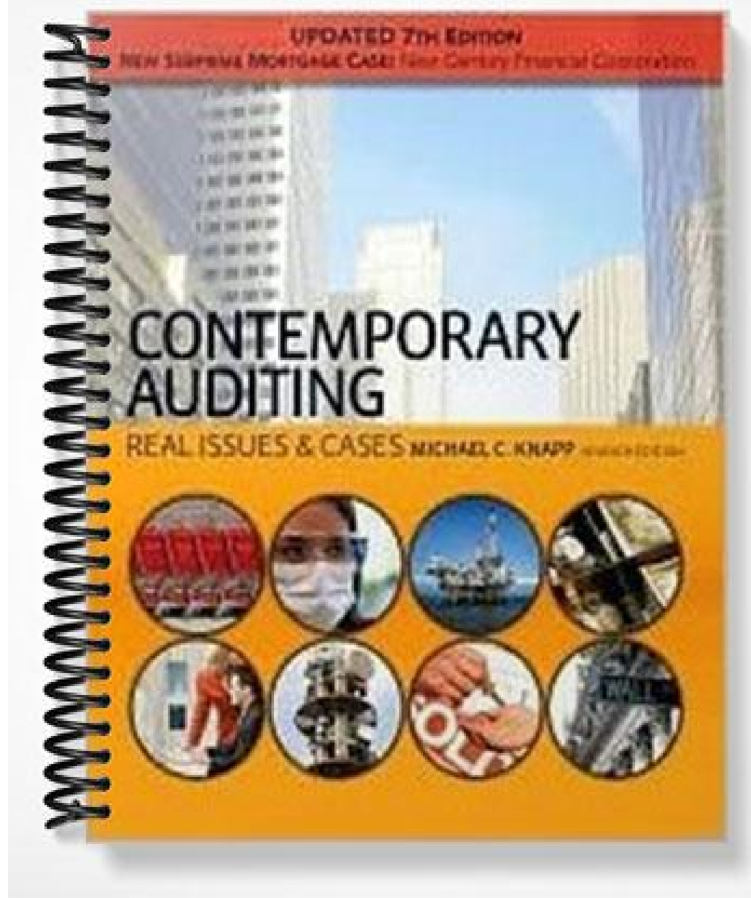
SOLUTIONS MANUAL



CASE 2.4

CAPITALBANC CORPORATION

Synopsis

This case examines an embezzlement scheme involving CapitalBanc Corporation, a publicly-owned bank holding company based in New York City. The principal operating unit of CapitalBanc was Capital National Bank, a bank that had five branch offices scattered across the New York City metropolitan area. CapitalBanc's CEO, Carlos Cordova, embezzled at least $400,000 from the firm's 177th Street Branch office. Cordova's embezzlement was discovered after the bank was declared insolvent in 1990 and taken over by the Federal Deposit Insurance Corporation (FDIC). Cordova subsequently pleaded guilty to several counts of bank fraud.

In 1987, CapitalBanc retained Arthur Andersen to audit the financial statements to be included in its 10-K. Ironically, Arthur Andersen selected the 177th Street Branch to perform a surprise year-end cash count. When the auditors arrived, they discovered that $2.7 million, more than one-half of the branch's cash funds, were not accessible. Allegedly, those funds were segregated in a locked cabinet within the branch's main vault. According to branch personnel, three keys were required to unlock the cabinet, one of which was in Cordova's possession. Since Cordova was out of the country at the time, the employees were unable to unlock the cabinet. After consulting with their superiors on the audit engagement team, the Arthur Andersen auditors informed the branch's personnel that they would count the cash funds in the locked cabinet when Cordova returned.

Upon returning to New York City, Cordova had cash funds from other CapitalBanc branches transferred to the 177th Street Branch to conceal his embezzlement. When the Arthur Andersen auditors returned to that branch to count the funds in the locked cabinet, they did not count the cash funds of the other branches and thus failed to discover the shortage. Nor did the Arthur Andersen auditors adequately corroborate Cordova's explanation regarding why such a large portion of the 177th Street Branch's cash funds were segregated in the locked cabinet and thus unavailable for use by the branch.

Following the FDIC takeover of CapitalBanc, the SEC investigated Arthur Andersen's 1987 audit of the bank holding company. That investigation resulted in the federal agency censuring the Arthur Andersen audit manager and audit partner assigned to the CapitalBanc engagement.

CapitalBanc Corporation--Key Facts

1. Shortly after going public, CapitalBanc Corporation retained Arthur Andersen to audit its consolidated financial statements for the fiscal year ending December 31, 1987.

2. On December 29, 1987, during a surprise cash count at CapitalBanc's 177th Street Branch, the Andersen auditors discovered a $2.7 million reconciling item in the branch's cash accounting records.

3. The auditors were told that the $2.7 million had been segregated in a locked cabinet in the bank's main vault and that one of the three keys required to unlock the cabinet was in the possession of the CEO, Carlos Cordova, who was out of the country.

4. The audit manager told the audit staff that they could count the cash in the locked cabinet when Cordova returned and that it was not necessary to secure the cabinet in any way.

5. On January 14, 1988, the locked cabinet was opened in the presence of the Andersen auditors, who accounted for the $2.7 million, although they did not simultaneously count the other cash funds of the 177th Street Branch or the cash funds of the other branches.

6. Cordova explained that the $2.7 million was segregated in the locked cabinet because a customer had previously cashed a large CD and insisted that the funds be available on demand.

7. The Andersen auditors failed to adequately corroborate Cordova's explanation for the $2.7 million of segregated cash.

8. Arthur Andersen issued an unqualified opinion on CapitalBanc's 1987 financial statements.

9. After CapitalBanc was declared insolvent, an SEC investigation revealed that Cordova had misappropriated at least $400,000 of the $2.7 million allegedly stored in the locked cabinet and had intentionally concealed this shortage from the Andersen auditors.

10. The SEC censured the Arthur Andersen audit manager and audit partner assigned to the CapitalBanc engagement.

Instructional Objectives

1. To illustrate the lengths to which dishonest client personnel may go to conceal critical information from auditors.

2. To identify key audit procedures for cash funds maintained on a client's premises.

3. To demonstrate the need for auditors to corroborate important representations made by client management with other forms of audit evidence.

4. To emphasize the need for auditors to follow up thoroughly on all suspicious items noted during the course of an audit.

Suggestions for Use

This case focuses on a cash embezzlement scheme carried out by the CEO of a New York City banking firm and the apparent deficiencies in the audit procedures applied to the firm's cash funds. The case is ideally suited to be integrated with coverage of cash-related audit tests. Additionally, this is another case that can be used to impress upon students the importance of auditors having a healthy dose of skepticism when examining client financial statements.

Suggested Solutions to Case Questions

1. The nature of cash makes it more susceptible to theft and other misuses than most assets. As a result, "existence" is typically the financial statement assertion of most concern to auditors when examining a client's cash resources. This is true for both cash funds maintained by a client and those maintained by a third party, such as a bank. Another assertion particularly relevant to cash is the "rights and obligation" assertion (which is one of the "account balance" assertions discussed in *SAS No. 106*). For example, auditors should ascertain whether there are any significant restrictions on the use of a client's cash resources, such as, compensating balance requirements. These restrictions, if any, should be properly disclosed in a client's financial statements, an issue relevant to the "classification and understandability" assertion (which is one of the "presentation and disclosure" assertions discussed in *SAS No. 106*).

2. Following are examples of audit procedures that can be applied to cash funds maintained on a client's premises:

   a) Count the cash. (Note: Cash funds should be counted in the presence of client personnel. Additionally, it may be necessary to count other cash funds and/or securities simultaneously to ensure that the client has not concealed a cash shortage by transferring amounts between cash funds and/or by disposing of securities.)
   b) Reconcile the total of the cash count to the general ledger cash balance.

c) When counting a petty cash or "imprest" fund, an auditor should review disbursement vouchers included in the fund to determine that they are for appropriate expenditures.
d) Determine that adequate controls are in place to safeguard the cash.

3. Following are apparent mistakes or oversights made by Arthur Andersen personnel during their audit of cash funds maintained at CapitalBanc's 177th Street Branch:

   a) While counting the branch's cash funds, the auditors apparently did not take steps to establish control over other cash funds and/or securities of the client to prevent a cash shortage from being concealed by transferring cash from another source or by disposing of securities.
   b) The auditors failed to verify the existence of the three-key security system.
   c) The auditors failed to place audit seals on the doors of the locked cabinet to prevent client personnel from gaining access to the cabinet before the date it was to be opened.
   d) The auditors failed to adequately confirm that a liability existed in the branch's accounting records to offset the segregated funds (again, those funds allegedly represented a customer's proceeds from a cashed CD).
   e) The auditors did not obtain documentation to support the client's assertion that a customer had cashed a large CD and intended to use those proceeds for a specific purpose.
   f) The auditors failed to ask client representatives why a substantial amount of the branch's cash was inaccessible to branch personnel and was not invested in appropriate interest-bearing securities.

CASE 2.5

SMARTALK TELESERVICES, INC.

Synopsis

Throughout his long tenure as the chairman of the SEC, Arthur Levitt campaigned against "earnings management" practices used by many public companies to window dress their reported operating results. A primary target of his campaign were the restructuring reserves that SEC registrants often established after acquiring another company. Levitt contended that many of the items included in restructuring reserves were actually routine operating expenses that the given companies would incur in future reporting periods. The apparent intent of the companies that used this accounting gimmick was to take a "big bath" in the current reporting period, while setting themselves up for a quick earnings rebound in future periods.

This case focuses on a company that used a restructuring reserve in the late 1990s to manage its reported earnings, namely, SmarTalk Teleservices, Inc., a company in the telecommunications industry. In 1997, SmarTalk established a $25 million restructuring reserve that was made up of individual items that did not qualify as restructuring charges, according to a subsequent SEC investigation. The SEC's investigation also revealed that SmarTalk's audit firm, PwC, had altered its audit workpapers for the 1997 SmarTalk audit after learning of a large class-action lawsuit being filed by the company's stockholders. The SEC fined PwC $1 million and required the company to establish quality control procedures to prevent its personnel from making undocumented changes to audit workpapers in the future.

SmarTalk Teleservices, Inc.--Key Facts

1. A major focus of Arthur Levitt's tenure as SEC Chairman was discouraging public companies from using so-called "earnings management" techniques to distort their reported operating results.

2. "Restructuring reserves" was a primary target of Levitt's campaign against earnings management.

3. Companies typically establish a restructuring reserve to accrue various "exit expenditures" after acquiring one or more other companies.

4. During the 1990s, many companies took a "big bath" in the current reporting period by charging future operating expenses to a restructuring reserve, an accounting gimmick that set those companies up for a quick and impressive profit recovery in future reporting periods.

5. SmarTalk Teleservices, a telecommunications firm, established a $25 million restructuring reserve in 1997 after acquiring several other companies.

6. A subsequent SEC investigation revealed that SmarTalk did not have a formal "exit plan," which is required by EITF 94-3 before a company can establish a restructuring reserve.

7. Even if SmarTalk had approved a formal exit plan, the items charged to its restructuring reserve would not have qualified as "exit expenditures."

