CONTEMPORARY AUDITING
REAL ISSUES AND CASES

Seventh Edition

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Australia • Brazil • Japan • Korea • Mexico • Singapore • Spain • United Kingdom • United States
Case 1.1  Enron Corporation

Arthur Edward Andersen established a simple motto that he required his subordinates and clients to invoke: "Think straight, talk straight." For decades, that motto served Arthur Andersen & Co. well. Unfortunately, the firm's association with one client, Enron Corporation, abruptly ended Andersen's long and proud history in the public accounting profession.

KEY TOPICS: history of the public accounting profession in the United States, scope of professional services provided to audit clients, auditor independence, and retention of audit workpapers.

Case 1.2  Just for FEET, Inc.

In the fall of 1999, just a few months after reporting a record profit for fiscal 1998, Just for Feet collapsed and filed for bankruptcy. Subsequent investigations by law enforcement authorities revealed a massive accounting fraud that had grossly misrepresented the company's reported operating results. Key features of the fraud were improper accounting for "vendor allowances" and intentional understatements of the company's inventory valuation allowance.

KEY TOPICS: applying analytical procedures, identifying inherent risk and control risk factors, need for auditors to monitor key developments within the client's industry, assessing the health of a client's industry, and receivables confirmation procedures.

Case 1.3  Jamaica Water Properties

Shortly after accepting an executive position with JWP, David Sokol discovered several suspicious items in the company's accounting records. Sokol insisted on thoroughly investigating those items. When that investigation uncovered evidence of a pervasive fraud, Sokol resigned and turned over that evidence to the company's board of directors.

KEY TOPICS: ethical responsibilities of corporate management, control environment issues, and auditor independence.

Case 1.4  Health Management, Inc.

The Private Securities Litigation Reform Act (PSLRA) of 1995 amended the Securities Exchange Act of 1934. This new federal statute was projected to have a major impact on auditors' legal liability under the 1934 Act. The first major test of the PSLRA was triggered by a class-action lawsuit filed against BDO Seidman for its 1995 audit of Health Management, Inc., a New York–based pharmaceuticals distributor.

KEY TOPICS: inventory audit procedures, auditor independence, audit workpapers, inherent risk factors, and auditors' civil liability under the federal securities laws.

Case 1.5  The Leslie Fay Companies

In January 2002, Paul Polishan, the former chief financial officer of The Leslie Fay Companies, began serving a nine-year prison sentence for fraudulently misrepresenting Leslie
Fay's financial statements in the early 1990s. Among the defendants in a large class-action lawsuit stemming from the fraud was the company's audit firm, BDO Seidman.

**KEY TOPICS:** applying analytical procedures, need for auditors to assess the health of a client's industry, identifying and assessing "red flags," control environment issues, and auditor independence.

**Case 1.6  Star Technologies, Inc.**  
This computer manufacturer found itself trapped in its industry's short product life cycle. The company incurred heavy R&D expenditures to develop new products, only to have those products soon become obsolete. Management began tampering with the company's accounting records to conceal its deteriorating financial condition.

**KEY TOPICS:** auditor-client conflict, conflict between auditors, audit review process, auditing inventory, auditing the allowance for bad debts, classification of liabilities, and intercompany transactions.

**Case 1.7  Lincoln Savings and Loan Association**  
Charles Keating's use of creative accounting methods allowed him to manufacture huge paper profits for Lincoln.

**KEY TOPICS:** substance-over-form concept, detection of fraud, identification of key management assertions, collegial responsibilities of auditors, assessment of control risk, and auditor independence.

**Case 1.8  Crazy Eddie, Inc.**  
"Crazy Eddie" Antar oversaw a profitable chain of consumer electronics stores on the East Coast during the 1970s and 1980s. After new owners discovered that the company's financial data had been grossly misrepresented, Antar fled the country, leaving behind thousands of angry stockholders and creditors.

**KEY TOPICS:** auditing inventory, inventory control activities, management integrity, the use of analytical procedures, and the hiring of former auditors by audit clients.

**Case 1.9  ZZZZ Best Company, Inc.**  
Barry Minkow, the "boy wonder" of Wall Street, created a $200,000,000 company that existed only on paper.

