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 discover in a client's accounting and control systems and business environment.

Suggestions for Use

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. 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. AS 1101.04, "Audit Risk," of the PCAOB auditing standards defines audit risk as the "risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated, i.e., the financial statements are not presented fairly in conformity with the applicable financial reporting framework." "Inherent risk," "control risk," and "detection" risk are the three individual components of audit risk, according to AS 1101. Following are brief descriptions of these components that were also taken that standard:

•Inherent risk: refers to the susceptibility of an assertion to a misstatement, due to error or fraud, that could be material, individually or in combination with other misstatements, before consideration of any related controls.

•Control risk: the risk that a misstatement due to error or fraud that could occur in an assertion and that could be material, individually or in combination with other misstatements, will not be prevented or detected on a timely basis by the company's internal control. Control risk is a function of the effectiveness of the design and operation of internal control.
•Detection risk: the risk that the procedures performed by the auditor will not detect a misstatement that exists and that could be material, individually or in combination with other misstatements. Detection risk is affected by (1) the effectiveness of the substantive procedures and (2) their application by the auditor, i.e., whether the procedures were performed with due professional care.

According to the AICPA Professional Standards, the phrase "audit risk" refers to the likelihood that "the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated" (AU-C 200.14). "Inherent risk," "control risk," and "detection" risk are also the three individual components of audit risk within the AICPA Professional Standards. Following are brief descriptions of these components that were taken from AU-C 200.14:

•Inherent risk: the susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
•Control risk: the risk that a misstatement that could occur in an assertion about a class of transaction, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal controls.
•Detection risk: the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

(Note: Both AS 1101 and the AICPA Professional Standards point out that the product of inherent risk and control risk is commonly referred to as the "risk of material misstatement.)

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 businesses 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 perform 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 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) that control.

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 superseded by PCAOB *Auditing Standard No. 5,* "An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements"—which is now integrated into AS 2201. AS 2201 does not require walk-throughs. The AICPA Professional Standards have never mandated 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. (Granted, the effectiveness of this audit test would likely have been undermined by Fred's fraudulent conduct.)
- 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. (There would have been a lower risk of Fred's misconduct undercutting the intent of this audit test.)
- 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, 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 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 control deficiencies because it would not be cost-effective to do so.)

Note: AS 2201, “An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements,” provides guidance to auditors charged with auditing a public client’s financial statements while at the same time auditing the client’s internal control over financial reporting. AS 2201.78 mandates that auditors report all “material weaknesses” in writing to client management and to the audit committee. Likewise, auditors must report to the client’s audit committee all “significant deficiencies” in internal controls that they discover (AS 2201.80). But, again, AS 2201 does not require auditors to “insist” that their clients eliminate those material weaknesses or significant deficiencies.

Final note: in the AICPA Professional Standards, the reporting responsibilities of auditors for internal control related matters are discussed in AU-Section 265, “Communicating Internal Control Related Matters Identified in an Audit.”

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 conquers his health problems and resumes his onslaught on Jack’s 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 negotiated 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 Twentieth 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 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 easily one of the most 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. Notes: 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. 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. In this suggested solution, I apply the set of assertions included in AU-C Section 315.A128 of the AICPA Professional Standards. Recall that rather than 13 assertions spread across three categories (classes of transactions and events, account balances, and presentation and disclosure), AS 1105, "Audit Evidence," of the PCAOB's auditing standards identifies only five types of financial statement assertions, namely, existence or occurrence, completeness, valuation or allocation, rights and

obligations, and presentation and disclosure (AS 1105.11). (Of course, these latter assertions were the "official" assertions recognized by the AICPA at the time this case transpired. Recognize also that the PCAOB permits auditors to apply the AICPA's "assertions map" in planning and performing audits of public companies. That is, audit firms of SEC registrants are free to choose which of the two mappings of management assertions in the professional auditing standards that they will apply.)

•Existence/occurrence: According to AU-C 315.A128, "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 corresponding revenue linked to those receivables, 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" while the corresponding revenues had not "occurred." (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 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-C 315.A128). 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 make it appear that the two accounting methods produced effectively the same revenues/unbilled receivables.

•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 were making an assertion to the effect that the change was not required to be disclosed to financial statement users. This assertion could have been tested by researching the appropriate professional standards and/or by referring the matter to consultants in Andersen's national headquarters office.
•Completeness: Although not addressed explicitly in the case, the SEC also criticized Andersen for not attempting to determine whether Paragon's total estimated costs for its individual construction projects were reasonable, that is, "complete"—understating a project's total estimated cost allowed Golden Bear to "frontload" the revenue recorded for that project. 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 professional 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 Guide when planning and carrying out an audit based upon the AICPA Professional Standards. These guides do not replace the authoritative guidance included in AICPA Professional Standards but rather include recommendations on how to apply those standards in specific circumstances. What about audits of public companies that are guided by the PCAOB's auditing standards? After considerable research, I could not find any reference to the AICPA Audit and Accounting Guides in the PCAOB's auditing standards. As a result, those guides, apparently, are not considered authoritative literature vis-à-vis audits of public companies.

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 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." [Note: *SFAS No. 154* is now integrated into Topic 250, "Accounting Changes and Error Corrections," in the FASB Accounting Standards Codification.] 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 . . . net income, and related per-share amounts of the current period."

CASE 2.3

TAKE-TWO INTERACTIVE SOFTWARE, INC.

Synopsis

Grand Theft Auto is the sixth best-selling video game "franchise" of all time and easily ranks among the most controversial as well. The game's "adult" content has resulted in caustic and unrelenting criticism by prominent politicians, public service organizations, and major media outlets. Despite that criticism, *Grand Theft Auto* has been hugely profitable for Take-Two Interactive Software, Inc., its maker and distributor. Take-Two was founded in 1993 by 21-year-old Ryan Brant, the son of a billionaire businessman.

An SEC investigation of Take-Two's financial statements resulted in the company being forced to issue restated financial statements twice in two years shortly after the turn of the century. Then, just a few years later, Take-Two was caught up in the huge "options backdating" scandal and forced to restate its financial statements a third time. This case focuses on the underlying cause of the initial restatement, which was primarily a series of fraudulent sales transactions booked by the company in 2000 and 2001. Take-Two executives recorded those sham sales transactions to ensure that the company met or surpassed its consensus quarterly earnings forecasts established by Wall Street analysts.

Take-Two's longtime audit firm, PwC, was also caught up in the company's financial reporting scandal. One of many SEC enforcement releases issued regarding that scandal focused on the alleged misconduct of Robert Fish, the PwC partner who had supervised the 1994 through 2001 Take-Two audits. In particular, the SEC criticized the audit tests applied to Take-Two's domestic receivables by Fish and his subordinates. In addition, the PwC auditors were chastised by the SEC for their alleged failure to properly audit Take-Two's reserve for sales returns.

An interesting feature of this case is the close relationship between Robert Fish and Ryan Brant. In addition to serving as the Take-Two audit engagement partner, Fish was apparently the much younger Brant's most trusted business advisor. In fact, in an interview with a business publication Fish suggested that he and Brant effectively had a father-son type relationship. Also interesting is the fact that PwC sharply discounted the professional fees that it charged Take-Two. Those discounted fees almost certainly helped to cement PwC's relationship with the rapidly growing company.

Take-Two Interactive Software, Inc.--Key Facts

1. In 1993, when he was only 21-years-old, Ryan Brant organized Take-Two Interactive Software, a company that produced and distributed video games.

2. Robert Fish, a PwC audit partner, supervised the annual audits of Take-Two from 1994-2001; Fish also served as one of Brant's principal business advisors and, when interviewed, suggested that he had a father-son type relationship with the much younger Brant.

3. While Take-Two was in a developmental stage, PwC sharply discounted the professional fees that it charged the company.

4. Brant took his company public in 1997 to obtain the funding necessary to fuel Take-Two's growth-by-acquisition strategy.

5. A video game produced by a company acquired by Take-Two would become *Grand Theft Auto*, one of the most controversial but best-selling video games of all time.

6. An SEC investigation revealed that Take-Two executives recorded a large volume of bogus sales transactions during 2000 and 2001 to ensure that the company achieved its consensus earnings forecasts each quarterly reporting period.

7. Take-Two would ultimately be required to restate its financial statements three times over a five-year period to correct material misrepresentations resulting from the bogus sales transactions and improper "backdating" of stock option grants.

8. The SEC issued an enforcement release that criticized PwC's 2000 Take-Two audit; the enforcement release focused on improper decisions allegedly made by Robert Fish during that engagement.

9. Fish identified "revenue recognition" and "accounts receivable reserves" as areas of "higher risk" for the 2000 audit, according to the SEC, but failed to properly respond to those high-risk areas during the engagement.

10. The "alternative audit procedures" that PwC applied after realizing an extremely low response rate on its accounts receivable confirmation requests were flawed and inadequate.

11. PwC also failed to properly audit Take-Two's reserve for sales returns, which may have prevented the firm from discovering the bogus sales recorded by the company.

12. The SEC sanctioned Fish, Brant, and three other Take-Two executives; Brant resigned from Take-Two during the SEC's investigation of the company's scheme to backdate its stock option grants, a scheme that he had masterminded.

Instructional Objectives

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

2. To examine the nature of, and key audit objectives associated with, accounts receivable confirmation procedures and related "alternative audit procedures."

3. To examine the meaning of "negligent," "reckless," and "fraudulent" as those terms relate to auditor misconduct or malfeasance.

4. To identify circumstances that may threaten the de facto and apparent independence of auditors.

Suggestions for Use

You might begin class coverage of this case by asking for a show of hands of those students who have played one or more versions of *Grand Theft Auto*. If you have "age appropriate" college students, you will likely find that most of your male students have played the game, while just a smattering of your female students have experienced the game. After asking for the show of hands, I typically single out individual students and ask them to comment on whether or not they believe the game is morally objectionable. More often than not, I receive a reply similar to the following: "It's only a game!" [By the way, I have never played the game myself, although I was well aware of it and its controversial content before I developed this case.] Next, I tend to segue into a discussion of the final case question, namely, whether audit firms should accept "ethically-challenged" companies and organizations as clients. That issue often spawns a far-ranging, if not raucous, debate among students. I have found that students also enjoy debating and discussing the two auditor independence issues raised in this case: the question of whether the "father-son" relationship between the client CEO and the audit engagement partner was problematic and the question of whether PwC's independence was in any way impaired by the heavy discounting of fees charged to Take-Two when it was in a developmental stage.

Suggested Solutions to Case Questions

1. Following are the requested financial ratios for Take-Two for the period 1998-2000. Notice that the accounts receivable turnover and inventory turnover ratios are also provided.

Financial Ratios for Take-Two:

	2000	1999	1998
Age of Accts Receivable*	114.4	93.6	80.4
Age of Inventory*	63.5	57.2	57.9
Gross Profit Percentage	36.0%	29.7%	24.0%
Profit Margin Percentage	6.5%	5.3%	3.7%
Return on Assets	8.6%	9.6%	8.7%
Return on Equity	18.3%	27.1%	30.2%
Current Ratio	1.41	1.28	1.30
Debt to Equity Ratio	.88	1.72	2.08
Quality of Earnings Ratio	-2.21	-1.03	-1.12

* In days

Accts Receivable Turnover	3.19	3.90	4.54
Inventory Turnover	5.75	6.38	6.30

Equations:
A/R Turnover: net sales / average accounts receivable
Age of A/R: 365 days / accounts receivable turnover
Inventory Turnover: cost of goods sold / average inventory
Age of Inventory: 365 days / inventory turnover
Gross Profit Percentage: gross profit / net sales
Profit Margin Percentage: net income / net sales
Return on Assets: net income / average total assets
Return on Equity: net income / average stockholders' equity
Current Ratio: current assets / current liabilities
Debt to Equity: total liabilities / total stockholders' equity
Quality of Earnings: net operating cash flows / net income

Discussion:

The most prominent red flag revealed by these ratios is the extremely poor "quality of earnings" being produced by Take-Two over this three-year time frame. Investors want and expect a company to have a quality of earnings ratio higher than 1.0. Simply from a mathematical standpoint, you would expect a company to have a greater than 1.0 quality of earnings ratio because of noncash expenses, principally depreciation expense. A large number of factors may collectively or individually produce a negative quality of earnings ratio for a given company. One such factor is the recording of fraudulent sales—the bogus accounts receivable due to fraudulent sales simply "pile up" on the given company's balance sheet in such circumstances and cause net income to be higher than net operating cash flows. Notice that the negative quality of earnings ratios being experienced over the time frame 1998-2000 was accompanied by a telltale slowdown in accounts receivable turnover (which, in turn, caused Take-Two's age of receivables to increase significantly).

Notice also that Take-Two's age of inventory was increasing between 1998 and 2000 but not as consistently or dramatically as the company's age of receivables. One cause of an increasing age of inventory is the fact that a company is overstating its period-ending inventory. Consequently, an increasing age of inventory should prompt auditors to focus more attention on the existence and valuation assertions for that account. Note: The SEC did not allege that Take-Two was overstating its inventories. However, given that the company was recording bogus sales/receivables, it is certainly a possibility that it was also overstating its period-ending inventory, particularly given the slowing inventory turnover.

Another key red flag that suggested something may have been awry in Take-Two's reported operating results was the significant increases in the company's gross profit percentage and profit margin percentage during the year 2000. As noted in the case, many of Take-Two's competitors went out of business as a direct result of the challenging economic conditions that accompanied the "tech crash" that began in early 2000. Auditors of a company that is "bucking" such a trend by reporting impressive financial data should definitely consider the possibility that the client is somehow window-dressing its financial statements.

2. "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.

The key difference between positive and negative confirmation requests is that the given third party is asked to respond to a positive confirmation request whether or not the information to be confirmed is accurate, while for a negative confirmation request the third party is asked to respond only if the information to be confirmed is not accurate. Auditors must perform other audit procedures (alternative audit procedures) in those instances in which the third party does not return a positive confirmation request. No follow-up procedures are necessary when the auditor does not receive a response to a negative confirmation request. Given the fundamental difference between positive and negative confirmation requests, the audit evidence yielded by the former is of much higher quality (much more reliable) than audit evidence yielded by the latter.

AS 2310, "The Confirmation Process," of the PCAOB's auditing standards is the authoritative source in this context for audits of SEC registrants, such as Take-Two. AU-C Section 505, "External Confirmations," of the AICPA Professional Standards discusses at length the use of confirmation procedures to collect audit evidence in audits of other types of entities. Both of these sections of the respective standards suggest that negative confirmations provide less persuasive audit evidence than positive confirmations. AS 2310.20 notes that negative confirmation requests may be used by auditors when the following three circumstances are present: "(a) the combined assessed level of inherent risk and control risk is low, (b) a large number of small balances is involved, and (c) the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration."

3. AS 2310.32 of the PCAOB's auditing standards identifies the following "alternative procedures" that may be applied by an auditor when a positive confirmation request has failed to produce a response: "examination of subsequent cash receipts (including matching such receipts with the actual items being paid), shipping documents, or other client documentation." Notice the parenthetical statement which is very relevant to the Take-Two case. The SEC specifically criticized the PwC auditors for failing to "match up" subsequent cash receipts with the actual amounts being paid. Likewise, PwC only examined $18 million of subsequent cash receipts when the total recorded value of the unconfirmed receivables was approximately $100 million. (Note: Paragraph A24 of AU-C Section 505, "External Confirmations," of the AICPA Professional Standards identifies the same "alternative procedures" in this context as AS 2310.)

Ironically, the results of alternative audit procedures may, in fact, yield stronger audit evidence than that yielded by a properly returned and signed positive confirmation. This is particularly true when the auditor examines subsequent cash collections and is able to trace those cash receipts to the specific items that were included in the given receivable. Despite this possibility, however, auditors typically prefer that the client's customers confirm their period-ending balances by signing and returning a positive confirmation request. Why? Because considerably less audit effort is required in such circumstances and the quality of the audit evidence provided is almost always deemed acceptable.

4. The following list of alleged and/or potential deficiencies in the 2000 PwC audit of Take-Two will be helpful in responding to this question: failing to properly respond to high audit risk areas identified during the planning phase of the engagement, failing to investigate why such a modest response rate was received from the positive confirmation requests, failing to determine that the one positive confirmation request received was invalid (see footnote 18), accepting as audit evidence for the unconfirmed receivables subsequent cash receipts that could not be traced to specific invoiced sales amounts, identifying and reviewing only a modest amount of subsequent cash receipts related to the unconfirmed accounts receivable, failing to track the sample of five sales returns to specific invoiced sales transactions or otherwise investigate the validity of those sales returns. Of course, more general, broad-brush allegations were included in the SEC enforcement release. The case notes, for example, that the SEC charged that Fish "failed to exercise due professional care and professional skepticism."

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.

We can certainly conclude that the PwC auditors were not fraudulent in this case because they were unaware of the client's indiscretions and there was no effort on their part to deceive third-party users of Take-Two's financial statements. Regarding the question of whether the auditors were negligent or reckless, recognize that the SEC enforcement release that focused on that audit and, in particular, Robert Fish's role in that audit, did not characterize the mistakes made as negligent or reckless. (Note: The issue of whether or not given auditors were negligent or reckless is often the central issue in a civil lawsuit filed against those auditors but is typically not addressed directly within an SEC enforcement release.) However, the SEC's enforcement release did strongly criticize Fish's conduct. For example, the SEC charged that "he failed to exercise due professional care and professional skepticism, and failed to obtain sufficient competent evidential matter" (taken from quote in case). This summary statement suggests that Fish was at least negligent in auditing Take-Two given the above definition of "negligence."

Was Fish reckless? Since we don't have access to all of the pertinent information for this case, it is difficult to decide whether or not his misconduct rose to the level of recklessness. Consider having your students debate this issue. What I often do in this type of setting is to have one group of students take one side of such a debate and another group of students take the other side. After a lively give and take between the two competing camps, I then have a third set of students vote (anonymously) to choose the "winner."

5. Professional auditing standards do not address this issue. Rule-making bodies in the auditing discipline apparently believe that the level of audit fees to be charged on any given audit engagement is an issue that will be properly resolved by the interplay of supply and demand forces in the audit market. It has been alleged in the past that major audit firms attempted to expand their client bases by discounting their fees. In the 10th edition of my casebook, Case 1.7, "Lincoln Savings and Loan

Association," notes that Arthur Young & Company expanded its client base by more than 100 clients in the mid-and late 1980s. Although not mentioned in that case, third parties alleged that Arthur Young used "aggressive pricing" during that "marketing campaign" to significantly increase its client portfolio.

I would suggest that, ceteris paribus, it is permissible to discount the audit fees charged to developmental stage companies. Having said that, this practice may create independence issues for the given audit firm. For example, if the audit fee for such a client does not allow the audit firm to recover its costs on the given engagement, then the audit firm might attempt to retain the client over a sufficient period of time to recover those costs and ultimately earn a profit on the relationship with that client. This mindset of needing or wanting to retain the client might induce the audit firm to be less than strict in auditing the client. Why? Because the audit firm may fear that employing a rigorous audit strategy would result in the client severing the relationship.

6. The central issue here is whether Robert Fish maintained his objectivity and independence while supervising the Take-Two audits, given his close relationship with Ryan Brant. The AICPA *Code of Professional Conduct* provides the following overview of those two important and related traits that auditors should possess.