8. The SEC's investigation resulted in the federal agency severely criticizing PwC's audit of SmarTalk's restructuring reserve.

9. The SEC also criticized PwC for altering its 1997 SmarTalk audit workpapers *ex post* after learning of a class-action lawsuit filed by the company's stockholders.

10. The SEC fined PwC $1 million and required the firm to establish quality control procedures to prevent PwC personnel from making undocumented *ex post* changes in audit workpapers.

Instructional Objectives

1. To introduce students to the controversial practice of "earnings management" that many large public companies have allegedly used in recent years.

2. To identify key audit issues posed by restructuring reserves.

3. To document the need for auditors to maintain the integrity of audit workpapers.

4. To identify the function of the FASB's Emerging Issues Task Force in the rule-making process for accounting standards.

Suggestions for Use

I typically include a module in my graduate case course for cases such as this that involve one "high-risk" account, the objective being to allow students to focus almost exclusively on client accounts that can pose significant problems for auditors. (Of course, Section 2 of my casebook provides instructors with a series of "high-risk account" cases for that specific purpose.) This case could also be integrated into an ethics module in your course. The SmarTalk case brings to mind the Enron debacle involving Arthur Andersen & Co. since it involves the alteration and discarding of workpapers. Notice that case question No. 3 specifically addresses this latter topic. As a point of information, the large class-action lawsuit filed by SmarTalk's stockholders apparently prompted PwC personnel to modify *ex post* the 1997 audit workpapers for that client. However, at the time those modifications were made, PwC had not been named as a defendant in that lawsuit. Even more important, as pointed out by the suggested solution to case question No. 3, the SEC had yet to initiate its investigation of the 1997 SmarTalk audit when PwC modified the workpapers for that engagement. I believe it is important to make these latter points very precisely so that students do not draw too close a parallel between this case and the Enron case.

Suggested Solutions to Case Questions

1. The key objectives for any given audit engagement are linked to one or more of the management assertions identified by *SAS No. 106*, "Audit Evidence." Listed next are management assertions that would be relevant to a large restructuring reserve established by an audit client. [Note: this answer is not intended to be comprehensive. In fact, a reasonable argument could be made that each of the thirteen management assertions identified by *SAS No. 106* apply to a restructuring reserve. Likewise, many of these assertions would overlap for such a reserve and thus could be corroborated with the same evidence.]

Existence: "Assets, liabilities, and equity interests exist." The existence assertion definitely applies to a restructuring reserve given the recent efforts of companies to use these reserves to manage their reported earnings. For a restructuring reserve, an auditor should determine whether the given liabilities represented by that reserve actually exist as of the end of the relevant accounting period. To address this issue, an auditor should first examine the client's "exit plan" to determine

that the client is committed to the program that resulted in the booking of the restructuring reserve and then discuss the plan with management to obtain further confirmation of that commitment. An auditor would then develop appropriate audit procedures to collect sufficient appropriate evidence supporting the existence assertion for each of the material items charged to the restructuring reserve. For example, an auditor might review employment contracts, board of directors' minutes, and external contracts with third parties to corroborate individual components of the reserve.

Note: Much of the evidence collected to corroborate the existence assertion for a restructuring reserve would likely corroborate as well the related "occurrence assertion" for the transactions and events that resulted in the recording of the reserve. *SAS No. 106* defines the occurrence assertion for transactions and events as follows: "Transactions and events that have been recorded have occurred and pertain to the entity."

Completeness: "All transactions and events that should have been recorded have been recorded" [transaction-related assertion]; "All assets, liabilities, and equity interests that should have been recorded have been recorded" [account balance-related assertion]; "All disclosures that should have been included in the financial statements have been included" [presentation and disclosure-related assertion]. Companies engaging in earnings management would not be prone to understate a restructuring reserve. But a company that is attempting to establish a legitimate restructuring reserve might fail to identify all future expenditures that should be charged to such a reserve and thus violate one or more prongs of *SAS No. 106's* completeness assertion. As a result, an auditor should attempt to determine whether a given client's restructuring reserve includes all future expenditures that relate to the given "exit activities" and that the financial statement footnotes provide adequate or "complete" disclosure of the reserve. Inquiries of management, third-party representations (expert opinions regarding the sufficiency of asset impairment estimates), and documentary evidence (review of a client's exit plan) are examples of types of audit evidence that could be collected to support the three-pronged completeness assertion for a restructuring reserve.

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." This assertion often goes hand in hand with the existence and occurrence assertions, that is, auditors often design audit procedures that address these assertions simultaneously. In the context of a restructuring reserve, an auditor would want to determine that a client's restructuring reserve was established in the proper amount and that the related restructuring charges have been allocated properly to the current reporting period. Documentary evidence, representations by third parties, client representations, and mathematical evidence would likely be required to substantiate the valuation assertion for a restructuring reserve and its individual components. For example, mathematical evidence would be needed to substantiate the amount of severance payments charged to the restructuring reserve. To corroborate the amount of future asset impairments charged off to a restructuring reserve, an auditor might obtain third party representation*s* (such as appraisals or other expert opinions).

Classification and understandability: "Financial information is appropriately presented and described and disclosures are clearly expressed." An auditor would want to determine that the client has provided an "understandable" description of its restructuring reserve in its financial statement footnotes. To achieve this audit objective, auditors would likely review the client's exit plan and any contracts or commitments related to that plan to ensure that the restructuring reserve is properly presented and discussed in the client's footnotes. Note: This latter assertion for a restructuring reserve clearly overlaps with the presentation and disclosure-related assertion for such reserves.

2. Here is a brief excerpt taken from the FASB's website that describes the EITF and its mission.

> "The Emerging Issues Task Force was formed in 1984 in response to the recommendations of the FASB's task force on timely financial reporting guidance and an FASB Invitation to Comment on those recommendations. The mission of the EITF is to assist the FASB in improving
>
> financial reporting through the timely identification, discussion, and resolution of financial accounting issues within the framework of existing authoritative literature."

Kieso, Weygandt & Warfield (*Intermediate Accounting*, 11th Edition, John Wiley & Sons) provide the following additional snippet of information regarding the EITF.

> "The EITF is composed of 13 members, representing CPA firms and preparers of financial statements. Also attending EITF meetings are observers from the SEC and the AICPA. The purpose of the task force is to reach a consensus on how to account for new and unusual financial transactions that have the potential for creating differing financial reporting practices." (p. 10)

"Yes," EITF pronouncements do have GAAP "status." In particular, AU Section 411, which was derived principally from *SAS No. 69*, includes EITF pronouncements in the GAAP hierarchy. See the table, "GAAP Hierarchy Summary," included in AU 411.18.

3. The key distinction between this case and the Enron case is that the PwC personnel who modified the SmarTalk audit workpapers were not attempting to obstruct any ongoing investigation by a regulatory body or law enforcement agency.

I would suggest that PwC violated the overarching "due professional care" standard of the profession, which is embodied directly or indirectly in GAAS (the third general standard). Likewise, one could reasonably argue that PwC violated Rule 102, "Integrity and Objectivity," and Rule 201, "General Standards," of the AICPA's *Code of Professional Conduct*. By not clearly documenting and justifying the changes made in the 1997 SmarTalk audit workpapers, PwC likely failed to do what a prudent audit practitioner would have done in such circumstances. Of course, the "prudent practitioner concept" is often applied by the courts in addressing the issue of whether a given professional or professional firm lived up to their responsibilities in a given situation.

As a point of information, neither *PCAOB Auditing Standard No. 3*, "Audit Documentation," nor *SAS No. 103*, "Audit Documentation," were in effect during the time frame in which this case took place. One could reasonably argue that conduct such as PwC's in this case would be a clear violation of *SAS No.103* since that standard requires auditors to not only adequately document the results of their audit procedures but also to retain and "protect the integrity" of that documentation (AU 339.34).

CASE 2.6

CBI HOLDING COMPANY, INC.

Synopsis

Ernst & Young audited the pharmaceutical wholesaler CBI Holding Company, Inc., in the early 1990s. In 1991, Robert Castello, CBI's owner and chief executive, sold a 48% stake in his company to TCW, an investment firm. The purchase agreement between Castello and TCW identified certain "control-triggering" events. If one such event occurred, TCW had the right to take control of CBI.

In CBI's fiscal 1992 and 1993, Castello orchestrated a fraudulent scheme that embellished the company's reported financial condition and operating results. The scheme resulted in Castello receiving bonuses for 1992 and 1993 to which he was not entitled. A major feature of the fraud involved the understatement of CBI's year-end accounts payable. Castello and several of his subordinates took steps to conceal the fraud from CBI's Ernst & Young auditors and from TCW (two of CBI's directors were TCW officials). Concealing the fraud was necessary to ensure that Castello did not have to forfeit his bonuses. Likewise, the fraud had to be concealed because it qualified as a "control-triggering" event.

This case examines the audit procedures that Ernst & Young applied to CBI's year-end accounts payable for fiscal 1992 and 1993. The principal audit test that Ernst & Young used in auditing CBI's accounts payable was a search for unrecorded liabilities. Although Ernst & Young auditors discovered unrecorded liabilities each year that resulted from Castello's fraudulent scheme, they did not properly investigate those items and, as a result, failed to require CBI to prepare appropriate adjusting entries for them. A subsequent lawsuit examined in detail the deficiencies in Ernst & Young's accounts payable-related audit procedures during the 1992 and 1993 CBI audits. Following a 17-day trial, a federal judge ruled that Ernst & Young's deficient audits were the proximate cause of CBI's bankruptcy and the resulting losses suffered by TCW and CBI's creditors.

CBI Holding Company, Inc.--Key Facts

1. In 1991, TCW purchased a 48% ownership interest in CBI from Robert Castello, the company's owner and chief executive.

2. The TCW-CBI agreement identified certain "control-triggering events;" if one of these events occurred, TCW would be permitted to take control of CBI.

3. During CBI's fiscal 1992 and 1993, Castello oversaw a fraudulent scheme that resulted in him receiving year-end bonuses to which he was not entitled.

4. A major feature of the fraud was the understatement of CBI's year-end accounts payable.

5. Castello realized that the fraudulent scheme qualified as a control-triggering event.

6. Castello and his subordinates attempted to conceal the unrecorded liabilities by labeling the payments of these items early in each fiscal year as "advances" to the given vendors.

7. Ernst & Young auditors identified many of the alleged advances during their search for unrecorded liabilities.

8. Because the auditors accepted the "advances" explanation provided to them by client personnel, they failed to require CBI to record adjusting entries for millions of dollars of unrecorded liabilities at the end of fiscal 1992 and 1993.

9. The federal judge who presided over the lawsuit triggered by Castello's fraudulent scheme ruled that Ernst & Young's deficient audits were ultimately the cause of the losses suffered by TCW and CBI's creditors.

10. The federal judge also charged that several circumstances that arose during Ernst & Young's tenure as CBI's auditor suggested that the audit firm's independence had been impaired.

Instructional Objectives

1. To illustrate methods that client management may use to understate accounts payable.

2. To examine the audit objectives related to accounts payable and the specific audit tests that may be used to accomplish those objectives.

