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SEC Enforcement Actions Against Auditors: Auditing Education Linked to the Pitfalls of Audit Practice

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ABSTRACT: The SEC's Accounting and Auditing Enforcement Releases (AAERs) describe cases of fraudulent financial reporting. In many of these cases, the auditor is disciplined because of a failure to meet professional standards. The use of SEC materials in the accounting curriculum has frequently been advocated in recent years by Robert J. Sack and SEC officials at numerous American Accounting Association meetings. This article describes methods for using releases in the auditing course. Our framework divides the auditing course into four basic sections and provides core discussion questions relevant to AAERs involving auditors. We identify AAERs relevant to the four sections of the auditing course. For seven AAERs, we provide cases with discussion questions and teaching notes. We have also developed a list of AAERs which describes the main issues and classifies them according to our framework.

Approaches to teaching the first auditing course are usually structured around a textbook designed to produce understanding of audit theory and practice. Books of readings, cases, video presentations and practice sets are often used to simulate real-world audit situations. Many instructors use these tools and their own practical experience to prepare their students for auditing practice. The purpose of this article is to provide educational materials and illustrate how the Securities and Exchange Commission's (SEC) Accounting and Auditing Enforcement Releases (AAERs) may be used to enhance the students' understanding of possible auditing pitfalls.

The use of SEC materials in the accounting curriculum has frequently been advocated in recent years by Robert J. Sack and SEC officials at numerous American Accounting Association meetings. Martin (1991, 206) asserts that:

> the Securities and Exchange Commission comprises an important, if not the most important, part of the regulatory environment in which accountants work. Thus, it is imperative that accountants have an understanding of that environment. Because of the profession's renewed commitment toward broadening the education

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> of accounting students to encompass a better grasp of the environment in which accountants work and because of recently mandated continuing education requirements of AICPA members, both educators and practitioners may give more attention toward upgrading their SEC knowledge.

Martin (1991) also points out that the fundamentals of SEC knowledge are not widely taught. Ketz and Kunitake (1985) emphasize that one of the areas where graduating seniors appear weakest is knowledge of the accounting requirements of the SEC.

The National Commission on Fraudulent Financial Reporting survey (the Treadway Commission 1987) found that, in general, accounting and auditing textbooks had little or no discussion of fraudulent financial reporting. The Commission recommended (1987, 83) that "business and accounting students should be well-informed about the regulation and enforcement activities by which government and private bodies safeguard the financial reporting system and thereby protect the public interest." Educators need access to information on actual incidents of fraudulent financial reporting to be able to help their students understand why and how this type of fraudulent financial reporting occurs.

The Accounting Education Change Commission (AECC 1995), in Issues Statement No. 5 on evaluating and rewarding effective teaching, cited one of the characteristics of effective teaching as the ability to use well-conceived course materials that are consistent with current developments in the field. The AAERs provide an opportunity for professors to provide the student with real-world auditing problems and how they are dealt with by the SEC.

This article describes how accounting educators can use releases in the auditing course. We have developed a framework that divides the auditing course into four basic sections and provides core discussion questions relevant to AAERs involving auditors. In our discussion of the four sections of the auditing course, pertinent AAERs are identified. For seven AAERs, we provide educational materials in the form of cases with discussion questions and teaching notes. We have also developed a list of AAERs which describes the main issues and classifies them according to our framework.

BACKGROUND OF THE AAERs

The SEC publishes many official rulings and directives that concern the administration of the Securities Act of 1933 and the Securities and Exchange Act of 1934. In 1982, the SEC codified its financial reporting policies which were still in force, and instituted two new series of releases. The series dealing with accounting and auditing matters is called Accounting and Auditing Enforcement Releases.

The two major types of enforcement actions taken by the SEC against accountants are civil injunctive actions and administrative proceedings. Civil injunctive actions order the violators to comply with the appropriate securities law in the future. They can be accepted by consent or tried before federal district judges. The violators may be a company, directors, officers or employees, a company's attorneys, an accounting firm or individual accountants, or any other party involved in the preparation of false financial information or other information required by the SEC. The court may also stipulate additional action in certain cases, such as requiring an auditor to undergo a peer review. Violations of these injunctions can lead to contempt proceedings with resulting fines or imprisonment.

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Administrative proceedings provide other types of remedies in financial reporting cases. They may be entered into by consent or take place before an administrative law judge. The remedies for these proceedings: (1) include stop orders, refusing to permit or suspending the effectiveness of a 1933 act registration statement; (2) denials, suspensions or revocations of registrations, or prohibitions against trading securities for noncompliance with 1934 act provisions; and (3) censure, or permanent or temporary denial of the right to appear or practice before the SEC for attorneys, auditors or other professionals. The AAERs describe the SEC's findings and actions. One caveat is that an auditor may consent to an SEC action but not agree with all the SEC's findings. In many cases, the respondent submits an offer of settlement and the AAER contains language such as, "Without admitting or denying the factual assertions, the findings or conclusions set forth in this Order or in the Order to the entry of the findings stated herein, to the issuance of this Opinion and Order, and to the imposition of the sanctions set forth herein, without adjudication of law or fact."

TEACHING FRAMEWORK

We reviewed the AAERs from their inception in 1982 to August 1995. From the group of releases about SEC actions against auditors, we selected specific AAERs which provide sufficient detail to illustrate a basic concept or area covered in the typical introductory auditing course. This detail includes background information on the client and auditor, the specific provisions violated by the auditor, and penalties or remedies imposed by the SEC. To provide a framework, we have classified these AAERs by four general topic areas and specified core discussion questions.

The four topical areas covered in the first undergraduate auditing course are (1) the auditing profession; (2) the auditing process; (3) applications of the auditing process: transactions cycles; complex computer systems, audit tests, and other issues; and (4) completing the audit and offering other services. These topical areas (defined below) are consistent with those covered in most basic auditing textbooks (Wallace 1995; Arens and Loebbecke 1994; Guy et al. 1993).

The core discussion questions relevant to most AAERs are:

1. What were the auditing deficiencies?
2. What is the proper accounting?
3. What were the red flags?
4. What should the auditor have done differently?

Our seven cases and teaching notes based on AAERs span the four topic areas. To focus on the major lessons of our seven cases, some of these basic questions are combined, expanded or omitted. Many AAERs apply to more than one of the four topic areas. Our seven cases include a summary of the AAER. However, professors may want to have their students read the entire release for more detail. The releases are published by Commerce Clearing House, Inc., 1984–1995 and available on the Lexis database.

THE AUDITING PROFESSION

This area describes the nature of auditing and auditing firms, the AICPA and the SEC. Audit reports, professional ethics and the auditor's legal liability are typically covered here.

Audit Reports

Many auditing students do not understand the significance of the auditor's report because they have not seen good examples of situations requiring exceptions. AAER No. 87 in exhibit 1 provides an excellent illustration of a client-imposed scope restriction. The SEC found

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EXHIBIT 1 (Continued)

that the inventory tags were not controlled and that the counts were not reconciled to the perpetual records. Given that BPD's general ledger was missing, it seems that it would be impossible to reconstruct the inventory. Even if another physical were taken, it is not clear that the inventory value could be rolled back to the financial statement date.

