E&Y's computer system to produce an appropriate electronic time stamp on the revised NextCard workpapers.

10. Trauger instructed his subordinates to dispose of any incriminating evidence but Oliver Flanagan, a senior audit manager, failed to comply with those instructions and ultimately provided the evidence that federal authorities used to prosecute Trauger for obstruction of justice.

11. In October 2004, Trauger pleaded guilty to impeding a federal investigation and was sentenced to one year in federal prison; his two subordinates pled guilty to similar charges but did not receive prison sentences.

12. NextCard was liquidated by a federal bankruptcy court in the summer of 2003; five of the company's former executives were indicted on various fraud charges.

Instructional Objectives

1. To examine auditors' ethical responsibilities when they are instructed by a superior to violate professional standards.

2. To help students understand the enormous pressures that auditors, particularly audit partners, can face on high-profile audit engagements.

3. To allow students to identify, and discuss the implications of, fraud risk factors that are present on a given audit engagement.

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

5. To demonstrate the impact of the Sarbanes-Oxley Act on the auditing profession and work environment of auditors.

Suggestions for Use

This case allows auditing instructors to cover the following three "hot" topics in the auditing profession: (1) ethical responsibilities of auditors, (2) auditors' fraud detection responsibilities, and (3) the Sarbanes-Oxley Act. This is a good case to assign early in the semester of an undergraduate auditing course, possibly as a prelude to the ethics and legal liability chapters (which are typically presented back-to-back in an undergraduate auditing text). You might consider using a role-playing exercise to introduce the case. Choose two students to assume the role of Thomas Trauger and Oliver Flanagan. Then, set up the meeting in which Trauger informs Flanagan that they will be "revising" the 2000 NextCard workpapers. (Consider choosing "forceful" or headstrong students to assume the Trauger role.) This role-playing exercise can be used to help students obtain a better understanding of the dynamics of evolving ethical dilemmas. After several pairs of students have assumed the roles of Trauger and Flanagan, the class should have plenty of "ammunition" to provide insightful responses to case question no. 6.

As a point of information, some of my students have found this case very troubling. Those students find it difficult to believe that an audit partner would so blatantly violate the profession's most basic ethical standards *and* goad his subordinates to do the same. Trauger's conduct demonstrates very profoundly the enormous pressure that audit partners face when supervising the audit of a high profile company, pressure that results in large part from the litigious environment in which major audit firms operate.

Suggested Solutions to Case Questions

1. The professional auditing standards do not explicitly require auditors to "evaluate the soundness" of a client's business model. Nor do the standards require auditors to document the client's business model in their workpapers. Nevertheless, AU-C Section 315, "Understanding the Entity and its Environment and Assessing the Risk of Material Misstatement" of the AICPA Professional Standards requires auditors to obtain an understanding of the "nature of the entity, including its operations, its ownership and governance structure . . . the way that the entity is structured and how it is financed . . ." (AU-C 315.12). Likewise, PCAOB Auditing Standard No. 9,

"Audit Planning," requires auditors to "evaluate whether the following matters are important to the company's financial statements and internal controls over financial reporting and, if so, how they will affect the auditor's procedures:" "matters affecting the industry in which the company operates such as financial reporting practices, economic conditions, laws and regulations, and technological changes;" "matters relating to the company's business, including its organization, operating characteristics, and capital structure;" "the relative complexity of the company's operations. . . ." (AS 9.7).

Obtaining a thorough understanding of a client's business operations is especially critical when the client operates in a new industry and/or relies on an unproven business model, which was true in this case. Since new businesses have a high failure rate, it is incumbent on auditors to more rigorously consider the going-concern status of such a client.

2. When identifying fraud risk factors for a given case, I typically require my students to classify those factors into the A's, I's and O's of fraud. That is, students are required to classify those factors as either "attitudes," "incentives" (pressures), or "opportunities."

Listed next are specific fraud risk factors that were apparently present during the 2000 NextCard audit.

- The high degree of subjectivity required to arrive at NextCard's allowance for bad debts (opportunities)
- NextCard's management team did not have a proper appreciation of the importance of internal controls and honest financial reporting (attitudes and opportunities)
- NextCard's management had a practice of making firm commitments to financial analysts regarding their company's future earnings goals (attitudes and incentives/pressures)
- NextCard operated in an extremely competitive industry that was dominated by a few financially strong and high profile companies (incentives/pressures)
- The bursting of the Internet bubble in the stock market limited NextCard's access to the debt and equity markets (incentives/pressures)
- NextCard's recurring operating losses weakened the company's financial condition (incentives/pressures)
- NextCard operated in a highly regulated industry, meaning that the company's financial affairs and operating policies and procedures were under constant scrutiny by an array of federal regulatory authorities (incentives/pressures)

AU-C Section 240 of the AICPA Professional Standards points out that auditors have an obligation to obtain "reasonable assurance" regarding whether a client's financial statements are "free of material misstatement, whether caused by error or fraud" (AU-C 240.05). The same responsibility is imposed on auditors by AU Section 316.01 of the PCAOB's Interim Standards.

After having identified specific audit risk factors, an auditor must consider how those factors should impact the nature, extent and timing of his or her subsequent audit procedures. Following are just a few specific examples of how subsequent audit procedures may be changed to take into consideration an audit engagement team's fraud risk assessment.

- Perform audit procedures at locations on a surprise or unannounced basis
- Request that the client's inventories be counted at year-end or as close to year-end as practical

- Perform substantive analytical procedures using disaggregated data (such as financial data "broken down" by the client's individual lines of business)
- Engage a specialist to arrive at an independent estimate of a key financial statement amount that was estimated by management
- Review and/or investigate the business rationale for significant unusual transactions that occurred during the period being audited

3. The audit documentation responsibilities imposed on auditors and the related objectives of audit documentation are discussed in AU-Section 230 of the AICPA Professional Standards and PCAOB Auditing Standard No. 3.

AU-C Section 230:

Paragraph AU-C 230.02 notes that the "nature and purposes" of audit documentation include documenting the "evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditors;" and documenting the "evidence that the audit was planned and performed in accordance with generally accepted auditing standards (GAAS) and applicable legal and regulatory requirements."

Paragraph AU-C 230.03 goes on to observe that "additional purposes" served by audit documentation include, among others:

- "Assisting the engagement team to plan and perform the audit"
- "Assisting members of the engagement team . . . to supervise the audit work"
- "Enabling the engagement team to demonstrate that it is accountable for its work"
- "TRetaining a record of matters of continuing significance to future audits of the same entity"
- "Assisting auditors to understand the work performed in the prior years as an aid in planning and performing the current engagement"

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."

PCAOB Auditing Standard No. 3:

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" (paragraph .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).

PCAOB No. 3 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" (paragraph .05). Similar to AU-C Section 230 of the AICPA Professional Standards, this standard 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 to: a) understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached, and b) 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" (paragraph .06).

4. An efficient way to address this question is to simply "walk" through the ten generally accepted auditing standards incorporated in AU Section 150 of the PCAOB's Interim Standards with your students and point out apparent or potential violations of each standard.

[Note: The AICPA Professional Standards (the "clarified" auditing standards) do not explicitly include the ten "generally accepted auditing standards" found in the PCAOB's Interim Standards—of course, those ten "generally accepted auditing standards" were explicitly included in the previous version of the AICPA Professional Standards. In the "clarified" auditing standards, those ten "generally accepted auditing standards" have been integrated into AU-C Section 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards."]

General Standards

1. *Proper technical training and technical proficiency*: one could question whether the NextCard audit was properly staffed since a relatively inexperienced individual, Oliver Flanagan, was serving as the senior audit manager on that engagement
2. *Independence*: N/A (although, one could suggest that given the size and prominence of NextCard, Thomas Trauger may have been inclined to be more lenient with that client when addressing and/or interpreting important accounting or auditing issues that arose during audits of the company)
3. *Due professional care*: This is the "catch-all" professional standard. Any violation of one of the other nine auditing standards results in an automatic violation of this standard.

Field Work Standards

1. *Adequate planning and proper supervision*: Clearly, Thomas Trauger failed to provide proper supervision of his two subordinates, Oliver Flanagan and Michael Mullen. Although the SEC did not criticize E&Y's planning of the 2000 NextCard audit, in retrospect, it seems apparent that the planning phase of that audit failed to identify the huge audit (inherent) risk posed by the client's accounts receivable.
2. *Sufficient understanding of the entity, its environment, and its internal control*: NextCard's internal control system failed to prevent the improper accounting decisions for the company's receivables and related accounts. As a result, E&Y may have understated the control risk for the sales and collection cycle when analyzing NextCard's internal controls.

3. *Sufficient appropriate evidence*: The NextCard audit engagement team apparently failed to collect appropiate evidential matter to support the unqualified opinion issued on NextCard's 2000 financial statements.

Reporting Standards

1. *Accordance with GAAP*: NextCard's financial statements were not presented in accordance with GAAP, which means that E&Y should have pointed this out in its 2000 audit opinion.
2. *Consistent application of GAAP*: N/A
3. *Proper disclosures*: In retrospect, E&Y likely should have required NextCard to discuss in the footnotes to the company's 2000 financial statements the inordinate collectibility risk posed by its credit card receivables.
4. *Proper opinion*: E&Y failed to issue a proper opinion on NextCard's 2000 financial statements. Almost certainly, an adverse opinion, rather than an unqualified opinion, should have been issued on those financial statements.