3. To illustrate the need for auditors to rigorously investigate questionable items discovered during an audit.

4. To examine circumstances arising during an audit that can jeopardize auditors' independence.

Suggestions for Use

This case focuses on accounts payable and, consequently, is best suited for coverage during classroom discussion of the audit tests appropriate for that account. Alternatively, the case could be integrated with coverage of audit evidence issues. Finally, the case also raises several interesting auditor independence issues.

As a point of information, you will find that this case doesn't fully examine all facets of the fraudulent scheme perpetrated by CBI's management. The cases in this section purposefully focus on high-risk accounts and auditing issues related to those accounts. If I fully developed all of the issues posed by the cases in this text, each case would qualify as a "comprehensive" case. [I make this point because many adopters have raised this issue with me. By the way, I greatly appreciate such comments and concerns!]

Suggested Solutions to Case Questions

1. "Completeness" is typically the management assertion of most concern to auditors when investigating the material accuracy of a client's accounts payable. Generally, clients have a much stronger incentive to violate the completeness assertion for liability and expense accounts than the other management assertions relevant to those accounts. Unfortunately for auditors, a client's financial controls for accounts payable are typically not as comprehensive or as sophisticated as the controls established in accounting for the analogous asset account, accounts receivable. Clients have a strong economic incentive to maintain a reliable tracking system for amounts owed to them by their customers. This same incentive does not exist for payables since the onus for keeping track of these amounts and ensuring that they are ultimately paid rests with a company's creditors. Granted, a company needs sufficient records to ensure that their vendors are not overcharging them. Nevertheless, the relatively weak accounting and control procedures for payables often complicate auditors' efforts to corroborate the completeness assertion for this account.

In my view, the two primary audit procedures that Ernst & Young applied to CBI's accounts payable would likely have yielded sufficient appropriate evidence to corroborate the completeness assertion—if those procedures had been properly applied. The search for unrecorded liabilities is almost universally applied to accounts payable. This search procedure provides strong evidence

supporting the completeness assertion because audit clients in most cases have to pay year-end liabilities during the first few weeks of the new fiscal year. [Of course, one feature of the search procedure is examining the unpaid voucher file to uncover any year-end liabilities that remain unpaid late in the audit.] The reconciliation procedure included in Ernst & Young's audit programs for accounts payable provides additional evidence pertinent to the completeness assertion. In particular, that audit test helps auditors nail down the "timing" issue for payables that arose near a client's year-end. Vendor statements should identify the shipping terms and shipment dates for specific invoice items and thus allow auditors to determine whether those items should have been recorded as liabilities at the client's year-end.

2. Before answering the explicit question posed by this item, let me first address the "explanation" matter. In most circumstances, auditors are required to use confirmation procedures in auditing a client's accounts receivable. Exceptions to this general rule are discussed in *SAS No. 67* and include cases in which the client's accounts receivable are immaterial in amount and when the use of confirmation procedures would likely be ineffective. On the other hand, confirmation procedures are not generally required when auditing a client's accounts payable. Accounts receivable confirmation procedures typically yield evidence supporting the existence, valuation & allocation, and rights & obligations assertions (account balance-related assertions). However, the key assertion corroborated most directly by these tests is existence. When performing confirmation procedures on a client's accounts payable, the auditor is most often concerned with the completeness assertion (as pointed out in the answer to the prior question).

The differing objectives of accounts payable and accounts receivable confirmation procedures require an auditor to use different sampling strategies for these two types of tests. For instance, an auditor will generally confirm a disproportionate number of a client's large receivables. Conversely, because completeness is the primary concern in a payables confirmation procedure, the auditor may send out confirmations on a disproportionate number of accounts that have relatively small balances or even zero balances. Likewise, an auditor may send out accounts payable confirmations to inactive vendor accounts and send out confirmations to vendors with which the client has recently established a relationship even though the client's records indicate no outstanding balance owed to such vendors.

A final technical difference between accounts payable and accounts receivable confirmation procedures is the nature of the confirmation document used in the two types of tests. A receivable confirmation discloses the amount reportedly owed by the customer to the client, while a payable confirmation typically does not provide an account balance but rather asks vendors to report the amount owed to them by the client. Auditors use blank confirmation forms in an effort to identify any unrecorded payables owed by the client.

Should the Ernst & Young auditors have applied an accounts payable confirmation procedure to CBI's payables? No doubt, doing so would have yielded additional evidence regarding the completeness assertion and, in fact, likely have led to the discovery of Castello's fraudulent scheme. One could certainly suggest that given the fact that the 1992 and 1993 audits were labeled by Ernst & Young as high-risk engagements, the audit firm should have considered erring on the conservative side by mailing confirmations--at least to CBI's major vendors. On the other hand, since payable confirmations are seldom used and since the two procedures that Ernst & Young applied to CBI's accounts payable would yield, in most circumstances, sufficient appropriate evidence to support the completeness assertion, most auditors would likely not criticize Ernst & Young for not using payable confirmations.

3. AU Section 561 discusses auditors' responsibilities regarding the "subsequent discovery of facts" existing at the date of an audit report. That section of the professional standards suggests that, as a general rule, when an auditor discovers information that would have affected a previously issued audit report, the auditor has a responsibility to take appropriate measures to ensure that the information is relayed to parties who are still relying on that report. In this particular case, AU Section 561 almost certainly required Ernst & Young to inform CBI's management, TCW officials, and other parties of the advances ruse orchestrated by Castello that was not uncovered by Ernst & Young during the 1992 and 1993 audits. In my view, the obligation to inform CBI management (including the TCW representatives sitting on CBI's board) of the oversights in the prior audits was compounded by the fact that Ernst & Young was actively seeking to obtain the reaudit engagement.

Generally, auditors do not have a responsibility to inform client management of "mistakes" made on earlier audits. On practically every audit engagement, simple mistakes or oversights are likely to be made. However, if such mistakes "rise" to the level of AU 561, for example, involve gaffes by auditors that resulted in an improper audit opinion being issued, certainly the given audit firm has a responsibility to comply with AU 561 and ensure that the appropriate disclosures are made to the relevant parties.

4. The key criterion in assigning auditors to audit engagements should be the personnel needs of each specific engagement. Certainly, client management has the right to complain regarding the assignment of a particular individual to an audit engagement if that complaint is predicated on the individual's lack of technical competence, poor interpersonal skills, or other skills deficiencies. On the other hand, a client request to remove a member of an audit team simply because he or she is too "inquisitive" is certainly not a valid request. Castello's request was particularly problematic because it involved the audit manager assigned to the engagement. The audit manager on an engagement team often has considerable client-specific experience and expertise that will be forfeited if he or she is removed from the engagement.

5. Determining whether high-risk audit clients should be accepted is a matter of professional judgment. Clearly, "economics" is the overriding issue for audit firms to consider in such circumstances. An audit firm must weigh the economic benefits (audit fees and fees for ancillary services, if any) against the potential economic costs (future litigation losses, harm to reputation, etc.) in deciding whether to accept a high-risk client. Complicating this assessment is the fact that many of the economic benefits and the economic disincentives related to such decisions are difficult to quantify. For example, quite often one of the best ways for an audit firm to establish a foothold in a new industry is to accept high-risk audit clients in those industries (such clients are the ones most likely to be "available" in a given industry). Likewise, audit firms must consider the important "utilization" issue. An audit firm will be more prone to accept a high-risk audit client if rejecting that client would result in considerable "down time" for members of the given office's audit staff. In any case, the decision of whether to accept or reject a high-risk audit client should be addressed deliberately, reached with the input of multiple audit partners, and ultimately reviewed at a higher level than the practice office. (Most large accounting firms have a "risk management" group that reviews each client acceptance/rejection decision.)

As a point of information, after Ernst & Young issued an unqualified opinion on CBI's 1993 financial statements, the audit engagement partner recommended that Ernst & Young dissociate itself from CBI. In the partner's view, the audit risk posed by CBI was simply too high. Despite this recommendation, the audit partner was overruled by his fellow partners in his practice office. (The

decision to retain CBI as an audit client proved inconsequential since the company went “belly up” before the 1994 audit was commenced.)

CASE 2.7

CAMPBELL SOUP COMPANY

Synopsis

The Campbell Soup Company has dominated the soup "industry" since the company developed a cost-effective method of producing condensed soup products in 1899. Throughout most of the twentieth century, Campbell was known as one of the most conservative companies in the United States. In 1980, Campbell startled the business world by selling debt securities for the first time and by embarking on a program to lengthen and diversify its historically "short" product line. Despite a sizable increase in revenues, the diversification program failed to improve Campbell's profitability, which prompted the company's executives to refocus their attention on their core business, namely, manufacturing and marketing soup products. Unfortunately, by the end of the twentieth century, the public's interest in soup was waning. Faced with a shrinking market for its primary product, Campbell's management team allegedly began using a series of questionable business practices and accounting gimmicks to prop up the company's reported profits.

A class-action lawsuit filed in early 2000 by disgruntled Campbell stockholders charged top company executives with misrepresenting Campbell's operating results in the late 1990s. The principal allegation was that the executives had used a variety of methods to inflate the company's revenues, gross margins, and profits during that time frame. Eventually, PricewaterhouseCoopers (PwC), Campbell's independent audit firm, was named as a co-defendant in the case. The plaintiffs in the class-action lawsuit claimed that PwC had recklessly audited Campbell, which effectively allowed Campbell's executives to continue their illicit schemes.

This case examines the allegations filed against PwC by Campbell's stockholders with the primary purpose of illustrating the audit objectives and procedures that can and should be applied to a client's revenue and revenue-related accounts. The case also provides students with important insights on how the Private Securities Litigation Reform Act of 1995 has affected auditors' civil liability in lawsuits filed under the Securities and Exchange Act of 1934.

Campbell Soup Company--Key Facts

1. During much of its history, Campbell Soup was known as one of the most conservative large companies in the U.S. economy.

2. Campbell's conservative corporate culture abruptly changed in the 1980s when the company sold debt securities for the first time and embarked on an ambitious program to diversify and expand its product line.

3. In the late 1990s, after the diversification program had produced disappointing financial results and when market data indicated that the public's interest in soup was waning, Campbell executives allegedly began using several illicit methods to meet Wall Street's earnings targets for the company.

4. A class-action lawsuit filed in 2000 charged that Campbell had offered customers large, period-ending discounts to artificially inflate sales, accounted improperly for those discounts, recorded bogus sales, and failed to record appropriate reserves for anticipated sales returns.

5. PwC, Campbell's audit firm, was named as a defendant in the class-action lawsuit and was charged with recklessly auditing Campbell's financial statements.

6. Because the class-action lawsuit was filed under the Securities Exchange Act of 1934, the federal judge presiding over the case had to decide whether the allegations involving PwC satisfied the new "pleading standard" established by the Private Securities Litigation Reform Act of 1995.

7. The PSLRA's pleading standard requires plaintiffs to plead or allege facts suggesting that there is a "strong inference of scienter" on the part of a given defendant.

8. To satisfy the PSLRA pleading standard in the Third Circuit of the U.S. District Court in which the Campbell lawsuit was filed, a plaintiff, at a minimum, must allege that the given defendant acted with "recklessness."

9. After reviewing PwC's audit workpapers, the federal judge ruled that the plaintiffs had failed to satisfy the PSLRA pleading standard, which resulted in PwC being dismissed as a defendant in the case.