> Objectivity is a state of mind, a quality that lends value to a member's services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interests. Independence precludes relationships that may appear to impair a member's objectivity in rendering attestation services (ET 0.300.050.02).

As the AICPA notes, objectivity, which is the underpinning of independence, is a "state of mind." Consequently, it is impossible for third parties to discern whether or not an auditor performs a given audit objectively. On the other hand, a close relationship between an auditor and his or her client may cause third parties to question the auditor's independence. This latter possibility is sufficient to undercut the credibility of the auditor regardless of whether or not he or she maintains an objective mindset during the given engagement.

So, was Fish's relationship with Brant improper? Given the information conveyed during the interview of Fish that is reported in this case, I believe that at least some professional accountants would respond with a resounding "Yes." The suggestion that there was a father-son type relationship between the two individuals would likely cause third-party financial statement users to question whether Fish could objectively and independently assess Take-Two's financial statements that were ultimately the responsibility of Brant.

7. This is a question that I have used as an essay question on many in-class exercises and, occasionally, on the final exam for my graduate auditing seminar. As you might expect, I don't focus much on the "yes" or "no" answers provided by students but instead analyze the overall quality of the logical reasoning that they provide to support their answers. This question is certainly pertinent to this case because of the wide-ranging criticism that Take-Two has garnered for its *Grand Theft Auto* game. One strategy that I hope my students apply in responding to this question is to examine the issue it raises from the standpoint of the following six ethical "principles" included in

the AICPA *Code of Professional Conduct*: Responsibilities, The Public Interest, Integrity, Objectivity and Independence, Due Care, and Scope and Nature of Services. Those students who use this strategy typically focus on the Integrity and/or Public Interest principles.

CASE 2.4

GENERAL MOTORS COMPANY

Synopsis

Billy Durant created General Motors Corporation in 1908 when he merged several automobile manufacturers that he had acquired over the previous few years. For most of the 20th century, GM reigned as the largest automobile producer worldwide and one of the U.S.'s most prominent corporations. By the early years of the 21st century, however, GM's dominance of the automotive industry was waning in the face of stiff competition from several foreign carmakers. In 2009, Toyota supplanted GM as the world's largest automotive company in terms of annual sales. That same year, GM filed for bankruptcy after being caught in the undertow of the massive financial crisis that crippled the U.S. economy beginning in late 2008.

Many critics had argued for decades that GM's executives routinely "doctored" the company's periodic financial statements to conceal its deteriorating financial health. This case focuses on one feature of the window-dressing efforts of GM. In early 2009, the SEC released the results of a lengthy investigation of GM's accounting and financial reporting decisions over the previous decade. A major focus of that investigation was GM's questionable accounting for its massive pension liabilities and expenses. Among other allegations, the SEC claimed that for fiscal 2002 GM applied an inflated discount rate to its pension liabilities that resulted in those liabilities being materially understated. This case examines the controversy surrounding GM's pension-related accounting decisions and the role of the company's longtime audit firm, Deloitte, in those decisions. The case questions require students to consider the types of auditing procedures that should be applied to a client's pension-related financial statement items.

General Motors Company--Key Facts

1. Billy Durant, who worked as an itinerant salesman as a young man, became extremely wealthy after organizing General Motors in 1908; however, Durant lost his fortune in the stock market and spent the final few years of his life in poverty and relative obscurity.

2. GM reigned as the world's largest automobile manufacturer for nearly eight decades until 2009 when it filed for bankruptcy during the midst of a severe economic crisis gripping the U.S. economy.

3. A key factor that contributed to GM's downfall was the company's significant pension and other postretirement benefit expenses that made its cars more costly than those of foreign competitors.

4. In the decades prior to GM's bankruptcy filing, critics accused GM executives of "juggling" the company's reported financial data to conceal its deteriorating financial health; GM's pension-related financial statement amounts were among the items allegedly misrepresented.

5. Accounting for pension-related financial statement items has long been a controversial issue within the accounting profession; in 1985, the FASB finally adopted a new accounting standard that moved the profession toward accrual basis accounting for those items.

6. The FASB's new standard still allowed companies to manipulate their pension-related financial statement amounts because of several key assumptions that had to be made in accounting for them, including the discount rate used to determine the present value of pension liabilities.

7. For fiscal 2002, GM chose to apply a 6.75% discount rate to determine its pension liability when most available evidence suggested that a considerably lower discount rate should have been applied.

8. After initially contesting the 6.75% discount rate, GM's audit firm, Deloitte, eventually acquiesced and accepted that rate.

9. Deloitte agreed to approve the 6.75% discount rate after GM officials indicated that they would include a "sensitivity analysis" in their company's 2002 financial statements demonstrating the financial statement impact of a range of different discount rates including 6.75%.

10. In a subsequent complaint filed against GM, the SEC maintained that the company's pension-related amounts and disclosures within its 2002 financial statements were "materially misleading," including the sensitivity analysis.

11. In January 2009, the SEC sanctioned GM for several abusive accounting and financial reporting practices including its accounting and financial reporting decisions for its pension liabilities and related items.

12. In July 2009, the "new General Motors" (General Motors Company) emerged from bankruptcy proceedings; the federal government was the new company's principal stockholder.

Instructional Objectives

1. To identify key audit risks and issues posed by an important long-term liability, namely, the liability stemming from an organization's defined benefit pension plan.

2. To identify specific audit procedures appropriate for long-term accrued liabilities such as pension liabilities.

3. To identify circumstances under which auditors should retain outside experts to assist them in completing an audit.

4. To demonstrate the importance of insisting that audit clients include appropriate disclosures in their financial statement footnotes regarding significant accounting estimates.

Suggestions for Use

While developing this case, I reviewed several auditing textbooks to gain insight on the type and extent of the textbook treatment typically given to the topic of pension liabilities and related financial statement items. I was surprised to find almost no coverage of that topic. Given the materiality of pension-related financial statement amounts for many companies, it seems reasonable that we should, at a minimum, provide auditing students with an overview or "brief taste" of the key audit issues for those items. This case addresses that need. [Sidebar: No doubt, the auditing of pension-related financial statement items is among the more complex assignments on most audit engagements. Consequently, this task is typically assigned to more experienced auditors, which likely explains why this topic is not dealt with extensively in standard introductory-level auditing textbooks.]

As you probably know, to demonstrate the real-world significance of audit issues, I present those issues in the context of real-world circumstances or dilemmas. One downside to this strategy is that students sometimes are "derailed" by peripheral issues that are not directly audit-related. In covering this case, for example, students enjoy debating the factors that contributed to GM's demise. You may find it necessary to direct students' attention away from such issues and back to the central accounting and auditing issues highlighted by the case.

Suggested Solutions to Case Questions

1. Listed next are examples of general audit procedures that could be applied to a company's reported pension obligation or liability and/or its related pension expense. This list is not intended to be comprehensive by any stretch of the imagination. The purpose of this question is simply to force students to think in general terms of the key issues that should be addressed in auditing these items. Notice that I list the audit objective first followed by the specific audit procedure. You may want to instruct your students to use that conventional "horse before the cart" strategy for this question as well. Sidebar: you may want to point out to your students that pension amounts are accounting estimates and thus AS 2501, "Auditing Accounting Estimates," of the PCAOB's auditing standards can be used as a general framework for developing appropriate audit procedures for those items. (The corresponding section in the AICPA Professional Standards is AU-C Section 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures.")

a. 1. Audit objective: To determine whether the client's pension obligation is recorded in the financial statements at the appropriate amount. ["Valuation and allocation" assertion regarding period-ending account balances.]
   2. Audit procedure: Identify discount rates applied by comparable companies to determine their pension liabilities. Given those discount rates, evaluate the reasonableness of the client's chosen discount rate.

b. 1. Audit objective: To determine whether the client's pension obligation is recorded in the financial statements at the appropriate amount. ["Valuation and allocation" assertion regarding period-ending account balances.]
   2. Audit procedure: Have an independent actuary review the key actuarial assumptions used by the client in arriving at its reported pension obligation. (For example, the actuary would likely review the reasonableness of mortality assumptions applied by the client.)

c. 1. Audit objective: To determine whether the client's pension obligation is recorded in the financial statements at the appropriate amount. ["Valuation and allocation assertion regarding period-ending account balances.]
   2. Audit procedure: Test the mathematical accuracy of the client's computations of the pension obligation and pension expense amounts.

d. 1. Audit objective: To determine that all disclosures that should have been included in the client's financial statements have been included. ["Completeness" assertion concerning presentation and disclosure issues.]
   2. Audit procedure: Read client financial statement footnotes to determine whether the client has made all necessary and appropriate disclosures regarding its pension liability.

e. 1. Audit objective: To determine that financial information is appropriately presented and described and disclosures are clearly expressed. ["Classification and understandablity" assertion regarding presentation and disclosure issues.]
   2. Audit procedure: Read client financial statement footnotes to determine whether its pension-related disclosures are explained precisely and clearly.

2. AS 1210, “Using the Work of a Specialist,” of the PCAOB’s auditing standards discusses the general circumstances under which auditors should consider retaining the services of an independent expert during the course of an audit engagement. This section identifies several types of specialists or experts that auditors may need to consult on specific engagements including actuaries, appraisers, engineers, environmental consultants, and geologists. AS 1210.06 provides the following general guidance for auditors to follow in deciding whether the services of a specialist should be retained:

> “The auditor’s education and experience enable him or her to be knowledgeable about business matters in general, but the auditor is not expected to have the expertise of a person trained or qualified to engage in the practice of another occupation or profession. During the audit, however, an auditor may encounter complex or subjective matters potentially material to the financial statements. Such matters may require special skill or knowledge and in the auditor’s judgment require using the work of a specialist to obtain appropriate audit evidential matter.”

In auditing pension-related financial statement items, an auditor may find it necessary to retain the services of an actuary to assess the reasonableness of key assumptions made by the client in arriving at those accounting estimates. For example, assumptions regarding the projected life spans of retirees have a significant impact on those amounts. Auditors typically do not have the experience or training to properly evaluate such mortality assumptions and thus should consider relying on the services of an independent actuary to assess their reasonableness.

(Note: AU-C Section 620, “Using the Work of an Auditor’s Specialist,” is the section of the AICPA Professional Standards that corresponds with AS 1210. The responsibilities imposed on auditors by the two sections are very similar.)

3. In retrospect, it appears that there was significant evidence suggesting that the 6.75% discount rate was a poor choice by GM. However, as always, the information that was available in the public domain in developing this case was certainly only a fraction of the information that was likely relied upon by Deloitte in arriving at the decision to accept the 6.75% discount rate. So, one should be careful in criticizing that decision—you might point out to your students that, as indicated in the case, the SEC has yet to criticize Deloitte for its role in this matter.

The principal purpose of this question is not to criticize Deloitte but rather to prompt students to identify additional audit tests or procedures that should have been applied by the audit firm—and possibly were. Those audit procedures could have included performing analytical tests to determine whether the use of the 6.75% discount rate had a material impact on relevant financial statement benchmarks (see next question), reviewing past choices of discount rates made by GM to determine whether the company had a “track record” of questionable decisions in this regard, and inquiring of client personnel as to why an unconventional method was used to select the pension discount rate for the year in question and then analyzing the rationality or reasonableness of those explanations.

4. Notice that a footnote to this case provides several key financial benchmarks that would be relevant in assessing whether GM’s chosen discount rate had a material impact on its 2002 financial statements. I think most of us would answer a resounding “yes” to that question.

CASE 2.5

LIPPER HOLDINGS, LLC

Synopsis

Media reports described Kenneth Lipper as a "bon vivant" and "renaissance man." Lipper, the son of a shoe salesman, grew up in a modest working-class neighborhood in the South Bronx. A childhood friend of Al Pacino and a contemporary of Bernie Madoff, Lipper made a name for himself on both Wall Street and in Hollywood. Lipper served as a partner of Lehman Brothers and then Salomon Brothers during the 1970s and 1980s before becoming a pioneer of the emerging hedge fund industry. After collaborating on Oliver Stone's popular film *Wall Street* in the late 1980s, Lipper adopted a bicoastal lifestyle. Lipper capped his Hollywood career by winning an Oscar for a documentary film that he produced. In addition to his careers in high finance and films, Lipper also served as deputy mayor of New York City for three years under Ed Koch.

Kenneth Lipper's reputation as a Wall Street maven was dashed in February 2002 when his company, Lipper Holdings, LLC, reported that the collective market values of the investments held by three hedge funds that it managed had been grossly overstated. The hedge funds were subsequently liquidated resulting in huge losses for many of Lipper's prominent investors. Investigations by regulatory and law enforcement authorities revealed that the market values of the hedge funds' investments had been intentionally overstated by one of Lipper's top subordinates who had served as the portfolio manager for those funds.

Another target of the investigations into the collapse of the Lipper hedge funds was PricewaterhouseCoopers (PwC), the longtime auditor of Lipper Holdings and its hedge funds. PwC was criticized for failing to uncover the fraudulent scheme used by the hedge funds' portfolio manager to materially inflate the market values of their investments. Particularly galling to those parties familiar with the fraud was the fact that the portfolio manager had used patently simple methods to overstate those market values. This case focuses on the alleged flaws in PwC's audits of the three Lipper hedge funds.

Lipper Holdings, LLC--Key Facts

1. Kenneth Lipper, the son of a shoe salesman, was raised in a modest working-class neighborhood in the South Bronx community within New York City.

2. In addition to establishing a prominent Wall Street investment firm and serving several years as a deputy mayor of New York City, Lipper had a successful career in Hollywood as a screenwriter and film producer.

3. Lipper was a leader of the rapidly growing hedge fund industry during the 1990s; his firm, Lipper Holdings, managed three hedge funds, the largest of which was Lipper Convertibles.

4. One of Lipper's top subordinates, Edward Strafaci, served as the portfolio manager for the three Lipper hedge funds.

5. To inflate the reported rates of return earned by the three Lipper hedge funds Strafaci began overstating the year-end market values of the investments they held.

6. Following Strafaci's sudden and unexpected resignation in January 2002, an internal investigation revealed his fraudulent scheme.

7. Lipper Holdings' longtime audit firm, PwC, became a focal point of the SEC's investigation of Strafaci's fraud.

8. The SEC's investigation revealed that PwC had collected considerable evidence indicating that the collective market values of the three hedge funds' investments were materially overstated.

9. Despite that audit evidence, PwC issued unqualified audit opinions on the hedge funds' financial statements throughout its tenure as their independent auditor.

10. The SEC suspended the former partner who had supervised the Lipper hedge fund audits after ruling that he had been a "cause" of their violations of federal securities laws.

Instructional Objectives

1. To identify audit risk factors posed by sophisticated financial services clients such as hedge funds.

2. To identify audit objectives and related audit procedures for a client's securities investments.

3. To examine factors that may contribute to poor or deficient decisions by independent auditors.

Suggestions for Use

As the opening prologue for this case suggests, hedge funds are easily among the most controversial investment vehicles in today's capital markets. They are also among the most mysterious and least understood Wall Street "creatures." For those reasons, alone, I believe this case will pique your students' interests. Consider having a student or group of students provide a five-minute in-class report on the "state of the hedge fund industry." By the time you discuss this case, there may have been important changes in the regulatory environment for hedge funds that would have at least indirect implications for those entities' independent auditors.

AS 2501, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities," of the PCAOB's auditing standards discusses specific audit strategies, audit objectives, and audit procedures to apply to securities investments and related transactions (see suggested solution to second case question). Also relevant to this case is AS 2502, "Auditing Fair Value Measurements and Disclosures." Consider having a student or group of students present an in-class report on these sections prior to discussing this case. Warning: this won't be an *easy* assignment! (Note: The sections in the AICPA Professional Standards that would be relevant to the audit of a non-SEC registrant are AU-C Section 501, "Audit Evidence—Specific Considerations for Selected Items," paragraphs .04-.10 and .A1-.A19, and AU-C Section 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures.")

Suggested Solutions to Case Questions

1. The three categories of fraud risk factors discussed in AS 2401, "Consideration of Fraud in A Financial Statement Audit," in the PCAOB's Interim Standards are "incentives/pressures," "opportunities," and "attitudes/rationalizations" (of course, collectively these three categories of fraud risk factors are often referred to as the "fraud triangle.") The appendix to AS 2401 provides numerous examples of fraud risk factors in each category. Listed next are examples of specific fraud risk factors faced by the PwC auditors assigned to the Lipper hedge fund audits. (Note: AU-C Section 240, "Consideration of Fraud in a Financial Statement Audit," is the section in the AICPA Professional Standards that corresponds to AS 2401 in the PCAOB's auditing standards.)

Incentives/pressures:

- "High degree of competition" (the Lipper hedge funds were competing against literally thousands of other investment alternatives that investors could choose)
- "Perceived or real adverse effects of reporting poor financial results" (as noted in the case, Strafaci believed that the hedge funds had to report impressive rates of return to continue attracting new investors)
- "Significant financial interests in the entity" (the restitution that the courts forced Strafaci to pay was due to the large profits that he had earned from his investments in the hedge funds)

Opportunities:

- "Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate" (as noted in a footnote to the case, many of the hedge funds' investments were in "thinly-traded" securities that often did not have readily determinable market values)
- "Domination of management by a single person" (in this case, Strafaci)
"Ineffective oversight over the financial reporting process and internal control by those charged with governance" (one could argue that Kenneth Lipper should have exercised more effective oversight of the hedge funds including Strafaci's role in managing the funds)

Attitudes/rationalizations:

- "Known history of violations of securities laws or other laws" (as noted in the case, Kenneth Lipper had been previously accused of aiding and abetting violations of federal securities laws)
- "Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend" (again, Strafaci's zealous interest in ensuring that the hedge funds achieved impressive rates of return was consistent with this fraud risk factor)
- "Management failing to correct known significant deficiencies or material weaknesses in internal control on a timely basis" (if Larry Stoler was aware of the significant internal control weaknesses within the hedge funds' operations, client management was almost certainly aware of those problems also)

How should PwC have responded to these and other risk factors posed by the audits of the Lipper hedge funds? By making proper adjustments in the audit NET for those audits, that is, the nature, extent and timing of the audit procedures to be applied during those engagements. Granted, in some cases, audit firms may simply choose not to be associated with an audit client for which an extensive number of fraud risk factors is present.

Note: In the SEC enforcement release for this case, the federal agency reported that the auditors prepared an annual risk analysis for the Lipper hedge fund engagements. Among the "high risk" factors identified during those risk analyses was "management governance and oversight of management." Although the auditors identified that critical issue as a "high risk" factor during the planning phase of those audits, the SEC suggested that the auditors did not respond appropriately to that risk factor during later phases of the audits.

2. AS 1105.11 identifies five management assertions that are relevant to independent auditors. The "audit objectives" on audits of SEC registrants involve collecting sufficient appropriate evidence to corroborate these assertions for specific financial statement line items or disclosure items. [Note: the AICPA Professional Standards identify 13 specific management assertions that are closely related to the "original" five management assertions incorporated in AS 1105. See AU-C Section 315.A128 for a list of those assertions.]

AS 2503, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities," is replete with examples of audit objectives for "complex financial instruments and transactions" which is the focus of this case question. Listed next are examples of such audit objectives and corresponding audit procedures suggested by AS 2503.