5. A mentor is defined in *Random House Webster's College Dictionary* as "a wise and trusted counselor or teacher." The professional standards do not refer directly to the term "mentor;" however, the standards seem to suggest that "mentoring" is an important feature of the quality control process within the auditing profession. For example, the first standard of field work in the PCAOB's Interim Standards requires that "assistants" be "properly supervised." Likewise, the profession's quality control standards refer on several occasions to the importance of proper supervision of the subordinates assigned to professional services engagements. As we all know, much, if not a majority, of the detailed evidence collection procedures on audit engagements are performed by relatively inexperienced auditors. If those individuals are not properly supervised by a "wise" superior ("teacher"), the quality of an audit will be adversely affected.

In this case, of course, Flanagan was not an inexperienced "assistant" or an entry-level accountant but rather a senior-level manager. So, we normally would not expect Trauger to be required to closely supervise or oversee Flanagan's work. Nevertheless, Trauger did have a responsibility to serve as a proper role model for Flanagan. Clearly, engaging in behavior that is a blatant violation of professional standards and asking his two subordinates to do the same is not serving as a proper role model or "mentor."

As a point of information, in this case Flanagan indicated that he had hoped that Trauger would serve as his "mentor." In fact, Flanagan may have actually wanted Trauger to serve as his "sponsor." In this context, the term "sponsor" is used to refer to a senior member of an accounting firm who takes affirmative steps to help a specific subordinate advance through the employment hierarchy of that firm. An example of a "sponsorship" activity would be making sure that the subordinate in question is given challenging work assignments and/or assignments that will provide him or her with high visibility in the given practice office. Certainly, Trauger did not have a responsibility to serve as Flanagan's "sponsor."

6. We all recognize that Oliver Flanagan had a professional responsibility to not blindly acquiesce to Thomas Trauger's instructions to alter the 2000 NextCard workpapers. However, the intent of this question is to require students to place themselves in Flanagan's situation before responding. For example, students should recognize that Flanagan has a great deal of respect for Trauger and, in fact, apparently hopes that Trauger will help him advance up the employment hierarchy of E&Y. Plus,

students should recognize that Flanagan is somewhat of an "outsider." He has been in the U.S. for only a short time and is probably not entirely familiar with the cultural norms and mores that affect the organizational dynamics and "politics" of the work environment of a U.S. accounting firm. For example, he may not have a good grasp of exactly how "whistleblowing" is viewed within E&Y or, at least, within the firm's San Francisco office.

Your students will likely identify a wide range of alternative courses of actions that Oliver Flanagan could have pursued. Here, we will examine a small sample of those alternatives. One obvious measure that Flanagan could have and probably should have taken would have been to consult other audit partners within the San Francisco office. Almost certainly, this would have solved Flanagan's dilemma. The audit partners he contacted would have discussed the matter with Trauger and very likely convinced him that altering the NextCard workpapers was not a reasonable decision. Granted, there is a high likelihood that if Flanagan had chosen this alternative, his professional relationship with Trauger would have been impaired, if not ended. Another option would have been to discuss the matter directly with Trauger. Flanagan apparently did not view this as a viable alternative because of the forceful nature of Trauger's personality. A third option would have been to discuss the matter with Michael Mullen, the other audit manager assigned to the NextCard engagement. He and Mullen could then have approached Trauger together—the "strength in numbers" concept is relevant here. Finally, at least one of the major accounting firms reportedly has an anonymous "hot line" that subordinates can use to discuss ethical dilemmas, such as the one facing Oliver Flanagan, with a senior member of the firm who is in another practice office or the firm's headquarters office.

Following is a list of individuals who were affected by Oliver Flanagan's decision to cooperate with Trauger in altering the NextCard workpapers.

(a) Himself: Students often overlook the responsibility that an accountant has to herself or himself. An individual who exercises poor ethical or moral judgment may lose not only the respect of others, but more importantly, his or her self-respect.

(b) Partners and employees of his firm: Recent history suggests that unethical or otherwise unprofessional conduct by a public accountant can cost his or her employer considerable prestige and credibility and impose huge monetary losses on the firm.

(c) Other members of the accounting profession: Poor judgment by an individual accountant, if widely publicized, can serve as a "black eye" for the entire profession.

(d) Investing and lending public: These individuals and entities rely on independent auditors to carry out their "public watchdog" function rigorously, including reporting honestly and candidly on their clients' financial statements. The integrity and efficiency of our nation's capital markets are undermined when auditors do not fulfill their professional responsibilities.

(e) Thomas Trauger: As a colleague of Thomas Trauger, Flanagan had an obligation to consider his best interests and the best interests of his family. Just imagine the grief that Trauger would have avoided if Flanagan had convinced the audit partner that it was inappropriate to alter the NextCard workpapers.

CASE 1.7

LINCOLN SAVINGS AND LOAN ASSOCIATION

Synopsis

The collapse of Lincoln Savings and Loan Association in 1989 was one of the most expensive and controversial savings and loan failures in U.S. history. Charles Keating, Jr., is seemingly the perfect example of the aggressive, risk-seeking entrepreneurs who were attracted in large numbers to the savings and loan industry when it was deregulated by the federal government in the early 1980s. Many of these individuals, including Keating, developed innovative, if not ingenious, methods for diverting the insured deposits of their savings and loans into high-risk commercial development projects. A large number of these ventures proved unprofitable or were undermined by the greed of their sponsors. The final result was an estimated price tag of $500 billion for the federal bailout of the savings and loan industry.

The congressional hearings subsequent to the collapse of Lincoln Savings and Loan resulted in widespread criticism of Lincoln's auditors and the public accounting profession as a whole. The most serious charge leveled at Lincoln's auditors was that they failed to ensure that the economic substance, rather than the legal form, of their client's huge real estate transactions dictated the accounting treatment applied to those transactions. Other important audit issues raised by this case include the responsibility of auditors to detect management fraud, quality control issues related to the acceptance of prospective audit clients, the effect that an extremely competitive audit market may have on client acceptance decisions and ultimately on auditor independence, and the collegial responsibilities of audit firms.

Lincoln Savings and Loan Association--Key Facts

1. Charles Keating dominated the operations of both Lincoln and its parent company, ACC, and was largely responsible for the phenomenal growth experienced by the savings and loan during the 1980s.

2. Keating had been charged with professional misconduct in the late 1970s by the SEC.

3. The principal lending activities of Lincoln involved commercial development projects and other high-risk ventures.

4. Lincoln's real estate transactions were complex and thus difficult for its auditors to understand.

5. Arthur Young accepted Lincoln as an audit client during the course of an intensive marketing effort to attract new clients.

6. Jack Atchison, Lincoln’s audit engagement partner, developed a close relationship with Charles Keating and lobbied on Keating's behalf with regulatory officials.

7. Arthur Young relied upon real estate appraisals obtained by Lincoln in auditing certain of the savings and loan's large real estate transactions.

8. After joining ACC, Atchison served as an interface between ACC/Lincoln and the Arthur Young auditors.

9. After Janice Vincent assumed control of the Lincoln audit, the Arthur Young auditors apparently became more aggressive in questioning the validity of the savings and loan's large real estate transactions.

10. In October 1988, Arthur Young resigned as Lincoln’s auditor following several heated disputes involving Vincent and Keating, disputes that focused on Lincoln’s aggressive accounting treatments.

11. Ernst & Young, Arthur Young’s successor, eventually paid $400 million to settle several lawsuits filed by the federal government that charged the accounting firm with substandard audits of four savings and loans, including Lincoln.

12. In 1999, Charles Keating finally admitted, in a plea bargain agreement reached with federal prosecutors, that he had committed various fraudulent acts while serving as ACC’s CEO.

Instructional Objectives

1. To illustrate the impact that excessive competition in the audit market may have on client acceptance and retention policies of audit firms.

2. To demonstrate the legal exposure that audit firms face when they accept high-risk audit clients.

3. To emphasize the importance and necessity of candid communications between predecessor and successor audit firms.

4. To stress the importance of auditors maintaining a high degree of skepticism when dealing with a client whose management has adopted an aggressive, growth-oriented philosophy.

5. To establish that the economic substance of a client's transactions should be the determining factor in choosing how to account for those transactions.

6. To illustrate the pressure that client executives may impose on their auditors to interpret technical issues to the benefit of the client.

7. To illustrate the importance of auditors maintaining both their de facto independence and their appearance of independence.

8. To emphasize the importance of audit firms' collegial responsibilities to each other.

Suggestions for Use

This is another case that I often use during the first week of the semester to introduce students to the purpose, nature, and importance of the independent audit function. This case could also be assigned during class discussion of client acceptance and retention decisions [or, more broadly, the discussion of quality control standards for audit firms] since both Arthur Young and Touche Ross were criticized for agreeing to accept Lincoln as an audit client. In this same vein, the case discusses the aggressive client development philosophy adopted by Arthur Young in the mid-1980s that may have been at least partially responsible for the audit firm's decision to accept the high-risk Lincoln engagement. Finally, since several ethical issues are raised in this case, including issues related to collegial responsibilities of audit firms and the de facto and apparent independence of auditors, the case could be assigned during coverage of the AICPA *Code of Professional Conduct*.