3. This question is open-ended. The students (with the help of the professor) might be able to imagine what problems might arise. We cannot tell from the AAER exactly what happened as it relates to Fox. The AAER notes that there was not sufficient fieldwork supervision. The two individuals named in this AAER were partners in the firm. We do not know how available they were on the audit, or what level of competence they had. Given this client had a high degree of risk, one would expect that the firm would have spent a lot of time on the job. There may have been time constraints or other time budget pressures that limited the work on the job. Alternatively, the client may have been very persuasive in explaining the problems away.

   SAS No. 56 requires the use of analytic procedures both in the planning and final review stages of the audit. In this case the large increase in inventory should have indicated the need to spend more time auditing this account. Clearly, the auditors should have been concerned over the lack of controls in this area.

Authoritative Pronouncements

SAS No. 1: The auditor must satisfy him/herself about the effectiveness of client inventory-taking procedures. Planning and supervision: any field work performed by assistants must be properly supervised.

SAS No. 56: Use of analytical procedures to indicate possible errors in financial statements and to assess the client's ability to continue as a going-concern.

SFAS No. 13: Accounting for leases.

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the presence of several red flags that should have required the auditors to qualify their opinion, issue a disclaimer or to perform additional audit work.

AAER No. 106 provides a concise discussion of a situation where the auditor should have issued a disclaimer. The problems included the auditor's lack of experience in auditing public companies, unavailability of the predecessor auditor's working papers, and the client's unwillingness to provide books and records of the company requested by the auditor.

AAER No. 114 provides an illustration of Section 561 of the Codification of Statements on Auditing Standards (SAS No. 1, AU Section 561) where, subsequent to the date of his report, the auditor becomes aware of facts existing on the balance sheet date that would have affected his report.

AAER No. 216 describes a situation where the auditor should have insisted that the client correct the financial statements or receive an adverse opinion. Instead, the auditor issued an unqualified opinion, even though there were numerous GAAP violations.

Professional Ethics

Numerous AAERs describe independence violations, many of which appear to be blatant. AAER No. 467 in exhibit 2 describes a situation where the auditor acted as an employee of the client by making accounting decisions. The amount of the audit fee as compared to the auditor's total income also impaired the appearance of independence.

In AAER No. 2, the auditor violated independence by providing automated bookkeeping services to the client and exhibited a general lack of objectivity. AAERs Nos. 57 and 68 describe a partner of a national public accounting firm receiving cash payments directly from the client. The penalties imposed by the

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EXHIBIT 2 (Continued)

treatment depends on management's classification of securities into portfolios, we can expect continuing problems in this area.

Had this pronouncement been in effect at the time of this case, the balance sheet account for debt securities would have been properly recorded. However, the effect on income would not have been correct unless the client had treated the loss as realized.

4. First, the fee from his only audit client represented 75 percent of the auditor's revenue. The SEC noted that the auditor was financially dependent on the client. AAER No. 321 was cited because that action disciplined an auditor as financially dependent on the client because 30 to 60 percent of his cash income was received from the audit client. Secondly, he acted in the capacity of an employee, performing tasks that the client firm's accountants should have performed. The client did not have adequate accounting expertise on its staff, so the auditor was fulfilling two roles, accountant and auditor. Certainly, the auditor could have insisted that the client hire a competent accounting professional.

Authoritative Pronouncements

SFAS No. 12: Accounting for certain marketable securities.
SFAS No. 60: Accounting and reporting by insurance enterprises.
SAB No. 59: *SEC Staff Accounting Bulletin: Views on Accounting for Noncurrent Marketable Securities.*
SAS No. 1: Auditor independence and client fee dependence.

SEC were among the strongest encountered in our review of the AAERs. They included freezing the violating partner's assets, disgorgement, and permanently restraining the CPA from providing services to any publicly traded companies. One of the most egregious violations of independence would be the case in AAER No. 192 where the auditor owned stock of a client.

Many of the AAERs cite an auditor for a lack of due professional care, which is a violation of Rule 201 of the AICPA Code of Professional Conduct. AAER No. 53 in exhibit 3 provides an example of this type of violation. The auditor failed to gather sufficient evidence to express an opinion and ignored information that should have alerted him that the financial statements he was certifying were false.

Legal Liability

We recommend three cases for covering auditor fraud. AAER No. 25 describes the criminal conviction of an auditor who prepared and certified false and misleading financial statements, which reported totally nonexistent or inflated assets and revenues and, contrary to the auditor's report, were not audited in accordance with GAAS. AAER No. 246 illustrates willful fraud and lack of independence as the CPA acted as both the internal accountant and independent accountant for the same client. In AAER No. 237, the auditor issued an audit opinion when he knew the client had no assets, liabilities, or business activity.

THE AUDITING PROCESS

Topics covered in this section are planning and general concepts of evidence accumulation and documentation. Planning includes: (1) engagement planning, audit programs, and analytical procedures; (2) an introduction to materiality and risk, and their effects on the audit; and (3) understanding of a firm's internal control structure.

Audit Planning, Audit Evidence and Analytical Procedures

AAER No. 109A provides an in-depth discussion of analytical procedures and SAS No. 23, AU Section 318.

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EXHIBIT 1
AAER No. 87
In the Matter of Arthur Rogovin and Albert DeBicarri

Summary

Fox & Co., a national accounting firm was the auditor of Saxon Industries, which manufactured and distributed paper products and photocopy machines. The SEC found that Saxon misstated its assets, liabilities and income on its 1979–1981 financial statements. Saxon's officers and employees fraudulently falsified the financial statements to inflate the inventory of copiers and incorrectly applied the lease accounting requirements under SFAS No. 13. Most of the problems with the audit were related to the inventory. There were large increases in the inventory levels from 1979 to 1980, though the auditors were not given documentation for the increases. In addition, the auditors did not have adequate control of the physical inventory observation for BPD, a division of Saxon. Other tests to verify the inventory and tests for obsolescence were either not done or not done properly. In addition, the general ledger for BPD apparently did not exist.

The SEC notes repeatedly that there were numerous "red flags" that should have made the auditors more skeptical. More time spent on analytical procedures would have raised these "red flags" and have affected audit planning and tests. In addition to the problems noted above, the auditors' access to the records was limited and only certain employees were allowed to answer questions.

The client also incorrectly recorded sales of copiers under SFAS No. 13 that were not sales because Saxon retained substantial risk of ownership. Approximately twenty-five percent of the 16,000 copiers included in inventory did not exist. While the auditor did not count these copiers, Fox had relied on other tests to verify their existence. Fox assumed that because the copiers were generating rental income, the copiers must be real. However, the "income test" was also flawed.

The effect of all these errors was material to both the balance sheet and the income statement. Saxon filed for bankruptcy reorganization in 1982.

Discussion Questions

1. What are the audit deficiencies in this case?
2. The auditing profession emphasizes the importance of auditing inventory. What specific requirements or recommendations does the profession make? What should Fox have done differently here? Is there any way that Fox could have made up for the deficiencies with the physical inventories?
3. Several times the SEC notes that "red flags" were raised, but that Fox did not follow up on them. Looking at the case after-the-fact, the problems seem obvious. What factors about the audit engagement and the client may have affected the auditor's judgment? What suggestions does the auditing profession give concerning analytical procedures?

Discussion Questions/Teaching Notes

1. The students should be able to list the major deficiencies, in particular the scope limitations (i.e., the absence of a general ledger), and the inadequate control of the inventory. The client's application of SFAS No. 13, and the resulting sales recognized were not in accordance with GAAP. In addition, the SEC notes that the audit field work was not properly supervised, as covered by GAAS Field Work Standard No. 3 (SAS No. 1).
2. Because inventory is such a significant asset for many companies, GAAS requires that a physical inventory be taken at least once a year, and that the auditors observe and maintain adequate control over the process. A general reading of the AAERs shows that many violations involve inventory, so auditors should be very careful in this area.