10. In February 2003, Campbell settled the class-action lawsuit by agreeing to pay the plaintiffs $35 million, although company executives denied any wrongdoing.

Instructional Objectives

1. To demonstrate that even the largest and highest profile audit clients can pose significant audit risks.

2. To identify discretionary business practices and accounting "gimmicks" that can be used to distort a company's reported operating results.

3. To identify audit procedures that should be applied to a client's sales and sales-related accounts.

4. To examine the implications that the Private Securities Litigation Reform Act of 1995 has for the civil liability of independent auditors in lawsuits filed under the Securities Exchange Act of 1934.

5. To examine the concepts of recklessness and negligence in the context of auditors' civil liability.

Suggestions for Use

The "high-risk" accounts that are the focus of this case are sales and sales-related accounts. This case focuses students' attention on schemes that companies can use to enhance their reported operating results. These schemes involve both "discretionary" business practices and accounting gimmicks. Auditing textbooks generally ignore the fact that audit clients often manage or manipulate their reported profits by using discretionary business practices—such as delaying advertising or maintenance expenditures. This case requires students to address this possibility and consider the resulting audit implications. After discussing this case, I hope my students recognize that companies that use discretionary business practices to "rig" their profits are likely inclined to use accounting gimmicks for the same purpose. As an out-of-class assignment, you might ask students to find in the business press recent examples of companies that have attempted to manage their earnings without violating any accounting or financial reporting rules. Have students present these examples and then discuss them when addressing case question No. 1. I think you will find that students have very different opinions on whether it is ethical for public companies to "massage" their income statement data while complying with the technical requirements of GAAP.

You might consider packaging this case with the Health Management, Inc., case (Case 1.4). The Health Management case provides a general discussion of the PSLRA. The Campbell Soup case contributes to students' understanding of the PSLRA by examining in more depth the "pleading standard" established by that federal statute and the impact that standard has on lawsuits filed against auditors under the Securities Exchange Act of 1934.

Suggested Solutions to Case Questions

1. Here are a few examples of discretionary business practices that corporate executives can use to influence their company's revenues and/or expenses.

Deferring advertising, maintenance, or other discretionary expenditures until the following period.
Slowing down (or accelerating) work on long-term construction projects or contracts for which the percentage-of-completion accounting method is used to recognize revenue.
Using economic incentives to stimulate sales near the end of an accounting period (a technique used by Campbell).

Are the practices just listed "ethical"? Typically, students suggest that since these practices do not violate any laws, GAAP, or other "black and white" rules, the practices cannot be considered "unethical"—a roundabout way of arguing that they are ethical. That general point-of-view seems consistent with the following comment that Judge Irenas made regarding Campbell's period-ending "trade loading:" "There is nothing inherently improper in pressing for sales to be made earlier than in the normal course . . . there may be any number of legitimate reasons for attempting to achieve sales earlier."

For what it is worth, I believe that corporate executives who defer needed maintenance expenses or who postpone advertising programs that would likely produce sizable sales in future periods are not acting in the best interests of their stockholders. In other words, I do not believe such practices are proper or "ethical." Likewise, corporate executives who take advantage of the inherent flexibility of the percentage-of-completion accounting method, ostensibly to serve their own economic interests, are not individuals who I would want serving as stewards of my investments. In my view, it is a little more difficult to characterize the "trade loading" practices of Campbell as unethical. Why? Because, allegedly, the company's competitors were using the same practice. If Campbell chose not to offer large, period-ending discounts to their customers, the company would likely have lost sales to its competitors. [Note: Campbell's CEO who resigned in 2000 announced in mid-1999 that his company was discontinuing trade loading.]

2. I would suggest that companies that use various "legitimate" business practices to "manage" their earnings are more prone to use illicit methods (accounting gimmicks, etc.) for the same purpose. As a result, auditors could reasonably consider such business practices as a "red flag" that mandates more extensive and/or rigorous audit tests. [Note: Professional auditing standards suggest that corporate executives who place excessive emphasis on achieving earnings forecasts may be prone to misrepresenting their company's financial statement data.]

3. *SAS No. 106*, "Audit Evidence," identifies three categories of management assertions implicit in an entity's financial statements that independent auditors should attempt to corroborate by collecting sufficient appropriate audit evidence. The third of these categories is "presentation and disclosure." Included in the latter category is the following item: "*Classification and understandability*. Financial information is appropriately presented and described and disclosures are clearly expressed." [AU 326.15] Likewise, one of the five transaction-related assertions is entitled "*Classification*." This latter assertion suggests that, "Transactions and events have been recorded in the proper accounts."

Here are examples of "spin" techniques that can be used to enhance income statement data without changing net income:

Classifying cost of goods sold components as SG&A expenses to inflate gross profit on sales.
Reporting items that qualify as operating expenses/losses as nonoperating expenses/losses to

inflate operating income. (One of the most common variations of this "trick" in recent years has been including legitimate operating expenses in "restructuring" losses.)

Treating "other losses" as extraordinary losses to inflate income from continuing operations.

4. *Shipping to the yard:* Year-end sales cutoff tests are intended to identify misclassification of sales occurring near the end of a client's fiscal year. Auditors will typically choose a small sample of sales that the client recorded in the final few days of the fiscal year and a comparable sample of sales that occurred in the first few days of the new fiscal year. Then, the relevant shipping and other accounting documents for those sales will be inspected to determine that they were recorded in the proper period. This standard test might have revealed the fact that Campbell was booking some unusually large sales near the end of accounting periods. Even though the shipping documents for these sales might have suggested that they were valid period-ending sales, a curious auditor might have investigated the sales further. For example, that auditor might have attempted to determine whether the resulting receivables were collected on a timely basis. During the course of such an investigation, the auditor would likely have discovered that the sales were reversed in the following period or dealt with in some other nonstandard way.

Accounts receivable confirmation procedures might also have resulted in the discovery of these "sales." Customers to whom such sales were charged would likely have identified them as differences or discrepancies on returned confirmations. Subsequent investigation of these items by the auditors may have revealed their true nature. As pointed out by the plaintiffs in this case, during physical inventory counting procedures auditors typically take notice of any inventory that has been segregated and not counted—for example, inventory that is sitting in parked trucks. If there is an unusually large amount of such segregated inventory—which was apparently true in this case, the auditors should have inquired of the client and obtained a reasonable explanation. The old, reliable "scanning year-end transactions to identify large and/or unusual transactions" might also have led to the discovery of Campbell's sales "shipped to the yard."

Guaranteed sales: During the first few weeks of a client's new fiscal year, auditors should review the client's sales returns and allowances account to determine whether there are any unusual trends apparent in that account. Auditors should be particularly cognizant of unusually high sales returns and allowances, which may signal that a client overstated reported sales for the prior accounting period. Accounts receivable confirmation procedures may also result in auditors discovering an unusually high rate of "charge-backs" by the client's customers. In some cases, clients will have written contracts that document the key features of sales contracts. Reviewing such contracts may result in the discovery of "guaranteed sales" or similar transactions. Finally, simply discussing a client's sales policies and procedures with client personnel may result in those personnel intentionally or inadvertently "tipping off" auditors regarding questionable accounting practices for sales, such as shipping to the yard or guaranteed sales.

5. Here are definitions of "negligence" and "recklessness" that I have referred to in suggested solutions for questions in other cases. These definitions were taken from the following source: D.M. Guy, C.W. Alderman, and A.J. Winters, **Auditing, Fifth Edition** (San Diego: Dryden, 1999), 85-86.

> **Negligence:** "The failure of the CPA to perform or report on an engagement with the due professional care and competence of a prudent auditor."
> **Recklessness:** "A serious occurrence of negligence tantamount to a flagrant or reckless departure from the standard of due care."

After reviewing the definition of "negligence," ask your students to define or describe a "prudent auditor." Then, ask them whether they believe that definition/description applies to the PwC auditors assigned to the 1998 Campbell audit.

Here are two hypothetical examples drawn from this case involving what I would characterize as "reckless auditors."

A client employee tells PwC auditors that many year-end sales are "guaranteed" and that no reserve has been established for the large amount of returns that will likely be produced by those sales. PwC decides not to investigate this allegation because of manpower constraints on the engagement.

While reviewing receivables confirmations returned by Campbell customers, PwC auditors discover that approximately one-fourth of those customers indicate that their balances include charges for large amounts of product purchased near the end of the year, product that they did not order or receive. PwC dismisses this unusually large number of similar reported differences as a "coincidence."

6. Here is a list of key parties that have been affected by the PSLRA.

Investors who suffer large losses that they believe were caused by reckless or fraudulent conduct on the part of a given company's management team, its auditors, or other parties associated with the company's financial statements. At least some of these investors have likely found it more difficult and costly to recover their losses because of the barrier to securities lawsuits erected by the PSLRA. [Note: Granted, the PSLRA has little impact on the ability of investors to recover losses in those cases involving obvious gross fraud or malfeasance by corporate management or other parties.]

Some parties have argued that the PSLRA diminishes the overall efficiency of the stock market. These parties argue that by making it more difficult for investors to file lawsuits under the 1934 Securities Act, the PSLRA has resulted in a larger portion of scarce investment capital being squandered by irresponsible corporate executives, which, in the long run, diminishes the strength of our economy and our nation's standard of living.

Generally, corporate executives have benefited from the PSLRA since it has reduced, to some degree, their exposure to civil liability.

As pointed out in the Health Management, Inc., case (Case 1.4), the PSLRA apparently has not been very beneficial to large accounting firms. For whatever reason, in recent years, there has been a general upward trend in federal securities cases alleging accounting irregularities. Not only are independent auditors more likely to be named as defendants in such cases, the settlements in those cases tend to be considerably higher than in other lawsuits filed under the federal securities laws.

CASE 2.8

ROCKY MOUNT UNDERGARMENT COMPANY, INC.

Synopsis

Near the end of 1985, the executives of Rocky Mount Undergarment Company (RMUC) faced the unpleasant realization that their firm's operating results for that year would be unimpressive. In fact, RMUC's 1985 net income would fall short of $500,000, less than one-third of the company's reported profit for the previous year. The executives decided that RMUC's actual operating results were unacceptable and decided to change them. How? By pressuring three of RMUC's accounting clerks to significantly overstate the company's year-end inventory.

Initially, the three employees did not want to become involved in the fraudulent scheme. However, the employees subsequently changed their minds. What caused them to have a change of heart? The executives told the employees that unless they inflated the company's reported net income, the company might cease operations. Later, while the employees were actively involved in the inventory fraud, they had another change of heart. They told RMUC's executives that they were unwilling to continue falsifying the company's year-end inventory quantities. After renewed coaxing and goading by the executives, the three employees once again became active, if unwilling, participants in the fraud.

Following the SEC's discovery of RMUC's fraudulent scheme, the federal agency sanctioned the two executives responsible for masterminding the fraud. RMUC was also required to issue corrected financial statements for 1985.

Rocky Mount Undergarment Company, Inc.--Key Facts

1. The "success" of many, if not most, fraudulent accounting schemes hinges on the willingness of lower-level employees to participate in them.

2. In 1985, RMUC failed to sustain its impressive profit trend as the company's actual net income was less than one-third of the previous year amount.