This case demonstrates the importance of the independent audit function and the number of third parties who rely upon the professional integrity and competence of independent auditors. I believe it is important for an instructor to point out that, in situations such as this, auditors can make a difference. To help make this point, I like to stress how Arthur Young's approach to the Lincoln audit changed when Janice Vincent became the audit engagement partner. As noted in the case, Vincent's disagreements with Keating over the proper accounting treatment for certain of Lincoln’s transactions ultimately resulted in Arthur Young resigning as the savings and loan's audit firm.

A key focus of this case is the substance over form concept. Allegedly, Lincoln abused this concept in accounting for several of its large real estate transactions. Because of their lack of "real world" experience, students often have the misperception that the answer to any technical issue they

will face in their careers can simply be “looked up” in the appropriate authoritative source. Unfortunately, that is not the case. Practicing auditors and accountants must be aware of, and be able to apply, the broad conceptual constructs of our profession, such as the substance over form concept, when addressing ambiguous technical problems or issues.

Suggested Solutions to Case Questions

1. The "substance over form" concept dictates that the true nature, that is, economic substance, of a transaction, rather than its legal or accounting form, should determine the manner in which it is reflected in an entity's accounting records. This concept is particularly pertinent for transactions involving related parties. Quite often, such transactions will not have taken place on an arm's length basis. For instance, the underlying purpose of a sale of property between two related entities may be to distort the apparent profitability of one or both entities, rather than being the result of an economic negotiation between the two parties.

An entity's accountants, not their independent auditors, are primarily responsible for ensuring that the substance over form concept is not violated. An auditor is responsible for reviewing and testing the client's accounting records to determine that the substance of a client's transactions are reflected in those records. An auditor who discovers that the substance over form concept has been violated must then consider the resulting impact on the material fairness of the client's financial statements. If the violation(s) of this concept causes the financial statements to be materially misstated, the auditor would be required to issue either a qualified or adverse opinion on the client's financial statements.

2. The professional judgment of auditors may be compromised when their firm is overly dependent on one or a few large clients. Auditors, even those at the lower levels of a CPA firm, are likely cognizant of the economic impact that losing such a client would have on their firm and possibly on their own professional careers. This awareness alone may cause auditors to be more “flexible” during such engagements. This problem may be compounded when a large client poses a relatively high audit risk since there is a greater likelihood that problematic issues requiring the exercise of professional judgment will arise on such an engagement.

Criticism of the auditing profession has sensitized investors, creditors, and other third-party financial statement users to the paradoxical nature of audit independence. Third parties often find it difficult to accept that auditors can maintain an objective, professional point of view when the client retains and compensates the audit firm. This skepticism is likely heightened in circumstances such as those that existed in the Phoenix audit market in 1985. In a highly competitive audit market, the acceptance of a huge client, such as Lincoln, may cause third parties to assume that the given audit firm will resolve key accounting and auditing issues in the client's favor to ensure retention of the client.

Determining whether large, high-risk audit clients should be accepted is a matter of professional judgment. Certainly, a valid factor to consider in such circumstances is whether the size of the audit fee (and other ancillary fees) would fairly compensate the audit firm for the risks that such a client poses (litigation risk, etc.). Since the risk aversion of individual audit firms likely varies significantly, one audit firm might be willing to accept a given high-risk client, while another audit firm would not. Nevertheless, there are certain conditions that, if present, should cause an audit firm to be reluctant to accept such a client even if the audit fee compensates the audit firm for the readily apparent risks posed by the client. For instance, an audit firm that has recently suffered adverse

publicity as the result of an audit failure or alleged audit failure might choose to avoid risking further damage to its reputation by accepting a large, high-risk audit client.

3. There are two key issues an auditor should consider when a client has engaged in material related-party transactions: 1) whether economic substance, rather than legal form, was the determining factor in the accounting for such transactions, and 2) whether such transactions have been disclosed adequately in the client's financial statements as required by U.S. GAAP. The latter of these issues does not present any major problems for the auditor since GAAP are very explicit regarding the disclosures necessary for related party transactions. Determining whether the economic substance of a related party transaction has prevailed over its legal form is generally a much more difficult issue for the auditor to resolve. Professional auditing standards discuss the procedures that an auditor should consider applying to material related party transactions. Listed below are examples of such procedures.

a. determine whether the transaction has been approved by the board of directors
b. examine invoices, executed copies of agreements, contracts and other pertinent documents, such as receiving reports and shipping documents
c. inspect evidence in possession of the other party or parties to the transaction
d. confirm or discuss significant information with intermediaries, such as, banks, guarantors, agents, or attorneys
e. with respect to material uncollected balances [resulting from related party transactions], obtain information about the financial capability of the other party or parties to the transaction

4. The COSO framework describes the control environment component of an internal control process as follows: "The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values, management's operating style, delegation of authority systems, as well as the processes for managing and developing people in the organization."

Listed next are weaknesses that were evident in Lincoln's control environment.

a. The prior problems of Charles Keating, Jr., with the SEC suggest that the he may not have had the proper degree of control consciousness (this an important observation since subordinates usually look to superiors for guidance on such matters).
b. The efforts of Lincoln management to obscure the true nature of the Hidden Valley transaction suggest that management may have attempted to subterfuge the controls that were present in the entity's accounting system.
c. The problems identified by the 1985 FHLBB audit, i.e., file-stuffing, violation of banking laws, and other complaints not mentioned in the case, also tend to suggest that control consciousness was not an important concern of Lincoln management.
d. The appointment of Charles Keating, III, as president of Lincoln demonstrates that managerial and technical competence were not factors that top management necessarily considered in making important personnel decisions.

5. The party holding a nonrecourse note resulting from a sales transaction has no legal recourse other than to retake possession of the previously sold asset if the maker of the note defaults.

Consequently, an auditor examining sales transactions involving such notes must attempt to determine whether the purchaser intends to complete the transaction by paying the balance of the nonrecourse note. Quite often, this is a difficult assessment to make since future events, such as appreciation in the value of the acquired asset, may ultimately determine whether the purchaser will choose to pay the balance of the note.

6. PCAOB Auditing Standard No. 15, paragraph 11, identifies the following five management assertions that auditors should consider in developing an audit plan: occurrence, completeness, accuracy, cutoff, and classification. (Note: The AICPA Professional Standards identify thirteen management assertions that are closely related to the five management assertions included in AS No. 15. See AU-C 315.A114 for a list of those thirteen assertions.) Of these five assertions "accuracy" seems to have been the most relevant to the Hidden Valley transaction. "*Accuracy*. Amounts and other data relating to recorded transactions and events have been recorded appropriately." In addition to "accuracy," other management assertions identified in AS No. 15 that were relevant to some degree to the Hidden Valley transaction include the "completeness" assertion for presentation and disclosure and the "valuation and allocation" assertion for account balances: "*Completeness*. All disclosures that should have been included in the financial statements have been included." "*Valuation and allocation*: Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded."

To corroborate the "accuracy" assertion for the Hidden Valley transaction, Lincoln's auditors should have first attempted to determine whether the transaction was, in terms of economic substance, a valid sales transaction. A cursory investigation of the transaction would likely have revealed that it qualified as a related party transaction. At this point, it would have been incumbent on the auditors to apply the appropriate audit procedures for related party transactions (see suggested answer to Question 3). For example, given the size of the transaction and its unusual characteristics (such as a sales price greatly in excess of the property's appraised value), the auditors, at a minimum, should have confirmed or discussed the transaction with intermediaries and other parties to the transaction.

If the auditors concluded that the Hidden Valley transaction was, in fact, a valid related party sales transaction, they should have attempted to determine that the appropriate GAAP-mandated related party disclosures were made in the client's financial statements, that is, were those disclosures "complete." (Note: Whether or not E. C. Garcia was a "related party" to Lincoln was not an issue raised during the congressional hearings; however, the close ties between Keating and Garcia suggest that the latter was, in fact, a related party as defined by GAAP.) To address the "valuation and allocation" assertion regarding the note receivable resulting from the Hidden Valley transaction, the auditors should have evaluated the ability and incentive of the maker of that note to pay the balance owed Lincoln, among other audit procedures.

The key forms of audit evidence that Arthur Young should have collected (and may have collected) to support the Hidden Valley transaction include third party confirmations, documentary evidence (copy of the sales contract, copy of board of directors minutes approving the sale, etc.), and representations by client personnel involved in the transaction.

NOTE: The actual procedures that Arthur Young used vis-a-vis the Hidden Valley transaction were not discussed at length in the congressional transcripts. The suggested solution to this question is not intended to imply that Arthur Young did not use the most appropriate procedures to audit this

particular transaction. Nevertheless, William Gladstone's comment that his firm had to rely upon real estate appraisals provided by Lincoln was somewhat curious. Almost certainly, Arthur Young had the option of retaining independent appraisals of Lincoln's properties.