   It is highly unlikely that the auditors could have satisfied themselves as to the inventory value without having the client perform another physical inventory. The AAER notes

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EXHIBIT 2
AAER No. 467
In the Matter of Bernard Tarnowsky, CPA

Summary

Bernard Tarnowsky, a 73-year old sole practitioner CPA had just one audit client, Presidential Life Corporation (Presidential). The client, whose major product was annuity products, had received an unqualified audit report for 1989. Presidential, being an insurance company, had a large marketable securities portfolio. During 1989, there was a large decline in the market value of the debt and equity securities in Presidential's portfolio. The auditor, Tarnowsky, allowed the client to record the decline as if it were temporary, while the SEC found the decline to be permanent. The decision to consider the decline temporary had two effects. The debt securities could still be carried at amortized cost, and the reduction to market of the equity securities would be reported in stockholders' equity, rather than as a component of income. Therefore, this error in reporting had a significant effect on both the assets and income of the company.

The SEC also stated that Tarnowsky could not be considered independent because his fee from his client, Presidential, was so material to his business. During 1989 he received a fee of $285,000 from Presidential which was about 75 percent of Tarnowsky's income for the year. In addition, the SEC found that Tarnowsky acted more as an employee for Presidential, making accounting decisions that should have properly been made by the client. The client, in this case, did not have accounting personnel with insurance accounting expertise, and thus relied on Tarnowsky inappropriately.

The SEC prohibited Tarnowsky from practicing before it for a period of 18 months. In order to resume practice, Tarnowsky would have to receive an unqualified peer review and practice in accordance with the SEC Practice Section requirements.

Discussion Questions

1. What are the audit deficiencies in this case?
2. What were the accounting standards for marketable securities for this AAER?
3. How have the standards changed for marketable securities? How would the new standards have affected this case?
4. Why did the SEC think the auditor was not independent? What, if anything, could the auditor have done to maintain his independence?

Discussion Questions/Teaching Notes

1. The auditor did not follow generally accepted auditing standards in two main areas. First, he issued an unqualified opinion even though the marketable securities were not properly accounted for. Second, the SEC did not find the auditor to be independent.
2. SFAS No. 12 was the standard in effect at the time of this AAER. SFAS No. 60, *Accounting and Reporting by Insurance Enterprises*, is consistent with SFAS No. 12. The standards require that equity securities be recorded at lower of cost or market using an allowance account, and that changes to the account would be recorded directly to stockholders' equity. Long-term debt securities were recorded at amortized cost. However, if the decline in market value is not temporary, both equity and debt securities must be reduced to market, with the unrealized loss deemed realized and recorded on the income statement.
3. SFAS No. 115 has changed the standards for reporting marketable securities. In most cases, both debt and equity securities will be reported at market (rather than lower of cost or market or amortized cost). The adjustment to market will continue to affect stockholders' equity directly, rather than via the income statement. Declines in market value that are not temporary will continue to be treated as realized losses. Since the accounting

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EXHIBIT 3
AAER No. 53
In the Matter of Russell G. Davy

Summary

Russell Davy was engaged as the auditor of SNG Oil & Energy Company for 1978–1979. SNG, whose president was Ian Allison, was a new company, incorporated in 1976, and had substantially no business activities. SNG was involved in complicated real estate transactions, some involving mineral rights during 1979. Even though the sales agreements were never completed, SNG showed the ownership of the real estate and the mineral rights on its 1979 financial statements. The effect of including these assets on the financial statements was material. In addition, SNG showed marketable securities as inventory, and purchases and sales of bankers' acceptances as sales and cost of goods sold. The AAER notes that "SNG's total listed assets of $1,435,805, and total stockholders' equity of $1,108,647, should have been $125,805 and $123,647, respectively."

The SEC maintained that Davy did not obtain adequate documentation for the real estate transactions. In addition, the SEC found that the accounting for the securities transactions was incorrect. The AAER notes that Davy accepted in "good faith" the client's journal entries related to the real estate transactions and that while he disagreed with the treatment of the securities, he didn't think many people were going to receive the financial statements. In fact, SNG used the audited statements in filing a registration statement with the SEC. Though Davy later found out that the real estate transactions did not go through, he did not issue a new audit report.

Discussion Questions

1. What are the audit deficiencies depicted in this case?
2. SNG appears to have been a development stage enterprise. What additional procedures and disclosures should the auditor have considered with this client?
3. What are the auditor's responsibilities in issuing an unqualified opinion? Should additional information become available that the financial statements are incorrect, what corrective action should the auditor take?

Discussion Questions/Teaching Notes

1. The auditor did not obtain adequate evidence of the major transactions in which the firm was involved, which is a violation of the third standard of fieldwork. In addition, there appears to be a lack of due care when the auditor accepts client entries with which the auditor disagrees. The client also incorrectly accounted for security sales, treating them as if they were inventory.
2. In general, development-stage enterprises are more risky than ongoing companies. Therefore, in planning an audit, the auditor should plan to do more analysis of the information, and look for problem transactions, particularly those with related parties. In addition, SFAS No. 7 should be applied. SFAS No. 7 does not require different GAAP, but defines at what point a company ceases being a development-stage enterprise, and requires additional disclosure.

   The auditor also noted that he did not think that the financial statements were to be used by many people. Auditors cannot assume that the statements are not to be issued, and may be liable to users.
3. SAS No. 46, *Consideration of Omitted Procedures after the Audit Date*, states that the auditor must do the omitted procedures to support the report. If, after doing this, the auditor realizes the financial statements are misleading, then the auditor should contact his/her attorney to determine appropriate responsibility concerning the report. Most likely,

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EXHIBIT 3 (Continued)

Davy should have requested the client to issue revised financial statements and Davy should have notified the SEC of the problem.

Authoritative Pronouncements

AICPA Industry Audit Guide:	*Audits of Construction Contractors*
SAS No.1:	Planning and supervision of fieldwork, third standard of fieldwork as it relates to evidence.
SAS No. 46:	Consideration of omitted procedures after the report date.
SFAS No. 7:	Accounting for development-stage enterprises.
SAS No. 1, AU No. 561:	"Subsequent Discovery of Facts Existing at the Date of the Auditor's Report."

The SEC found that the auditors in this case, members of a Big 6 firm, did not attach enough significance to the warning signals raised by their analytical procedures. An interesting aspect of this case is the ruling by the SEC that client fraud was not an acceptable defense in this situation. The discussion of SAS No. 16, the detection of fraud, and the inadequate analytical procedures itemized make this a useful auditing case.

An important part of audit planning is the search for related-party transactions. AAER No. 150 discusses a situation where the auditor did not implement audit procedures to identify related parties. AAER No. 200 provides an extensive discussion of audit planning. The first violation cited for the auditor, a Big 6 firm, was a lack of knowledge of the client's business and industry (SAS No. 22), which is critical to the proper planning of any audit.

AAER No. 39 shows the importance of the audit program in the view of the SEC. In this release, the auditor used a "canned" audit program, making no attempt to tailor the program to the client's circumstances. Moreover, there was no partner review of the audit program or the procedures and tests employed by the assistants until after the field work had been completed.