Audit objective: Audit objectives related to "assertions about the valuation of derivatives and securities address whether the amounts reported in the financial statements through measurement or disclosure were determined in conformity with generally accepted accounting principles." AS 2503.26
Example of a relevant audit procedure: "If quoted market prices are not available for the derivative or security, estimates of fair value frequently can be obtained from broker-dealers or other third-party sources based on proprietary valuation models or from the entity based on internally or externally developed valuation models." AS 2503.38

Audit objective: Audit objectives related to "assertions about rights and obligations address whether the entity has the rights and obligations associated with derivatives and securities, including pledging arrangements, reported in the financial statements." AS 2503.25
Example of a relevant audit procedure: "Confirming significant terms with the counterparty to a derivative or the holder of a security, including the absence of any side agreements." AS 2503.25

Audit objective: Audit objectives related to "completeness assertions address whether all of the entity's derivatives and securities are reported in the financial statements through recognition or disclosure." AS 2503.22
Example of a relevant audit procedure: The auditor should request "counterparties or holders who are frequently used, but with whom the accounting records indicate that there are presently no derivatives or securities, to state whether they are counterparties to derivatives with the entity or holders of its securities." AS 2503.22

Audit objective: "The auditor should evaluate whether the presentation and disclosure of derivatives and securities are in conformity with generally accepted accounting principles." AS 2503.49
Example of a relevant audit procedure: The auditor should determine whether "the information presented in the financial statements is classified and summarized in a reasonable manner, that is, neither too detailed nor too condensed." AS 2503.49

3. Listed next are examples of specific factors that *may have* contributed to the alleged flaws in the audit procedures applied by the PwC auditors while testing the year-end market values of the Lipper hedge funds' investments.

- *Kenneth Lipper's prominence and influence in the hedge fund industry and the investment community* (History has proven that auditors are sometimes prone to give prominent audit clients or audit client executives the "benefit of the doubt." Auditors may do so because they don't want to jeopardize losing the given client and/or because they believe that a prominent client or client executive is not likely to jeopardize its/his/her prominence by being associated with misrepresented financial statements.)
- *Improper planning* (This is arguably the most common factor associated with "busted audits.")
- *Inadequate supervision* (This was one of the specific allegations levied against Stoler by the SEC.)
- *Lack of proper expertise on the part of members of the audit engagement team* (Hedge funds are just one example of a type of audit client that almost certainly requires that one or more auditors assigned to the engagement team have specific "industry" expertise or knowledge.)
- *Inadequate time budgets* (There was no indication that this factor was relevant to the Lipper hedge fund audits; nevertheless, this factor appears to have been a contributing factor to many alleged audit failures.)
- *Overbearing client executives who interfere with the audit* (This is another factor commonly associated with alleged audit failures. Again, there was no indication that Strafaci or other Lipper personnel attempted to divert the attention of the PwC auditors or otherwise disrupt their work.)

What measures can audit firms take to lessen the likelihood that the factors just identified (and many other factors, as well) will undercut the quality of their audits? The easy (and proper) answer is for audit firms to have rigorous quality control mechanisms in place to ensure that the relevant professional auditing standards are complied with on each and every audit engagement. Examples of such quality controls include a thorough workpaper review process for every audit, the assignment of a review or concurring partner to audits, participation in peer review programs in which auditors from other firms are allowed to peruse and criticize the workpapers prepared for certain clients, and establishment of a risk management function to "weed out" audit clients that pose excessive audit risks.

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 civil lawsuit focused on 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 percent 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 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 them 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 AS 2310, "The Confirmation Process," of the PCAOB's auditing standards 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 related to period-ending accounts receivable balances. 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). [Note: AU-C Section 505, "External Confirmations," is the section in the AICPA Professional Standards that corresponds with AS 2310.]

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. AS 2905 of the PCAOB's auditing standards 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, AS 2905 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. (Note: AU-C Section 560, "Subsequent Events and Subsequently Discovered Facts," of the AICPA Professional Standards corresponds with AS 2905.)

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 trigger auditors' responsibilities under AS 2905—for example, the mistakes involve gaffes by auditors that resulted in an improper audit opinion being issued—certainly the given audit firm has a responsibility to comply with AS 2905 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

BANKRATE, INC.

Synopsis

Bankrate, Inc. is an Internet-based company that aggregates and then publishes on its websites financial data needed by U.S. consumers. Those data include information regarding the financial products offered by approximately 5,000 banks, insurance companies, and other financial services providers. For example, consumers can search the relevant Bankrate website to obtain comparative data regarding the interest rates that banks across the U.S. are offering on certificates of deposit.

In June 2011, Bankrate re-emerged as a public company after having been a private company for two years. Financial analysts tracking the company wrote glowing reports concerning the company's future prospects. Those reports were predicated on Bankrate being the dominant aggregator of financial data needed by U.S. consumers and on the proven business model that the company had developed over the previous several decades.

Bankrate settled a large class-action lawsuit in August 2014 by agreeing to pay $18 million to a group of its stockholders who alleged that the company had improperly embellished its potential revenues shortly after it went public in 2011. Just one month after the announcement of that settlement, Bankrate issued a press release revealing that it was the subject of an SEC investigation. That investigation focused on Bankrate's reported operating results for the second quarter of 2012.

The SEC announced in September 2015 that it had reached an agreement to settle fraud charges that it had filed against the company. That settlement included a $15 million fine to be paid by Bankrate. At the same time, the SEC announced that it had settled fraud charges filed against a former Bankrate executive, Hyunjin Lerner. The SEC fined Lerner approximately $180,000 and suspended him from practicing before the SEC for five years. (Both Bankrate and Lerner neither admitted nor denied the charges filed against them.)

On the same date that the settlements with Bankrate and Lerner were announced, the SEC reported that it was continuing to pursue "litigation" against two of Lerner's former colleagues, Edward DiMaria and Matthew Gamsey. DiMaria had served as Bankrate's CFO, while Gamsey had served as Bankrate's director of accounting. The SEC spelled out the charges filed against those two men in a 43-page legal complaint.

The complaint alleged that DiMaria had orchestrated an accounting scam—with the assistance of Lerner and Gamsey—to ensure that Bankrate's operating results for the second quarter of 2012 did not fall short of the company's consensus earnings forecasts for that quarter. This case documents the specific measures allegedly used by DiMaria and his subordinates to misrepresent Bankrate's reported operating results. Those measures included tactics to conceal the accounting scam from Grant Thornton, the company's audit firm.

Bankrate, Inc.--Key Facts

1. In June 2011, Bankrate re-emerged as a public company; financial analysts predicted that the company would be very successful because it was the dominant aggregator of financial information needed by U.S. consumers and because it had a proven business model.

2. Bankrate's two primary revenue streams include payments for leads (referrals) delivered to the approximately 5,000 financial services providers whose products are profiled on its websites and the sale of display advertising on those same websites.

3. In August 2014, Bankrate paid $18 million to a group of its stockholders who claimed that the company had improperly embellished its potential leads revenue shortly after going public in 2011.

4. One month later, in September 2014, Bankrate revealed that the SEC was investigating its reported operating results for the second quarter of 2012.

5. In September 2015, Bankrate and Hyunjin Lerner, the company's former vice president of finance, settled fraud charges filed against them by the SEC without either admitting or denying those charges; Bankrate paid a $15 million fine while Lerner paid a fine of $180,000 and agreed to a five-year ban from practicing before the SEC.

6. At the same time that the settlements with Bankrate and Lerner were announced, the SEC reported that it was continuing to pursue charges filed against Edward DiMaria and Matthew Gamsey, Bankrate's former CFO and director of accounting, respectively.

7. In a 43-page legal complaint, the SEC alleged that DiMaria had "fostered a corporate culture within Bankrate's accounting department that condoned using improper accounting techniques to achieve financial targets."

8. In July 2012, Bankrate's preliminary adjusted EBITDA and adjusted EPS for the second quarter of 2012 came up short of analysts' consensus earnings estimates for that quarter.

9. To eliminate the earnings shortfall, DiMaria allegedly instructed Lerner and Gamsey to make several improper entries in Bankrate's accounting records.

10. Those improper entries included recording approximately $800,000 of bogus revenue and reducing a marketing expense account and the corresponding accrued liability account by $400,000.

11. The conspirators took explicit measures to conceal the accounting fraud from the company's

Grant Thornton auditors.

12. In June 2015, following the conclusion of the SEC's investigation, Bankrate issued restated financial statements for the second quarter of 2012.

Instructional Objectives

1. To determine what responsibilities auditors have to search for fraudulent misstatements during a quarterly review of a public company's financial statements.

2. To identify the factors that should be considered by accountants and auditors when deciding whether a given financial statement amount is "material."

3. To determine which parties should bear some degree of responsibility when an entity's financial statements are materially impacted by fraud.

4. To identify the primary audit objectives for a client's accrued liabilities.

5. To identify circumstances that complicate the auditing of a client's accrued liabilities.

Suggestions for Use

When assigning this case you may want your students or a subset of your students to research and identify any recent developments that are relevant to the case. In particular, your students should attempt to determine if the fraud charges filed against Edward DiMaria, Bankrate's former CFO, and Matthew Gamsey, Bankrate's former director of accounting, have been resolved. You might also consider requiring your students to do a brief update on the recent financial performance of Bankrate.

Public companies' rampant use of "non-GAAP performance measures" is a controversial topic in the financial reporting domain. This case provides an excellent opportunity to discuss that important financial reporting topic. In particular, you might ask your students to identify the key issues embedded in that topic. Arguably, the most important of those issues is the lack of comparability across the non-GAAP performance measures used by public companies. A closely related issue is the fact that some (many?) public companies use non-GAAP performance measures to direct investors' attention away from GAAP-based measures of financial performance.

Another financial reporting topic central to this case is the required quarterly reporting of financial results by public companies. Many critics have suggested that quarterly reporting imposes a significant burden on SEC registrants and prompts a non-trivial number of such companies to take drastic measures (including fraudulent accounting) to reach or surpass the consensus quarterly earnings forecasts issued by Wall Street analysts. In fact, a prominent Wall Street executive recently suggested that quarterly financial reporting by SEC registrants should be discontinued.

Of course, you can link the two financial reporting topics discussed in the two previous paragraphs to the auditing domain. For example, there is no doubt that the accounting gimmicks or outright fraudulent accounting that corporate executives sometimes use to window-dress their quarterly financial reports pose significant challenges for auditors who review those reports.

Suggested Solutions to Case Questions

1. AS 4105, "Reviews of Interim Financial Information," of the PCAOB's auditing standards is the authoritative source in this context. According to AS 4105.07, "The objective of a review of interim financial information pursuant to this section is to provide the accountant [auditor] with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles." This paragraph goes on to clearly distinguish between the nature and scope of an interim review and a full-scope financial audit. For example, the paragraph notes that a review "consists principally of performing analytical procedures and making inquiries of persons responsible for financial and accounting matters . . ."

The first reference to "fraud" can be found in AS 4105.11. That paragraph instructs an accountant [auditor] performing a review "to update his or her knowledge of the entity's business and internal controls . . ." During such an update, the accountant should "specifically consider" several factors including "(c) identified risks of material misstatement due to fraud . . ." While inquiring of "members of management who have responsibility for financial and accounting matters" an accountant performing a review should ask such individuals about "Their knowledge of any fraud or suspected fraud affecting the entity involving (1) management, (2) employees who have significant roles in internal control, or (3) others where the fraud could have a material effect on the financial statements. (AS 4105.18)

At any point during a review, if an accountant becomes aware of "information that leads him or her to believe that the interim financial information may not be in conformity with generally accepted accounting principles," the interim review procedures must be "extended." (AS 4015.22) This requirement would mandate that an accountant pursue any apparent indications of financial statement fraud having a material impact on the client's accounting data.

So, must auditors [accountants] search for fraud while "reviewing" a public company's quarterly financial statements? I suppose the answer to that question depends on how you interpret the relevant directives included in AS 4105. I believe the best answer is that "yes" auditors [accountants] have a responsibility to search for fraud during such a review . . . but they don't have to search "very hard." Granted, if they trip across indications of fraud during the performance of review procedures, then they have a more onerous responsibility to determine whether fraud has impacted the given financial statements.

The fraud risk factors that the Grant Thornton auditors should have considered during the review of Bankrate's quarterly financial statements include: (1) the preoccupation of DiMaria with reaching or surpassing Bankrate's consensus quarterly earnings forecasts (this "preoccupation" may not have been readily apparent to the auditors); (2) the fact that the compensation of Bankrate's top executives, including DiMaria, was directly linked to the EBITDA reported by the company—see footnote 7 in the case; (3) the suspicious nature of the $300,000 of revenue recorded by the Insurance division (the revenue was recorded after the close of the quarter and helped the company reach its earnings target for that quarter); and (4) the fact that the company's management team had an incentive to fulfill the high expectations that had been established for Bankrate by financial analysts when it re-emerged as a public company (fiscal 2012 was Bankrate's first full fiscal year after going public again).

2. Generally, the SEC defines earnings management as a "material and intentional misrepresentation" of a given entity's reported operating results. Because that definition could be used interchangeably with "fraudulent accounting," the two expressions are effectively equivalent to the SEC. Other parties, however, typically define earnings management less ominously than fraudulent accounting. For example, the online business encyclopedia, *Investopedia*, defines earnings management as "The use of accounting techniques to produce financial reports that may paint an overly positive picture of a company's business activities and financial position." This latter definition is less severe than the SEC's definition because it doesn't include a reference to materiality. Although the *Investopedia* definition of earnings management appears to be more widely accepted, there is no doubt that the SEC's definition of earnings management should "carry more weight" among corporate executives, auditors, etc. given the critical oversight role that the federal agency plays in the accounting and financial reporting domain.

Under what conditions is earnings management acceptable? If we define that term as "painting an overly positive picture" of an entity's operating results, one set of circumstances that could qualify as "acceptable" earnings management is when a company defers discretionary expenditures near the end of a financial reporting period to reach a target earnings number. Then again, the deferral of many, if not most, discretionary expenditures, such as maintenance costs on production line equipment, is not in the best interests of a given entity over the long term, meaning that company management may be violating their fiduciary responsibility to stockholders and other parties when they do so. Another possible case when earnings management is "acceptable" is when there is considerable "wiggle room" in a given accounting or financial reporting rule. That is, the given rule is quite subjective and a company's executives "take advantage" of that subjectivity by interpreting the rule in the most beneficial way for their entity. Although many parties may suggest this type of earnings management is "acceptable," I believe the majority of professional accountants would disagree.

3. The best strategy for answering this question is to first define the phrase "materiality." Ironically, the SEC does not have its own "materiality standard." Instead, the SEC invokes the following definition of materiality applied by the U.S. Supreme Court: "Information is material if there is a substantial likelihood that a reasonable investor would consider the information in making an investment decision or if the information would significantly alter the total mix of available information."

The FASB's definition of materiality can be found in *Statement of Financial Accounting Concepts No.8*: "Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity's financial report." [Note: At press time, the FASB was considering a proposal to adopt the Supreme Court/SEC definition of materiality.]

Both AS 2105, "Consideration of Materiality in Planning and Performing an Audit," of the PCAOB auditing standards and the relevant AICPA Professional Standards effectively embrace the U.S. Supreme Court/SEC definition of materiality. (The relevant discussion of materiality in the AICPA Professional Standards can be found at AU-C Section 320.02.) The AICPA Professional

Standards, however, have also introduced the concept of "performance materiality" to the professional auditing literature. That term is defined as follows:

> "The amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, *performance materiality* also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances, or disclosures. Performance materiality is to be distinguished from tolerable misstatement." [AU-C 320.09]

In turn, AU-C 530.05 defines "tolerable misstatement as follows:

> "A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population."

In summary then, from an accounting and financial reporting standpoint "materiality" refers to an amount or item or set of circumstances that would "make a difference" in the minds of a reasonably informed user of financial statements. The auditing domain embraces this general definition or concept but is more concerned with "applying" the materiality construct in the context of auditing a set of financial statements.

To finally address Question #3, we have to identify the factors that determine whether a specific financial statement amount is "material." There are two general sets of such factors: quantitative and qualitative factors. (See paragraph 17 of AS 2810, "Evaluating Audit Results.") Quantitatively speaking, accountants and auditors typically identify "material" items in reference to some given financial statement benchmark such as net income or change in net income from one period to the next. The old "5 percent rule" is probably the most widely used (if not abused) quantitative materiality standard, that is, an amount is material if it would change the given base or benchmark amount by 5 percent or more. For example, Bankrate's net income for the second quarter of 2012 was overstated by approximately 5 percent. The SEC ruled that overstatement was material.

DiMaria, financial analysts tracking the company's stock, and the SEC apparently all agreed that the most relevant financial benchmarks for the company were adjusted EBITDA and adjusted EPS. Understand that although Bankrate's adjusted EPS was misstated by a little more than 5 percent by the company's accounting gimmicks ($.18 / $.17), the corresponding misstatement of adjusted EBITDA was less than 4 percent ($37.5 million / $36.2 million). This is where the issue of "qualitative" materiality came into play. The SEC apparently believed that when it came to an overall global decision of whether Bankrate's EBITDA was materially misstated due to its fraudulent accounting, it was really a question of whether or not the fraudulent accounting decisions allowed the company to reach its earnings target for the given quarter. In other words, in this important context, materiality determination became a qualitative or "nominal" (yes/no) measurement. More generally, a misstatement due to fraud has a lower qualitative materiality threshold than a misstatement due to some unintentional cause.

4. The key audit objective for accrued liabilities is to determine whether those amounts are "complete." Unlike assets and revenues, audit clients have an incentive to understate liabilities and expenses. Just by their nature, understatements are more challenging to uncover than overstatements. For example, when it comes to accrued liabilities, auditors may be searching for liabilities/expenses that have never been recorded. For overstatements, on the other hand, auditors have an explicit "starting point," namely, the amount recorded for the given item by the client.

Another factor that complicates the auditing of accrued liabilities (and their offsetting expenses) is the discretionary nature of those amounts. Many, if not most, accrued liabilities are "guesstimates" which are heavily influenced by key assumptions made by the client. When auditing accrued liabilities, auditors are often forced to challenge the rigor or reliability of those assumptions. In effect, this creates a variation of the "he said, she said" dilemma—in this context, the dilemma would be "I believe, you believe." Because clients typically have a better understanding of all the parameters relevant to the determination of the dollar amount for a given accrued liability, they have some degree of leverage to prod, cajole, or coerce auditors into accepting the amount that has been recorded for the given item.

5. (a) Audit committees play a critical oversight role in the financial reporting domain. Those committees have a proactive responsibility to "ride herd" on corporate executives to prevent the types of abusive accounting practices evident in this case. Having said that, DiMaria and his subordinates apparently took measures to conceal their "creative accounting" from not only Bankrate's independent auditors but also from the company's audit committee and other corporate executives. (Recall that DiMaria warned Lerner to keep certain improper accounting adjustments "under the radar.")

(b) The Grant Thornton auditors were apparently never criticized by the SEC, PCAOB, or other third parties. Nevertheless, auditors should always be cognizant of, and investigate, red flags indicative of accounting fraud. There were several red flags in this case, most noteworthy was the approximately $800,000 of additional revenue for the second quarter of 2012 that Bankrate suddenly "found" a week or so following the end of that quarter. Making that red flag redder was the fact that the bogus revenue (and other questionable accounting decisions) made by Bankrate ex post allowed the company to reach the two earnings targets that had been previously established by financial analysts. (Again, it is important to reinforce the fact that the conspirators in this case took explicit measures to hide their fraudulent actions from the company's independent auditors.)