7. At the time that Atchison served as Lincoln's audit engagement partner, there were no explicit rules that forbid auditors from lobbying on behalf of a client's interest. Whether such behavior on the part of auditors is "professional" and/or appropriate is a question that has been widely debated both within and outside the profession. Apparently, Atchison did not believe that his lobbying efforts on behalf of Lincoln were inappropriate. In fact, in most ethical dilemmas that arise in an audit context, the audit professional must use his/her own ethical yardstick to determine how to proceed.

Again, once Atchison left Arthur Young and joined ACC, there were no explicit rules that prohibited him from interfacing with members of the Arthur Young audit team. So, Atchison had to decide for himself whether his actions were appropriate, that is, whether his interaction with his former Arthur Young subordinates jeopardized their independence or objectivity.

As a point of information, Section 206 of the Sarbanes-Oxley Act of 2002 specifically prohibits an accounting firm from providing "audit services" to a company that has recently hired an employee of the firm to serve in a top accounting position.

> "It shall be unlawful for a registered public accounting firm to perform for an issuer any audit service . . . if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit."

8. The predecessor of the *Code of Professional Conduct* contained a series of rules entitled "Responsibilities to Colleagues." Presently, there are no such rules in the *Code of Professional Conduct*. Nevertheless, implicit in the Principles of the *Code of Professional Conduct* is the responsibility to treat colleagues within the profession with dignity and respect.

During the congressional hearings into the collapse of Lincoln Savings and Loan, representatives of the two CPA firms called to testify expressed distinct differences of opinion on a number of issues. At one point in the testimony, one of these individuals suggested that the work of the other firm was "unprofessional." Several of the congressmen sitting on the investigative committee perceived this to be an unprovoked and an unjustified attack. Whether the work performed by the audit firm was, in fact, unprofessional, is a matter of judgment. However, it is very important that audit firms in such public forums treat each other with due respect and courtesy, otherwise they may diminish the prestige and credibility of the public accounting profession as a whole.

9. AU Section 110.02 (as well as AU Section 316.01) of the PCAOB Interim Standards succinctly summarizes an auditor's responsibility for fraud detection. "The 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." (A similar responsibility is imposed on auditors by AU-C Section 240.05 of the AICPA Professional Standards.) AU Section 316 discusses how auditors should and can fulfill that responsibility. Among other procedures, that section requires auditors to complete the following general tasks:

1. Discuss [among members of the audit engagement team] the risks of material misstatement due to fraud that are posed by a client
2. Obtain the information needed to identify the risks of material misstatement due to fraud.
3. Identify the risks that may result in a material misstatement due to fraud
4. Assess the identified risks after taking into account an evaluation of the entity's programs and controls that address the risks
5. Respond to the results of the risk assessment by, among other ways, making appropriate changes in the nature, extent, and timing of audit procedures to be performed
6. Evaluate audit test results
7. Communicate the results of the relevant fraud-related audit procedures to appropriate client personnel
8. Document fraud-related procedures and their outcomes.

Because fraud is often well concealed, auditors do not have an absolute responsibility to discover fraud-related misstatements in a client's financial statements, as explicitly noted in AU 316.12: "However, absolute assurance is not attainable and thus even a properly planned and performed audit may not detect a material misstatement resulting from fraud." For instance, in cases in which forgery and/or collusion among client personnel has occurred, the likelihood that the auditor will uncover the fraud is probably quite low regardless of the nature and extent of the audit procedures employed. Conversely, an auditor's responsibility to detect an obvious fraud, such as the theft of huge amounts of inventory or the kiting of large checks at year-end, is much greater. In the Lincoln audit, Arthur Young was severely criticized by congressional investigators for failing to discover that many of the client's real estate transactions were not properly reflected in the client's financial records. However, the testimony of Lincoln executives subsequent to the congressional hearings strongly suggested that the true nature of those transactions was intentionally obscured to mislead the auditors.

CASE 1.8

CRAZY EDDIE, INC.

Synopsis

Eddie Antar opened his first retail consumer electronics store in 1969 near Coney Island in New York City. By 1987, Antar's firm, Crazy Eddie, Inc., was a public company with annual sales exceeding $350 million. The rapid growth of the company's revenues and profits after it went public in 1984 caused Crazy Eddie's stock to be labeled as a "can't miss" investment by prominent Wall Street financial analysts. Unfortunately, the rags-to-riches story of Eddie Antar unraveled in the late 1980s following a hostile takeover of Crazy Eddie, Inc. After assuming control of the company, the new owners discovered a massive overstatement of inventory that wiped out the cumulative profits reported by the company since it went public in 1984. Subsequent investigations by various regulatory authorities, including the SEC, resulted in numerous civil lawsuits and criminal indictments being filed against Antar and his former associates.

Following the collapse of Crazy Eddie, Inc., in the late 1980s, regulatory authorities and the business press criticized the company's auditors for failing to discover that the company's financial statements had been grossly misstated. This case focuses on the accounting frauds perpetrated by Antar and his associates and the related auditing issues. Among the topics addressed by this case are the need for auditors to have a thorough understanding of their client's industry and the importance of auditors maintaining a high level of skepticism when dealing with a client whose management has an aggressive, growth-oriented philosophy. This case also clearly demonstrates the need for auditors to consider weaknesses in a client's internal controls when planning the nature, extent, and timing of year-end substantive tests.

Crazy Eddie, Inc.--Key Facts

1. Most of Crazy Eddie’s top executives were relatives or close friends of Eddie Antar who lacked the appropriate qualifications for their positions.

2. The consumer electronics industry realized a dramatic increase in sales from 1981 through 1984, which prompted Eddie Antar to convert Crazy Eddie's stores into consumer electronics supermarkets.

3. In 1984, Eddie Antar took Crazy Eddie public to raise capital needed to finance his company's aggressive expansion program.

4. To help market Crazy Eddie's stock, Antar dismissed the company's small accounting firm and retained Main Hurdman, which later merged with Peat Marwick.

5. Antar ordered his subordinates to inflate inventory and understate accounts payable after the company went public in 1984 to enhance Crazy Eddie's operating results and maintain the company's stock price at a high level.

6. Several of Crazy Eddie’s top accounting officials cooperated with Antar’s fraudulent schemes.

7. By 1986, the boom days for the consumer electronics industry had ended, creating financial problems for Crazy Eddie.

8. Following a 1987 hostile takeover of Crazy Eddie, the new owners discovered that the company's inventory was grossly overstated.

9. In 1989, Crazy Eddie filed a bankruptcy petition and then later that year ceased operations and liquidated its assets.

10. Crazy Eddie's auditors allegedly failed to adequately consider several "red flags," including pervasive internal control weaknesses, dominance of the company by one individual, the volatility of the consumer electronics industry, and unusual relationships among key account balances.

Instructional Objectives

1. To illustrate the lengths to which client management will sometimes go to misrepresent a company's operating results and financial position.

2. To emphasize the importance of auditors having a thorough understanding of the client's industry, including any major changes the industry is undergoing.

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

4. To stress the need for auditors to maintain a high degree of skepticism when dealing with a client whose management has an aggressive, growth-oriented philosophy.

5. To examine auditors' responsibilities to detect management fraud and to identify specific procedures that may lead to the detection of fraudulent misrepresentations.

6. To emphasize the importance of considering major weaknesses in a client's internal controls when planning the nature, extent, and timing of year-end substantive tests.

Suggestions for Use

This case could be integrated with classroom coverage of analytical procedures. Crazy Eddie's auditors were criticized by third parties for failing to investigate red flags in the company's financial statements that resulted from Antar's fraudulent schemes. The first case question requires students to apply analytical procedures to the company's financial statements to identify those red flags.

Since a major focus of this case is management fraud and auditors' responsibility to detect fraudulent misrepresentations in clients' financial statements, the case could be assigned in conjunction with classroom discussion of those important topics. Finally, this is another case that could be used during the first week of an auditing course to acquaint students with the nature of the independent audit function and the problematic circumstances that auditors often encounter.

Suggested Solutions to Case Questions

1. On the following pages are common-sized balance sheets and income statements for Crazy Eddie's for the period 1984-1987. Additionally, key financial ratios for the company's 1986 and 1987 fiscal years are presented.

Clearly, Crazy Eddie's inventory account should have been, and almost certainly was, a focal point of attention during the company's 1984-1987 audits. Inventory is nearly always the key asset of a retailer: no inventory, no sales . . . no company. In the case of Crazy Eddie's, the inventory account dominated the company's periodic balance sheets. Granted, at the end of fiscal 1987, inventory was only the second largest asset of the company but that was an anomaly due to the company investing proceeds from sales of stock and convertible debentures into short-term marketable securities.

Notice that Crazy Eddie's inventory increased dramatically over this time period, from $23 million in 1984 to nearly $110 million in 1987. Also notice that the company's inventory turnover slowed considerably during 1987 resulting in the average age of inventory leaping from 80 days to more than 111 days. When the age of a company's inventory increases significantly, the risk of obsolescence and related valuation problems must be seriously considered by the firm's auditors.

Another high-risk account for a retailer is typically accounts receivable. Notice that Crazy Eddie's accounts receivable turnover also slowed considerably during 1987, resulting in the age of receivables nearly doubling.