AAER Nos. 115 and 117 illustrate a situation where an auditor agreed to complete an audit within a week to help the client meet an SEC filing deadline. An associate involved in the audit left the firm, leaving the partner-in-charge to complete the audit, but the partner did not use an audit program and did not sign off on each step as required by firm policy. This led the SEC to cite the partner for a lack of due professional care for issuing an unqualified opinion even though there was incomplete fieldwork.

Violations of GAAS Field Work Standard No. 3 (sufficient competent evidence) were uncovered in AAERs Nos. 30 and 179, which discuss auditor failures to gather sufficient evidence regarding client inventory. In AAER No. 30, the auditors failed to maintain adequate control over inventory count sheets. This allowed the client's management to add three fictitious count sheets to the valid ones, causing a significant overstatement. AAER No. 179 examines an audit evidence-gathering problem where the client sold and rented video tapes and equipment. It provides a brief discussion of inventory problems and the lower of cost or market rule.

Materiality and Risk

AAER No. 111 deals with the issue of materiality. In this case, the auditor had knowledge of a related-party transaction, but concluded that it did not need to be disclosed because it was under five percent of the client's total assets. In the ruling, the SEC provided an extensive discussion of the materiality issue with

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references to FASB Statement of Financial Accounting Concepts No. 2. The SEC ruled that the related-party transaction was material and disclosure was required, noting that even immaterial items should be disclosed if they arise in abnormal circumstances.

In AAER No. 129, a Big 6 auditor of a commercial bank ignored the inherent risk of a client with a deteriorating financial position. Materiality was also an issue here since the auditor failed to investigate the substance of certain material transactions. This case contains an extensive discussion of the substance over form issue with specific references to SAS No. 69, AU Section 411.09.

A different type of risk was at issue in AAER No. 200 where an "unseasoned" auditor of a Big 6 firm was assigned to perform the riskiest parts of the audit. Because this AAER dealt with an auditing firm's misuse of an inexperienced junior accountant, this is a rich case for an undergraduate auditing student to analyze and discuss.

Internal Control Structure

AAER No. 13, summarized in exhibit 4, deals with a Big 6 audit partner who issued both an unqualified audit report for a client and a report on the client's system of internal accounting control which stated that no material weaknesses were found. The client in this

EXHIBIT 4
AAER No. 13
In the Matter of Stanley I. Goldberg

Summary

Stanley Goldberg, initially a partner with Touche Ross and then with Richard A. Eisner & Co., was the engagement partner on the 1978–1980 audits of J. B. Hanauer & Co. (Hanauer), a broker-dealer of securities. Hanauer accommodated certain clients who wanted to buy and sell securities anonymously by creating false accounts for them and/or destroying the confirmations of transactions. The client executed many of its purchase and sale transactions in cash and hand delivered the bonds to these customers. The procedures for handling these accounts allowed some sales people to defraud customers by inflating the offering price of certain securities, with the sales people keeping the difference. The client's hand-delivery method of conducting its business constituted a material weakness in internal accounting controls since the salespersons opened the accounts, received currency, delivered the bearer bonds, made deposits, and exercised control over customer confirmations.

The main deficiency in the audit was that Goldberg allowed the client to remove certain accounts from the confirmation process. The sales people were allowed by management to select which customers to remove from the list. In the first year, approximately twenty percent of the customer accounts were not confirmed. In the next two years, between 17 and 25 percent of the accounts were not confirmed. While Goldberg attempted to perform additional work on these accounts, all of the data was provided by the client.

In addition to finding fault with the audit procedures, the SEC found that Goldberg knew of the internal control weaknesses that allowed the sales people to deal in cash transactions and to access customer accounts, and, therefore, should have changed the audit procedures.

Discussion Questions

1. What auditing deficiencies were there in this case?
2. Given Goldberg decided not to confirm all of the customer balances, what additional procedures could he have done to satisfy himself that the accounts were stated fairly?
3. This case involves client fraud, which is usually considered difficult to find by the auditors. What special problems do fraud cases pose for the auditors?

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EXHIBIT 4 (Continued)

Discussion Questions/Teaching Notes

1. The students should be able to list the major deficiencies, in particular the decision not to confirm all the accounts, and letting the client choose which accounts not to confirm. In addition, the class could discuss what changes the auditor should have made to the audit program, given the problems found in the internal control system.
2. The AAER notes that all the documentation for the balances came from Hanauer, and was made up of computerized listings of transactions and customer accounts. Goldberg could have tried to view documentation originating and/or processed outside of the firm, such as canceled checks and deposit slips. However, given the number of cash transactions and the destroyed evidence, it is unlikely that Goldberg could have satisfied himself of the accounts' accuracy. In looking for the outside verification, Goldberg may have become more suspicious of the accounts and expanded his confirmations.
3. There are countless examples of large client frauds, including Equity Funding and ZZZZ Best. Generally, the profession believes that client fraud is very hard to detect, especially if there is significant collusion on the part of top management. However, per SAS No. 53 and SAS No. 54, the auditor does have considerable responsibility for uncovering management fraud and reporting this to the audit committees. In 1996, the AICPA's Auditing Standards Board issued an exposure draft (available from the AICPA, that became SAS No. 82) that would change the auditor's responsibility for detecting fraud. In addition, while fraud may be difficult to detect, the auditor is vulnerable for lawsuits here. The AAERs often note "red flags" that should have alerted the auditor to problems. If the auditor does not heed these warnings, he/she could be sued for gross negligence or fraud.

Authoritative Pronouncements

SAS No. 1: Auditors must have complete independence when choosing which accounts receivable to confirm.
SAS No. 53: Although management fraud is difficult to uncover,
SAS No. 54: auditors do have considerable responsibility for uncovering material management fraud. See SAS No. 82.
SAS No. 55: Auditors are required to obtain understanding of the client's structure of internal controls.
SAS No. 60: Discusses reportable conditions to the Audit Committee when an internal control weakness is found.

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case was a broker/dealer whose practices included purchasing municipal bearer bonds for customers who did not want their true identities connected with these transactions. The SEC also concluded that permitting all these duties to be performed by one person subjected the client to potential losses, including possible damage actions by the defrauded customers. Students analyzing this release will gain a good understanding of what constitutes an internal control weakness in real-world terms. They may also wish to consider if the penalties imposed, including a 30-day practice suspension and 40 CPE hours, are appropriate.

AAER No. 36 also involved a registered broker-dealer. The books and records were falsified by periodically overvaluing common stock of a Japanese corporation held in certain accounts. Using this stock as collateral, cash was withdrawn (supposedly as loans from the firm). The stock's falsified valuation was $96,000 per share when the scheme was discovered, but it was only worth approximately $1.80 per share. The perpetrator defrauded the audit client of $32 million in misappropriated funds related to the inflated collateral values and $15 million in interest. The SEC found the auditors to have issued misleading audit reports because they

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failed to discover certain irregularities. Many of these irregularities were in the internal control area, including a lack of substantive tests of compliance to ensure the proper functioning of the internal control system, no utilization of an internal control questionnaire or checklist, and no documentation in the working papers describing the internal control review or the extent that the auditor relied on internal controls (i.e., reduced control risk from its maximum level, in the context of current GAAS). This case is an interesting one for student analysis because of the size of the fraud involved and the fraud's apparent duration—almost 28 years.