(c) There were likely several individuals within Bankrate—other than DiMaria, Gamsey, and Lerner—who were aware of the accounting shenanigans. Those individuals may have included some lower-ranking members of the company's accounting staff. Those accountants had a responsibility to report any misconduct that they observed by their superiors. Such misconduct could have been reported to the audit committee. Alternatively, those individuals could have reported the misconduct directly to the SEC.

(d) One could argue that some measure of responsibility for cases such as this must be borne by the regulatory authorities that require public companies to report financial results on a quarterly basis. This requirement places a significant degree of pressure on corporate executives each quarter to at least reach their company's consensus earnings estimate.

CASE 2.8

BELOT ENTERPRISES

Synopsis

David Robinson, an audit senior assigned to the audit engagement team for Belot Enterprises, faces a dilemma common to auditors. Client management has taken an aggressive position regarding the period-ending balances of several large discretionary expense accruals, including the company's allowances for bad debts and inventory obsolescence. Robinson discovered the client's new accrual strategy while performing review procedures on the company's financial statements for the recently ended second quarter. The end of that quarter coincided with the end of the "Nail the Number" campaign organized by Belot's new chief operating officer (COO). The goal of the corporate-wide campaign was to significantly improve Belot's year-over-year operating results for the second quarter.

Zachariah Crabtree, Belot's longtime accounting general manager, came up with the idea to "tighten" the quarter-ending accruals as his contribution to the Nail the Number campaign. Crabtree is the primary client contact person for Robinson at Belot. Over the past several years, Crabtree has been very generous with his time to Robinson, resulting in a strong friendship developing between the two accountants. That friendship is complicating Robinson's decision regarding how to deal with the aggressive accruals. In fact, Crabtree has attempted to convince Robinson to simply "pass" on those accruals and not bring them to the attention of the audit manager and audit partner assigned to the review engagement.

Complicating Robinson's decision even further is that recently he has become more intent on pursuing a long-term career with his Big Four employer as the result of a meeting with the Belot audit engagement partner. The partner told Robinson that he is "partner material" and should become more focused on planning his career with the firm. Robinson realizes that he could "score points" with the partner by dealing firmly with the controversy over Belot's accruals. The case ends with Robinson considering how he plans to deal with the dilemma that he faces.

Belot Enterprises--Key Facts

1. David Robinson is an audit senior assigned to the audit engagement team for Belot Enterprises, a wholly-owned subsidiary of a large public company, Helterbrand Associates.

2. Robinson is in the process of completing the review of Belot's financial statements for the company's second quarter.

3. Robinson has discovered that five of the client's discretionary expense accruals, including the allowances for bad debts and inventory obsolescence, are lower than he expected them to be.

4. Zachariah Crabtree, Belot's accounting general manager, explained to Robinson that the June 30^{th} balances of the accruals are lower because of a new "precise point estimate" method that he used in determining them.

5. In the past, Belot established the five accruals at a conservative level, that is, the accruals were overstated somewhat.

6. For the current quarter, Crabtree chose to eliminate the "fat" from the accruals to help Belot reach the target operating income figure for the three-month corporate-wide "Nail the Number" campaign.

7. Six months earlier, Helterbrand placed a new COO in charge of Belot's operations; that individual, Kyle Allen, is responsible for reviving the company's sagging operating results.

8. Allen's Nail the Number Campaign included several measures, such as incentive-based compensation programs for the company's sales staff, intended to produce a significant increase in Belot's year-over-year operating results for the second quarter of the current year.

9. Allen was pleased with Crabtree's decision to lower the discretionary accruals; in fact, the Nail the Number campaign reached its financial goal principally because of the lower accruals at the end of the second quarter.

10. Robinson's decision on how to deal with the accruals "issue" is complicated by the fact that over the past four years he and Crabtree have become good friends—Crabtree has asked Robinson to "pass" on the accruals and not bring the matter to the attention of the audit manager and partner.

11. Further complicating Robinson's decision is the fact that he was recently told by the Belot audit engagement partner that he is partner "material.

12. Robinson is conflicted by his loyalty to Crabtree and his desire to impress the audit partner by "standing up" to Crabtree.

Instructional Objectives

1. To help students understand the dynamics of the relationships that develop between auditors and client personnel.

2. To examine the ethical principle of "integrity" as it relates to auditors and client personnel.

3. To identify key audit objectives for discretionary expense accruals.

4. To identify auditors' responsibilities when reviewing a client's quarterly financial statements.

Suggestions for Use

A key objective of this casebook is to introduce students to the "real world" of the auditing discipline. This case provides students with a window on that that world by demonstrating how a relationship between a senior auditor and a key client contact person (accounting general manager) affects the dynamics of the given engagement. To make this case even more "real" for your students consider setting up a role-playing exercise involving David Robinson (the audit senior) and Zachariah Crabtree (the accounting general manager). There are two "scenes" that students can role play. The first scene involves the discussion that took place between Robinson and Crabtree shortly after the former discovered the "tightening" of the period-ending discretionary accruals. The second scene would focus on the end of the case when Robinson encounters Crabtree at the company picnic. Students' creativity will be tested by the latter scene since the case ends just as the two individuals come face to face with each other at the picnic.

Suggested Solutions to Case Questions

1. What I hope students recognize in addressing this issue is that Robinson's suggested compromise does not appear to be based upon a thoughtful analysis of the underlying accounting and financial reporting issues or concepts. For example, Robinson's compromise does not explicitly address the question of whether the change to the "precise point estimate" method had a material impact on Belot's operating results for the second quarter [granted, it seems fairly obvious that it did]. Even more important, his suggested compromise does not address the question of whether the change to the "precise point estimate" method is a change in accounting method or a change in accounting estimate. [I would suggest that it is a change in accounting estimate and thus should be dealt with prospectively, which it effectively was.] Instead of being "driven" by accounting issues or concepts, Robinson's suggested compromise appears to simply be a "meet-you-about-halfway" sort of offer intended to settle the matter with as little acrimony as possible. I believe students should recognize that the audit process should not be reduced to a bargaining process between client management and auditors.

You might use the disagreement over the accruals to initiate a general discussion of materiality. In a situation such as the one posed by the accruals dispute, I sometimes ask students to individually decide what the given materiality threshold should be. In this case, consider asking students what minimum percentage of the year-over-year increase in Belot's operating income would have to be due to the change in the accruals estimation method for that change to have a material impact on the company's operating income. The most obvious choice would be approximately 29%, which would cause the company's second quarter operating income to fall just below the target goal of a 100% increase. During this discussion, one or more students will likely point out that Crabtree made an invalid argument when he insisted that none of the changes in the accruals individually would be "material." Of course, the key issue is what was the collective impact of the change in estimation methods on Belot's operating income.

2. You may want to point out to your students that "integrity" is one of the ethical principles included in the AICPA *Code of Professional Conduct*. The discussion of that ethical principle within the Code provides a context in which to address the questions of whether or not Crabtree and Robinson possess integrity. According to ET 0.300.040.03-.04.:

> Integrity requires a member to be, among other things, honest and candid within the constraints of client confidentiality. Service and the public trust should not be subordinated to personal gain and advantage. Integrity can accommodate the inadvertent error and the honest difference of opinion; it cannot accommodate deceit or subordination of principle.
>
> Integrity is measured in terms of what is right and just. In the absence of specific rules, standards, or guidance, or in the face of conflicting opinions, a member should test decisions and deeds by asking: "Am I doing what a person of integrity would do? Have I retained my integrity?" Integrity requires a member to observe both the form and the spirit of technical and ethical standards; circumvention of those standards constitutes subordination of judgment.

Given the information in the case, it is difficult to build a strong argument that Crabtree lacks integrity. Nevertheless, there are certainly some "issues" that can be raised regarding his ethical fiber. Students typically suggest that Crabtree's integrity is brought into question by the fact that he "violated" the chain of command rule when he discussed the accruals issue directly with Allen rather than raising the matter first with his immediate superior, Travis Logan. Other students typically use an "end justifies the means" argument to defend Crabtree's conduct. Crabtree was almost certainly aware that Logan would quash the idea of tightening the accruals, so, in the interests of the "greater good," he bypassed Logan and went directly to Allen. Another "minus" in evaluating Crabtree's integrity is that his conduct could be considered self-serving. He stands to benefit personally by reducing the accruals, that is, doing so may help him keep his job and possibly "win" a promotion if Logan resigns. [Granted, as the case points out, Robinson doesn't believe that Crabtree is attempting to replace Logan, but who knows.] A final demerit for Crabtree is the fact that he didn't apprise Robinson of the switch to the precise point estimate method of computing the accruals. It is possible that Crabtree hoped that Robinson wouldn't uncover the fact that the accruals had been systematically "tightened." In rebuttal to this latter point, some students typically suggest that Crabtree did not have an obligation to inform Robinson of the change in the method used to compute the accruals.

Is Robinson a "person of integrity"? Students are typically more critical of Robinson than Crabtree. Given the facts of the case, Robinson seems to be strongly motivated by "personal gain." Again, as pointed out in the solution to Question 1, Robinson's compromise proposal is not predicated on "good" accounting but rather on helping him both appease his friend (Crabtree) and "score points" with his superior (Hansen). In sum, Robinson seems to be "subordinating" his role as the public's financial watchdog to his own personal gain or interests.

Does Robinson have an inappropriate relationship with Crabtree? It is certainly not unusual for friendships to develop between client personnel and independent auditors. However, the issue is at what point do such friendships become dysfunctional? I would suggest that they become dysfunctional when they begin influencing the performance of the given engagement, that is, undermining or potentially undermining the quality of the engagement. In this case, it appears that the relationship between Crabtree and Robinson is doing just that.

3. As a point of information, two of the "accruals" referred to in this case are not accrued liabilities but rather "accrued" valuation accounts. These two accounts are the allowances for bad debts and for inventory obsolescence. The other three discretionary accruals referred to in this case (the accruals for coupon redemptions, employee vacations, and product warranties) are accrued liabilities. The offsetting debits for each of these period-ending "accruals," however, all have a downward effect on an entity's earnings since they involve expense accounts.

The key audit objective for an asset valuation account, an accrued liability, and an expense account is to determine whether the period-ending balances of those accounts are "complete," that is, the auditor is most concerned with understatements of those accounts. A secondary audit objective for these accounts stems from the "existence" assertion. In some cases, dishonest clients may have an incentive to overstate the period-ending balances of those accounts, for instance, to accomplish a "big bath" agenda. Likewise, an honest audit client may consistently be too conservative in establishing the period-ending balances of those accounts. In either case, the existence assertion would be violated. The bottom line is that auditors must at least consider the possibility that those accounts' period-ending balances are overstated, that is, that a portion of those balances do not "exist."

The FASB's Conceptual Framework identifies "conservatism" as a "constraint," similar to the cost-benefit principle and the concept of materiality. The Conceptual Framework does NOT suggest that reporting entities routinely overstate valuation accounts, accrued liabilities, and expenses. Instead, the purpose of the conservatism constraint is to provide a simple rule for reporting entities to follow when there is significant doubt regarding the proper amount of a given financial statement item. That rule is to resolve such doubt by recording the given transaction or event in such a way that the entity's net assets and/or net income are understated rather than overstated.

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

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

CASE 2.9

POWDER RIVER PETROLEUM INTERNATIONAL, INC.

Synopsis

Brian Fox, a Canadian with a background in the oil and gas industry, took control of Powder River in late 2003. Fox became not only the principal stockholder of the small company but also its CEO and CFO. Prior to Fox's arrival, Powder River had posted large losses each year. Thanks to a new strategy implemented by Fox, Powder River became an "overnight" success. Well, not literally. But in 2006, only three years after Fox assumed control of the company, Powder River posted a $5.7 million net income on total revenues of $13.2 million.

Fox's turnaround business strategy for the small oil and gas exploration company involved marketing minority "working interests" in oil and gas properties owned by the company to well-heeled Asian investors, primarily citizens of Singapore. With the help of a business associate with whom he had worked in the past, Fox produced more than $43 million of gross revenue from "Property and Working Interest Sales" in a little more than four years. The gross profit margin on those revenues was enormous. For example, Powder River's 2006 federal tax return reported $17.7 million of taxable revenues from sales of working interests that had a cost basis of less than $150,000.

In 2007, Powder River's "bubble" burst when the company disclosed in its annual Form 10-K filed with the SEC that there was a "catch" to the working interest sales contracts. The company had promised to repay the Asian investors their investments in eleven years or less. More specifically, the sales contracts obligated Powder River to repay, on an annual basis, 9 percent of the purchase price of each working interest until the investors had fully recovered their investments. Fox had concealed this critical feature of the sales contracts from the SEC, his fellow stockholders, and his independent audit firm. By 2007, the company was using the proceeds from new "sales" of working interests to meet its obligation to repay the investments of earlier investors. In the words of the SEC, Fox was operating a Ponzi scam. The SEC also ruled that the "sales" transactions were, in reality, loans from the investors to Powder River.

This case focuses primarily on the independent auditors of Powder River. Both the SEC and the PCAOB castigated the two partners who had supervised the 2004-2007 audits of Powder River. The two agencies reported a litany of oversights made by the partners. In addition, the PCAOB reported that the partners' audit firm had a seriously deficient quality control system that had contributed to the busted audits of Powder River.

Powder River Petroleum International, Inc.--Key Facts

1. In 2003, Brian Fox, a Canadian citizen with experience in the oil and gas industry, became the principal stockholder, CEO, and CFO of Powder River, a small and unprofitable oil and gas exploration company.

2. Fox quickly "turned around" Powder River by implementing a strategy of selling minority working interests in the company's oil and gas properties to Asian investors; Powder River realized a gross profit margin of up to 99% on these sales.

3. Fox concealed a key feature of the working interest sales contracts from the SEC, his fellow stockholders, and the company's auditors, namely, the fact that Powder River was obligated to repay 9% of those "sales" each year until the individual investors had recovered their investments.

4. Even after disclosing the 9% repayment clause, Powder River continued to report the working interest transactions as revenues in its annual financial statements filed with the SEC.

5. Following an investigation, the SEC alleged that Fox was operating a Ponzi scheme and that he had grossly overstated Powder River's reported assets, revenues, and profits.

6. The results of the SEC's investigation and a parallel investigation by the PCAOB revealed numerous deficiencies in the annual audits of Powder River.

7. The SEC charged that the two partners who supervised the 2004-2007 Powder River audits had relied on Brian Fox's characterization of the working interest transactions as sales despite their knowledge of the 9% guaranteed payments being made to the investors annually.

8. The SEC also charged that the two partners failed to discover that Powder River did not own certain oil and gas properties included in its annual balance sheets and failed to properly review the engineering reports that Powder River used to corroborate its reported "proved reserves."

9. In addition to reiterating the SEC's criticisms of the Powder River audit partners, the PCAOB alleged that the partners' audit firm had a seriously flawed quality control system.

10. The SEC suspended Powder River's former audit engagement partners for five years and banned their audit firm from servicing SEC registrants.

11. The PCAOB prohibited Powder River's audit firm from auditing public companies, banned one of the former audit engagement partners from being associated with a PCAOB-registered audit firm for five years, and permanently banned the other partner from associating with such a firm.

12. In 2010, Powder River's Chapter 11 bankruptcy petition was converted to a Chapter 7 or involuntary bankruptcy filing, meaning that the company would be liquidated; in 2011, the SEC filed a civil fraud complaint against Brian Fox.

Instructional Objectives

1. To demonstrate the importance of auditors' obtaining a thorough understanding of new, large and/or unusual client transactions.

2. To demonstrate the limitations of client representations as audit evidence.

3. To help students identify fraud risk factors.

4. To document auditors' responsibilities when relying on audit evidence produced by a "specialist."

5. To examine the nature and purpose of an audit firm's quality control system.

Suggestions for Use

This case focuses on several consecutive audits of an oil and gas exploration company. The case is not highly technical and does not require any background in, or prior knowledge of, the oil and gas industry. Having said that, the case does revolve around accounting and financial reporting decisions for "working interests" in oil and gas properties; however, your students will have no problem grasping the nature of working interests and the related revenue recognition and financial disclosure issues. Certainly, if you want, you could have your students or a group of your students research the key accounting and financial reporting issues for oil and gas companies and then present the results of that research in class prior to covering this case. No doubt, such an assignment would provide your students with a deeper appreciation of the "ticklish" technical accounting and financial reporting issues posed by oil and gas audit clients.

A common caveat that I offer for many of my cases is that they don't necessarily address every significant technical accounting, financial reporting, or auditing issue that was relevant in the given context. That is certainly true for this case. To keep the length of the case manageable, I didn't attempt to address every facet of the Powder River debacle. For example, I didn't address at length Powder River's restatement of its quarterly financial statements for the first three quarters of 2007—which the company bungled, according to the SEC. If you have an interest in addressing financial statement restatements and/or "corrections of errors," you might consider having your students research this facet of the case.

Another interesting issue that you may want to raise in covering this case is auditors' responsibilities vis-à-vis an oil and gas client's supplementary reserve disclosures. An important aspect of this case was the failure of Powder River to include reliable disclosures in its financial statements regarding its oil and gas reserves. The first and only "interpretation" of AS 2705, "Required Supplementary Information," addresses the nature of auditors' responsibilities in this context. That interpretation is entitled "Required Supplementary Information" (AI 19.01-06).

Suggested Solutions to Case Questions

1. In the PCAOB's report in which it disciplined CBN, Todd Chisholm, and Troy Nilson (see PCAOB Release No. 105-2011-003), the agency noted that, "Chisholm and the Firm also failed to consider, or exercise professional skepticism in evaluating, whether information obtained during the audit represented risk factors for fraud." The report went on to identify the following three specific items of information that were fraud risk factors:

   a. the high percentage of revenues (95%) from the sale of working interests in contrast to the minor amount of revenue realized through petroleum production (the remaining 5%);
   b. the issuer's [Powder River's] commitment to pay a 9% return to the Third Parties [Asian investors] irrespective of success or failure in the development of oil fields; and
   c. the ambiguous roles of the parties involved in the purchases and sales of working interests.

Notes: Item "c" is not discussed in the case and revolves around the fact that there was conflicting evidence regarding exactly how the "sales" to the Asian investors were consummated. Certain "audit evidence" indicated that Fox's business associate who was involved in arranging the working interest sales actually purchased the working interests from Powder River and resold them to the Asian investors. Other "audit evidence" suggested that Fox's business associate simply acted as Powder River's sales agent in helping to arrange the transactions. The PCAOB report does not explain the exact nature or source of the conflicting audit evidence, nor how it came into Chisholm's possession; however, the report suggested that Chisholm should have investigated that evidence. Instead, the report notes that Chisholm "relied on uncorroborated representations by management in understanding the" nature of the transactions with the Asian investors. As a point of information, Fox's business associate received a hefty (20 percent) commission on the "sales" to the Asian investors.

In addition to the three fraud risk factors specifically identified by the PCAOB, there were clearly other fraud risk factors present during the Powder River audit engagements. The appendix, "Examples of Fraud Risk Factors," that follows AS 2401, "Consideration of Fraud in a Financial Statement Audit," in the PCAOB's auditing standards categorizes fraud risk factors into the three "angles" of the fraud triangle. Following are paraphrased versions of selected fraud risk factors from that appendix that were particularly relevant to the Powder River audits.