Two other accounts that Crazy Eddie's auditors likely identified as being high-risk accounts were accounts payable and accrued expenses. Generally, auditors expect that changes in inventory and accounts payable will be correlated. The more inventory a company purchases, the higher its year-end accounts payable should be, as a general rule. Notice that although Crazy Eddie's inventory increased by nearly $50 million during fiscal 1987, accounts payable actually decreased over that same time span. [Of course, one factor contributing to inventory increasing more rapidly than accounts payable can be slowing sales of inventory.] Also suspicious is the fact that Crazy Eddie's year-end accrued expenses for 1987 were lower than at the end of the three previous fiscal years, although the company's assets increased by approximately 800% between 1984 and 1987.

In summary, Crazy Eddie's 1984-1987 financial statements contain several red flags suggesting that certain key accounts demanded special attention by the firm's auditors. These red flags, when coupled with other factors, such as the company's tremendous growth rate in sales, demonstrate that the Crazy Eddie audits during this time frame likely posed a higher than normal level of overall audit risk.

Common-sized balance sheets for Crazy Eddie, 1984-1987:

	March 1, 1987	March 2, 1986	March 3, 1985	May 31, 1984
Current assets				
Cash	3.2	10.4	34.0	3.8
Short-term investments	41.4	21.1	--	--
Receivables	3.6	1.8	4.2	7.1
Merchandise inventories	37.0	47.2	40.5	63.8
Prepaid expenses	3.6	1.9	1.0	1.4
Total current assets	88.8	82.4	79.7	76.1
Restricted cash	--	2.6	10.8	--
Due from affiliates	--	--	--	15.7
Property, plant and equipment	9.0	5.7	5.6	5.0
Construction in process	--	4.9	1.8	--
Other assets	2.2	4.4	2.1	3.2
Total assets	100.0	100.0	100.0	100.0
Current liabilities				
Accounts payable	17.0	40.7	35.2	55.0
Notes payable	--	--	--	8.0
Short-term debt	16.8	1.8	.7	.3
Unearned revenue	1.2	2.9	1.8	2.1
Accrued expenses	1.9	13.5	13.3	16.6
Total current liabilities	36.9	58.9	51.0	82.0
Long-term debt	2.9	6.1	11.6	.1
Convertible subordinated debentures	27.5	--	--	--
Unearned revenue	1.1	1.5	1.0	.9
Stockholders' equity				
Common stock	.1	.2	.2	.1
Additional paid-in capital	19.5	13.9	18.8	1.6
Retained earnings	12.0	19.4	17.4	15.3
Total stockholders' equity	31.6	33.5	36.4	17.0
Total liabilities and stockholders' equity	100.0	100.0	100.0	100.0

Common-sized income statements for Crazy Eddie, 1984-1987:

	Year Ended March 1, 1987	Year Ended March 2, 1986	Nine Months Ended March 3, 1985	Year Ended May 31, 1984
Net sales	100.0	100.0	100.0	100.0
Cost of goods sold	77.2	74.1	75.9	77.9
Gross profit	22.8	25.9	24.1	22.1
Selling, general and admin. expense	17.4	16.4	15.0	16.4
Interest and other income	2.1	1.2	.9	.5
Interest expense	1.5	.3	.3	.4
Income before taxes	6.0	10.4	9.7	5.8
Pension contribution	.1	.3	.4	--
Income taxes	2.9	5.1	5.0	3.1
Net income	3.0	5.0	4.3	2.7

Financial Ratios for Crazy Eddie:

	1987	1986
Liquidity:		
Current ratio	2.41	1.40
Quick ratio	1.40	.60
Solvency:		
Debt to assets	.68	.66
Times interest earned	4.94	33.3
Long-term debt to equity	.96	.18
Activity:		
Inventory turnover	3.22	4.50
Age of inventory	111.8 days	80.0 days
Accounts receivable turnover	53.9	105.2
Age of accounts receivable	6.7 days	3.4 days
Profitability:		
Gross margin	22.8%	25.9%
Profit margin on sales	3.0%	5.0%
Return on total assets	5.4%	11.1%
Return on equity	15.6%	39.8%

2. a. Falsification of inventory count sheets:

1) Copy all inventory count or compilation sheets following completion of the physical inventory. If this procedure is not feasible because of the number of inventory count sheets, then the auditor may record the numerical sequence of the count sheets used during the physical inventory. To minimize the likelihood that the client will add additional items to partially full count sheets, auditors may draw a slash through the unused portion of each count sheet or deface the unused portion in some other fashion.
2) To reduce the likelihood of clients' recording bogus inventory items, auditors must also determine that sufficient control has been established over inventory tags (on which inventory counts are typically recorded before being transferred to count or compilation sheets). Recording the numerical sequence of the tags used during the counting process is one of several relevant audit procedures in this context.

b. Recording of bogus debit memos for accounts payable:

1) Mail accounts payable confirmations on selected accounts and follow up on all reported differences.
2) Randomly select a sample of debit memos charged to accounts payable and investigate supporting documentation to determine whether the charges appear reasonable.
3) Review subsequent payments of accounts payable to determine whether amounts deducted from year-end payable balances via client-prepared debit memos were later paid by the client.

c. Recording transshipping transactions as retail sales:

1) Review the documentation for large volume retail sales transactions, particularly those recorded near year-end, to determine that the sales are valid and properly recorded. For instance, match sales invoices with shipping documentation for these transactions.
2) Review the client's procedures for recording wholesale transactions to ensure that proper controls exist for these transactions. Perform tests of controls to assess the operating effectiveness of these controls.

d. Inclusion of consigned merchandise in year-end inventory:

When a client has merchandise in its retail outlets that is owned by third parties, the client should have a procedure to ensure that the consigned merchandise is not included in the year-end inventory. Crazy Eddie's auditors should have reviewed this procedure, assuming that it existed, and taken steps to determine whether it was implemented properly by client personnel. For example, the auditors could have reviewed inventory count sheets to determine whether consigned merchandise had been included on those sheets.

3. The overall health of a client's industry has important implications for the financial health of that company. Likewise, the changes that an industry is undergoing have implications for the future of each company within that industry. For these reasons, auditors must be cognizant of, and explicitly consider, industry-related factors in planning audits. AU-C Section 315.A18 of the AICPA Professional Standards suggests that auditors should obtain an understanding of a client's industry including such "industry conditions" as "the competitive environment, supplier and customer relationships, and technological developments." Likewise, paragraph 7 of PCAOB Auditing Standard No. 9, "Audit Planning," requires auditors to consider the follow issues, among others, when planning an audit: "matters affecting the industry in which the company operates such as financial reporting practices, economic conditions, laws and regulations, and technological changes."

By the late 1980s, the retail consumer electronics industry was experiencing problems, including slackening demand for its products and intense competition among companies within the industry. Both of these factors had immediate and important implications for the financial health of Crazy Eddie. From an auditing standpoint, these factors increased the likelihood that client management might attempt to "window dress" the company's financial statements to downplay the negative effect the industry's problems were having on the firm's operating results. Likewise, the auditors should have realized that the changes the industry was undergoing would gradually diminish Crazy Eddie's ability to extract "sweetheart" deals from its suppliers and to supplement its retail sales with bulk sales to its competitors. Collectively, these and other related factors had pervasive implications for the financial health of Crazy Eddie and should have been considered by the auditors during the planning phase of each Crazy Eddie audit.

4. Lowballing" refers to a method used by accounting firms to obtain audit clients, principally in a competitive bidding process. When an audit firm lowballs, it offers to provide an independent audit to a prospective client at an annual fee that is considerably below what other audit firms would charge to provide that audit. In many cases, audit firms that lowball to obtain an audit client hope to sell consulting services or other professional services to that client to compensate for the minimal revenue earned by providing the audit. However, if the audit firm issues other than an unqualified opinion on the client's financial statements, it faces some risk of being dismissed by the client. If the audit firm is dismissed, it will almost certainly be unable to sell other professional services to the former audit client. Net result: the audit firm's strategy of compensating for lost revenue on the audit engagements with revenue from the provision of other professional services doesn't "pan out." So, an audit firm that lowballs to obtain an audit client may be very reluctant to issue other than an unqualified opinion on the client's financial statements out of fear of losing the client.

5. Different auditors would respond in different ways to this scenario. Probably the most common response, and many would argue the most appropriate, would be to significantly expand the year-end substantive tests applied to the client's inventory account. For example, the cutoff test, itself, would likely be expanded significantly. The most troubling feature of such a scenario is the possibility that the client is not providing the requested documentation because it wants to conceal the fact that the year-end inventory cutoff was intentionally or unintentionally "messed up." That is, the client did not record inventory sales and purchase transactions occurring near year-end in the proper fiscal year.

6. This is an important issue that the accounting profession has debated extensively in recent years. Many critics of the profession have suggested that the integrity of an independent audit is

undermined when companies hire their former auditors. Why? Because a former auditor, at least theoretically, could help his or her new employer subvert the purpose of the independent audit. Likewise, the quality of audit services in such situations may be adversely affected because of the personal relationships between the former auditor and his or her former colleagues within the given audit firm. For example, on subsequent audits, the auditors may place too much trust in their former colleague and thus overlook or discount potential problems in the client's financial statements.