**KEY TOPICS:** identification of key management assertions, limitations of audit evidence, importance of candid predecessor-successor auditor communications, client confidentiality, and client-imposed audit scope limitations.

**Case 1.10  United States Surgical Corporation**  
An SEC investigation revealed that officials of this company went to great lengths to conceal fraudulent misrepresentations in the company's accounting records from its independent auditors.

**KEY TOPICS:** the use of analytical procedures, accounting for revenue and capital expenditures, implications of the imbalance of power in the auditor-client relationship, and evaluation of conflicting audit evidence.
Case 1.11 New Century Financial Corporation

The collapse of New Century Financial Corporation in April 2007 signaled the beginning of the subprime mortgage crisis in the United States, which would eventually destabilize securities and credit markets around the globe. A federal bankruptcy examiner has maintained that New Century's independent audits were inadequate.

KEY TOPICS: auditing loan loss reserves, Section 404 audit procedures, material internal control weaknesses, auditor independence, and audit staffing issues.

SECTION 2 Audits of High-Risk Accounts

Case 2.1 Jack Greenberg, Inc.

A federal judge criticized Greenberg's independent auditors for failing to realize the impact that pervasive internal control problems had on the reliability of the company's inventory accounting records.

Case 2.2 Golden Bear Golf, Inc.

Jack Nicklaus, the "Golden Bear," endured public embarrassment and large financial losses when key subordinates misapplied the percentage-of-completion accounting method to numerous golf course development projects.

Case 2.3 Happiness Express, Inc.

To compensate for flagging sales of their Mighty Morphin Power Rangers toys, this company's executives booked millions of dollars of bogus sales. Deficiencies in the audit procedures applied by Happiness Express's auditors resulted in the bogus sales and receivables going undetected.

Case 2.4 CapitalBanc Corporation

What is the most important asset of a bank? Cash, of course. This case examines an audit that failed to uncover a large embezzlement scheme perpetrated by a bank's chief executive officer.

Case 2.5 SmarTalk Teleservices, Inc.

In recent years, "restructuring" reserves have been a controversial subject in the financial reporting domain. This case examines accounting and auditing issues stemming from a large restructuring reserve booked by SmarTalk.

Case 2.6 CBI Holding Company, Inc.

This case focuses on audit procedures applied to accounts payable, including the search for unrecorded liabilities and the reconciliation of year-end vendor statements to recorded payables balances.
Case 2.7  Campbell Soup Company  
On Wall Street, Campbell easily ranks among the "bluest" blue chip companies. Nevertheless, Campbell and its audit firm were widely criticized when an investigation revealed that company executives had inflated the sales of its famous "red and white" product line by employing a variety of gimmicks.

Case 2.8  Rocky Mount Undergarment Company, Inc.  
You are the accountant of a corporation experiencing severe financial problems. Top company officials suggest that several hundred employees will lose their jobs unless you embellish the company's financial data. Three employees of Rocky Mount faced this unpleasant dilemma.

SECTION 3  Internal Control Issues  

Case 3.1  The Trolley Dodgers  
Control deficiencies in the Dodgers' payroll transaction cycle allowed an accounting manager to embezzle several hundred thousand dollars.

Case 3.2  Howard Street Jewelers, Inc.  
Given the susceptibility of cash to theft, retail companies typically establish rigorous internal controls for their cash processing functions. This case documents the high price of failing to implement such controls.

Case 3.3  Saks Fifth Avenue  
Saks' "zero tolerance" policy for employee theft was tested in this case by a sales clerk. After being dismissed, the employee tested Saks again by suing the firm for wrongful termination.

Case 3.4  Triton Energy Ltd.  
Executives of Triton Energy violated the Foreign Corrupt Practices Act of 1977 (FCPA). In addition, to paying bribes to officials of foreign governments, company executives failed to comply with the FCPA's record-keeping and internal-control provisions.

Case 3.5  Goodner Brothers, Inc.  
An employee of this tire wholesaler found himself in serious financial trouble. To remedy this problem, the employee took advantage of his employer's weak internal controls by stealing a large amount of inventory, which he then sold to other parties.