Incentives/Pressures:

- High degree of competition (the oil and gas industry is very competitive—this is especially true for "small-time" oil and gas firms such as Powder River)
- Operating losses making the threat of bankruptcy, foreclosure or hostile takeover imminent (prior to Fox's arrival, Powder River was mired in large operating losses)
- Management has significant financial interests in the entity (as pointed out in the case, Fox owned 40% of Powder River's outstanding common stock)

- Management compensation is contingent on strong operating results (Powder River's impressive reported operating results were used to justify Fox's exorbitant compensation)

Opportunities:

- Key financial statement amounts are based on estimates (among the most critical items in Powder River's financial statements and accompanying footnotes were the estimates of the company's oil and gas reserves)
- Significant, unusual transactions (that is, the transactions with the Asian investors)

Attitudes/Rationalizations:

- Fox's prior "run-in" with Canadian regulatory authorities suggests that he may have not been predisposed to "following rules"

The fraud risk factors identified by the PCAOB and the additional AS 2401 fraud risk factors identified above had significant implications for the CBN auditors. In particular, these risk factors should have prompted the auditors to adjust the NET (nature, extent and timing) of the audit procedures that they applied during the Powder River engagements. (Note: AU-C 240 is the section of the AICPA Professional Standards that corresponds to AS 2401.)

2. This question can be addressed without requiring your students to explore the sometimes tedious accounting and financial reporting rules for oil and gas companies. In fact, the proper accounting for the sales of the working interests and the guaranteed payments to the Asian investors was not particularly challenging. Assume, for example, that Powder River "sold" a working interest to an investor for $100 for which it was paid immediately. [Note: the impact of the sales commissions on the transactions will be ignored.] Also, assume that the cost basis of the working interest was $5. Finally, assume that the net present value of the guaranteed (9%) annual payments to the investors was $74. The proper accounting entry for this transaction would have been:

Cash	$100	
Oil and Gas Properties		$ 5
Loan		74
Revenue		21

Granted, we could quibble over the specific account titles to use for the "Loan" and "Revenue" accounts, but the basic nature of the transaction is captured by this journal entry.

Regarding the annual guaranteed payment to this investor, the proper accounting entry would have been of the following general nature (assuming that $9 was repaid each year):

Loan	$5	
Interest Expense	4	
Cash		$9

Of course, the "divvying up" of the $9 between Loan and Interest Expense would be a mathematical exercise. Likewise, the amount debited to each account over the 11-year repayment period would change annually.

Note: You might consider referring your students to the audit and accounting guide that the AICPA has issued for oil and gas companies if you want them to analyze in more depth audit-related issues for such companies. That guide is entitled, "Audits of Entities with Oil and Gas Producing Activities." The PCAOB referred to this publication in the release it issued regarding Chisholm, Nilson, and the CBN firm. [Note: Despite the PCAOB's express reference to the latter document, I have not found any statement in the PCAOB's auditing standards indicating that the AICPA's audit and accounting guides are considered authoritative literature by the PCAOB.]

3. AS 1105, "Audit Evidence," of the PCAOB auditing standards identifies five general categories of management assertions embedded in any given set of financial statements: existence/occurrence, completeness, valuation/allocation, rights and obligations, and presentation and disclosure (see AS 1105.11):

"Existence or occurrence—Assets or liabilities of the company exist at a given date, and recorded transactions have occurred during a given period."
"Completeness—All transactions and accounts that should be presented in the financial statements are so included."
"Valuation or allocation—Asset, liability, equity, revenue, and expense components have been included in the financial statements at appropriate amounts."
"Rights and obligations—The company holds or controls rights to the assets, and the liabilities are obligations of the company at a given date."
"Presentation and disclosure—The components of the financial statements are properly, classified, described, and disclosed."

The management assertions that were particularly relevant to the "sales" of working interests to the Asian investors were: Completeness, Valuation or Allocation, and Presentation and Disclosure. Powder River violated the completeness assertion by not recording the liabilities stemming from those transactions. Likewise, the company failed to record the revenues resulting from those transactions in the proper amounts and thus violated the valuation/allocation assertion. Finally, the failure of Powder River to provide complete disclosure of the true nature of the working interest transactions in the company's financial statement footnotes violated the presentation and disclosure assertion. (Note: granted, in 2007, Powder River finally referred to the existence of the 9% guaranteed payments to the Asian investors in a financial statement footnote.)

The management assertions that were particularly relevant to the guaranteed payments made to the purchasers of working interests were: Valuation/Allocation and Presentation and Disclosure. Powder River violated the Valuation/Allocation assertion by improperly recording the guaranteed payments as a contra revenue—of course, during the first three quarters of 2007, the company debited those payments to a prepaid expense (asset) account before restating the quarterly financial statements for those three periods and returning to debiting the payments to a contra revenue account. (Note: of course, this latter accounting treatment was patently wrong, as pointed out by the

SEC.) The company violated the Presentation and Disclosure assertion for the guaranteed payments by failing to disclose them prior to 2007. As noted in a footnote to the case, Powder River also improperly referred to the guaranteed payments as a "future commitment" rather than a current and ongoing commitment." (Note: Within the AICPA Professional Standards, the management assertions that underlie the audit objectives developed for specific audit engagements are discussed in AU-C Section 315.A128. Of course, the AICPA's assertion "list" includes 13 items that were derived from the "original" five assertions introduced in the "old" AICPA Professional Standards. Those "old" assertions are retained in the PCAOB's auditing standards.)

4. The definitions of negligence, recklessness, and fraud presented here are found in 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.

Determining the "level" of malfeasance of the oversights made by CBN is a task for a court of law. (Note: I am not aware of any civil lawsuits that have been filed against CBN as a result of this case.) The purpose of this question is to give students an opportunity to "try" CBN in their own court of justice. For what it is worth, my students have generally suggested that CBN's failure to discover that Powder River was including bogus assets in its oil and gas properties qualified as "reckless" behavior.

5. Paragraph .03 of AS 1210, "Using the Work of a Specialist," in the PCAOB's auditing standards identifies the following three scenarios when auditors should consider retaining the

services of an independent expert during the course of an audit engagement. (Note: AU-C Section 620, "Using the Work of an Auditor's Specialist," is very similar but not identical to AS 1210.)

a. "Management engages or employs a specialist and the auditor uses that specialist's work as evidential matter in performing substantive tests to evaluate a material financial statement assertion."
b. "Management engages a specialist employed by the auditor's firm to provide advisory services and the auditor uses that specialist's work as evidential matter in performing substantive tests to evaluate material financial statement assertions."
c. "The auditor engages a specialist and uses that specialist's work as evidential matter in performing substantive tests to evaluate material financial statement assertions."

The first scenario was relevant to the CBN auditors during their audits of Powder River. AS 1210.06 provides the following general guidance for auditors to follow in deciding whether the services of a specialist (of their own) should be retained in that scenario:

> "The auditor's education and experience enable him or her to be knowledgeable about business matters in general, but the auditor is not expected to have the expertise of a person trained or qualified to engage in the practice of another occupation or profession. During the audit, however, an auditor may encounter complex or subjective matters potentially material to the financial statements. Such matters may require special skill or knowledge and in the auditor's judgment require using the work of a specialist to obtain appropriate evidential matter."

Once an auditor has decided to retain the services of a specialist, AS 1210 identifies the following general steps that the auditor should take:

1. Review the qualifications of the specialist to determine whether he or she "possesses the necessary skill or knowledge in the particular field." (AS 1210.08)
2. Obtain a general understanding of the work performed by the specialist.
3. "Evaluate the relationship of the specialist to the client, including circumstances that might impair the specialist's objectivity." (AS 1210.10)
4. Most important, the auditor should: "(a) obtain an understanding of the methods and assumptions used by the specialist; (b) make appropriate tests of data provided to the specialist, taking into account the auditor's assessment of control risk; and (c) evaluate whether the specialist's findings support the related assertions in the financial statements." (AS 1210.12)

6. QC Section 20, "System of Quality Control for a CPA Firm's Accounting and Auditing Practice" in the PCAOB's quality control standards provides an overview of the nature and purpose of a CPA firm's quality control system. (Note: the quality control standards are somewhat different for private company auditors. See the "QC" sections of AICPA Professional Standards.) QC 20.07 identifies the following five elements of quality control for a CPA firm registered with the PCAOB:

a. Independence, Integrity, and Objectivity

b. Personnel Management
c. Acceptance and Continuance of Clients and Engagements
d. Engagement Performance
e. Monitoring

In the PCAOB's report focusing on CBN, the agency criticized the audit firm's quality control system with regard to three of the quality control elements, namely, "personnel management," "acceptance and continuance of clients and engagements," and "engagement performance." Regarding "personnel management," the PCAOB alleged that CBN failed to ensure that audit engagement teams were staffed with individuals having the necessary "technical training and proficiency." In terms of "acceptance and continuance of clients and engagements," the PCAOB criticized CBN for "accepting more engagements than the Firm's partners and staff could appropriately conduct and manage." In terms of "engagement performance," audit assistants assigned to CBN audit engagements were often poorly supervised and, in some cases, had to "decide for themselves" what audit procedures they should apply.

CASE 2.10

LOCATEPLUS HOLDINGS CORPORATION

Synopsis

The management team of LocatePlus developed a New Age business model but relied on an old-fashioned fraud scheme to burnish their company's financial statements. LocatePlus collected a massive database that consisted of information profiles for 98 percent of all U.S. citizens. The company sold access to the database to a wide range of parties that wanted to investigate the backgrounds of job candidates, future business partners, or possibly a prospective son-in-law. By 2004, the company had accumulated an accumulated deficit of $30 million. To improve its operating results, LocatePlus's CEO and CFO developed an imaginary customer. During 2005 and 2006, the two executives relied on this fictitious customer to boost LocatePlus's revenues by more than $6 million. Despite the bogus revenues, the company continued to post large losses each year.

This case focuses on the failure of LocatePlus's independent auditors to uncover their client's less than artful accounting fraud. During both the 2005 and 2006 LocatePlus audits, the company's auditors identified red flags indicative of fraud but failed to properly investigate them. Two partners involved in those audits, the audit engagement partner and the concurring partner, were charged with engaging in "highly unreasonable conduct" by the SEC. In addition to three-year suspensions for each partner, their firm was fined and was required to provide CPE to employees that focused on such topics as fraud detection and risk assessment.

LocatePlus Holdings Corporation--Key Facts

1. The business model of LocatePlus involved selling access to its huge database of information profiles on U.S. citizens to a wide range of parties, including government agencies, corporations, and individuals.

2. To enhance LocatePlus's 2005 and 2006 operating results, the company's CEO and CFO fabricated more than $6 million of revenues from an imaginary customer, Omni Data; the conspirators used fraudulent cash transfers and journal entries to conceal the fraud from their independent auditors.

3. Livingston & Haynes (L & H) accepted LocatePlus as an audit client in early 2005 despite information they obtained from the prior audit firm that suggested the company's management was not trustworthy.

4. During 2005, L & H discovered several red flags that raised serious doubt regarding the reliability of LocatePlus's accounting records; the most critical of these red flags were unsolicited statements from a former board member who maintained that Omni Data was a bogus entity.

5. "Overstated and/or fictitious revenues/accounts receivable" from Omni Data were identified by the L & H auditors as a fraud risk factor during their fraud "brainstorming session" for the 2005 audit.

6. Despite the fraud risk identified for the Omni Data revenues and receivable during the 2005 audit, the key audit evidence collected by L & H to corroborate those material financial statement items was a questionable confirmation obtained from the alleged president of Omni Data.

7. Among other oversights, L & H did not complete a "fraud risk assessment" template for the 2005 LocatePlus audit and failed to reach "any conclusion about the merits" of the allegations made by the company's former board member.

8. The 2006 LocatePlus audit suffered from the same general deficiencies evident during the 2005 audit; in addition, during the 2006 audit, L & H failed to investigate a state agency's claim that "many aspects" of LocatePlus's business "were either highly exaggerated or fictitious."

9. The 2005 and 2006 LocatePlus audit opinions were unqualified but contained a fourth explanatory paragraph that questioned whether the company was a going concern.

10. The SEC accused the LocatePlus audit engagement partner and concurring partner with "highly unreasonable conduct;" both partners were suspended while L & H was fined $130,000 and required to provide CPE for its audit staff members that focused on fraud detection and related topics.

Instructional Objectives

1. To obtain an understanding of auditors' responsibilities when they are considering the possibility that fraud has impacted a public company's financial statements.

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

3. To demonstrate the importance of candid predecessor-successor auditor communications.

4. To examine the role of concurring partners on audit engagements.

5. To understand the nature and purpose of a letter of representations.

Suggestions for Use

This is a case that could be used by instructors to provide a comprehensive review of the requirements of AS 2401, "Consideration of Fraud in a Financial Statement Audit," of the PCAOB's auditing standards. The first case question focuses on that important section of the PCAOB's auditing standards and is easily the most challenging of the case questions. To properly answer that question, students must review AS 2401 and relate the specific requirements of that section to the oversights made by the LocatePlus auditors.

Suggested Solutions to Case Questions

1. Listed next is a bullet list of specific requirements included in AS 2401 of the PCAOB's auditing standards that L & H apparently failed to complete or complete adequately. This bullet list was drawn from the major subsections of AS 2401. A longer list could be compiled by "drilling down" into the detailed requirements of each of these major subsections. (Note: AU-C Section 240 in the AICPA Professional Standards corresponds with AS 2401.)

Paragraph 13: *Failure to exercise sufficient professional skepticism.* This deficiency was apparent in numerous instances during the 2005 and 2006 audits, particularly with regard to considering/investigating the allegations of the former board member of LocatePlus.

Paragraph 52: *Failure to "design and perform audit procedures in a manner that addresses the assessed risks of material misstatement due to error or fraud."* In 2005, L & H identified the fraud risks associated with the large receivable from Omni Data and the related revenues, however, as pointed out in the case they apparently failed to apply rigorous audit procedures to adequately address those fraud risks.

Paragraph 57: *Apparent failure to adequately investigate the possibility that client management had overridden internal controls.* This issue is not addressed in the case and was not addressed explicitly in the SEC Accounting and Auditing Enforcement Release on which the case is based. Nevertheless, given the identified fraud risk for the Omni Data receivable and revenues, it seems that L & H should have focused considerable attention on the question of whether LocatePlus management had circumvented the company's internal controls for the purpose of concealing fraudulent errors in the company's accounting records. As pointed out in the case, fraudulent cash transfers and accounting entries were used to help conceal the fraud from the L & H auditors. (Note: Paragraphs 58-67A of AS 2401 include a long list of specific audit tests and procedures that can be used by auditors to identify instances in which client management may have overridden the given company's internal controls.)

Paragraph 79: *Possible failure to adequately communicate with the client's audit committee regarding potential management fraud*. One could argue that L & H satisfied its responsibility to inform LocatePlus's audit committee regarding the possibility of management fraud when Howley forwarded the allegations of the former board member to the chairman of the company's audit committee. However, given the seemingly extreme nature of the fraud risks uncovered by L & H (and/or communicated to them by the former board member), it seems reasonable to argue that the audit firm should have insisted on having the face-to-face meeting with the audit committee that Howley called for during 2005.

Paragraph 83: *Failure to properly document the auditor's consideration of fraud*. During the 2005 audit, the L & H audit team failed to complete the "Fraud Risk Assessment Form" for that engagement. Even more seriously, the SEC noted that L & H's 2005 workpapers did not document "any conclusions about the merits" of the former board member's allegations of fraud within LocatePlus.

2. For audits of public companies, the relevant auditing standards in this context are presented in AS 2610, "Initial Audits—Communications Between Predecessor and Successor Auditors," of the PCAOB's auditing standards. The comparable auditing standards for audits of other entities can be found in AU-C 210 and AU-C 510 of the AICPA Professional Standards.

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

AS 2610 identifies five specific items of information that the successor auditor should request from the predecessor auditor: 1) information that might bear on the integrity of management, 2) disagreements with management as to accounting principles, auditing procedures, or other similar matters, 3) communications with the client's audit committee (or other parties with similar authority) regarding fraud, illegal acts, and internal control-related matters, 4) the predecessor auditor's understanding as to the reasons for the change in auditors, and 5) the predecessor auditor's understanding of related party relationships, related party transactions, and "significant unusual transactions."

Following the acceptance of the client by the successor auditor, the latter should ask the client to authorize the predecessor auditor to allow it (the successor) to review the predecessor's workpapers. It is customary for the predecessor auditor to provide the successor auditor with copies of key workpapers prepared during the prior year's audit.

3. Note: the source for this suggested solution is AS 1220, "Engagement Quality Review," of the PCAOB's auditing standards.

AS 1220.01 notes that, "An engagement quality review and concurring approval of issuance are required for the following engagements conducted pursuant to the standards of the Public Company Accounting Oversight Board (PCAOB): (a) an audit engagement; (b) a review of interim financial information; and (c) an attestation engagement performed pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers.* (Note: Prior to AS 1220, an "engagement quality review" was typically referred to as a "concurring partner review" or some similar expression.)

AS 1220.09 notes that "In an audit engagement, the engagement quality reviewer should evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report." AS 1220.10 identifies a litany of individual tasks that an engagement quality reviewer must perform on an audit engagement. Examples of these tasks include "evaluate the significant judgments that relate to engagement planning . . .; "evaluate the significant judgments made about materiality . . .;" and "review the financial statements, management's report on internal control, and the related engagement report." In sum, an engagement quality reviewer serves as an overall quality control mechanism for an independent audit.

The ultimate responsibility of the engagement quality reviewer is to decide whether or not to provide "concurring approval of issuance" of the audit report. AS 1220.12 notes that the engagement quality reviewer may not issue "concurring approval" if he or she is aware of any "significant engagement deficiency." That paragraph defines the latter term as follows:

> A *significant engagement deficiency* in an audit exists when (1) the engagement team failed to obtain sufficient appropriate evidence in accordance with the standards of the PCAOB, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement, (3) the engagement report is not appropriate in the circumstances, or (4) the firm is not independent of its client.

4. AS 2805 of the PCAOB's auditing standards documents the nature and purpose of a letter of representations ("management representation letter" is the actual phrase used in this context). The corresponding section of the AICPA Professional Standards is AU-C Section 580, "Written Representations."

AS 2805 mandates that U.S. auditors obtain "written representations from management" (Paragraph 1) and notes that such representations are "part of the evidential matter" (Paragraph 2) that auditors obtain to support the opinion they render on a given client's financial statements. Such representations must be obtained "for all financial statements and periods covered" (Paragraph 5) by the given auditor's report.

Written management representations are obtained to confirm explicit or implicit representations that client management makes to auditors during the course of an audit and also serve to "reduce the possibility of misunderstanding" (Paragraph 2) between the two parties. Among the most important observations made in AS 2805 is the fact that written representations obtained from management are intended to "complement other auditing procedures" (Paragraph 3), meaning that these representations are generally not intended to serve as the primary evidence collected to support key management assertions embedded in a set of financial statements. However, if client management refuses to furnish appropriate written representations to their auditors, such refusal "constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause an auditor to disclaim an opinion or withdraw from the engagement" (Paragraph 13). (Notes: Appendix A of AS 2805 includes an illustrative letter of representations. An implicit objective of obtaining a letter of representations is to mitigate an audit firm's legal liability if it becomes involved in litigation subsequent to completing an audit.)