As a point of information, Section 206 of the Sarbanes-Oxley Act of 2002 prohibits an accounting firm from providing “audit services” to a company that has recently hired an employee of the firm to serve in certain key positions.

> “It shall be unlawful for a registered public accounting firm to perform for an issuer any audit service . . . if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit.”

CASE 1.9

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 sixteen 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 audit and 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, vouching and tracing of transactions, 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 any written confirmations from certain parties 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 other 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 Interim Standards, *SAS No. 84* is integrated into AU Section 315.

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 (Note: *SAS 7* did not require successor auditors to request information regarding this item), and 4) the predecessor auditor’s understanding as to the reasons for the change in auditors. (Note: AU-C 210.A31 and AU 315.09 of the AICPA Professional Standards and the PCAOB’s Interim Standards are the relevant sources of the respective professional auditing standards in this context.) Following the acceptance of the client by the successor auditor, the latter should ask the client to authorize the predecessor auditor 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 of any type imposed by a client prevent auditors from complying, in material respects, with one or more of the generally accepted 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 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 1.10

DHB INDUSTRIES, INC.

Synopsis

David Brooks founded DHB Industries in the early 1990s. Throughout its existence, the principal operating unit of DHB was its Point Blank subsidiary that manufactured bullet-resistant vests for use by law enforcement and military personnel. Sales of protective vests accounted for more than 95 percent of DHB's revenues each year.

DHB and its free-spirited founder were often in the media spotlight. In 2005, a large number of the company's protective vests were recalled due to alleged "life-threatening flaws." A few months earlier, Brooks and his top two subordinates, the company's COO and CFO, were widely criticized when they realized huge stock market gains after selling the majority of their DHB stock. Brooks, alone, realized a stock market gain of more than $180 million when he sold two-thirds of his total ownership interest in DHB, an interest that he had acquired for a small fraction of that amount.

In July 2006, Brooks was ousted as DHB's CEO by the company's board. Over the following year, a forensic investigation of DHB's accounting records revealed that the company's impressive operating results from 2003 through 2005 had been the product of a massive accounting fraud. Brooks and his two subordinates had routinely and blatantly altered DHB's accounting records to achieve the earnings targets that he had established for the company. The primary account manipulated by the co-conspirators was DHB's inventory.

A major problem faced by the conspirators was concealing their misdeeds from the company's independent auditors. Accomplishing that objective was made easier by the fact that between 2001 and 2005 the company had four different accounting firms serve as its independent auditors. Frequent clashes between management and the company's auditors were responsible for the almost annual changes in auditors during that period.

DHB's former CFO accepted a plea bargain deal in exchange for testifying against Brooks and DHB's former COO during their criminal trial on multiple fraud charges. The eight-month trial in a New York federal court took on a circus atmosphere when the details of Brooks' scandalous lifestyle and management methods were documented by federal prosecutors. Brooks was ultimately found guilty of all seventeen charges filed against him including corporate fraud, insider trading, conspiracy and obstruction of justice. DHB's former COO was found guilty on fourteen of sixteen similar charges filed against her.

DHB Industries, Inc.--Key Facts

1. David Brooks was sanctioned in 1992 by the SEC for failing to establish proper internal control procedures for a brokerage firm owned and operated by his brother.

2. A few months before being sanctioned by the SEC, Brooks organized a small company that would ultimately be named DHB Industries, Inc.

3. The principal product sold by DHB throughout its existence was bullet-resistant vests used by law enforcement and military personnel.

4. DHB's sales of protective vests increased dramatically in the early 2000's due to the 9/11 terrorist attacks and the Second Gulf War.

5. Despite record revenues and earnings, DHB's net operating cash flows were very weak; in 2004, the company reported a net income of $30 million and a negative net operating cash flow of $10 million.

6. Brooks ruled DHB with a dictatorial and intimidating management style; the company's independent auditors were among the parties that were a common target of Brooks' angry demeanor and threats.

7. Repeated clashes between DHB's management and its auditors resulted in frequent auditor changes; between 2001 and 2005, four different accounting firms served as DHB's auditors.

8. At the conclusion of the fiscal 2005 audit, DHB's auditors refused to issue an opinion on the company's financial statements in time for DHB to meet the SEC filing deadline.

9. Following Brooks' dismissal as DHB's CEO and chairman of the board, a year-long forensic investigation revealed that the company's impressive operating results for the period 2003-2005 had been the product of a massive accounting fraud orchestrated by Brooks and DHB's COO and CFO.

10. The forensic investigators found that DHB's inventory accounts were the principal source of the material overstatements of the company's operating results and financial condition.

11. Law enforcement authorities filed a seventeen-count federal indictment against Brooks in late 2007 that included, among other charges, allegations of corporate fraud, insider trading, and conspiracy.

12. In late 2011, Brooks was found guilty by a federal jury of all seventeen charges filed against him, while DHB's former COO was found guilty of fourteen similar charges; DHB's former CFO had previously pled guilty to two fraud charges in exchange for testifying against her two former colleagues.

Instructional Objectives

1. To illustrate the lengths to which dishonest executives will go to misrepresent their company's reported financial data.

2. To examine the internal control reporting responsibilities of auditors and client management.

3. To identify fraud risk factors.

4. To provide students an opportunity to apply the materiality construct.

5. To examine the impact of frequent auditor changes on the quality of independent audit services.

6. To examine auditors' responsibilities for identifying and investigating related party transactions.

Suggestions for Use

One method I use in covering large cases is to require students, in groups of three or four, to complete a case template. After the students have met in their groups and completed the templates (one per group), we then reconvene and discuss the case by going over the completed templates. I use a variety of templates for this purpose. Listed next are the narrative items included in one such template:

1. Identify the three most important facts of this case.
2. Identify three other facts or circumstances regarding this case that you would have liked to have known.
3. What was the key auditing issue raised or addressed by this case?
4. Why is this case relevant to future auditors?
5. What is the most important take-away or learning point of this case?
6. Write a potential essay exam question based upon this case.

This exercise provides students with an opportunity to discuss and debate a given case in a relatively non-threatening (small group) environment. In addition, it has been my experience that the use of a template is an effective way to cover a lengthy case in a relatively short period of time.

Suggested Solutions to Case Questions

1. Before responding to this question, you may want to have your students discuss some of the general benchmarks that are used in making materiality decisions, such as, five percent of net income or one percent of net assets or net revenues. Of course, the authoritative professional literature does not include any "official" or definitive quantitative materiality guidelines. Likewise, you may want to refer your students to the definitions of materiality included in professional accounting and auditing standards. The PCAOB, for example, relies on the SEC's definition of materiality, which, in turn, was taken from a U.S. Supreme Court decision: "A fact is material if there is a substantial

likelihood that the . . . fact would have been viewed by [a] reasonable investor as having significantly altered the 'total mix' of information made available."

Listed next are examples of differences in DHB's original and restated 2004 financial statements that I would consider to be material (the balance sheet items are listed first followed by the income statement items):

- The $47 million difference in "Inventories"
- The $18.5 million difference in the current asset "Deferred Income Tax Assets"
- The $6.5 million difference in the current liability "Notes Payable" (granted, this was a classification difference since this figure was included as a long-term liability in the original financial statements)
- The $10 million difference in the current liability "Income Taxes Payable"
- The fact that the original financial statements did not include the $30 million liability for employment withholding taxes or the offsetting expense item
- The $28 million difference in Additional Paid-in Capital
- The huge difference in Retained Earnings (Retained Deficit)
- The $18 million difference in Net Sales
- The $20 million difference in Cost of Goods Sold
- The $38 million difference in Gross Profit
- The large differences in operating expenses reported in the two income statements
- The differences in the tax expense items between the two income statements
- The difference in the Net Income/Net Loss reported in the two income statements

Although this case question does not require students to explain the specific factors or circumstances that accounted for the material differences between the original and restated 2004 DHB financial statements, you may want to provide them with an overview of some of the major sources of those differences. The 2006 Form 10-K for DHB, which was issued in late 2007, presents a detailed analysis of the company's restated financial statements for 2003 and 2004 in a footnote appended to the 2006 financial statements (see "Note 2, Restatements.") That very lengthy footnote documents dozens of reconciling items that account for the significant differences between the original financial statement balances reported in the 2004 Form 10-K and the restated balances included in the 2006 Form 10-K. The sheer volume of those items precluded including them in the case or in this case solution. Listed next are examples of some of the sources of those reconciling items (in addition to the sources mentioned in this case):

- The failure of DHB to apply the lower of cost or market rule to inventories in preparing the original financial statements.
- Purchase rebates were recorded as revenues rather than as reductions to cost of goods sold in the original financial statements.
- By 2003, DHB had disclosed that TAP was a related party, which explains why related party amounts were reported in the original 2003-2004 financial statements. These related party items are not included in the restated financial statements because they were treated as inter-company transactions for purposes of those financial statements.