3. Two RMUC executives decided that the company's net income for 1985 was unacceptable and devised a fraudulent scheme to inflate that figure by more than 100 percent.

4. The executives instructed three RMUC employees to materially overstate the company's year-end inventory for 1985.

5. The employees were reluctant to cooperate but eventually agreed to do so when the executives told them that RMUC might otherwise cease operations--and thus lay off its entire workforce.

6. At one point, the three employees informed the executives that they were no longer going to participate in the fraud; however, the executives goaded them into changing their minds once more.

7. RMUC's senior executive also convinced one of the company's suppliers to submit a false confirmation letter to RMUC's audit firm; that confirmation indicated the supplier had $165,000 of RMUC inventory on hand at the end of 1985.

8. RMUC's senior executive signed a letter of representations addressed to the company's audit firm near the end of the 1985 audit that indicated he was not aware of any irregularities in RMUC's financial statements.

9. Following the discovery of the fraudulent inventory scheme, the SEC sanctioned RMUC's two executives who masterminded the fraud; RMUC also issued corrected financial statements for 1985.

Instructional Objectives

1. To suggest that the "success" of many, if not most, fraudulent accounting schemes depends on the willingness of lower-level employees to participate in those schemes.

2. To demonstrate the pressure that corporate executives may impose on an organization's accountants and clerical personnel to misrepresent the entity's financial data.

3. To allow students to assume the role of a corporate accountant who is being pressured to fraudulently overstate an entity's year-end inventory.

4. To examine audit procedures that may be effective in preventing or detecting fraudulent overstatements of inventory.

Suggestions for Use

This case examines an inventory fraud in which several lower-level employees were coerced into participating in the fraudulent scheme by two of the given company's executives. One of my objectives in an auditing course, particularly an undergraduate auditing course, is to dispel the naivete of my students regarding the "real world" that most of them are about to enter. Although the coercion of lower-level accounting employees that was evident in this case may be rare, it does occur in the real world and I believe that future auditors and corporate accountants should be aware that it occurs. I also believe that it is important to have students "step into such situations" and role play--which I often do with a case such as this one. I have found that such role-playing exercises are extremely thought-provoking and revealing for both the "actors" and the observers.

Suggested Solutions to Case Questions

1. In the United States, we don't have any definitive criteria for determining whether a given amount is "material." However, in this case, the 1985 overstatement of RMUC's inventory clearly had a very material impact on the company's key financial data. In evaluating an inventory misstatement, the most relevant benchmark is typically a company's net income for the given accounting period. In this case, the inventory fraud more than doubled RMUC's reported net income. Most accountants would likely conclude that the more than $1 million overstatement of inventory also had a material impact on RMUC's total assets, current assets, and stockholders' equity, each of which was overstated by approximately 5%.

2. The audit procedures that would have had the highest likelihood of detecting RMUC's inventory fraud would have been inventory observation procedures and the related follow-up procedures. As noted in the case, the three RMUC employees involved in the fraud overstated inventory quantities listed on the count sheets prepared during the physical inventory. If RMUC's auditors had test counted several of the company's inventory items, they might have discovered (later) that their test count quantities for those items did not correspond to the quantities listed in the final inventory compilation prepared by the client. Among other audit procedures that might have uncovered the

fraud were standard analytical tests focusing on the client's inventory turnover, gross profit margin, net operating margin, and related ratios.

Note: The SEC enforcement release did not comment on the inventory audit procedures applied by the company's audit firm, nor did that enforcement release criticize RMUC's independent auditors.

3. One of the key traits of audit evidence is "freedom from bias." The existence of the buyout option should have caused RMUC's auditors to question whether the Stretchlon executive who signed the confirmation letter was unbiased, that is, unaffected by any pressure or influence potentially exerted by RMUC personnel.

4. Companies are not inclined to be completely forthcoming when they must display their "dirty laundry." In my view, the footnote disclosure of the inventory overstatement was not adequate. If I was a potential investor in this company or a potential lender to the company, I would certainly be interested in the source of the inventory misstatement. Why? Because that information would influence the degree of credibility I would impute to the company's current and future financial disclosures.

Note: The information on which this case is based does not reveal whether the SEC formally reviewed and/or approved RMUC's footnote disclosure of the inventory misstatement. My guess would be that the SEC did review and approve the disclosure shown in Exhibit 2.

5. Again, I often select students to role play when addressing case questions such as this one. Here, it is appropriate to have two students assume the role of RMUC's two executives (one of whom was the company's senior executive) and three other students to assume the role of the low-level accounting employees who participated in the inventory fraud. Among the alternative courses of action available to the three employees were resigning, refusing to participate in the fraud and threatening legal action if pressured to do so by the two executives, discussing the matter with other executives or directors of RMUC, and referring the matter to the SEC and/or to RMUC's independent audit firm.

CASE 2.1

JACK GREENBERG, INC.

Synopsis

In the mid-1980s, Emanuel and Fred Greenberg each inherited a 50 percent ownership interest in a successful wholesale business established and operated for decades by their father. Philadelphia-based Jack Greenberg, Inc., (JGI) sold food products, principally meat and cheese, to restaurants and other wholesale customers up and down the eastern seaboard. The company's largest product line was imported meat products. Following their father's death, Emanuel became JGI's president, while Fred accepted the title of vice-president. In the latter role, Fred was responsible for all decisions regarding the company's imported meat products. When JGI purchased these products, they were initially charged to a separate inventory account known as Prepaid Inventory, the company's largest account. When these products were received weeks or months later, they were transferred to the Merchandise Inventory account.

In 1986, the Greenberg brothers hired Steve Cohn, a former Coopers & Lybrand employee, to modernize their company's archaic accounting system. Cohn successfully updated each segment of JGI's accounting system with the exception of the module involving prepaid inventory. Despite repeated attempts by Cohn to convince Fred Greenberg to "computerize" the prepaid inventory accounting module, Fred resisted. In fact, Fred had reason to resist since he had been manipulating JGI's periodic operating results for several years by overstating its prepaid inventory.

From 1986 through 1994, Grant Thornton audited JGI's annual financial statements, which were intended principally for the benefit of the company's three banks. Grant Thornton, like Steve Cohn, failed to persuade Fred Greenberg to modernize the prepaid inventory accounting module. Finally, in 1994, when Fred refused to make certain changes in that module that were mandated by Grant Thornton, the accounting firm threatened to resign. Shortly thereafter, Fred's fraudulent scheme was uncovered. Within six months, JGI was bankrupt and Grant Thornton was facing a series of allegations filed against it by the company's bankruptcy trustee. Among these allegations were charges that the accounting firm had made numerous errors and oversights in auditing JGI's Prepaid Inventory account.

Jack Greenberg, Inc.--Key Facts

1. Emanuel and Fred Greenberg became equal partners in Jack Greenberg, Inc., (JGI) following their father's death; Emanuel became the company's president, while Fred assumed the title of vice-president.

2. JGI was a Philadelphia-based wholesaler of various food products whose largest product line was imported meat products.

3. Similar to many family-owned businesses, JGI had historically not placed a heavy emphasis on internal control issues.

4. In 1986, the Greenberg brothers hired Steve Cohn, a former Coopers & Lybrand auditor and inventory specialist, to serve as JGI's controller.

5. Cohn implemented a wide range of improvements in JGI's accounting and control systems; these improvements included "computerizing" the company's major accounting modules with the exception of prepaid inventory—Prepaid Inventory was JGI's largest and most important account.

6. Since before his father's death, Fred Greenberg had been responsible for all purchasing, accounting, control, and business decisions involving the company's prepaid inventory.

7. Fred stubbornly resisted Cohn's repeated attempts to modernize the accounting and control decisions for prepaid inventory.

8. Fred refused to cooperate with Cohn because he had been manipulating JGI's operating results for years by systematically overstating the large Prepaid Inventory account.

9. When Grant Thornton, JGI's independent auditor, threatened to resign if Fred did not make certain improvements in the prepaid inventory accounting module, Fred's scheme was discovered.

10. Grant Thornton was ultimately sued by JGI's bankruptcy trustee; the trustee alleged that the accounting firm had made critical mistakes in its annual audits of JGI, including relying almost exclusively on internally-prepared documents to corroborate the company's prepaid inventory.

Instructional Objectives

1. To introduce students to the key audit objectives for inventory.

2. To demonstrate the importance of auditors obtaining a thorough understanding of a client's accounting and internal control systems.

3. To examine the competence of audit evidence yielded by internally-prepared versus externally-prepared client documents.

4. To identify audit risk issues common to family-owned businesses.

5. To demonstrate the importance of auditors fully investigating suspicious circumstances they uncover in a client's accounting and control systems and business environment.

Suggestions for Use

This case focuses on audit issues related to inventory. However, you will find that Jack Greenberg, Inc.'s largest inventory account, namely, Prepaid Inventory, was unconventional and posed several unconventional audit issues and risk factors. So, if you are interested in a conventional inventory case, you might consider one of the other offerings in my casebook that deal with more "normal" or customary inventory accounts.

One of my most important objectives in teaching an auditing course, particularly an introductory auditing course, is to convey to students the critical importance of auditors maintaining a healthy degree of skepticism on every engagement. That trait or attribute should prompt auditors to thoroughly investigate and document suspicious circumstances that they encounter during an audit. In this case, the auditors were faced with a situation in which a client executive stubbornly refused to adopt much needed improvements in an accounting module that he controlled. No doubt, in hindsight, most of us would view such a scenario as a "where there's smoke, there's likely fire" situation.

Since the litigation in this case was resolved privately, the case does not have a clear-cut "outcome." As a result, you might divide your students into teams to "litigate" the case themselves. Identify three groups of students: one set of students who will argue the point that the auditors in this case were guilty of some degree of malfeasance, another set of students who will act as the auditors' defense counsel, and a third set of students (the remainder of your class?) who will serve as the "jury."

Suggested Solutions to Case Questions

1. The phrase "audit risk" refers to the likelihood that an auditor "may unknowingly fail to appropriately qualify his or her opinion on financial statements that are materially misstated" [AU 312.02]. "Inherent risk," "control risk," and "detection" risk are the three individual components of audit risk. Following are brief descriptions of these components that were taken from AU 312 (paragraphs 21 and 24):

Inherent risk: the susceptibility of a relevant assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls.

Control risk: the risk that a misstatement that could occur in a relevant assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented or detected on a timely basis by the entity's internal control.

Detection risk: the risk that the auditor will not detect a material misstatement that exists in a relevant assertion that could be material, either individually or when aggregated with other misstatements.

Listed next are some examples of audit risk factors that are not unique to family-owned businesses but likely common to them.

Inherent risk:

I would suggest that family-owned businesses may be more inclined to petty infighting and other interpersonal "issues" than businesses overseen by professional management teams. Such conflict may cause family-owned businesses to be more susceptible to intentional financial statement misrepresentations.

The undeniable impact of nepotism on most family-owned businesses may result in key accounting and other positions being filled by individuals who do not have the requisite skills for those positions.

Many family-owned businesses are small and financially-strapped. Such businesses are more inclined to window-dress their financial statements to impress bankers, potential suppliers, and other third parties.