AS 1105 requires an auditor to collect sufficient appropriate evidence to support his or her opinion. In evaluating the quality of audit evidence, a key issue that the auditor considers is the source of the given evidence. Because client executives are not objective parties, representations they make may be biased, which, of course, devalues the quality or strength of this evidence. [Note: AS 2805 observes that when other evidence obtained by an auditor contradicts representations made by client management, the auditor should investigate the relevant circumstances and consider the reliability of the representations made. "Based on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of the financial statements is appropriate and justified" (Paragraph 4).]

CASE 2.11

OVERSTOCK.COM, INC.

Synopsis

In 1999, Patrick Byrne, the son of a wealthy associate of Warren Buffett, purchased a controlling interest in a small online retailer specializing in "excess" and "closeout" merchandise. Byrne renamed the company Overstock.com and invested several million dollars to expand its operations. Ironically, the bursting of the "dot.com bubble" in 2000 was the trigger that fueled the rapid growth of Overstock. When hundreds of other online companies began falling by the wayside, Overstock stepped in and liquidated their merchandise at fire sale prices. In 2002, Byrne took his company public with an IPO that raised $40 million.

This case revolves around an accounting dispute involving Overstock and the company's audit firm Grant Thornton. In March 2009, Overstock retained Grant Thornton after dismissing its longtime auditor, PwC. In October 2009, the SEC sent a letter to Overstock inquiring about several accounting decisions made by the company. The key focus of the SEC inquiry was the accounting treatment that had been applied to a $785,000 transaction involving one of Overstock's business partners—the company served as an intermediary or sales agent for more than 3,000 other businesses which it referred to as "partners." The accounting treatment applied to the transaction had effectively transferred $785,000 of gross profit from fiscal 2008 to fiscal 2009. When Grant Thornton became aware of this transaction after the SEC inquiry, the audit firm recommended that Overstock restate its prior financial statements to properly account for the transaction. However, Overstock's accounting staff and PwC believed that the original accounting treatment applied to the transaction was reasonable.

The dispute between Grant Thornton and Overstock resulted in Grant Thornton's dismissal in November 2009. Because Overstock did not have sufficient time to retain another audit firm to review its Form 10-Q for the third quarter of 2009, the company made the extremely unusual decision to file its 10-Q with the SEC despite the fact that the company's quarterly financial statements had not been reviewed by an independent audit firm. Adding to the ensuing controversy was a series of contentious exchanges between Overstock's management and Grant Thornton. Each party accused the other of misrepresenting the series of events that had preceded Grant Thornton's dismissal in November 2009. Overstock, for instance, alleged that Grant Thornton had acquiesced to the questionable accounting treatment applied to the $785,000 transaction when it agreed to serve as the company's auditor in March 2009. In an exhibit letter filed with the Form 8-K announcing its dismissal as Overstock's auditor, Grant Thornton insisted that it had been unaware of that questionable accounting treatment when it accepted the Overstock engagement.

Overstock.com, Inc.--Key Facts

1. Warren Buffett launched Patrick Byrne's career in corporate management when he appointed him the interim CEO of a struggling company owned by Berkshire Hathaway; 18 months later, Byrne struck out on his own when he purchased a controlling interest in a small, online retailer that marketed "excess" and "closeout" merchandise.

2. Byrne's company, which became Overstock.com, received a kickstart in 2000 with the bursting of the "dot.com bubble" that produced a huge increase in business for online liquidators such as itself.

3. After going public in 2002, Overstock's revenues grew rapidly, but the company struggled to become profitable; by 2008, the company had yet to report a profit for a full year.

4. In addition to the persistent losses and Patrick Byrne's overbearing public persona, Overstock's multiple financial restatements caused investors to shy away from the company's common stock.

5. In October 2009, Overstock received a letter of inquiry from the SEC that requested information regarding several accounting decisions made by the company including the accounting treatment applied to a $785,000 overpayment made by the company in 2008 to one of its business partners.

6. The accounting treatment applied to the $785,000 overpayment resulted in Overstock's cost of goods sold for 2008 being overstated by that amount; the company's cost of goods sold for the first quarter of 2009 was understated by that same amount when the overpayment was recovered.

7. In fiscal 2008, Overstock and PwC, its audit firm at the time, chose not to record a correcting entry for the overpayment because of uncertainty regarding whether the $785,000 would be recovered.

8. In March 2009, Overstock retained Grant Thornton as its new audit firm; according to Overstock's management, Grant Thornton agreed with the accounting treatment that had been applied to the $785,000 overpayment.

9. In November 2009, following an inquiry by the SEC regarding the accounting treatment applied to the $785,000 overpayment, Grant Thornton informed Overstock that it had never agreed with that accounting treatment; shortly thereafter, Overstock dismissed Grant Thornton.

10. Overstock and Grant Thornton traded combative accusations in a series of Form 8-K's filed with the SEC following the dismissal of Grant Thornton.

11. Because Overstock did not have sufficient time to hire a replacement audit firm, the company filed an "unreviewed" Form 10-Q for the third quarter of fiscal 2009 with the SEC.

12. In 2010, after hiring KPMG as its new audit firm, Overstock restated its prior financial

statements for fiscal 2008 and for the first three quarters of 2009; in 2012, the SEC decided not to file an enforcement action against Overstock for the improper accounting treatment applied to the $785,000 overpayment and related accounting misstatements.

Instructional Objectives

1. To examine the nature and purpose of SEC disclosure requirements for auditor changes.

2. To examine the implications and consequences of auditor-client disagreements.

3. To review the SEC's quarterly reporting requirements.

4. To compare and contrast the nature of audit and review engagements.

5. To identify quantitative and qualitative considerations that impact materiality judgments.

6. To review revenue recognition issues.

Suggestions for Use

This case is ideally suited to be integrated with class coverage of SEC reporting requirements, including those incorporated in the Sarbanes-Oxley statute—recognize that the SEC requirement mandating that quarterly financial statements be reviewed preceded SOX by two years. The case also "fits" well with corporate governance topics and how the independent audit function relates to corporate governance.

There is a "mystery" component of this case, namely, why the SEC didn't respond publicly to Overstock's decision to file an "unreviewed" Form 10-Q for the third quarter of its 2009 fiscal year. In fact, the SEC occasionally accepts "incomplete" filings and defers taking any action if a registrant has a plan to "cure" the deficient filing (you might consider having a group of students research this issue and provide an oral in-class report). Nevertheless, I thought that the SEC would at least make a public statement when a high profile company files "suspect" financial statements for public consumption. It seemed as if the SEC deferred to the relevant stock exchange, the NASDAQ in this case, to serve as the oversight body that ensured that Overstock eventually provided proper financial statement data to the investing public.

Suggested Solutions to Case Questions

1. The dispute between Overstock and Grant Thornton was not that unusual. Given the nature of their relationships, public companies and their independent auditors are commonly involved in disagreements that can range from minor differences of opinion to emotional, tension-packed confrontations. What was unusual was the fact that the Overstock-Grant Thornton dispute was made available for public consumption. No doubt, the finger pointing and caustic allegations diminished, to some degree, the public's respect for the financial reporting domain and the independent audit function. Granted, the most caustic, if not childish, statements were made by Overstock officials. Although Grant Thornton officials candidly expressed their disagreement with statements made by Overstock, they did so with a degree of professionalism and civility. Overstock officials were seemingly less than civil in their attacks on the accounting firm. For example, here is one of the

"jabs" that Overstock management directed at Grant Thornton after retaining KPMG as the company's new audit firm (this statement was not included in the case): "It's nice to be back with a Big Four accounting firm" (Overstock.com press release, 29 December 2009). That statement certainly seems unnecessary and somewhat childish.

You might point out to your students that in the past auditors and their former clients have been criticized for being less than forthcoming or candid in 8-K auditor-change announcements. The SEC adopted the disclosure rules for auditor changes to provide the investing public with meaningful insight on the factors or circumstances that may have contributed to a given change in audit firms. Such disclosures can, in particular, reveal situations in which public companies may be engaging in apparent "opinion shopping." Whatever the circumstances, however, that led to a given change in auditors, the two parties should strive to retain their professionalism and civility to maintain the credibility of, and the public's respect for, the financial reporting domain and the independent audit function.

2. Let me begin with a prologue or overview of what professional standards have to say regarding the critical materiality concept in an accounting context.

The FASB's definition of materiality can be found in *Statement of Financial Accounting Concepts No. 8*: "Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity's financial report." [Note: At press time, the FASB was considering a proposal to adopt the Supreme Court/SEC definition of materiality.]

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

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

Patrick Byrne, himself, suggested on more than one occasion that he didn't understand why so much controversy had arisen over a relatively small transaction involving $785,000. During the November 2009 conference call with financial analysts, for example, he pointed out that the amount of the overpayment was equal to less than .1% of the company's 2008 revenues. Granted, the SEC inquiries and subsequent investigation resulted in a financial restatement of $1.7 million—apparently, other accounting misstatements were discovered as a result of the investigation prompted by the SEC inquiries in the fall of 2009.

Comparing the $785,000 overpayment to the data points presented in Exhibit 1, the issue of quantitative materiality would be most relevant to Overstock's reported Net Loss amounts. If a proper correction had been recorded for the $785,000 overpayment, the 2008 Net Loss would have been reduced by approximately 6% while the Net Loss for the first quarter of 2009 would have been increased by more than 35%. Consequently, it seems reasonable to conclude that the improper accounting treatment initially applied to the overpayment had a material impact on those two amounts. When one considers the fact that the eventual restatement involved $1.7 million of profit being "moved" from 2009 to 2008, the overpayment "issue" was even more material to the 2008 and first quarter 2009 operating results. Note: The Epilogue to the case reveals that Overstock's Net Income for 2009 was $7.7 million. Again, either the $785,000 amount that was central to the Overstock-Grant Thornton dispute or the eventual restatement amount of $1.7 million would have been clearly material to that reported Net Income figure.

As the SEC has observed, "qualitative" factors are particularly relevant to materiality determinations. In the context of this case, one of the most important, if not the most important, qualitative consideration was the fact that Overstock was laser-focused on reporting a profit in 2009 for the first time in the company's history. Under such circumstances, auditors should be aware that the given client may take extraordinary measures to enhance their operating results. Likewise, the fact that Overstock had multiple accounting restatements in the past was certainly relevant to the materiality judgments to be made by the company's auditors. If a company has had multiple accounting restatements in the past, this seems to suggest that it plays "fast and loose" with its key accounting decisions. A final qualitative factor that Overstock's auditors should have considered in their materiality determinations was the fact that the company was the focus of inordinate attention on the part of regulatory authorities. If regulatory authorities are expected to go over a client's financial statements with "a fine tooth comb," auditors should be particularly cautious when assessing the materiality judgments of that client.

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

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

4. The fact that Form 10-Q financial statements are not accompanied by a "review" report although they are subjected to a review comes as a surprise to most students. The SEC mandates that a review report accompany 10-Q financial statements only if the given SEC registrant refers to the fact that the financial statements were reviewed. This was a major issue in the Warnaco securities fraud case in which Deloitte, the company's former audit firm, was named as a defendant. The given federal court

ruled that Deloitte could not be held "primarily" liable for any misstatements in Warnaco's quarterly financial statements because the given 10-Q financial statements were not accompanied by a review report. (The plaintiff argued that because third parties were generally aware that Warnaco was required to have Deloitte review its quarterly financial statements, Deloitte should be held responsible for material misstatements in those financial statements.)

The SEC apparently doesn't require SEC registrants to include review reports with their quarterly financial statements because of concern that investors will misinterpret the degree of assurance that the given auditors ("accountants" is the proper term in this context) are providing. No doubt, many investors, or, at least, naïve investors, would simply glance at a review report and assume that the accompanying financial statements had been audited.

5. The SEC website provides the following general description of the nature and purpose of Form 8-K filings.

> "Form 8-K provides investors with current information to enable them to make informed decisions. The types of information required to be disclosed on Form 8-K are generally considered to be 'material.' That means that, in general, there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision."

Companies generally have four business days to file an 8-K once the "triggering event" takes place. The SEC lists a wide range of disclosure "items" for which a Form 8-K filing is necessary. Following are some examples.

Entry into a "material definitive agreement"
Bankruptcy or receivership proceedings
Completion of a major acquisition or a major disposition of assets
The issuance of an earnings press release
A material impairment of assets
Notice of the delisting of a company's stock by a stock exchange
An unregistered sale of equity securities
A material modification to the rights of security holders
A change in a registrant's certifying accountant

Obviously, the SEC considers a change in auditors to be a "material" event that could impact a reasonable investor's decisions. The mandated disclosures for auditor changes include whether the auditor resigned or was dismissed, the date of the auditor change, whether the former auditor's reports for the prior two years included any qualifications or adverse opinions, whether the given company's audit committee approved the change in auditors, and whether any disagreements took place between the company and the former auditor over the two most recent years.

6. "Grossing" up revenue is a controversial practice. Generally, companies that act as intermediaries or sales agents for other businesses should record only the net amount they receive from their clients or "partners" (Overstock's term) as revenue. Grossing up revenue obviously enhances a company's operating results by making the entity appear more substantial. Enron was among the most notable

companies in the past that used this method to enhance its "top line"—Enron insisted on grossing up the revenue on the energy contracts that it traded. Many other e-commerce companies—Enron was primarily an online company—have also been criticized for enhancing their total revenues by using this accounting method (Priceline is another prominent example).

The notes accompanying Overstock's financial statements identify the conditions that must be met before the company records revenues on a gross basis. "When we are the primary obligor in a transaction, are subject to inventory risk, have latitude in establishing prices and selecting suppliers, or have several but not all of these indicators, revenue is recorded gross. If we are not the primary obligor in the transaction and amounts earned are determined using a fixed percentage, revenue is recorded on a net basis" (Overstock, 2014 Form 10-K). [Note: In March 2016, the FASB issued Accounting Standards Update (ASU) 2016-08, "Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)." This update provides additional guidance to companies, such as Overstock, that must decide whether they qualify as the "principal" or "agent" in revenue transactions involving multiple parties.]

Grossing up revenue is not only controversial from an accounting standpoint but also from an auditing point of view. The PCAOB specifically addressed this topic in Staff Audit Practice Alert No. 12, "Matters Related to Auditing Revenue in an Audit of Financial Statements" (September 9, 2014). In that practice alert, the PCAOB reported that the "Inspections staff observed instances in which auditors failed to perform sufficient procedures to evaluate whether a company's presentation of revenue on a gross basis (as a principal) versus a net basis (as an agent) was in conformity with the applicable financial reporting framework" (p. 9). The PCAOB went on to warn auditors that they had a responsibility to determine whether a client recording revenues on a gross basis was truly the "principal" in the given transaction rather than simply serving as an "agent" for the actual seller.

CASE 2.12

PARKER-HALSEY CORPORATION

Synopsis

Katelyn Light, a Big Four audit manager, unexpectedly finds herself supervising an awkward Saturday morning inventory observation. Katelyn was notified of the assignment just one day earlier by Juan Suarez, an audit partner with whom she works. The assignment is awkward because it is cloaked in secrecy. Suarez's largest audit client, Volterra Chemicals, is in the early stages of negotiations to acquire Parker-Halsey Corporation (PHC), an agrichemicals manufacturer. Volterra's senior management was "burned" on a recent corporate acquisition because the company that was acquired overstated its final year-end inventory prior to the takeover, resulting in its assets, revenues, and profits being significantly overstated. Volterra's executives want to minimize the risk that PHC's management does something similar.

Suarez was asked by Volterra's management to send a team of his "best" auditors to observe PHC's year-end physical inventory. Because Volterra doesn't want other parties to discover its interest in PHC, Suarez's auditors have been instructed to conceal their identities during the physical inventory observation—the only parties aware of the auditors' true identities and purpose are a few members of PHC's accounting staff who are present during the physical inventory.

Katelyn Light's two subordinates on the PHC assignment are an audit senior, Dani Morgan, and an audit associate, Tyler Christian. The three auditors encounter challenges commonly faced during an inventory observation assignment including less than cooperative client personnel and unexpected tactical problems in taking their test counts. Even more challenging, however, is concealing their true identities from the curious team of PHC's independent auditors who are also observing the company's physical inventory.

The major focus of the case is a significant disagreement that arises when Katelyn insists on re-weighing a sample of large inventory storage bins that were allegedly weighed earlier in the week in the presence of PHC's independent auditors. Given the nature of the assignment, Katelyn believes that she must insist that some of the bins be re-weighed. During the course of the disagreement, Katelyn and her subordinates' "cover" is blown, which leads to a heated exchange between her and PHC's audit engagement partner.

Parker-Halsey Corporation—Key Facts

1. Volterra Chemicals, a large public company, is in the early stages of negotiating a buyout of Parker-Halsey Corporation (PHC), a smaller private company that specializes in agrichemicals.

2. Because Volterra's executives are concerned that PHC may intentionally overstate its year-end inventory, they ask their audit engagement partner, Juan Suarez, to send a team of his "best" auditors to observe PHC's year-end physical inventory.

3. The auditors chosen by Suarez for the PHC assignment are Katelyn Light, an audit manager; Dani Morgan, an audit senior and Katelyn's close personal friend; and Tyler Christian, an audit associate who has worked in the past with both Katelyn and Dani.

4. The PHC assignment is complicated for the three auditors because Volterra insists that they conceal their true identities and the nature of their assignment; Volterra's executives don't want any third parties to learn that they are interested in acquiring PHC.

5. During the PHC assignment, the three auditors encounter problems commonly posed by inventory observations including less than cooperative client personnel.

6. The most awkward problem the three auditors face is concealing their true identities and the nature of their assignment from the other parties present during the taking of the physical inventory.

7. The individuals who are most curious about the presence of Katelyn, Dani, and Tyler are the PHC independent auditors who are also observing the physical inventory.

8. Katelyn and her two subordinates inform PHC's employees and independent auditors that they are inventory "consultants"—a few members of PHC's accounting staff, including the company's controller, who are present during the physical inventory are aware of, and participate in, this subterfuge.

9. The "cover" of Katelyn, Dani, and Tyler is blown when a heated disagreement arises; Katelyn insists that certain inventory storage bins must be re-weighed in her presence despite the fact that the bins were allegedly weighed earlier in the week in the presence of two of PHC's independent auditors.

10. PHC's audit engagement partner becomes angry when he discovers that Katelyn and her subordinates are auditors themselves; he is angered even more when Katelyn refuses to rely on the audit procedures that his two subordinates completed earlier in the week.

11. Eventually, PHC's controller agrees to re-weigh a sample of the inventory storage bins in question; the recorded weights of the majority of the bins that are re-weighed are found to be significantly inflated.

12. As a result of the evidence collected by Katelyn's team, Volterra terminates it buyout negotiations with PHC.

Instructional Objectives

1. To examine quasi-audit professional service engagements and the professional standards applicable to such engagements.

2. To identify the audit objectives associated with inventory observation assignments and the audit procedures typically performed during such assignments.

3. To identify the circumstances in which auditors can rely on the results of audit procedures performed by other auditors.

4. To identify internal control weaknesses in a client's physical inventory procedures and the resulting implications for auditors.

5. To examine interpersonal dynamics that may influence the outcome of audits and related professional services.

6. To examine the responsibility of auditors to treat client personnel and professional colleagues with dignity and respect on all engagements.

Suggestions for Use

Public accountants are typically assigned to numerous physical inventory observations during their first few years within the profession. If you "hang around" former auditors long enough, they will eventually begin sharing "war stories" regarding challenging, awkward, or even disastrous inventory observations to which they were assigned. In fact, I have begun coverage of this case by sharing several such anecdotes of my own with my students. If you have such experiences, you might consider sharing them with your students to kick off the coverage of this case. If you are teaching a graduate auditing course, it is very likely that you have students who have been involved in physical inventory observations as interns. Consider asking such students to share their experiences with their classmates.