- Certain property and equipment assets reported in DHB's original 2003-2004 financial statements were actually owned by other entities or individuals even though they were being used in the company's operations.
- "During the years ended December 31, 2004 and 2003, withholding taxes for bonuses paid and the exercise of stock options and warrants were not withheld and paid to the taxing authorities as required. The Company has now recorded liabilities for its potential obligations for federal and state payroll withholding taxes, plus penalties." This explanation that was included in the 2006 Form 10-K accounts for the large employment tax withholding liability and expense reflected in the 2004 restated financial statements.

Rather than providing this information directly, you might consider having your students or a group of your students review the Restatements footnote in DHB's 2006 Form 10-K and present an in-class overview of the major reconciling items documented in that footnote.

2. AU Section 316, "Consideration of Fraud in a Financial Statement Audit," of the PCAOB's Interim Standards has a lengthy appendix that identifies "Examples of Fraud Risk Factors." These risk factors are sorted by the three components or "angles" of the fraud triangle: incentives/pressures, opportunities, and attitudes/rationalizations. Listed next are fraud risk factors included in the appendix to AU Section 316. (Note: A comparable list of fraud risk factors is included in the AICPA Professional Standards at AU-C Section 240.A75.)

Incentives/pressures:

- High degree of competition
- High vulnerability to rapid changes, such as changes due in technology or product obsolescence
- Recurring negative operating cash flows
- Excessive pressure for management to meet the requirements or expectations of third parties
- Significant financial interests in the entity by management

Opportunities:

- Significant related-party transactions
- Significant financial statement amounts are based on estimates
- Domination of management by a single person or a small group
- Ineffective board of directors or audit committee oversight

Attitudes/rationalizations:

- Ineffective communication, implementation or support, or enforcement of the entity's values or ethical standards by management
- Nonfinancial management's excessive participation in, or preoccupation with, the determination of significant accounting estimates
- Known history of violations of securities laws
- Excessive interest by management in maintaining or increasing the entity's stock price or increasing the entity's stock price and earnings trend
- A practice by management of committing to analysts to achieve aggressive financial goals

- Management failure to correct significant internal control problems on a timely basis
- A strained relationship between management and independent auditors

Which of these fraud risk factors should have been of primary concern to DHB's auditors? There is certainly room for considerable debate when it comes to this question. At the top of my list I would include, in no particular order, the following items, each one of which had very significant implications for the integrity of DHB's financial statements and, in turn, for DHB's auditors.

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- Domination of management by a single person or a small group
- Ineffective board of directors or audit committee oversight
- Significant related-party transactions
- Excessive interest by management in maintaining or increasing the entity's stock price or increasing the entity's stock price and earnings trend
- A practice by management of committing to analysts to achieve aggressive financial goals
- Management failure to correct significant internal control problems on a timely basis
- A strained relationship between management and independent auditors

3. Note: in effect, the only evidence that DHB's auditors collected regarding the existence of the $7 million of vest components was a management representation that those items existed. Of course, this "evidence" was subsequently revealed to be patently false by another member of management, namely, David Brooks. As pointed out in the case, the controversy over the $7 million of "missing" vest components was a factor that contributed to DHB's auditors refusing to issue an audit opinion on the company's 2005 financial statements. (The background information used in preparing this case did not reveal what David Brooks told DHB's auditors after he admitted that the "hurricane" explanation—that is, the alleged destruction of the vest components by a hurricane—was a falsehood.)

When auditing a public company, the rules that dictate the quantity and quality of evidence that must be collected are found in PCAOB Auditing Standard No. 15, "Audit Evidence." The third paragraph of AS No. 15 notes that, "The objective of the auditor is to plan and perform the audit to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report." Paragraph 5 of AS No. 15 discusses both the quantitative (sufficiency) and qualitative (appropriateness) dimensions of audit evidence. Paragraphs 7-8 provide a more in-depth discussion of the two key criteria (relevance and reliability) used in assessing the appropriateness of audit evidence.

Paragraph 29 of AS No. 15 addresses those circumstances in which auditors have doubts regarding the overall integrity of certain audit evidence. "If audit evidence obtained from one source is inconsistent with that obtained from another, or if the auditor has doubts about the reliability of information to be used as audit evidence, the auditor should perform the audit procedures necessary to resolve the matter and should determine the effect, if any, on other aspects of the audit." If auditors conclude that they cannot obtain sufficient appropriate evidence to "sign off" on a given financial statement item, then they must consider how that conclusion impacts the audit opinion they will issue on the overall financial statements. If the financial statement item in question is a significant item, then the auditors will likely have to consider issuing either a qualified opinion or a

disclaimer of opinion. [Note: The section of the AICPA Professional Standards that is comparable to AS No. 15 is AU-C 500, "Audit Evidence."]

4. Note: AU Section 334, "Related Parties," within the PCAOB's Interim Standards discusses that agency's auditing standards for related parties and related-party transactions. AU-C Section 550, "Related Parties," includes the AICPA's auditing standards for related parties and related-party transactions. These two sets of standards are very similar.

Most importantly, professional auditing standards require auditors to "be aware of the possible existence of material related-party transactions that could affect the financial statements [being audited]" (AU 334.04). The standards require auditors to perform certain procedures for the express purpose of identifying specific "related parties" to a given client. Two such procedures are requesting client management to provide a list of known related parties and reviewing stockholder listings of a public company client to identify "principal stockholders" (AU 334.07).

There are two key issues an auditor should consider when a client has engaged in material related-party transactions: 1) whether economic substance, rather than legal form, was the determining factor in the accounting for such transactions, and 2) whether such transactions have been disclosed adequately in the client's financial statements as required by U.S. GAAP. The latter of these issues does not present any major problems for the auditor since GAAP are very explicit regarding the disclosures necessary for related-party transactions. Determining whether the economic substance of a related-party transaction has prevailed over its legal form is generally a more difficult issue for the auditor to resolve. Professional auditing standards discuss the procedures that an auditor should consider applying to material related-party transactions. Listed below are examples of such procedures.

a. determine whether the transaction has been approved by the board of directors
b. examine invoices, executed copies of agreements, contracts and other pertinent documents, such as receiving reports and shipping documents
c. inspect evidence in possession of the other party or parties to the transaction
d. confirm or discuss significant information with intermediaries, such as, banks, guarantors, agents, or attorneys
e. with respect to material uncollected balances [resulting from related-party transactions], obtain information about the financial capability of the other party or parties to the transaction

5. The Sarbanes-Oxley Act of 2002 dramatically changed the nature of internal control reporting responsibilities. For the first time, that federal statute mandated that the management of public companies report on the effectiveness of their organizations' internal controls. These reports must indicate whether a company's internal controls have been properly implemented and whether they are operating as intended. In assessing their internal controls, the management of a public company must use some reasonable benchmark or model. The internal controls model used by the great majority of public companies is the COSO framework. Most importantly, management reports on internal control must identify any "material weaknesses" in the given organization's internal controls.

The current internal control standard of the PCAOB, which is the enforceable standard for audits of public companies, is Auditing Standard No. 5, "An Audit of Internal Control Over Financial

Reporting That is Integrated With an Audit of Financial Statements." [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.]

Paragraph 3 of AS No. 5 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]." 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 No. 5 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 controls over financial reporting.

Paragraphs 78-84 of AS No. 5 address the specific "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 the auditors' principal responsibilities in this regard:

- "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 auditors 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."

6. Empirical research has demonstrated that there is somewhat of a "learning curve" effect in independent audits. That is, auditors generally become more proficient in detecting material errors in a client's financial statements the longer their "tenure" with that client. Frequent auditor changes undercut the learning curve effect and thus tend to diminish the overall quality of a given company's independent audit services.

The principal objective of the SEC's 8-K auditor change disclosure rule is to inform financial statement users of important contextual circumstances surrounding a change in auditors by a public company, such as, whether technical disagreements between the two parties preceded the auditor change. Given this information, financial statement users can reach their own conclusions regarding whether a given auditor change was made for valid reasons. A second and implicit objective of the 8-K auditor change disclosure rule is to discourage public companies from changing auditors for

improper reasons. In fact, the 8-K auditor change disclosure rule was adopted by the SEC in the 1970s in response to widespread allegations of "opinion shopping" by public companies. That is, in some cases when major technical disputes arose between auditors and client management the latter would allegedly dismiss the auditors and then "shop" for a more compliant or flexible audit firm, i.e., one that shared its view regarding the issue in dispute.

AU Section 315, “Communications between Predecessor and Successor Auditors,” of the PCAOB’s Interim Standards discusses the communications that should take place between a former and replacement audit team. These communications are intended to help ensure that successor auditors receive all the 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. AU 315 identifies four specific items of information that the 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, and 4) the predecessor auditor’s understanding as to the reasons for the change in auditors.

AU 315 also points out that following the acceptance of the client by the successor auditor, the latter should ask the client to authorize the predecessor auditor 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. (Note: The technical material included in AU 315 of the PCAOB’s Interim Standards regarding predecessor-success auditor communications is integrated into the “clarified” AICPA Professional Standards at sections AU-C 210 and AU-C 510.)

7. Clearly, auditors should not be subject to verbal abuse, intimidation, or other types of harassment by client management or employees. If lower-level auditors are the target of abusive treatment by client management or employees, they should immediately contact their immediate superior and explain the nature of that abuse. Then, it would be incumbent on the senior members of the audit engagement team to deal appropriately with the matter.