AAER No. 575, summarized in exhibit 5, discusses the auditor's failure to sufficiently study, evaluate or test the client's internal control structure, causing him to overlook deficiencies which

EXHIBIT 5
AAER No. 575
In the Matter of George M. Sologuren, CPA

Summary

George M. Sologuren, CPA, a partner in the accounting firm of Collier & Sologuren, P.A., performed audits and issued audit reports including unqualified opinions on C.J. Wright and Co., Inc.'s (CJW) 1986–1990 financial statements. CJW was registered with the SEC as a broker/dealer.

CJW raised approximately $4.4 million from at least 90 investors in two fraudulent investment schemes. One of the frauds was a Ponzi scheme where a portion of the funds obtained from new investors was used to pay off returns from existing investors, with Wright misappropriating the remainder of the funds. The second fraud involved actually purchasing some securities which incurred significant trading losses that were not disclosed to investors. The investors received false monthly statements concealing the losses while Wright misappropriated a portion of their funds.

There were several deficiencies in the audit performed by Sologuren: (1) Sologuren failed to develop an overall audit strategy for the conduct and scope of his audits. Instead he purchased generic audit programs that did not provide audit procedures specific to the brokerage industry. (2) CJW's internal control structure was obviously flawed with Wright maintaining exclusive control of operating, financing, accounting and banking functions. This possession and control of customer funds made it possible for Wright to operate his Ponzi scheme. Sologuren failed to sufficiently study, evaluate or test CJW's internal control structure and, in fact, issued a statement that "my study and evaluation disclosed no condition that I believed to be a material weakness." (3) Sologuren relied solely on accounting data provided by CJW and failed to obtain corroborating evidence from sources independent of CJW. He did not review customer files, broker confirmations or agreements to test CJW's trades and did not examine commissions earned and received. (4) Sologuren failed to identify and examine a bank account used by Wright to facilitate his Ponzi scheme. CJW had transfers to and from this bank account controlled by Wright. This constituted related-party transactions which should have been scrutinized by Sologuren.

Discussion Questions

1. Sologuren's failure to sufficiently study, evaluate or test CJW's internal control structure caused him to overlook deficiencies which fit the definition of reportable conditions in SAS No. 60. Explain what is meant by reportable conditions in SAS No. 60. What should the auditor do when discovering reportable conditions?
2. Sologuren failed to obtain sufficient competent evidential matter as the third standard of fieldwork under GAAS requires. He relied solely on internal documents and accounting

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EXHIBIT 5 (Continued)

data provided by CJW for his evidence. Distinguish between internal and external documents as evidence. What types of external evidence could the auditor have examined in this case study?

3. Sologuren failed to adequately examine the related-party transactions involving the bank account controlled by Wright because he relied on Wright's representation that the bank account was outside the scope of the audit. If he had adequately examined this bank account, what important audit evidence would he have discovered?

Discussion Questions/Teaching Notes

1. Reportable conditions are defined by SAS No. 60 as significant deficiencies in the design or operation of the internal control structure. They should be reported by the auditor to the audit committee. If there is no audit committee, they should be communicated to the person(s) in the organization who have overall responsibility for the internal control structure.
2. An internal document is one that has been prepared and used within the client's organization. An external document has been in the hands of both the client and an external party implying that both parties are in agreement about the information on the document. Auditors normally only accept an internal document as reliable evidence if it was created and processed under conditions of a good internal control structure. Since this was not the case with CJW, the auditor should have obtained external documents which would have provided more reliable evidence, such as customer confirmations, trade tickets and broker confirmations.
3. With an examination of this bank account, Sologuren would have discovered that material amounts of CJW's purported income were received from this account. This evidence would have helped the auditor to uncover the fraud taking place at CJW.

Authoritative Pronouncements

GAAS Fieldwork Standard No. 1:	The work is to be adequately planned.
SAS No. 55/GAAS Fieldwork Standard No. 2:	The auditor should obtain a sufficient understanding of the client's internal control structure.
GAAS Fieldwork Standard No. 3:	Sufficient competent evidential matter is to be obtained.
FASB Statement No. 57:	Related Party Transactions.
SAS No. 60:	Discusses reportable conditions to the Audit Committee when an internal control weakness is found.

fit the definition of a reportable condition in SAS No. 60. This case is ideal for illustrating what constitutes a reportable condition and what the auditor's obligations are per SAS No. 60. A discussion of internal documents vs. external documents as audit evidence and examples of related-party transactions are also provided.

In setting the audit scope and gathering evidence, the auditor should maintain an attitude of professional skepticism (Wallace 1995, 472). This concept is dealt with in AAER No. 27 where the SEC noted an absence of professional skepticism by the auditor who failed to consider the possibility of irregularities when faced with obvious red flags. AAER No. 111 also cites the auditor for a lack of professional skepticism for placing undue reliance on management representations.

An extensive discussion of professional skepticism and evidence gathering in the revenue recognition area may be found in AAER No. 274. In this case, revenue recognized under the percentage of completion method of contract

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accounting was found by the SEC to be overstated. The auditor knew that the client previously had been aggressive and creative in applying accounting policies. The SEC's position was that several red flags and an attitude of healthy skepticism by the auditor would have uncovered these overstatements. Other AAERs emphasizing professional skepticism include releases Nos. 129, 274, 465 and 511.

APPLICATIONS OF THE AUDITING PROCESS

The concepts covered in the applications section of the course include audits of the various transaction cycles such as the sales and collection cycle. Audit sampling and computer auditing are among the topics covered.

AAER No. 619, summarized in exhibit 6, deals with receivables confirmation procedures in the sales and collection transactions cycle. In this case the auditor, a Big 6 firm, did not confirm a large enough percentage of receivables, nor did it properly follow up on noted discrepancies. The use of analytical procedures (SAS No. 56) in this transaction cycle are also discussed.

AAERs Nos. 69 and 70 provide another illustration of pitfalls in confirming accounts receivable in the sales and collection cycle. The auditor of an IPO was found to be in violation of SAS Nos. 31 and 48, AU Section 326, which

EXHIBIT 6
AAER No. 619
In the Matter of Harry D. Sweeney, CPA, Henry Gayer, CPA, and Timothy S. Hart, CPA

Summary

Sweeney, Gayer and Hart were all associated with KPMG Peat Marwick (Peat), during the 1985 through 1988 audits of Sahlen & Associates. Sweeney and Gayer were engagement partners on the audit of Sahlen at different times and Hart was a manager. Sahlen, which provided investigative and guard services in the Florida area, had been started by Harold Sahlen in 1981 and had gone public in 1984.

While the company had grown after the initial public offering, it was unprofitable and had cash flow problems. However, at the end of 1985, the company changed its method of recording revenue for services to a percentage of completion method, recording a work-in-process (WIP) account. At this time the client began to fraudulently record revenue by creating fictitious accounts. The SEC states that Sahlen would determine the amount of revenue he wished to report, and the employees would work backwards to create the necessary WIP accounts to support the work. While the accounting fraud created income, Sahlen continued to have cash flow problems. Because many of the receivables were not real, collections were poor.