This case involves several named individuals. Consider developing a roster of these individuals and then using that roster in an exercise to initiate coverage of the case. For example, after posting a roster of the individuals involved in this case on the board or overhead, consider requiring students to rank the professionalism, integrity, and/or "likeability" of each of those individuals (this exercise would overlap somewhat with case question #6). At the very least, having such a roster readily accessible will facilitate and expedite the discussion of the case.

I often remind my students that interpersonal dynamics are critical when it comes to the success or failure of individual audit engagements or individual audit assignments. Interpersonal dynamics can be particularly critical during physical inventory observations. Quite often, these assignments produce "perfect storm" type circumstances in which anything that can go wrong, does go wrong.

Two factors, in particular, account for those perfect storm circumstances, namely, uncooperative client personnel who wish they were somewhere else and overworked auditors who, likewise, wish they were somewhere else. Complicating matters even more is the fact that entry-level auditors are typically given these assignments. Unlike this case, the norm is that entry-level auditors do not have supervisory personnel present during a physical inventory observation. Consequently, when issues arise, these inexperienced auditors are often "on their own" and subject to pressure imposed on them by the given client's supervisory personnel who are present. In other words, auditors can sometimes find themselves "bullied" in these circumstances.

The unanswered question in this case is who was responsible for the apparently systematic overstatement of the recorded weights for the majority of the Section B storage bins. The individual who provided the information on which this case is based did not know the answer to that question. As noted in the epilogue to the case, the company identified as Volterra Chemicals immediately ended its buyout negotiations with the company identified as Parker-Halsey Corporation when the inventory "issue" (overstatement of the Section B inventory weights) was uncovered. The most likely "candidate" in this context was Kenneth Aska, although he appeared to be genuinely shocked by the significant overweights that were discovered during PHC's physical inventory. You might ask your students to develop alternative theories that could explain how the overweights occurred. (The individual who provided the information for this case did report that approximately 10-15% of the Section B storage bins had been weighed correctly. He also reported that these bins were randomly scattered, that is, they were not "clustered together" in the storage area.)

Suggested Solutions to Case Questions

1. In fact, the individual who provided the key information for this case was not aware of how the hours spent on the inventory observation assignment were billed to the client identified as Volterra Chemicals. That individual speculated that since a limited number of hours were involved, they were most likely included in the standard billing for the upcoming Volterra audit, that is, there likely was not a separate engagement letter or agreement prepared for the inventory observation assignment. That individual did suggest that he/she viewed the engagement as a "consulting service" for Volterra that effectively involved forensic-type accounting services.

The AICPA Professional Standards define "consulting services" as follows: "Professional services that employ the practitioner's technical skills, education, observations, experiences, and knowledge of the consulting process. Consulting services may include one or more of the following " consultations . . . advisory services . . . implementation services . . . transaction services . . . staff and support services . . . product services" (CS 100.05). Paragraph CS 100.05 provides detailed descriptions of each of these latter services. The applicable professional standards for consulting engagements are the Statements on Standards for Consulting Services that are issued by the AICPA Management Consulting Services Executive Committee (see the CS Section in the *AICPA Professional Standards, Volume 2*.)

One could question whether the inventory observation assignment qualified as an "attest" engagement, which would mean that the Attestation Standards applied to the assignment. Paragraph AT Section 101.01 makes the following statement regarding the applicability of the profession's attestation standards: "This section applies to engagements, except for those services discussed in paragraph .04, in which a certified public accountant in the practice of public accounting (hereinafter referred to as a practitioner) is engaged to issue or does issue an examination, a review or an agreed-upon procedures report on subject matter, or an assertion about the subject matter (hereinafter referred to as the assertion), that is the responsibility of another party." The five specific exceptions referred to in the previous statement are audits, reviews, consulting engagements (as defined by the profession's consulting standards), advocacy engagements, and tax preparation or tax advisory engagements. The exception regarding consulting engagements includes the following verbiage: "Services performed in accordance with the Statements on Standards for Consulting Services, such as engagements in which the practitioner's role is solely to assist the client (for example acting as the company's accountant in preparing information other than financial statements), or engagements in which a practitioner is engaged to testify as an expert witness in accounting, auditing, taxation, or other matters, given stipulated facts."

As the case suggests, a verbal or possibly written report was prepared for Volterra Chemicals—that "report" prompted Volterra to end its buyout negotiations with PHC. But the information available in the case (and from the party who provided the central information for the case) suggests that the given report was not an "attest report." Again, the individual who was the principal source of the information for this case viewed the assignment as involving the provision of forensic consulting services.

Note: If the inventory observation assignment was treated as a "consulting" engagement by Juan Suarez's firm, then that assignment may have posed an independence problem for his firm. "The performance of Consulting Services for an attest client does not, in and of itself, impair independence. However, members and other firms performing attest services for a client should comply with applicable independence standards, rules, and regulations issued by AICPA, the state boards of accountancy, state CPA societies, and other regulatory agencies" (CS 100.09). You might consider extending this question by asking your students to identify the independence-related issues that the inventory observation assignment might have raised for the given firm's Volterra audit team. I would suggest that the engagement effectively placed Katelyn Light and her subordinates in the position of being advocates for Volterra, which is inconsistent with serving as the company's independent auditors. (Granted, Katelyn and her subordinates were not assigned to the Volterra audit team but they were employed by Volterra's audit firm and, even more importantly, their "boss" Juan Suarez headed up the Volterra audit engagement team.)

2. The key audit objective for the Dulin & Jensen auditors was to confirm the "existence" assertion for Volterra's inventory. The principal audit procedure applied to accomplish that goal is the taking of tests counts during a physical inventory observation. Those test counts are then tracked into the client's final inventory records. Other existence-related audit procedures are reviewing the client's physical inventory instructions to determine whether they are sufficient and observing the implementation of those procedures to determine that they were properly applied by client personnel involved in the physical inventory. Another concern of auditors during a client's physical inventory is the "valuation" assertion. While observing the client's physical inventory procedures and taking their own test counts, auditors should identify and record any indications that the inventory may be overvalued due to obsolescence, damage, or other circumstances. A secondary concern of auditors during an inventory observation is typically the "ownership" assertion. Auditors should attempt to determine that the inventory items they are counting are actually owned by the given client. For example, the auditors should determine that any consigned inventory on hand is not included in the

physical inventory and that inventory in-transit is properly dealt with by the client during the physical inventory.

Katelyn Light and her two subordinates were also focused on the existence, valuation, and ownership assertions. However, as documented in the answer to Question #1, Katelyn's team was not addressing those assertions from the standpoint of independent auditors. Instead, Light's team was present during the physical inventory observation as surrogates for their firm's audit client, Volterra Chemicals. As such, Katelyn, Dani, and Tyler were effectively serving as forensic investigators. Compared to independent auditors, forensic investigative teams generally require more extensive and rigorous evidence. Why? Because their clients demand a higher level of certainty than that yielded by an independent audit.

In addition to searching for violations of the existence, valuation, and ownership assertions, Katelyn's team was also instructed to search for internal control problems and any indications of "hanky panky" on the part of PHC. During the course of an inventory observation, independent auditors would certainly take note of internal control problems and any aberrant behavior on the part of client employees that they encounter. However, Katelyn and her subordinates, no doubt, were much more focused on searching for such circumstances given Juan Suarez's instructions to them.

3. The issue of whether or not to rely on the work of another audit firm most commonly arises in the context of an audit of "group financial statements." Such audits are discussed in AU-C Section 600, "Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)." In such engagements, individual "components" of the given entity being audited are examined by different audit firms. That situation does not apply to the case at hand. Nevertheless, we can extrapolate from the context of AU-C Section 600 to the setting of this case: "An auditor may find this section, adapted as necessary in the circumstances, useful when that auditor involves other auditors in the audit of financial statements that are not group financial statements. For example, an auditor may involve another auditor to observe the inventory count or inspect physical fixed assets at a remote location" (AU-C Section 600.02). Granted, Katelyn and her two subordinates were not technically "involved" in the PHC audit, but, nevertheless, her team was providing an audit-related professional service in which they had a choice of whether or not to rely on the work of another audit firm.

When deciding whether or not to rely on the work of another audit firm, the audit firm in question must consider several factors per AU-C Section 600. In the situation at hand, arguably the most important of those issues would have been the "professional competence" and "independence" of the Dulin & Jensen auditors. [Note: See AU-C Section 600.22 for a list of other factors that should be considered when deciding whether to rely on the work of another audit firm.] Given the statement made by Kenneth Aska, the Section B foreman, there was certainly some reason to doubt the competence of the Dulin & Jensen auditors, at least the two auditors who had witnessed the earlier weighing of the large storage bins in Section B. If Katelyn Light had decided to rely on those auditors' work, she would have had, at a minimum, a responsibility to investigate the veracity of the statement made by Kenneth Aska which suggested that the auditors had not properly completed their observation of the Section B inventory weighing process. (Of course, Katelyn, chose not to rely on the audit procedures performed by the Dulin & Jensen auditors—which she certainly had a right to do. Why did she choose not to rely on the work of those auditors? Most likely because regardless of what audit procedures were actually performed by Dulin & Jensen for the Section B inventory, she didn't consider those procedures adequate given the specific instructions she had received from Juan Suarez.)

In the PCAOB's auditing standards, AS 1205, "Part of the Audit Performed by Other Independent Auditors," addresses circumstances in which multiple accounting firms are involved in an audit of an SEC registrant. Again, although not directly relevant to this case, we can extrapolate from the context of AS 1205 to the setting of this case. AS 1205.10 provides insight on what steps should be taken when one audit firm is deciding whether or not to rely on the work of another audit firm: "Whether or not the principal auditor decides to make reference to the audit of the other auditor [in the relevant audit opinion], he should make inquiries concerning the professional reputation and independence of the other auditor." So, again, the overall competence and independence of the "other auditor" are key issues that should be addressed by an auditor when deciding whether to rely on the work of another auditor.

4. Listed next are weaknesses that were evident in PHC's inventory-taking procedures.

   (a) The most glaring weakness was the company's decision to continue shipping operations during the physical inventory. A cardinal rule of physical inventories is that shipping operations should be suspended while the inventory is being counted.
   (b) The instructions given to the inventory count teams were apparently inadequate (given Katelyn's observations regarding those instructions).
   (c) The poor organization of the inventory in the toxic section (a weakness observed by Dani).
   (d) The lack of familiarity of at least some count teams with the inventory items they were counting.
   (e) The lack of cooperation with Katelyn's audit team that was evident on the part of certain PHC employees, in particular, Kenneth Aska.
   (f) The significant differences in the "pre-weights" and the "re-weights" of the Section B storage bins. This condition cast doubt on not only the integrity/competence of PHC's inventory-taking procedures but also on the integrity/competence of its employees (and officers).

These significant weaknesses in PHC's inventory-taking procedures had significant implications for both sets of auditors. Given these weaknesses, the auditors should have expanded the rigor ("nature") and scope ("extent") of the audit tests they applied during and after the physical inventory. In fact, given the severity of the weaknesses, the auditors might have considered suggesting that the physical inventory be delayed until those weaknesses had been remedied.

5. This particular issue is not addressed in the professional auditing standards. However, one could easily argue that the job performance of lower-level auditors is enhanced by "keeping them in the loop," that is, by fully informing them of the purpose of the tasks that they have been assigned. Failure to do so, at a minimum, signals some degree of distrust on the part of their superiors. Although entry-level auditors are just that, they are also professionals and should be treated as such by their superiors. Having said that, there were certainly extenuating circumstances in this particular case. The most importance of those circumstances was the extreme degree of secrecy demanded by Volterra's management.

6. Consider listing each of the auditors and accountants involved in this case on the board or overhead and then lead an in-class discussion of the professionalism of each of those individuals and/or rank these individuals in terms of their overall professionalism (see the "Suggestions for Use" section). Listed next are the relevant individuals in this case and selected comments for each. (You might consider adding Kenneth Aska to this list. Although he wasn't an accountant, he had control-related responsibilities. I didn't list Mitch, the PHC assistant controller, or Kevin, the D&J auditor mentioned briefly in the case, since there was not sufficient information to assess their professionalism.)

Katelyn Light: This audit manager has to be given high marks for professionalism given the capable way in which she dealt with a particularly challenging set of circumstances. She not only was an

effective and considerate supervisor, but she also exhibited considerable grace and integrity "under fire" while dealing with the "storage bins" debacle.

Dani Morgan: Her temper tantrum during the early morning meeting with Katelyn and Tyler was not what one would expect of an audit senior with three years of experience. During the actual inventory observation, however, she did exhibit tenacity in completing her responsibilities. Granted, she was somewhat overbearing with Kenneth Aska and seemed to go out of her way to agitate him.

Tyler Christian: As the lowest-ranking member of the audit team, Tyler demonstrated a willingness to defer to his two superiors, which was admirable. But he seemed somewhat "cowed" by the overly aggressive Kenneth Aska. He also could have been more "focused" during the inventory observation assignment. The "slips of tongue" that he made during the assignment could have been impeded its successful completion.

Juan Suarez: We don't have much information to assess this individual's professionalism. One concern that could be raised is whether he consulted with his peers or someone in the regional or national office regarding his decision to accept the PHC inventory observation engagement. As noted in the suggestion solution to Question #1, that engagement may have posed an independence "problem" for the Volterra audit engagement.

Wade Cooper: Cooper, PHC's corporate controller, comes across as a thoughtful and level-headed individual in the case. He interceded when the exchange between Katelyn and Herzberger became heated; he made a seemingly proper decision to re-weigh some of the storage bins; and then, when the re-weighing procedure resulted in significant differences, he made the very reasonable decision to re-weigh all of the bins and provide the results to Katelyn on an ASAP basis.

Hayden Herzberger: His interaction with Katelyn did not present him in a favorable light. He attempted to "bully" her, interceded between Cooper and Katelyn when he should not have, and came across as an overall "hothead." Plus, he had to be held responsible, to some degree, for the apparent unprofessionalism of his two lower-level subordinates who apparently failed to properly complete their assignment to observe the original weighing of the storage bins.

"Tony": This Dulin & Jensen auditor is only mentioned in passing in the case. But that mention was not favorable. He was portrayed as overly inquisitive and as a "weak-kneed" auditor, that is, an auditor who capitulated to the demands or wishes of his client.

Two unnamed D&J auditors assigned to observe the original weighing of the Section B storage bins:

If true, these individuals' failure to complete their assigned task (and to report that failure to their superiors) causes them to be squarely placed in the "unprofessional" camp.

JACK GREENBERG, INC.

JACK GREENBERG, INC.

- 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.

JACK GREENBERG, INC.

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

JACK GREENBERG, INC.

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

JACK GREENBERG, INC.

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

JACK GREENBERG, INC.

- 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.

JACK GREENBERG, INC.

- 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.

JACK GREENBERG, INC.

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

JACK GREENBERG, INC.

- 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.

JACK GREENBERG, INC.

- 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.

JACK GREENBERG, INC.

- 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.

GOLDEN BEAR GOLF, INC.

GOLDEN BEAR GOLF, INC.

- 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 Twentieth Century.

GOLDEN BEAR GOLF, INC.

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

GOLDEN BEAR GOLF, INC.

- 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.

GOLDEN BEAR GOLF, INC.

- 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.

GOLDEN BEAR GOLF, INC.

- 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.

GOLDEN BEAR GOLF, INC.

- 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.

GOLDEN BEAR GOLF, INC.

- 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.

GOLDEN BEAR GOLF, INC.

- 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.

GOLDEN BEAR GOLF, INC.

- 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.

GOLDEN BEAR GOLF, INC.

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

TAKE-TWO INTERACTIVE SECURITIES, INC.

TAKE-TWO INTERACTIVE SOFTWARE, INC.

- In 1993, when he was only twenty-one years old, Ryan Brant organized Take-Two Interactive Software, a company that produced and distributed video games.

TAKE-TWO INTERACTIVE SOFTWARE, INC.

- Robert Fish, a PwC audit partner, supervised the annual audits of Take-Two from 1994-2001; Fish also served as one of Brant's principal business advisors and, when interviewed, suggested that he had a father-son type relationship with the much younger Brant.

TAKE-TWO INTERACTIVE SOFTWARE, INC.

- While Take-Two was in a developmental stage, PwC sharply discounted the professional fees that it charged the company.

TAKE-TWO INTERACTIVE SOFTWARE, INC.

- Brant took his company public in 1997 to obtain the funding necessary to fuel Take-Two's growth-by-acquisition strategy.

TAKE-TWO INTERACTIVE SOFTWARE, INC.

- A video game produced by a company acquired by Take-Two would become *Grand Theft Auto*, one of the most controversial but best-selling video games of all time.

TAKE-TWO INTERACTIVE SOFTWARE, INC.

- An SEC investigation revealed that Take-Two executives recorded a large volume of bogus sales transactions during 2000 and 2001 to ensure that the company achieved its consensus earnings forecasts each quarterly reporting period.

TAKE-TWO INTERACTIVE SOFTWARE, INC.

- Take-Two would ultimately be required to restate its financial statements three times over a five-year period to correct material misrepresentations resulting from the bogus sales transactions and improper “backdating” of stock option grants.

TAKE-TWO INTERACTIVE SOFTWARE, INC.

- The SEC issued an enforcement release that criticized PwC's 2000 Take-Two audit; the enforcement release focused on improper decisions allegedly made by Robert Fish during that engagement.

TAKE-TWO INTERACTIVE SOFTWARE, INC.

- Fish identified "revenue recognition" and "accounts receivable reserves" as areas of "higher risk" for the 2000 audit, according to the SEC, but failed to properly respond to those high-risk areas during the engagement.

TAKE-TWO INTERACTIVE SOFTWARE, INC.

- The “alternative audit procedures” that PwC applied after realizing an extremely low response rate on its accounts receivable confirmation requests were flawed and inadequate.

TAKE-TWO INTERACTIVE SOFTWARE, INC.

- PwC also failed to properly audit Take-Two's reserve for sales returns, which may have prevented the firm from discovering the bogus sales recorded by the company.

TAKE-TWO INTERACTIVE SOFTWARE, INC.

- The SEC sanctioned Fish, Brant, and three other Take-Two executives; Brant resigned from Take-Two during the SEC's investigation of the company's scheme to backdate its stock option grants, a scheme that he had masterminded.

GENERAL MOTORS COMPANY

GENERAL MOTORS COMPANY

- Billy Durant, who worked as an itinerant salesman as a young man, became extremely wealthy after organizing General Motors in 1908.

GENERAL MOTORS COMPANY

- Durant would lose his fortune in the stock market and spend the final years of his life in poverty and relative obscurity.

GENERAL MOTORS COMPANY

- GM reigned as the world's largest automobile manufacturer for nearly eight decades until 2009 when it filed for bankruptcy during the midst of a severe economic crisis gripping the U.S. economy.

GENERAL MOTORS COMPANY

- A key factor that contributed to GM's downfall was the company's significant pension and other postretirement benefit expenses that made its cars more costly than those of foreign competitors.

GENERAL MOTORS COMPANY

- In the decades prior to GM’s bankruptcy filing, critics accused GM executives of “juggling” the company’s reported financial data to conceal its deteriorating financial health.