Senior members of an audit engagement team who are the victims of inappropriate behavior by client personnel should probably deal with the matter directly by confronting the given individual or individuals and explaining that the given behavior will not be tolerated. When senior members of an audit engagement team are subject to extreme verbal abuse, including direct or indirect threats of physical abuse, they should probably refer the matter to the appropriate members of the audit firm’s legal counsel.

8. “Yes,” the SEC does have a responsibility to protect the investing public from self-interested corporate executives. According to the SEC’s website, its mission “is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.” Professional auditing standards are not as explicit, but independent auditors’ overall responsibilities certainly include protecting the investing public from short-sighted corporate executives. By issuing opinions on the material fairness of audited financial statements, independent auditors provide the equivalent of a Good Housekeeping Seal of Approval for such financial statements. Investors rely on that seal of approval to make a wide array of decisions.

9. The Sarbanes-Oxley Act revolutionized the audit committee function for public companies. SOX effectively mandates that every SEC registrant establish an audit committee. If a registrant does not have an audit committee, then the board of directors, as a whole, must provide the mandated functions of an audit committee. In a set of rules that became effective in April 2003, the SEC spelled out in elaborate detail the "Standards Relating to Listed Company Audit Committees" (SEC Release Nos. 33-8220; 34-47564; IC-26001; File No. S7-02-03). The primary responsibilities of audit committees of public companies include the following:

- The audit committee must retain and supervise the given company's independent auditors and, in doing so, determine that the audit engagement team is competent to conduct the audit.
- The audit committee must ensure that the company's auditors are independent.
- The audit committee must approve all professional services provided to the company by its independent auditors and ensure that auditors do not provide to the company any of the specifically prohibited services identified by SOX, such as bookkeeping services.
- The audit committee must receive and analyze key items of information from the independent auditors. These items of information include auditors' analysis of critical accounting policies adopted by the company. Other items of information that must be communicated to the audit committee by independent auditors include, among others, all significant deficiencies and material weaknesses in internal controls, significant audit adjustments, disputes with management over important items that have a potentially significant financial statement impact, and any serious problems that the auditors encountered in conducting the audit.
- The audit committee must establish procedures that effectively create an internal "whistle blowing" mechanism for the company. That is, the audit committee must ensure that procedures are in place to provide for the receipt, retention, and consideration of complaints regarding accounting, internal control, and auditing matters. In addition, there must be a structure in place that provides for the confidential and anonymous submission of such complaints by company employees.

Note: PCAOB Auditing Standard No. 16, "Communications with Audit Committees," requires auditors of SEC registrants to discuss a wide range of matters with a client's audit committee. These matters include the terms of the audit engagement, the overall audit strategy, the quality of the company's financial reporting, among others. Because the PCAOB has no jurisdiction over audit committees, all of the mandates include in AS No. 16 are directed toward auditors.

CASE 1.1

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 Arthur Andersen violated several of the ten generally accepted auditing standards included in AU Section 150 of the PCAOB's Interim Standards, including the following:

[Note: The AICPA Professional Standards (the "clarified" auditing standards) do not explicitly include the ten "generally accepted auditing standards" found in the PCAOB's Interim Standards—of course, those ten "generally accepted auditing standards" were explicitly included in the previous version of the AICPA Professional Standards. In the "clarified" auditing standards, those ten "generally accepted auditing standards" have been integrated into AU-C Section 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards."]

- Independence (second general standard): by becoming too involved in Enron's decisions for important accounting and financial reporting treatments, the Arthur Andersen auditors may have

forfeited some degree of objectivity when they reviewed those decisions during the course of subsequent audits.

•Due professional care (third general standard): any violation of one of the other nine GAAS effectively results in a violation of the catchall due professional care standard.

•Planning and supervision (first fieldwork standard): 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.

•Internal control evaluation (second fieldwork standard): one could argue that given the critical and seemingly apparent defects in Enron's internal controls, Andersen auditors failed to gain a "sufficient understanding" of the client's internal control system.

•Sufficient competent evidential matter (third fieldwork standard—under the current third fieldwork standard the auditor must obtain "sufficient appropriate" audit evidence): 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 competent 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 (fourth reporting standard): 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 *PCAOB Auditing Standard No. 3*, "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 15-17 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."

PCAOB Auditing Standard No. 3:

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).

PCAOB No. 3 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, this standard 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 to: a) understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached, and b) 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). PCAOB No. 3 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. (Note: AU-C Section 930, "Interim Financial Information," of the AICPA Professional Standards provides guidance to auditors on the "nature, timing, and extent of procedures to be applied" to a client's interim financial information. The comparable section of the PCAOB's Interim Standards is AU Section 722, "Interim Financial Information.")

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 1.2

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 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, *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.

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 whisteblower'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. To date, numerous lawsuits stemming from Lehman's collapse have named E&Y as a defendant or co-defendant.

12. E&Y insists that its audits and reviews of Lehman's periodic financial statements will ultimately be vindicated when the pending lawsuits are resolved.

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. 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. As a point of information, 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.

United States accounting standards do not currently include a rule equivalent to the "true and fair override" rule embedded in IFRS—that rule mandates not applying a required accounting standard if it would result in the given financial statements being misleading. However, Rule 203 of the AICPA *Code of Professional Conduct*, "Accounting Principles," effectively includes such an "override" rule. [Note: In the draft of the Proposed Revised *Code of Professional Conduct*, see "Accounting Principles Rule," 1.320.001.]

One of the problems in covering this case is that students tend to get bogged down in discussing the critical accounting and financial reporting issues. At some point, you will need to goad your students to address the related and extremely challenging auditing issues posed by this case.

By the time you assign this case, there will likely have been new developments relevant to it. Consider having a student or group of students present a brief overview of the recent developments involving this case prior to initiating classroom discussion of it.

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. AU 110.03 of the PCAOB's Interim Standards notes that "The financial statements are management's responsibility . . . [and] that management is responsible for adopting sound accounting policies . . ." PCAOB Auditing Standard No. 12 requires auditors to obtain an understanding of "the company's selection and application of accounting principles" (paragraph 7). 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 PCAOB Auditing Standard No. 12, paragraph 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 PCAOB Auditing Standard No. 12, paragraph 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. 2*, "Qualitative Characteristics of Accounting Information." For example, *SFAC No. 2* notes that "representational faithfulness" is a key qualitative attribute that accounting information should possess. [Representational faithfulness: "the correspondence or agreement between a measure or description and the phenomenon it purports to represent."] 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 "representational faithfulness" requirement is not considered a GAAP violation.

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 is 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.

Note: 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 relatively new auditing standard discusses the division of responsibilities on audits of "group financial statements," including the overarching responsibilities of the "group engagement partner."

5. The relevant section of the PCAOB's Interim Standards in this context is AU Section 550, "Other Information in Documents Containing Audited Financial Statements."

AU 550.04: "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 revisions."

AU 550 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 AU 550 of the PCAOB's Interim Standards.

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 the technical literature. Following are three viewpoints on materiality (the FASB definition of materiality is included in the case):

FASB: *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."

SEC: The SEC's principal statement regarding materiality can be found in *Staff Accounting Bulletin No. 99* issued in 1999. 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.

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).

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 Interim 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 1.3

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 twenty-one 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 facing numerous 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):

Ratio	Norm
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.
--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 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 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 1.4

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 charged 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 GAAS violations 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 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. Clearly, 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 pursue 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. More globally, I would suggest that an auditor's de facto independence has been impaired by a client relationship when that relationship results in the auditor violating one or more GAAS. Loss of independence may result in an auditor failing to gain a proper understanding of a client's internal controls, deciding not to collect sufficient appropriate evidence to support an audit-related decision, or even issuing an inappropriate audit opinion.

2. Interpretation 101-2, "Employment or Association with Attest Clients,"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.

> "When a member of the attest engagement team or an individual in a position to influence the attest engagement intends to seek or discuss potential employment or association with an attest client, or is in receipt of a specific offer of employment from an attest client, independence will be impaired with respect to the client unless the person promptly reports such consideration or offer to an appropriate person in the firm, and removes himself or herself from the engagement until the employment offer is rejected or employment is no longer being sought." [Note: 1.275.200, "Considering Employment or Association With an Attest Client" is the relevant section of the Proposed Revised *Code of Professional Conduct*. There is no substantive difference between Interpretation 101-2 and 1.275.200.]

Recognize that Section 206 of the Sarbanes-Oxley Act of 2002 prohibits an audit firm from providing "audit services" to a company that has recently hired an employee of the audit firm to serve in a top accounting position: "It shall be unlawful for a registered public accounting firm to perform for an issuer any audit service . . . if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit."

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.

Paragraph 8 of PCAOB Auditing Standard No. 15 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." (PCAOB Standard No. 15, "Audit Evidence," 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."

PCAOB Auditing Standard No. 3, "Audit Documentation," does not include a discussion directly comparable to that just highlighted in AU-C Section 230 of the AICPA professional Standards. However, Paragraph 6 includes the following blanket statement: "The auditor must document the procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions." Paragraph 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 AU 316, "Consideration of Fraud in A Financial Statement Audit," of the PCAOB's Interim 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.