The auditors did make note of the red flags noted above in their working papers. However, they did not sufficiently expand their audit procedures to compensate for the problems. In some cases the auditors attempted to expand their tests. For example, the auditors were told that the correct level of WIP was established by the field office. However, the auditors did not speak with the individuals supposedly responsible for the account. In addition, because Sahlen was actively deceiving the auditors, the auditors had trouble confirming the receivables. The response rate to the confirmations was very low and while the auditors attempted to follow up on the accounts, they did not do so adequately, according to the SEC. Over the years covered, there were numerous problems in confirming the existence of a contract with the customer, the validity of the receivable, and the adequacy of the allowance account. At one point, Sahlen offered to help the auditors contact purported customers using Federal Express and a mailing list provided by management. Using this strategy, the confirmation rate

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EXHIBIT 6 (Continued)

was over 95 percent, within a few days; and no discrepancies were noted. The SEC notes that after the previous problems, the auditors should have realized something was wrong.

The client also supported the existence of receivables by "selling" the old receivables (which were significant) to a factoring company. The auditor appeared to accept this, though the factoring company was actually a shell. The auditors did not investigate this scheme adequately. The SEC also found that the auditors signed opinions while they were still waiting for the additional evidence from Sahlen.

The SEC began an investigation into Sahlen and Peat was notified. At that time, Peat did additional audit work, and withdrew its opinions for the financial statements for the period of 1986 through 1989.

Discussion Questions

1. What were the audit deficiencies in this case?
2. Several times the SEC notes that red flags were raised, but that Peat did not follow up on them. Looking at the case after-the-fact the problems seem obvious. What factors about the audit and the audit engagement and the client may have affected the auditor's judgment?

Discussion Questions/Teaching Notes

1. The biggest deficiencies relate to the confirmation procedure for receivables. The auditor did not confirm a large enough percent of the receivables, nor properly follow up on those that noted discrepancies. In addition, the auditor did not adequately test either the allowance for doubtful accounts or the sale of receivables agreement.

   The auditor also appears to have noted many of the potential problems (red flags), but did not alter the audit procedures to investigate the problems. The auditors also signed the audit reports prior to receiving some of the evidence.
2. This question is open-ended. The students (with the help of the professor) might be able to imagine what problems might arise. This client had recently had an initial public offering. These types of clients tend to be riskier than established companies and, thus, the auditors may need to spend more time on the audit. There may have been time constraints or other time budget pressures that limited the work on the job. It appears that the auditor often questioned Sahlen on the "red flag" items and knew of the problems with the receivable confirmations. Perhaps the client was persuasive in explaining the problems away. SAS No. 56 requires the use of analytical procedures both in the planning and final review stages of the audit. In this case, the increase in revenues, but continual cash flow problems and slow collection of receivables, should have indicated the need to investigate the revenue transactions more carefully.

Authoritative Pronouncements

SAS No. 1: Auditors must have complete independence when choosing which accounts receivable to confirm.

SAS No. 56: The auditors should perform analytical procedures to aid in justifying the receivable balances.

SAS No. 53 and SAS No. 54: Although management fraud is difficult to uncover, auditors do have a responsibility to perform audit procedures for uncovering material management fraud. In 1996, the AICPA's Auditing Standards Board issued an exposure draft (available from the AICPA) that would change the auditor's responsibility for detecting fraud. See SAS No. 82.

ARB No. 45: Long-term construction-type contracts.

SFAS No. 5: Accounting for contingencies (as it relates to the allowance for doubtful accounts).

SFAS No. 77: Reporting by transferors for transfers of receivables without recourse.

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requires an auditor to obtain sufficient competent evidential matter to afford a reasonable basis for the opinion. The auditor accepted verbal accounts receivable confirmations over the telephone after having received no response to his written requests. Lacking confidence in this evidence, the auditor then requested written confirmations which were subsequently received only after first being handled by a third party.

Inventory audit problems in the inventory and warehousing transaction cycle, such as failure to test for obsolescence, are discussed in AAER No. 127. AAER No. 251 deals with cash, inventory and prepaid advertising audit deficiencies which are relevant to discussions of the transactions cycles.

COMPLETING THE AUDIT AND OFFERING OTHER SERVICES

This section includes summarizing audit tests, reviewing working papers, and other aspects of completing the audit. Assessing contingent liabilities, reviewing subsequent events and communications with management are also covered.

An important part of completing the audit is the partner's review of the audit work performed. In AAER No. 27 the partner was cited for not reviewing the audit work papers, which constituted a failure to adequately supervise the audit. The result was that the partner was not aware of numerous audit problem areas and red flags encountered by his associates. AAER No. 585, summarized in exhibit 7, describes an audit failure even though two partners reviewed the working papers. The "detail review partner" was criticized for relying too much on the judgment of the engagement partner. The AAER also provides an explanation of the SEC's expectation of the concurring partner review function and deals with management representation letters.

Two other AAERs deal with management representation letters. In AAER

EXHIBIT 7
AAER No. 585
In the Matter of Barry H. Silvestain, CPA, Lawrence L. Greenberg, CPA, Bennie Silvestain, CPA, and Wenner, Silvestain & Co.

Summary

Respondent Barry H. Silvestain, CPA, a partner, performed almost all of the audit field work himself. U.S. Mint became a public company via merger in July 1989. The audit client specialized in the manufacture, sale and marketing of gaming tokens and commemorative coins. The SEC's central regional office in Denver was conducting an examination of the broker-dealer that was the primary market maker for U.S. Mint's common stock. The auditor was engaged to perform the audit and was advised that, at the time they accepted the engagement, the audit was to be furnished to the broker-dealer in connection with the SEC's investigation.

The auditor issued an unqualified opinion on the financial statements. The financial statements showed land valued at $2,137,500, which comprised 94 percent of the net tangible assets. U.S. Mint claimed 75 percent interest in this San Diego land, which was acquired by exchanging 534,375 shares of preferred stock. Undetected by and unknown to the auditor, was the fact that title to the property was clouded; the prior owner (an estate) was in continuous litigation over the property during all times relevant to the SEC proceeding. The auditor relied upon a quit claim deed, certain oral representations of U.S. Mint's outside legal counsel, and the management representation letter, which was in a standardized format. The auditor failed to obtain an attorney representation letter, which the SEC believed should have

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EXHIBIT 7 (Continued)

addressed the U.S. Mint's title to the land. The SEC found nothing in the working papers that documents that the land transaction was specifically discussed with the client's attorney. The audit work papers note that the land was acquired via issuance of the convertible preferred stock at four dollars per share. Presumably, this is based on its four-to-one conversion ratio into the company's common stock, which in February 1990 was purportedly trading around one dollar a share, but the "pink sheets" at the time showed a bid price of only 50 cents per share. The client obtained an independent appraisal of the land as of May 1990, which indicated a value $862,500 higher than the book value. The auditor did not attempt to verify the appraisal or reconcile the different values.

There were other audit problems noted in the SEC's release. There was an inadequate audit of revenue and accounts receivable relating to fictitious sales invoices and cash receipts. Cash was overstated because the client had written but not delivered checks which would have resulted in an overdraft of approximately $61,000. Receivables and payables involving four different related parties were aggregated and offset improperly, even though there was no legal right of offset. An account receivable that was already 19 months old was not properly audited. The client's financial statements did not show any rent expense related to executive office space and the auditor was unaware that this was due to an affiliate paying the rent and sharing the space.

The CPA firm was a member of the AICPA's Division for CPA Firms' SEC Practice Section at the time of the audit. Respondent Greenberg served as the detail review partner on the audit. The SEC stated that his "role in the case was to review the audit to determine whether it was adequately performed and to evaluate whether results were consistent with conclusions presented in the audit report. Instead, he relied almost solely on the judgment of the auditor performing the field work." According to the SEC, the "responsibilities as a detail review partner require that he do more than rely on this judgment." The release states that "Greenberg should have independently reviewed matters documented in the audit work papers in order to make his own determination whether the work performed was adequate and whether the results supported the conclusions presented in the audit report." He failed to gain adequate assurance about the land ownership and valuation and failed to detect the other audit problems.