Control risk:

The potential for "petty infighting" and other interpersonal problems within family-owned businesses may result in their internal control policies and procedures being intentionally subverted by malcontents.

Likewise, nepotism tendencies in small businesses can affect the control risk as well as the inherent risk posed by these businesses. A business that has a less than competent controller or accounts receivable bookkeeper, for that matter, is more likely to have control "problems."

The limited resources of many family-owned business means that they are less likely than other entities to provide for a comprehensive set of checks and balances in their accounting and control systems. For example, proper segregation of duties may not be possible in these businesses.

I would suggest that it may be more difficult for family-owned businesses to establish a proper control environment. Family relationships, by definition, are typically built on trust, while business relationships require a certain degree of skepticism. A family business may find it difficult to establish formal policies and procedures that require certain family members to "look over the shoulder" and otherwise monitor the work of other family members.

Detection risk:

The relatively small size of many family-owned businesses likely requires them to bargain with their auditors to obtain an annual audit at the lowest cost possible. Such bargaining may result in auditors "cutting corners" to complete the audit.

Independent auditors often serve as informal business advisors for small, family-owned audit clients. These dual roles may interfere with the ability of auditors to objectively evaluate such a client's financial statements.

How should auditors address these risk factors? Generally, by varying the nature, extent, and timing of their audit tests. For example, if a client does not have sufficient segregation of key duties, then the audit team will have to take this factor into consideration in planning the annual audit. In the latter circumstance, one strategy would be to complete a "balance sheet" audit that places little emphasis or reliance on the client's internal controls. [Note: Modifying the nature, extent, and timing of audit tests may not be a sufficient or proper response to the potential detection risk factors identified above. Since each of those risk factors involves an auditor independence issue, the only possible response to those factors may simply be asking the given client to retain another audit firm.]

Final note: Recall that the federal judge in this case suggested that "subjecting the auditors to potential liability" is an appropriate strategy for society to use to help ensure that family-owned businesses prepare reliable financial statements for the benefit of third-party financial statement users. You may want to have your students consider how this attitude on the part of federal judges affects audit firms and the audits that they design and perform for such clients. In my view, this factor is not a component of "audit risk" but clearly poses a significant economic or "business" risk for audit firms.

2. The primary audit objectives for a client's inventory are typically corroborating the "existence" and "valuation" assertions (related to account balances). For the Prepaid Inventory account, Grant Thornton's primary audit objective likely centered on the existence assertion. That is, did the several million dollars of inventory included in the year-balance of that account actually exist? Inextricably related to this assertion was the issue of whether JGI management had achieved a proper "cutoff" of the prepaid inventory transactions at the end of each fiscal year. If management failed to ensure that prepaid inventory receipts were properly processed near the end of the year, then certain prepaid inventory shipments might be included in the year-end balances of both Prepaid Inventory and Merchandise Inventory. For the Merchandise Inventory account, both the existence and valuation assertions were likely key concerns of Grant Thornton. Since JGI's inventory involved perishable products, the Grant Thornton auditors certainly had to pay particularly close attention to the condition of that inventory while observing the year-end counting of the warehouse.

3. The controversial issue in this context is whether Grant Thornton was justified in relying on the delivery receipts given the "segregation of duties" that existed between JGI's receiving function and accounting function for prepaid inventory. In one sense, Grant Thornton was correct in maintaining

that there was "segregation of duties" between the preparation of the delivery receipts and the subsequent accounting treatment applied to those receipts. The warehouse manager prepared the delivery receipts independently of Fred Greenberg, who then processed the delivery receipts for accounting purposes. However, was this segregation of duties sufficient or "adequate"? In fact, Fred Greenberg had the ability to completely override (and did override) the control served by having the delivery receipts prepared and processed by different individuals.

You may want to reinforce to your students that the validity of the delivery receipts as audit evidence was a central issue in this case. Clearly, the judge who presided over the case was dismayed by Grant Thornton's decision to place heavy reliance on the delivery receipts in deciding to "sign off" on the prepaid inventory balance each year. The problem with practically any internally-generated document, such as the delivery receipts, is that they are susceptible to being subverted by two or more client employees who collude with each other or by one self-interested executive who has the ability to override the client's internal controls. On the other hand, externally-prepared documents (such as contracts or external purchase orders) provide stronger audit evidence since they are less susceptible to being altered or improperly prepared.

4. The phrase "walk-through audit test" refers to the selection of a small number of client transactions and then tracking those transactions through the standard steps or procedures that the client uses in processing such transactions. The primary purpose of these tests is to gain a better understanding of a client's accounting and control system for specific types of transactions. Likewise, walk-through tests can be used by auditors to confirm the accuracy of flowchart and/or narrative depictions of a given transaction cycle within a client's accounting and control system. [Note: as pointed out by the expert witness retained by JGI's bankruptcy trustee, if Grant Thornton had performed a walk-through audit test for JGI's prepaid inventory transactions, the audit firm almost certainly would have discovered that the all-important Form 9540-1 documents were available for internal control and independent audit purposes.]

PCAOB Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements," mandated that auditors of SEC registrants perform a walk-through audit test for "each major class of transactions"—see paragraph 79 of that standard. However, that standard was subsequently superceded by *PCAOB Auditing Standard No. 5*, "An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements." *PCAOB No. 5* does not require walk-throughs. The ASB has never issued a standard that mandates the performance of walk-throughs.

5. As a point of information, I have found that students typically enjoy this type of exercise, namely, identifying audit procedures that might have resulted in the discovery of a fraudulent scheme. In fact, what students enjoy the most in this context is "shooting holes" in suggestions made by their colleagues. "That wouldn't have worked because . . .," "That would have been too costly," or "How could you expect them to think of that?" are the types of statements that are often prompted when students begin debating their choices. Of course, such debates can provide students with important insights that they would not have obtained otherwise.

During the interim tests of controls each year, the auditors could have collected copies of a sample of delivery receipts. Then, the auditors could have traced these delivery receipts into the prepaid inventory accounting records to determine whether shipments of imported meat products were being recorded on a timely basis in those records. For example, the auditors could have examined the

prepaid inventory log to determine when the given shipments were deleted from that record. Likewise, the auditors could have tracked the shipments linked to the sample delivery receipts into the relevant reclassification entry prepared by Steve Cohn (that transferred the given inventory items from Prepaid Inventory to Merchandise Inventory) to determine if this entry had been made on a timely basis.

Similar to the prior suggestion, the auditors could have obtained copies of the freight documents (bills of lading, etc.) for a sample of prepaid inventory shipments. Then, the auditors could have tracked the given shipments into the prepaid inventory records to determine whether those shipments had been transferred on a timely basis from the Prepaid Inventory account to the Merchandise Inventory account.

During the observation of the physical inventory, the auditors might have been able to collect identifying information for certain imported meat products and then, later in the audit, have traced that information back to the prepaid inventory log to determine whether the given items had been reclassified out of Prepaid Inventory on a timely basis. This procedure may have been particularly feasible for certain seasonal and low volume products that JGI purchased for sale only during the year-end holiday season.

In retrospect, it seems that extensive analytical tests of JGI's financial data might have revealed implausible relationships involving the company's inventory, cost of goods sold, accounts payable, and related accounts. Of course, the federal judge who presided over this case suggested that the auditors should have been alerted to the possibility that something was awry by the dramatic increase in prepaid inventory relative to sales.

6. An audit firm (of either an SEC registrant or another type of entity) does not have a responsibility to "insist" that client management correct internal control deficiencies. However, the failure of client executives to do so reflects poorly on their overall control consciousness, if not integrity. Similar to what happened in this case, an audit firm may have to consider resigning from an engagement if client management refuses to address significant internal control problems. (Of course, in some circumstances, client management may refuse to address internal deficiencies because it would not be cost-effective to do so.)

Note: *PCAOB Auditing Standard No. 5*, "An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements," provides extensive guidance to auditors charged with auditing a public client's financial statements while at the same time auditing that client's "management's assessment of the effectiveness of internal control over financial reporting." For example, *PCAOB No. 5* mandates that auditors report all "material weaknesses" in writing to client management and to the audit committee (paragraph 78). Likewise, auditors must report to the client's audit committee all "significant deficiencies" in internal controls that they discover (paragraph 80). But, again, *PCAOB No. 5* does not require auditors to "insist" that their clients eliminate those material weaknesses or significant deficiencies.

CASE 2.2

GOLDEN BEAR GOLF, INC.

Synopsis

According to one sports announcer, Jack Nicklaus became "a legend in his spare time." Nicklaus still ranks as the best golfer of all time in the minds of most pasture pool aficionados—granted, he may lose that title soon if Tiger Woods continues his onslaught on golfing records. Despite his prowess on the golf course, Nicklaus has had an up and down career in the business world. In 1996, Nicklaus spun off a division of his privately owned company to create Golden Bear Golf, Inc., a public company whose primary line of business was the construction of golf courses. Almost immediately, Golden Bear began creating headaches for Nicklaus. The new company was very successful in obtaining contracts to build golf courses. However, because the construction costs for these projects were underestimated, Golden Bear soon found itself facing huge operating losses. Rather than admit their mistakes, the executives who obtained the construction contracts intentionally inflated the revenues and gross profits for those projects by misapplying the percentage-of-completion accounting method. This case focuses principally on the audits of Golden Bear that were performed by Arthur Andersen & Co. An SEC investigation of the Golden Bear debacle identified numerous "audit failures" allegedly made by the company's auditors. In particular, the Andersen auditors naively relied on feeble explanations provided to them by client personnel for a series of suspicious transactions and circumstances that they uncovered.

Golden Bear Golf, Inc.--Key Facts

1. Jack Nicklaus has had a long and incredibly successful career as a professional golfer, which was capped off by him being named the Player of the Century.

2. Like many professional athletes, Nicklaus became involved in a wide range of business interests related to his sport.

3. In the mid-1980s, Nicklaus's private company, Golden Bear International (GBI), was on the verge of bankruptcy when he stepped in and named himself CEO; within a few years, the company had returned to a profitable condition.

4. In 1996, Nicklaus decided to "spin off" a part of GBI to create a publicly owned company, Golden Bear Golf, Inc., whose primary line of business would be the construction of golf courses.

5. Paragon International, the Golden Bear subsidiary responsible for the company's golf course construction business, quickly signed more than one dozen contracts to build golf courses.

6. Paragon incurred large losses on many of the golf course construction projects because the subsidiary's management team underestimated the cost of completing those projects.

7. Rather than admit their mistakes, Paragon's top executives chose to misrepresent the subsidiary's operating results by misapplying the percentage-of-completion accounting method.

8. In 1998, the fraudulent scheme was discovered, which resulted in a restatement of Golden Bear's financial statements, a class-action lawsuit filed by the company's stockholders, and SEC sanctions imposed on several parties, including Arthur Andersen, Golden Bear's audit firm.

9. The SEC charged the Andersen auditors with committing several "audit failures," primary among them was relying on oral representations by client management for several suspicious transactions and events discovered during the Golden Bear audits.

10. The Andersen partner who served as Golden Bear's audit engagement partner was suspended from practicing before the SEC for one year.

Instructional Objectives

1. To demonstrate the need for auditors to have an appropriate level of skepticism regarding the financial statements of all audit clients, including prominent or high-profile audit clients.