GENERAL MOTORS COMPANY

- GM's pension-related financial statement amounts were among the items allegedly misrepresented.

GENERAL MOTORS COMPANY

- Accounting for pension-related financial statement items has long been a controversial issue within the accounting profession; in 1985, the FASB finally adopted a new accounting standard that moved the profession toward accrual basis accounting for those items.

GENERAL MOTORS COMPANY

- The FASB's new standard still allowed companies to manipulate their pension-related financial statement amounts because of several key assumptions that had to be made in accounting for those items, including the discount rate used to determine the present value of pension liabilities.

GENERAL MOTORS COMPANY

- For fiscal 2002, GM chose to apply a 6.75% discount rate to determine its pension liability when most evidence suggested that a considerably lower discount rate should have been applied.

GENERAL MOTORS COMPANY

- After initially contesting the 6.75% discount rate, GM's audit firm, Deloitte, eventually acquiesced and accepted that rate.

GENERAL MOTORS COMPANY

- Deloitte agreed to approve the 6.75% discount rate after GM officials indicated that they would include a “sensitivity analysis” in their company’s 2002 financial statements that would demonstrate the financial statement impact of a range of different discount rates, including the 6.75% rate.

GENERAL MOTORS COMPANY

- In a subsequent complaint filed against GM, the SEC maintained that the company's pension-related amounts and disclosures within its 2002 financial statements were "materially misleading," including the sensitivity analysis.

GENERAL MOTORS COMPANY

- In January 2009, the SEC sanctioned GM for several abusive accounting and financial reporting practices, including its accounting and financial reporting decisions for its pension liabilities and related items.

GENERAL MOTORS COMPANY

- In July 2009, the “new General Motors” (General Motors Company) emerged from bankruptcy proceedings; the federal government was the new company’s principal stockholder.

LIPPER HOLDINGS, LLC

LIPPER HOLDINGS, LLC

- Kenneth Lipper was raised in a modest working-class neighborhood in New York City.

LIPPER HOLDINGS, LLC

- In addition to establishing a successful Wall Street investment firm and serving as the deputy mayor of New York City, Lipper had a successful career as a Hollywood screenwriter and film producer.

LIPPER HOLDINGS, LLC

- Kenneth Lipper was a leader of the emerging hedge fund industry in the 1990s; his firm, Lipper Holdings, managed three hedge funds, the largest of which was Lipper Convertibles.

LIPPER HOLDINGS, LLC

- One of Lipper's top subordinates, Edward Strafaci, served as the portfolio manager for the three Lipper hedge funds.

LIPPER HOLDINGS, LLC

- To inflate the reported rates of return earned by the Lipper hedge funds, Strafaci began overstating the year-end market values of the investments they held.

LIPPER HOLDINGS, LLC

- Following Strafaci's unexpected resignation in January 2002, an internal investigation revealed his fraudulent scheme.

LIPPER HOLDINGS, LLC

- Lipper Holdings' longtime audit firm, PwC, became a focal point of the SEC's investigation of Strafaci's fraud.

LIPPER HOLDINGS, LLC

- The SEC's investigation revealed that PwC had collected considerable evidence indicating that the collective market values of the three hedge funds' investments were materially overstated.

LIPPER HOLDINGS, LLC

- Despite that audit evidence, PwC issued unqualified audit opinions on the Lipper hedge funds' financial statements throughout its tenure as their independent audit firm.

LIPPER HOLDINGS, LLC

- The SEC suspended the former PwC partner who had supervised the Lipper hedge fund audits after ruling that he had been a “cause” of their violations of federal securities laws.

CBI HOLDING COMPANY, INC.

CBI HOLDING COMPANY, INC.

- In 1991, TCW purchased a 48 percent ownership interest in CBI from Robert Castello, the company’s owner and chief executive.

CBI HOLDING COMPANY, INC.

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

CBI HOLDING COMPANY, INC.

- 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.

CBI HOLDING COMPANY, INC.

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

CBI HOLDING COMPANY, INC.

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

CBI HOLDING COMPANY, INC.

- 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.

CBI HOLDING COMPANY, INC.

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

CBI HOLDING COMPANY, INC.

- 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.

CBI HOLDING COMPANY, INC.

- 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.

CBI HOLDING COMPANY, INC.

- 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.

BANKRATE, INC.

BANKRATE, INC.

- In June 2011, Bankrate re-emerged as a public company; financial analysts predicted that the company would be very successful because it was the dominant aggregator of financial information needed by U.S. consumers and because it had a proven business model.

BANKRATE, INC.

- Bankrate’s two primary revenue streams include payments for leads (referrals) delivered to the approximately 5,000 financial services providers whose products are profiled on its websites and the sale of display advertising on those same websites.

BANKRATE, INC.

- In August 2014, Bankrate paid $18 million to a group of its stockholders who claimed that the company had improperly embellished its potential leads revenue shortly after going public in 2011.

BANKRATE, INC.

- One month later, in September 2014, Bankrate revealed that the SEC was investigating its reported operating results for the second quarter of 2012.

BANKRATE, INC.

- In September 2015, Bankrate and Hyunjin Lerner, the company’s former vice president of finance, settled fraud charges filed against them by the SEC without either admitting or denying those charges.

BANKRATE, INC.

- The settlement with the SEC required Bankrate to pay a $15 million fine and Lerner a fine of $180,000; Lerner also agreed to a five-year ban from practicing before the SEC.

BANKRATE, INC.

- At the same time that the settlements with Bankrate and Lerner were announced, the SEC reported that it was continuing to pursue charges filed against Edward DiMaria and Matthew Gamsey, Bankrate's former CFO and director of accounting, respectively.

BANKRATE, INC.

- In a 43-page legal complaint, the SEC alleged that DiMaria had “fostered a corporate culture within Bankrate’s accounting department that condoned using improper accounting techniques to achieve financial targets.”

BANKRATE, INC.

- In July 2012, Bankrate's preliminary adjusted EBITDA and adjusted EPS for the second quarter of 2012 came up short of analysts' consensus earnings estimates for that quarter.

BANKRATE, INC.

- To eliminate the earnings shortfall, DiMaria allegedly instructed Lerner and Gamsey to make several improper entries in Bankrate’s accounting records.

BANKRATE, INC.

- Those improper entries included recording approximately $800,000 of bogus revenue and reducing a marketing expense account and the corresponding accrued liability account by $400,000.

BANKRATE, INC.

- The conspirators took explicit measures to conceal the accounting fraud from the company’s Grant Thornton auditors.

BANKRATE, INC.

- In June 2015, following the conclusion of the SEC's investigation, Bankrate issued restated financial statements for the second quarter of 2012.

BELOT ENTERPRISES

BELOT ENTERPRISES

- David Robinson is an audit senior assigned to the audit engagement team for Belot Enterprises, a wholly-owned subsidiary of a large public company, Helterbrand Associates.

BELOT ENTERPRISES

- Robinson is in the process of completing the review of Belot's financial statements for the company's second quarter.

BELOT ENTERPRISES

- Robinson has discovered that five of the client’s discretionary expense accruals, including the allowances for bad debts and inventory obsolescence, are lower than he had expected them to be.

BELOT ENTERPRISES

- Zachariah Crabtree, Belot's accounting general manager, explained to Robinson that the June 30th balances of the accruals are lower because of a new "precise point estimate" method that he used in determining them.

BELOT ENTERPRISES

- In the past, Belot established the five accruals at a conservative level, that is, the accruals were overstated somewhat.

BELOT ENTERPRISES

- For the current quarter, Crabtree chose to eliminate the “fat” from the accruals to help Belot reach the target operating income figure for the three-month corporate-wide “Nail the Number” campaign.

BELOT ENTERPRISES

- Six months earlier, Helterbrand had placed a new COO in charge of Belot’s operations; that individual, Kyle Allen, is responsible for reviving the company’s sagging operating results.

BELOT ENTERPRISES

- Allen's Nail the Number campaign included several measures, such as incentive-based compensation programs for the company's sales staff, to produce a significant increase in Belot's year-over-year operating results for the second quarter of the current year.

BELOT ENTERPRISES

- Allen was pleased with Crabtree's decision to lower the discretionary accruals; in fact, the Nail the Number campaign reached its financial goal principally because of the lower accruals at the end of the second quarter.

BELOT ENTERPRISES

- Robinson’s decision on how to deal with the accruals “issue” is complicated by the fact that over the past four years he and Crabtree have become good friends—Crabtree has asked Robinson to “pass” on the accruals and not bring the matter to the attention of the audit manager and partner.

BELOT ENTERPRISES

- Further complicating Robinson's decision is the fact that he was recently told by the Belot audit engagement partner that he is partner "material."

BELOT ENTERPRISES

- Robinson is conflicted by his loyalty to Crabtree and his desire to impress the audit partner by “standing up” to Crabtree.

POWDER RIVER PETROLEUM INTERNATIONAL, INC.

Powder River Petroleum International, Inc.

- In 2003, Brian Fox, a Canadian citizen with experience in the oil and gas industry, became the principal stockholder, CEO, and CFO of Powder River, a small and unprofitable oil and gas exploration company.

Powder River Petroleum International, Inc.

- Fox quickly “turned around” Powder River by implementing a strategy of selling minority working interests in the company’s oil and gas properties to Asian investors; Powder River realized a gross profit margin of up to 99% on these sales.

Powder River Petroleum International, Inc.

- Fox concealed a key feature of the working interest sales contracts from the SEC, his fellow stockholders, and the company's auditors, namely, the fact that Powder River was obligated to repay 9% of those "sales" each year until the individual investors had recovered their investments.

Powder River Petroleum International, Inc.

- Even after disclosing the 9% repayment clause, Powder River continued to report the working interest transactions as revenues in its annual financial statements filed with the SEC.

Powder River Petroleum International, Inc.

- Following an investigation, the SEC alleged that Fox was operating a Ponzi scheme and that he had grossly overstated Powder River's assets, revenues, and profits.

Powder River Petroleum International, Inc.

- The results of the SEC's investigation and a parallel investigation by the PCAOB revealed numerous deficiencies in the annual audits of Powder River.

Powder River Petroleum International, Inc.

- The SEC charged that the two partners who supervised the 2004-2007 Powder River audits had relied on Brian Fox's characterization of the working interest transactions as sales despite their knowledge of the 9% guaranteed payments made to the investors annually.

Powder River Petroleum International, Inc.

- The SEC also charged that the two partners failed to discover that Powder River did not own certain oil and gas properties included in its annual balance sheets and failed to properly review the engineering reports that Powder River used to corroborate its reported "proved reserves."

Powder River Petroleum International, Inc.

- In addition to reiterating the SEC's criticisms of the Powder River audit partners, the PCAOB alleged that the partners' audit firm had a seriously flawed quality control system.

Powder River Petroleum International, Inc.

- The SEC suspended Powder River's former audit engagement partners for five years and banned their audit firm from servicing SEC registrants.

Powder River Petroleum International, Inc.

- The PCAOB prohibited Powder River's audit firm from auditing public companies, banned one of the former audit engagement partners from being associated with a PCAOB-registered audit firm for five years, and permanently banned the other partner from associating with such a firm.

Powder River Petroleum International, Inc.

- In 2010, Powder River's Chapter 11 bankruptcy petition was converted to a Chapter 7 or involuntary bankruptcy filing, meaning that the company would be liquidated; in 2011, the SEC filed a civil fraud complaint against Brian Fox.

LOCATEPLUS HOLDINGS CORPORATION

LOCATEPLUS HOLDINGS CORPORATION

- The business model of LocatePlus involved selling access to its huge database of information profiles on U.S. citizens to a wide range of parties, including government agencies, corporations, and individuals.

LOCATEPLUS HOLDINGS CORPORATION

- To enhance LocatePlus's 2005 and 2006 operating results, the company's CEO and CFO fabricated more than $6 million of revenues from an imaginary customer, Omni Data; the conspirators used fraudulent cash transfers and journal entries to conceal the fraud from their auditors.

LOCATEPLUS HOLDINGS CORPORATION

- Livingston & Haynes (L & H) accepted LocatePlus as an audit client in early 2005 despite information they obtained from the prior audit firm that suggested the company's management was not trustworthy.

LOCATEPLUS HOLDINGS CORPORATION

- During 2005, L & H discovered several red flags that raised serious doubt regarding the reliability of LocatePlus's accounting records; the most critical of these red flags were unsolicited statements from a former board member who maintained that Omni Data was a bogus entity.

LOCATEPLUS HOLDINGS CORPORATION

- “Overstated and/or fictitious revenues/ accounts receivable” from Omni Data were identified by the L & H auditors as a fraud risk factor during their fraud “brainstorming session” for the 2005 audit.

LOCATEPLUS HOLDINGS CORPORATION

- Despite the fraud risk identified for the Omni Data revenues and receivable during the 2005 audit, the key audit evidence collected by L & H to corroborate those material financial statement items was a questionable confirmation obtained from the alleged president of Omni Data.

LOCATEPLUS HOLDINGS CORPORATION

- Among other oversights, L & H did not complete a “fraud risk assessment” template for the 2005 LocatePlus audit and failed to reach “any conclusion about the merits” of the allegations made by the company’s former board member.

LOCATEPLUS HOLDINGS CORPORATION

- The 2006 LocatePlus audit suffered from the same general deficiencies evident during the 2005 audit; in addition, during the 2006 audit, L & H failed to investigate a state agency's claim that "many aspects" of LocatePlus's business "were either highly exaggerated or fictitious."

LOCATEPLUS HOLDINGS CORPORATION

- The 2005 and 2006 LocatePlus audit opinions were unqualified but contained a fourth explanatory paragraph that questioned whether the company was a going concern.

LOCATEPLUS HOLDINGS CORPORATION

- The SEC accused the LocatePlus audit engagement partner and concurring partner with "highly unreasonable conduct;" both partners were suspended while L & H was fined $130,000 and required to provide CPE for its audit staff members that focused on fraud detection and related topics.

OVERSTOCK.COM, INC.

OVERSTOCK.COM, INC.

- Warren Buffett launched Patrick Byrne’s career in corporate management when he appointed him the interim CEO of a struggling company owned by Berkshire Hathaway.

OVERSTOCK.COM, INC.

- Eighteen months later, Byrne struck out on his own when he purchased a controlling interest in a small online retailer that marketed “excess” and “closeout” merchandise.

OVERSTOCK.COM, INC.

- Byrne’s company, which became Overstock.com, received a kickstart in 2000 with the bursting of the “dot.com bubble” that produced a huge increase in business for online liquidators such as itself.

OVERSTOCK.COM, INC.

- After going public in 2002, Overstock’s revenues grew rapidly, but the company struggled to become profitable; by 2008, the company had yet to report a profit for a full year.

OVERSTOCK.COM, INC.

- In addition to the persistent losses and Patrick Byrne’s overbearing public persona, Overstock’s multiple financial restatements caused investors to shy away from the company’s common stock.

OVERSTOCK.COM, INC.

- In October 2009, Overstock received a letter of inquiry from the SEC that requested information regarding several accounting decisions made by the company including the accounting treatment applied to a $785,000 overpayment made by the company in 2008 to one of its business partners.

OVERSTOCK.COM, INC.

- The accounting treatment applied to the $785,000 overpayment resulted in Overstock's cost of goods sold for 2008 being overstated by that amount; the company's cost of goods sold for the first quarter of 2009 was understated by that same amount when the overpayment was recovered.

OVERSTOCK.COM, INC.

- In fiscal 2008, Overstock and PwC, its audit firm at the time, chose not to record a correcting entry for the overpayment because of uncertainty regarding whether the $785,000 would be recovered.

OVERSTOCK.COM, INC.

- In March 2009, Overstock retained Grant Thornton as its new audit firm; according to Overstock’s management, Grant Thornton agreed with the accounting treatment that had been applied to the $785,000 overpayment.

OVERSTOCK.COM, INC.

- In November 2009, following an inquiry by the SEC regarding the accounting treatment applied to the $785,000 overpayment, Grant Thornton informed Overstock that it had never agreed with that accounting treatment; shortly thereafter, Overstock dismissed Grant Thornton.

OVERSTOCK.COM, INC.

- Overstock and Grant Thornton traded combative accusations in a series of Form 8-K’s filed with the SEC following the dismissal of Grant Thornton.

OVERSTOCK.COM, INC.

- Because Overstock did not have sufficient time to hire a replacement audit firm, the company filed an “unreviewed” Form 10-Q for the third quarter of fiscal 2009 with the SEC.

OVERSTOCK.COM, INC.

- In 2010, after hiring KPMG as its new audit firm, Overstock restated its prior financial statements for 2008 and for the first three quarters of 2009.

OVERSTOCK.COM, INC.

- In 2012, the SEC decided not to file an enforcement action against Overstock for the improper accounting treatment applied to the $785,000 overpayment and related accounting misstatements.

PARKER HALSEY CORPORATION

PARKER-HALSEY CORPORATION

- Volterra Chemicals, a large public company, is in the early stages of negotiating a buyout of Parker-Halsey Corporation (PHC), a smaller private company that specializes in agrichemicals.

PARKER-HALSEY CORPORATION

- Because Volterra’s executives are concerned that PHC may intentionally overstate its year-end inventory, they ask their audit engagement partner, Juan Suarez, to send a team of his “best” auditors to observe PHC’s year-end physical inventory.

PARKER-HALSEY CORPORATION

- The auditors chosen by Suarez for the PHC assignment are Katelyn Light, an audit manager; Dani Morgan, an audit senior and Katelyn's close personal friend; and Tyler Christian, an audit associate who has worked in the past with both Katelyn and Dani.

PARKER-HALSEY CORPORATION

- The PHC assignment is complicated for the three auditors because Volterra insists that they conceal their true identities and the nature of their assignment; Volterra's executives don't want any third parties to learn that they are interested in acquiring PHC.

PARKER-HALSEY CORPORATION

- During the PHC assignment, the three auditors encounter problems commonly posed by inventory observations including less than cooperative client personnel.

PARKER-HALSEY CORPORATION

- The most awkward problem the three auditors face is concealing their true identities and the nature of their assignment from the other parties present during the taking of the physical inventory.

PARKER-HALSEY CORPORATION

- The individuals who are most curious about the presence of Katelyn, Dani, and Tyler are the PHC independent auditors who are also observing the physical inventory.

PARKER-HALSEY CORPORATION

- Katelyn and her two subordinates inform PHC’s employees and independent auditors that they are inventory “consultants”—a few members of PHC’s accounting staff, including the company’s controller, who are present during the physical inventory are aware of, and participate in, this subterfuge.

PARKER-HALSEY CORPORATION

- The “cover” of Katelyn, Dani, and Tyler is blown when a heated disagreement arises; Katelyn insists that certain inventory storage bins must be re-weighed in her presence despite the fact that the bins were allegedly weighed earlier in the week in the presence of two of PHC’s independent auditors.

PARKER-HALSEY CORPORATION

- PHC's audit engagement partner becomes angry when he discovers that Katelyn and her subordinates are auditors themselves; he is angered even more when Katelyn refuses to rely on the audit procedures that his two subordinates completed earlier in the week.

PARKER-HALSEY CORPORATION

- Eventually, PHC’s controller agrees to re-weigh a sample of the inventory storage bins in question; the recorded weights of the majority of the bins that are re-weighed are found to be significantly inflated.

PARKER-HALSEY CORPORATION

- As a result of the evidence collected by Katelyn's team, Volterra terminates its buyout negotiations with PHC.