Respondent Benny Silvestain (the field work auditor's father) performed the concurring partner review function on the audit—a requirement for firms that are members of the SEC Practice Section. The purpose of the concurring partner review is to provide additional assurance that the financial statements of the engagement are in conformity with GAAP and that the firm's report is in accordance with GAAS. The concurring partner discussed with the audit partner the high degree of audit risk involved in the land transaction and the extent of necessary auditing procedures. He reviewed all audit work papers, paying particular attention to significant items. However, he failed to assure that ownership and valuation of the land were properly verified and documented, and failed to detect the other audit deficiencies.

Discussion Questions

1. The preferred stock exchange for the land was restricted with regard to conversion at a ratio of four-to-one for the company's common shares for a period of two years. What auditing deficiencies were there with regard to land valuation?
2. What is the role of review partners in audit engagements?

Discussion Questions/Teaching Notes

1. The SEC was concerned that the auditors performed no steps to verify the land's basis in the estate, that sold the land to the audit client. The auditor did not verify the stock valuation. The preferred stock had no trading history and was not quoted in the pink sheets nor

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EXHIBIT 7 (Continued)

traded by any broker-dealer. The auditor was aware of the two-year restriction on conversion. The auditor did not attempt to verify the appraisal or reconcile the different values, but said he used the appraisal to substantiate the value of the land which was at least as high as the value represented by the management of U.S. Mint. In a class discussion of these questions, you may want to ask, "If the independent appraiser's higher valuation was the best indicator of value, would the financial statements be misleading?"

2. The SEC provided detailed explanation for the roles of detail review partners and concurring review partners. The detail review partner looked at all working papers. The SEC stated that he should have independently reviewed matters documented in audit work papers in order to make his own determination whether the work performed was adequate and whether the conclusions presented in the audit report were supported. Such a review typically results in a list of review questions for the audit partner. The audit partner attempts to resolve the questions and often discusses some of them with the review partner before the review partner signs off on some type of review checklist. The review questions are typically excluded from the working papers because they are no longer relevant. They are viewed as no longer being relevant because the issues have been resolved. In this case, the SEC requirement of concurring partner review was described. It should be noted that reference to review partners in SEC enforcement releases is not very common. One could ask, "Why not?" The concurring partner review is typically in less detail. However, in this case the SEC noted that the concurring partner reviewed all of the audit work papers, paying particular attention to significant items. The concurring partner's review is typically documented by signing off on the same audit report review checklist.

Authoritative Pronouncements

SAS Nos. 22, 47 and 48, AU 311:	Auditors must prepare a documented auditing program with adequate substantive audit procedures designed to test material transactions.
SAS Nos. 31 and 48, AU 326:	Auditors must obtain sufficient competent evidential matter.
SAS No. 12, AU 337:	Auditors must obtain an attorney representation letter concerning litigation claims and assessments.
SAS No. 19, AU 333.02:	Auditors must obtain written management representation.
SAS No. 32, AU 431:	Disclosures in financial statements must be adequate.
SAS No. 45, AU 334:	The auditor must identify related parties and satisfy himself concerning financial statement accounting and disclosures.

No. 111 the auditor was found to be at fault for not obtaining corroborative evidence for information contained in the management representation letter. AAER No. 150 provides an extensive discussion of the purpose of the management representation letter. This release emphasizes that implicit in the securing of the management representation letter is the concept that the auditor and management have reached agreement with respect to the matters discussed in the letter.

STUDENT ASSIGNMENTS

There are many ways the AAERs can be used in the classroom. Several of the seven cases provided in this article can be substituted for end-of-chapter textbook material. By using several cases at different points in the course, the students' understanding of SEC enforcement is enhanced.

To gain insight into the types of violations by auditors that lead to SEC action, student writing assignments to review or scan through all the AAERs for

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a given period of time are fruitful. Students should be assigned to select one or more interesting releases and write a two-page synopsis of the facts and the final outcomes. The details of their synopsis could include the parties named in the release, such as officers of the client, client accountants and the auditors, as well as specifics of the violations and penalties imposed. In our experience, this method provides an effective exposure to the AAERs while using no in-class time and requiring a limited amount of the student's out-of-class time.

A more comprehensive assignment would be to require each student to do a writing assignment based on one of the more detailed AAERs. Selecting several AAERs relating to one topic is an excellent way of doing this. We have classified the AAERs from 1982 to August 1995 (*Federal Securities Law Reporter* 1995) by auditing topic area for this purpose (see the appendix). To accomplish this, the student would have to read the assigned AAER and identify accounting and auditing standards cited in the release. The body of the paper would include a synopsis of the AAER, a discussion of how professional standards were violated, and a critical discussion of the auditors' performance. Students should conclude the paper with an assessment of whether the SEC's actions were appropriate based on the information in the AAER and the implications of the release to other public companies and their auditors. Don't be surprised if most of your students view the SEC's actions as being too easy on the auditor. The writing assignment could be extended to a series of individual student or group papers and class presentations by assigning AAERs related to major auditing topics. In our experience, grading factors for writing skills, content and conclusion should be clearly specified in advance. We advise that the greatest weight be assigned to the professional standards and auditor performance discussion because this ties in directly to the auditing topics.

Another approach to expand the writing assignment is to require library research on the accounting and auditing standards of the specific case. Students may find articles that discuss pitfalls or shortcomings of the professional standards, and they will probably find information on the case and the public company. Grading factors should be revised to place heavy weight on the integration of the additional information into the manuscript.

We found that students respond to group presentation assignments in creative and resourceful ways. Some groups chose a straight presentation of the AAER's facts, supplemented with background material from the text and other sources, and followed by a discussion of the implications for the auditing profession. Other groups chose a role-play presentation with students assuming the roles of SEC regulators, the auditor and management. The students mixed some levity in with the presentations, which was effective in holding the interest of their classmates. One group even did a mock-up of "The People's Court" television show, called "The Auditor's Court." The quality of the AAER presentations was excellent, and we believe this was a result of the group's desire to impress their peers, as well as their professor.

A debate on some dimension of the SEC's regulatory role is another possibility—Resolved: The SEC is not tough enough on auditors. Data could be gathered and analyzed for a number of topics, such as AAERS involving Big 6 firms, AAERs involving smaller firms, and AAERs imposing strong penalties, such as practice suspensions.

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CONCLUSION

Being involved in an audit failure can have a devastating effect on an auditor's career. The AAERs vividly point out potential pitfalls that await auditors. By studying how auditors failed to meet professional standards and were fooled by management, the student's perspective of professional skepticism should be enhanced and grounded in reality. Entry-level accountants must be mentally prepared for the sometimes tedious quality control policies and procedures. Many of the audit failures described in the Accounting and Auditing Enforcement Releases prompt the question: how could this happen? The materials provided in this article illustrate the richness of the AAERs and provide an opportunity for professors to enhance the real-world aspects of their auditing course.

APPENDIX

AAERS Classified by Auditing Topic Area, from 1982 to August 1995

Topic Areas

A. Auditing Profession
B. Auditing Process
C. Applications of the Auditing Process: Transaction Cycles
D. Completing the Audit and Offering Other Services

References are to statements/standards in force at the time the deficiencies took place.