2. To demonstrate that oral management representations is a weak form of audit evidence.

3. To examine audit risks posed by the percentage-of-completion accounting method.

4. To illustrate the need for auditors to thoroughly investigate suspicious transactions and events that they discover during the course of an engagement.

5. To examine the meaning of the phrase "audit failure."

Suggestions for Use

Many, if not most, of your students will be very familiar with Jack Nicklaus and his sterling professional golf career, which should heighten their interest in this case. One of the most important learning points in this case is that auditors must always retain their professional skepticism. Encourage your students to place themselves in Michael Sullivan's position. Sullivan had just acquired a new audit client, the major stockholder of which was one of the true superstars of the sports world. I can easily understand that an audit engagement partner and his or her subordinates might be inclined to grant that client the "benefit of the doubt" regarding any major audit issues or problems that arise. Nevertheless, even in such circumstances students need to recognize the importance of auditors' maintaining an appropriate degree of professional skepticism.

You may want to point out to your students that because of the subjective nature of the percentage-of-completion accounting method, it is arguably one of the most easily abused accounting methods. Over the years, there have been numerous "audit failures" stemming from misuse or misapplication of this accounting method.

Suggested Solutions to Case Questions

1. Note: I have not attempted to identify every management assertion relevant to Paragon's construction projects. Instead, this suggested solution lists what I believe were several key management assertions for those projects. Additional note: When auditing long-term construction projects for which the percentage-of-completion accounting method is being used, the critical audit issue is whether the client's estimated stages of completion for its projects are reliable. As a result, most of the following audit issues that I raise regarding Paragon's projects relate directly or indirectly to that issue.

Existence/occurrence: *In SAS No. 106*, "existence" is an "account balance-related" assertion that refers to whether specific assets or liabilities exist at a given date. "Occurrence," on the other hand, is a "transaction-related" assertion that refers to whether a given transaction or class of transactions

actually took place. On the Golden Bear audits, these two assertions were intertwined. The existence assertion pertained to the unbilled receivables, while the occurrence assertion related to the unbilled revenue, each of which Paragon booked as a result of overstating the stages of completion of its construction projects. To investigate whether those unbilled receivables actually existed and whether the related revenue transactions had actually occurred, the Andersen auditors could have made site visitations to the construction projects. Andersen could also have contacted the given owners of the projects to obtain their opinion on the stages of completion of the projects—if the stages of completion were overstated, some portion of the given unbilled receivables did not "exist." (Of course, this procedure was carried out for one of the projects by subordinate members of the Andersen audit team.) The auditors could have also discussed the stages of completion directly with the onsite project managers and/or the projects' architects.

Valuation (and allocation): This account balance-related assertion relates to whether "assets, liabilities, and equity interests are included in the financial statements at appropriate amounts" and whether "any resulting valuation or allocation adjustments are appropriately recorded" (AU Section 326.15). This assertion was relevant to the unbilled receivables that Paragon recorded on its construction projects and was obviously closely linked to the existence assertion for those receivables. Again, any audit procedure that was intended to confirm the reported stages of completion of Paragon's construction projects would have been relevant to this assertion. Michael Sullivan attempted to address this assertion by requiring the preparation of the comparative schedules that tracked the revenue recorded on Paragon's projects under the earned value method and the revenue that would have been recorded if Paragon had continued to apply the cost-to-cost method. Of course, client management used the $4 million ruse involving the uninvoiced construction costs to persuade Sullivan that his analysis was incorrect.

Occurrence: The occurrence assertion was extremely relevant to the $4 million of uninvoiced construction costs that Paragon recorded as an adjusting entry at the end of fiscal 1997. The uninvoiced construction costs allowed Paragon to justify booking a large amount of revenue on its construction projects. To test this assertion, the Andersen auditors could have attempted to confirm some of the individual amounts included in the $4 million figure with Paragon's vendors.

Classification and understandability: This presentation and disclosure-related assertion was relevant to the change that Paragon made from the cost-to-cost to the earned value approach to applying the percentage-of-completion accounting method. By not disclosing the change that was made in applying the percentage-of-completion accounting method, Golden Bear and Paragon's management was making an assertion to the effect that the change was not required to be disclosed to financial statement users. The Andersen auditors could have tested this assertion by researching the appropriate professional standards and/or by referring the matter to technical consultants in their firm's national headquarters office.

Completeness: Although not addressed explicitly in the case, the SEC also briefly criticized Andersen for not attempting to determine whether Paragon's total estimated costs for its individual construction projects were reasonable, that is, "complete." To corroborate the completeness assertion for the estimated total construction costs, Andersen could have discussed this matter with architects and/or design engineers for a sample of the projects. Alternatively, Andersen could have

reviewed cost estimates for comparable projects being completed by other companies and compared those estimates with the ones developed for Paragon's projects.

2. The term "audit failure" is not expressly defined in the professional literature. Apparently, the SEC has never defined that term either. One seemingly reasonable way to define "audit failure" would be "the failure of an auditor to comply with one or more generally accepted auditing standards." A more general and legal definition of "audit failure" would be "the failure to do what a prudent practitioner would have done in similar circumstances." The latter principle is commonly referred to as the "prudent practitioner concept" and is widely applied across professional roles to determine whether a given practicing professional has behaved negligently.

"No," Sullivan alone was clearly not the only individual responsible for ensuring the integrity of the Golden Bear audits. Sullivan's subordinates, particularly the audit manager and audit senior assigned to the engagement, had a responsibility to ensure that all important issues arising on those audits were properly addressed and resolved. This latter responsibility included directly challenging any decisions made by Sullivan that those subordinates believed were inappropriate. Audit practitioners, including audit partners, are not infallible and must often rely on their associates and subordinates to question important "judgment calls" that are made during the course of an engagement. The "concurring" or "review" partner assigned to the Golden Bear audits also had a responsibility to review the Golden Bear audit plan and audit workpapers and investigate any questionable decisions apparently made during the course of the Golden Bear audits. Finally, Golden Bear's management personnel, including Paragon's executives, had a responsibility to cooperate fully with Sullivan to ensure that a proper audit opinion was issued on Golden Bear's periodic financial statements.

3. Most likely, Andersen defined a "high-risk" audit engagement as one on which there was higher than normal risk of intentional or unintentional misrepresentations in the given client's financial statements. I would suggest that the *ultimate* responsibility of an audit team is the same on both a "high-risk" and a "normal risk" audit engagement, namely, to collect sufficient appropriate evidence to arrive at an opinion on the given client's financial statements. However, the nature of the operational responsibilities facing an audit team on the two types of engagements are clearly different. For example, when a disproportionate number of "fraud risk factors" are present, the planning of an audit will be affected. Likewise, in the latter situation, the nature, extent, and timing of audit procedures will likely be affected. For example, more extensive auditing tests are typically necessary when numerous fraud risk factors are present.

4. "Yes," auditors do have a responsibility to refer to any relevant AICPA *Audit and Accounting Guides* when planning and carrying out an audit. These guides do not replace the authoritative guidance included in *Statements on Auditing Standards* but rather include "recommendations on the application of SASs in specific circumstances." Following is an excerpt from the prologue of one *Audit and Accounting Guide*.

> "Auditing guidance included in an *AICPA Audit and Accounting Guide* is an interpretive publication pursuant to *Statement on Auditing Standards (SAS) No. 95*, 'Generally Accepted Auditing Standards.' Interpretive publications are recommendations on the application of SASs in specific circumstances, including engagements for entities in specialized industries. Interpretive publications are issued under the authority of the Auditing Standards Board. The

members of the Auditing Standards Board have found this guide to be consistent with existing SASs.

The auditor should be aware of and consider interpretive publications applicable to his or her audit. If the auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance."

5. The following footnote was included in *Accounting and Auditing Enforcement Release No. 1676*, which was a primary source for the development of this case. "Regardless of whether the adoption of the 'earned value' method was considered a change in accounting principle or a change in accounting estimate, disclosure by the company in its second quarter 1997 interim financial statements and its 1997 annual financial statements was required to comply with GAAP." In the text of the enforcement release, the SEC referred to the switch from the cost-to-cost method to the earned value method as a change in "accounting methodology," which seems to suggest that the SEC was not certain how to classify the change. However, *APB Opinion No. 20*, "Accounting Changes," which was in effect during the relevant time frame of this case, and *SFAS No. 154*, "Accounting Changes and Error Corrections," the new FASB standard that replaced *APB No. 20*, point out that the phrase "accounting principle" refers to accounting principles or practices and "to the methods of applying them." This statement implies, to me at least, that Paragon's switch from the cost-to-cost approach to the earned value approach of applying the percentage-of-completion accounting method was a "change in accounting principle."

Under *SFAS No. 154*, a change in accounting principle "shall be reported by retrospective application unless it is impracticable to determine either the cumulative effect or the period-specific effects of the change." This is an important difference with the prior standard, *APB No. 20*, that required a "cumulative effect of a change in accounting principle" to be reported by the given entity in its income statement for the period in which the change was made. *SFAS No. 154* requires that a change in accounting estimate "shall be accounted for in the (a) period of change if the change affects that period only or (b) the period of change and future periods if the change affects both."

In terms of financial statement disclosure, *SFAS No. 154* mandates that the "nature of and justification for the change in accounting principle shall be disclosed in the financial statements of the period in which the change is made." Regarding changes in accounting estimates, this standard notes that, "When an entity makes a change in accounting estimate that affects several future periods (such as a change in service lives of depreciable assets), it shall disclose the effect on income before extraordinary items, net income, and related per-share amounts of the current period."

CASE 2.3

HAPPINESS EXPRESS, INC.

Synopsis

In 1989, two longtime sales reps in the toy industry, Joseph and Isaac Sutton, founded Happiness Express, Inc. The business model developed by the Sutton brothers involved acquiring the licensing rights to market toys and other merchandise featuring popular characters appearing in movies, television programs, and books and other publications intended principally for children. The company got off to a quick start, thanks to the uncanny ability of the Sutton brothers to identify children's characters, such as The Little Mermaid and Barney, that would have tremendous appeal among children. By 1994, the company had annual sales of $40 million. That same year, the Sutton brothers took Happiness Express public with a successful IPO.

By 1995, the company's "hottest" line of merchandise featured the Mighty Morphin Power Rangers. In fact, 75 percent of the company's reported revenues for fiscal 1995 resulted from sales of Power Rangers toys and merchandise. Unfortunately for the Sutton brothers and their fellow stockholders, sales of Power Rangers merchandise began falling dramatically near the end of the company's 1995 fiscal year as children's interest in the enigmatic crusaders subsided. To sustain their company's impressive profit and revenue trends, Happiness Express booked several million dollars of fictitious sales and accounts receivable near the end of fiscal 1995. (Ironically, the fraudulent scheme resulted in Happiness Express being named the "#1 Hot Growth Company" in the United States by *Business Week*.)