AAER	Primary Area	Topic
No. 2	A, B, C	Professional Ethics— Auditor provided bookkeeping services, as well as performing a substandard audit; failure to review internal controls; cash and inventory deficiencies.
No. 13:	B, C	Internal Control Structure— Many problems are cited here. The client has a material internal control weakness that should have required expanded audit procedures; scope limitations.
No. 25	A	Legal Liability— The auditor is criminally prosecuted for certifying false and misleading financial statements.
No. 27	B, D	Predecessor-Successor Communication— Insufficient inquiries made to predecessor auditor, SAS No. 7 discussed. The partner did not review work papers. Absence of professional skepticism.
No. 30	B, C	Evidence and Documentation— Inadequate inventory control allowed overstatement of inventory.
No. 36	A, B, C	Internal Control Structure— Auditor did not test the internal controls and missed significant problems involving cash transactions of a broker-dealer. Misleading audit report issued.
No. 39	A, B	Audit Programs— Auditor used a "canned" audit program but did not tailor it to the client's circumstances; Rule 10B-5 violation.
No. 45	D	Substance over Form— Issue was a major factor in this case; APB 4 discussed in detail.

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No. 53	A, B	Insufficient Evidence Gathered— Auditor was "recklessly indifferent" to his responsibilities.
Nos. 57, 68	A	Professional Ethics— Auditor received improper cash payments from the client.
Nos. 69, 70	B, C	Evidence and Documentation— Problems with controlling the accounts receivable confirmation process.
No. 83	B	Evidence and Documentation— There was inadequate evidence in confirming the extinguishment of accounts payable, with resulting overstatement of revenue.
No. 87	A	Audit Reports— No audit trail existed, and there was significant interference from the client (scope restriction). Auditor should have issued a disclaimer.
No. 106	A	Audit Reports— Auditor's inexperience and unavailable working papers should have resulted in disclaimer.
No. 109A	B, D	Audit Planning— Auditors did not act on warning signals from analytical procedures; responsibility to detect fraud (SAS No. 16).
No. 111	B, D	Materiality and Risk, Management Representation Letters— Auditor did not think a related-party transaction involving five percent of the client's assets was material.
No. 114	A, D	Audit Reports— Events arising subsequent to issuing a report for an IPO should have resulted in the auditor's withdrawing his report; interim financial statements.
Nos. 115, 117	B	Audit Program— The auditor, working under a tight deadline, failed to follow a formal audit program, and did not adequately complete the field work.
No. 127	B, C	Inventory Audit Problems— Failure by the auditor to test for obsolescence, also inventory valuation problems.
No. 129	B	Materiality and Risk— Certain material transactions were not investigated. The problem was magnified by the client's deteriorating financial position—an inherent risk.
No. 150	B, D	Audit Planning and Management Representation Letters— Auditor did not complete procedures to identify related parties.
No. 159	B, D	Staff Member Violations— Staff member signed off on audit procedures not performed. Both partner and staff member were penalized.
No. 179	B	Evidence and Documentation— Inventory problems with a video business are discussed.
No. 192	A	Professional Ethics— Auditor received stock from the client firm. Extensive discussion of independence.
No. 200	B	Auditing Planning— General lack of planning by a Big 6 firm, including a lack of understanding about the client's industry (SAS No. 22).
No. 216	A, C	Audit Reports— Significant client errors are not corrected. The auditor still issues

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		an unqualified opinion. Receivables confirmation procedures discussed.
No. 220	A, B	Opinion Shopping— Client opinion shopping situation where the auditor was a willing victim is described.
No. 237	A	Professional Ethics— Auditor knew that the client had no assets, liabilities or business activity, but issued an opinion.
No. 242	A, B, C	Accounts Receivable and Inventory Audit Problems— Thorough discussion of audit procedures in both areas. Accounts receivable confirmations non-responses and exceptions not followed up.
No. 244	A	Professional Ethics— Multiple violations including client loans to the auditor, the client and auditor in a partnership together, and providing the client with bookkeeping services.
No. 246	A	Legal Liability— Willful fraud; the auditor acted as both independent auditor and internal accountant.
No. 251	A, C	Cash, Inventory, and Prepaid Advertising Audit Deficiencies— Discussion of GAAS violations in these three areas including the issue of slow moving inventory.
No. 264	B, C	Accounts Receivable and Inventory Audit Problems, Audit Responsibilities for Detecting Errors or Irregularities— SAS No. 43, AU Section 331 dealing with confirmations is discussed.
No. 274	B	Evidence and Documentation— Overstatement of revenue under the percentage of completion accounting method.
No. 453	B, D	Audit Planning and Internal Control Structure— Failed to adequately plan the audit and gain an understanding of internal controls; improper supervision and review.
No. 455	A,B	Professional Ethics and Evidence and Documentation— Improper professional conduct and inadequate audit evidence.
No. 462	D	Due Professional Care— Complex transaction.
No. 465	A,B	Due Professional Care and Professional Skepticism— Materiality judgment related to receivables.
No. 467	B	Independence— Auditor acted in the capacity of employee; size of audit fee impaired the appearance of independence.
No. 482	A, B	Due Professional Care and Inadequate Evidence— Deferral of operating losses and inadequate disclosure of loss contingencies.
No. 487	A, B	Due Professional Care and Inadequate Evidence— Overstatement of investment values.
No. 511	A, B, D	Lack of Due Care, Professional Skepticism, Competence, Audit Planning— Valuation of investments and revenue realization.
No. 528	A	Lack of Independence— Investments overvalued.

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No. 534	B	Evidential Matter— Overvalued assets and improper accounting for losses.
No. 554	A, B, D	Due Professional Care, Evidence, Planning, and Disclosures— Numerous financial statement problems; Big 6 auditor.
No. 564	A, B	Professional Ethics, Independence, Evidence— Fictitious assets and auditor-owned shares in IPO.
No. 575	A, B	Due Care, Audit Planning and Internal Controls— Improper revenue realization and failure to detect Ponzi scheme.
No. 585	B	Audit Planning and Evidence— Improper accounting for complex transactions at year-end.
No. 590	B, C	Evidential Matter— Failed to test and confirm assets.
No. 608	A, B	Due Professional Care and Insufficient Evidential Matter— Overstated accounts receivable and revenue recognition due to fictitious accounts.
No. 613	A	Independence, Client Acceptance— Audit client had criminal record; auditor maintained company's books.
No. 619	B, C	Substantive Testing— Receivables confirmation procedures in the sales and collection transactions cycle; auditor did not confirm a large enough percentage of receivables, nor properly follow up on noted discrepancies.
No. 641	A, B, C	Lack of Due Care, Audit Planning Problems, Insufficient Audit Evidence, Improper Reporting— Overstated assets by not recording them at historical cost; overstated revenues and understated liabilities. Cash audit procedures discussed.
No. 678	B, C	Evidence Documentation— No meaningful tests performed to determine existence and valuation of receivables by a collection agency.
No. 681	B	Audit Planning and Evidence— Audit program did not include steps requiring calculation of net realizable value of client's investment in real estate.
No. 688	B, C, D	Audit Planning— No audit plan developed; inadequate inventory tests; concurring review partner signed off but performed no real review.
No. 695	B	Audit Risk and Evidence— Failure to assess relevant audit risks when determining sample sizes.

Source of AAERs: Federal Securities Law Reporter (1995)

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