Public allegations of insider trading involving Happiness Express's executives and hints of financial irregularities in its accounting records prompted an SEC investigation and ultimately resulted in the company filing for bankruptcy in the fall of 1996. A class-action lawsuit by Happiness Express's stockholders targeted Coopers & Lybrand, which had issued unqualified opinions on the company's financial statements each year through fiscal 1996. The principal thrust of the lawsuit was that Coopers & Lybrand recklessly audited Happiness Express's sales and accounts receivable, which prevented the firm from discovering the bogus sales and receivables entered in the company's accounting records near the end of fiscal 1995. This case examines the audit procedures that Coopers & Lybrand applied to Happiness Express's sales and receivables, with a particular focus on the firm's receivables confirmation and sales cut-off procedures.

Happiness Express, Inc.--Key Facts

1. In 1989, Joseph and Isaac Sutton founded Happiness Express, Inc., a small toy company that marketed licensed merchandise featuring popular children's characters.

2. During the early 1990s, Happiness Express's revenues grew rapidly; in May 1995, Happiness Express was named the "#1 Hot Growth Company" in the United States by *Business Week*.

3. Happiness Express was heavily dependent on the continued popularity of certain children's characters for which it had purchased licensing rights; for example, in fiscal 1995, sales of Mighty Morphin Power Rangers merchandise accounted for 75% of the company's total revenues.

4. Happiness Express began experiencing financial problems during the spring of 1995 when sales of its Power Rangers merchandise began falling sharply.

5. To conceal Happiness Express's deteriorating financial condition, company executives booked several million dollars of fictitious sales near the end of fiscal 1995.

6. When the fraudulent scheme was uncovered, Happiness Express's stockholders filed a class-action lawsuit against Coopers & Lybrand, which had issued unqualified opinions on the company's financial statements through fiscal 1996.

7. The primary focus of the lawsuit was on the audit procedures that Coopers & Lybrand had applied to Happiness Express's sales and year-end receivables for fiscal 1995.

8. Plaintiff attorneys argued that Coopers & Lybrand had overlooked key red flags regarding Happiness Express's sales and receivables and, consequently, failed to develop a proper audit plan for the 1995 audit engagement.

9. Coopers & Lybrand was also charged with recklessly performing year-end sales cutoff tests and accounts receivable confirmation procedures during the 1995 audit.

10. In 2002, Coopers & Lybrand agreed to pay $1.3 million to resolve the class-action lawsuit.

Instructional Objectives

1. To make students aware of the need for auditors to identify the unique or atypical audit risks posed by specific industries and client business models.

2. To demonstrate the importance of auditors' obtaining a thorough understanding of their client's operations and any major changes in those operations that have occurred since the prior year's audit.

3. To demonstrate the need for auditors to thoroughly investigate large and/or suspicious year-end transactions recorded by a client.

4. To discuss the nature of, and audit objectives associated with, sales cutoff tests and accounts receivable confirmation procedures.

Suggestions for Use

Consider using this case to illustrate the audit objectives related to accounts receivable and sales as well as the audit procedures that can be used to accomplish those objectives. In particular, this case can be used to provide your students with a solid understanding of the nature and purpose of year-end sales cutoff tests and accounts receivable confirmation procedures. Another important feature of this case is that it demonstrates the need for auditors to identify and carefully consider important "red flags" present in their clients' accounting records or in key circumstances surrounding those records. No doubt, one of the "top 10" red flags associated with financial frauds is large and unusual year-end transactions. In this case, the auditors apparently did not carefully scrutinize large and unusual sales transactions recorded by the client on the final day of its fiscal year. Another important feature of this case is that it clearly demonstrates that auditors should take a "big picture" view of their client when planning an audit. Key features of a client's industry (for example, in this case, the difficulty of predicting children's taste in toys) and critical elements of a client's business model (in this case, the heavy reliance of Happiness Express on one or a few lines of merchandise) can have significant implications for the successful completion of an audit.

Suggested Solutions to Case Questions

1. "Existence" and "valuation" are the primary management assertions that auditors hope to corroborate when confirming a client's accounts receivable. Confirmation procedures are particularly useful for supporting the existence assertion. A client's customer may readily confirm that a certain amount is owed to the client (existence assertion); however, whether that customer is willing and/or able to pay the given amount (valuation assertion) is another issue.

Not surprisingly, year-end sales cutoff tests are used to corroborate the "cutoff" assertion for individual transactions or classes of transactions. These tests are designed to determine whether transactions have been recorded in the proper accounting period. The "completeness" assertion is also a primary focus of year-end cutoff tests, particularly for expense and liability transactions.

When examining a client's year-end sales cutoff, auditors intend to determine whether the client properly sorted sales transactions near the end of the fiscal year into the proper accounting period—either the fiscal year under audit or the "new" fiscal year. If a sales transaction recorded on the last day of a client's fiscal year actually occurred on the following day, then the cutoff assertion has been violated. A sales transaction that was recorded on the first day of the new fiscal year but that was actually a valid transaction of the "old" fiscal year is another example of a violation of the cutoff assertion. [You might point out that both types of errors—when they are "honest" errors--are typically due to client personnel improperly applying the FOB shipping point/FOB destination features of year-end sales or improperly applying other criteria that clients have established to determine when "a sale is a sale." As a general rule, companies can establish any reasonable cutoff criteria for year-end sales as long as those criteria are applied consistently from period to period.]

2. I would suggest that Coopers & Lybrand made three mistakes or errors in judgment vis-a-vis the Wow Wee confirmation. **First**, from the facts reported in the legal transcript used to prepare this case, the auditors effectively allowed Goldberg to take control of the confirmation process for the Wow Wee account. Throughout the confirmation process, auditors should maintain control over the confirmation requests and responses to minimize the risk that client personnel will attempt to intercept and/or alter those requests and responses. **Second**, the auditors apparently did not take all necessary precautions regarding the acceptance of facsimile confirmations. "Facsimile responses involve risks because of the difficulty of ascertaining the sources of the responses. To restrict the risks associated with facsimile responses and treat the confirmations as valid audit evidence, the auditor should consider taking certain precautions, such as verifying the source and contents of a facsimile response in a telephone call to the purported sender. In addition, the auditor should consider requesting the purported sender to mail the original confirmation directly to the auditor." [AU 330.28] **Third**, given the circumstances, the auditors likely should have considered performing additional procedures to corroborate the existence assertion for the Wow Wee receivable. For example, the auditors could have reviewed subsequent payments made on that account.

Following are definitions/descriptions that I have found very useful in helping students distinguish among the three key types of auditor misconduct. These definitions were taken from the following source: D.M. Guy, C.W. Alderman, and A.J. Winters, **Auditing, Fifth Edition** (San Diego: Dryden, 1999), 85-86.

> **Negligence**. "The failure of the CPA to perform or report on an engagement with the due professional care and competence of a prudent auditor." Example: An auditor fails to test a client's reconciliation of the general ledger controlling account for receivables to the subsidiary ledger for receivables and, as a result, fails to detect a material overstatement of the general ledger controlling account.
>
> **Recklessness** (a term typically used interchangeably with gross negligence and constructive fraud). "A serious occurrence of negligence tantamount to a flagrant or reckless departure from the standard of due care." Example: Evidence collected by an auditor suggests that a client's year-end inventory balance is materially overstated. Because the auditor is in a hurry to complete the engagement, he fails to investigate the potential inventory overstatement and instead simply accepts the account balance as reported by the client.

> **Fraud**. "Fraud differs from gross negligence [recklessness] in that the auditor does not merely lack reasonable support for belief but has both knowledge of the falsity and intent to deceive a client or third party." Example: An auditor accepts a bribe from a client executive to remain silent regarding material errors in the client's financial statements.

I do not have access to all of the facts pertinent to this case since it never went to trial, as a result, I do not feel comfortable characterizing Coopers & Lybrand's misconduct as negligent, reckless, or fraudulent. But, I assure you, your students will be more than happy to complete this task for me. [Note: the information presented in this case was drawn from a preliminary ruling issued by Judge Robert Patterson who had been assigned to preside over the lawsuit filed by Happiness Express's former stockholders. Much of the information presented in his ruling was simply a rehash of the key allegations made by the plaintiff legal counsel.]

3. Given the size of the West Coast receivable—it represented approximately 13% of Happiness Express's year-end accounts receivable, which, in turn accounted for 32% of the company's total assets—it certainly seems reasonable to conclude that the account should have been confirmed. Since this case never went to trial, Coopers & Lybrand did not have an opportunity to give a full accounting for, or justification of, its decision not to confirm the West Coast account. In responding to an early legal brief in the case, Coopers & Lybrand did report, according to Judge Patterson's preliminary ruling in the case, that it "examined cash receipts that West Coast paid after year-end." However, Judge Patterson's ruling indicates that the accounting firm did not "cite workpapers or other evidence to support this claim," nor did the firm challenge plaintiff counsel's allegation that the failure to confirm the West Coast account was a violation of a generally accepted auditing procedure.

Plaintiff counsel criticized Coopers & Lybrand for not including any of the bogus West Coast sales transactions in its year-end sales cutoff tests. However, apparently none of those sales occurred in the year-end cutoff period defined by Coopers & Lybrand—although the case does not indicate the length of the year-end cutoff period, it typically includes the five business days on either side of the client's fiscal year-end. [Note: As pointed out in the case, the bulk of the bogus West Coast sales were booked in the last month of fiscal 1995, but apparently *not* in the final few days of fiscal 1995—which was the case for the bogus Wow Wee sales. So, you would not have expected any of the bogus West Coast sales to be included in the year-end sales cutoff test.]

4. Examination of subsequent cash receipts and inspection of shipping documents are the two most common "alternative" procedures auditors apply when a confirmation cannot be obtained for a large receivable. Another alternative procedure in such circumstances is simply to sit down with appropriate client personnel and have a heart-to-heart discussion regarding the given receivable. The purpose of this discussion would be to determine whether the client is aware of any unusual risks or circumstances regarding the given receivable that have important audit implications.

Generally, a positive confirmation received from an independent third party, such as a client's customer, is considered to be more reliable than the evidence yielded by the alternative procedures identified in the prior paragraph. For example, a deceitful audit client may "fake" shipping documents and subsequent cash receipts to conceal the true nature of bogus sales transactions.

5. You will not find a reference to "insider trading" in the topical index to the professional auditing standards. Nevertheless, insider trading is clearly an "illegal act" that may have significant

implications for a client and significant implications for the client's independent audit firm. AU Section 317 discusses at length auditors' responsibilities regarding illegal acts perpetrated by a client. AU 317.05 notes that auditors' responsibilities for illegal acts that have a direct and material effect on a client's financial statements are the same as auditors' responsibilities for misstatements caused by error or fraud as described in AU Section 110. The principal focus of AU Section 317 is on illegal acts that have a material but indirect effect on a client's financial statements. AU 317.06 refers specifically to insider trading as an example of an illegal act that may have such an effect on a client's financial statements.

According to AU 317.07, auditors "should be aware of the possibility that such illegal acts [those having a material and indirect effect on financial statement amounts] may have occurred." That paragraph goes on to suggest that if specific information comes to the auditor's attention that provides evidence concerning the existence of such illegal acts, "the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred."

In summary, I would suggest that "yes" auditors do have a responsibility to consider the possibility that client executives have engaged in insider trading. Additionally, if they uncover evidence suggesting that insider trading has occurred, auditors have a responsibility to investigate that possibility. [AU Section 317 lists various audit procedures that can be used to investigate potential illegal acts.]