Case 3.6  Troberg Stores  
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Top management of this company systematically misrepresented its operating results and financial condition. The company’s controller often questioned his superiors’ decisions before acting as a “good soldier” and following their instructions.

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SECTION 7  Professional Issues  

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During the late 1990s, several international accounting firms developed investment banking practices. In fact, by 1998, two of those firms, KPMG and PricewaterhouseCoopers (PwC), ranked first and second in the investment banking industry in terms of the number of M&A (merger and acquisition) transactions completed annually. In 2002, the SEC sanctioned PwC for accepting contingent fee payments from several of its investment banking clients.

Case 7.2  Stephen Gray, CPA  
This sole practitioner challenged an ethical rule that banned CPAs from receiving commissions. Although he lost in court, the state board of accountancy later changed the controversial rule.

Case 7.3  Scott Fane, CPA  
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Under what circumstances does an accounting firm have a right and responsibility to withdraw from an audit engagement? After Deloitte resigned as MedTrans' independent auditor, the accounting firm was sued for not completing the audit that was in progress.

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This 1931 legal case established the Ultramares Doctrine that decades later has a pervasive influence on auditors' civil liabilities under the common law.

Case 7.9  First Securities Company of Chicago
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In this case, the Supreme Court defined the degree of auditor misconduct that must be present before a client can recover damages from an auditor in a lawsuit filed under the Securities Exchange Act of 1934.

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Garth Drabinsky built Livent, Inc., into a major force on Broadway during the 1990s. A string of successful Broadway productions resulted in numerous Tony Awards for the company. Despite Livent's theatrical success, the financial affairs of the Canadian company were in disarray. Drabinsky and several of his top subordinates used a wide range of abusive accounting practices to conceal Livent's financial problems from their independent auditors.

Case 8.2  Royal Ahold, N.V.  419

The Public Company Accounting Oversight Board (PCAOB) implied that this large-scale accounting fraud involving the Netherlands' largest company demonstrated that foreign accounting and auditing regulatory bodies were failing to fulfill their oversight responsibilities. The PCAOB's insinuation prompted indignant responses from many of those organizations.
Case 8.3  Kansayaku  435

Like the United States, Japan has recently made significant changes in the regulatory infrastructure for its financial reporting system. Many of these changes have directly impacted Japan's accounting profession and independent audit function. An accounting and auditing scandal involving a large cosmetics and apparel company, Kanebo Limited, posed the first major challenge of that new regulatory framework.

Case 8.4  Registered Auditors, South Africa  445

The South African economy was rocked in recent years by a series of financial reporting scandals. To restore the credibility of the nation's capital markets, the South African Parliament passed a controversial new law, the Auditing Profession Act (APA). The APA established a new auditing regulatory agency and a new professional credential for independent auditors. The APA also mandated that independent auditors immediately disclose to the new auditing agency any "reportable irregularities" committed by an audit client.

Case 8.5  Zuan Yan  457

The Big Four accounting firms view China as one of the most lucrative markets for accounting and auditing services worldwide. However, those firms face major challenges in that market. Among these challenges are an increasing litigation risk and the difficulty of coping with the often heavy-handed tactics of China's authoritarian central government.

Case 8.6  Kaset Thai Sugar Company  469

This case focuses on the 1999 murder of Michael Wansley, a partner with Deloitte Touche Tohmatsu. Wansley was supervising a debt-restructuring engagement in a remote region of Thailand when he was gunned down by a professional assassin.

Case 8.7  Australian Wheat Board  473

During the United Nations (U.N.) embargo imposed on Iraq following that nation's invasion of Kuwait, this large Australian company paid $300 million in bribes to secure lucrative Iraqi wheat contracts administered through the U.N. Oil-for-Food program. After the bribes were discovered in 2005 by a U.N. task force, two major international accounting firms became involved in the ensuing controversy.

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Business Week referred to the huge Gazprom debacle as "Russia's Enron." For the first time in the history of the new Russian republic, a Big Four accounting firm faced a lawsuit for allegedly issuing improper audit opinions on a Russian company's financial statements.

Case 8.9  Tata Finance Limited  497

A financial reporting fraud involving this large Indian company became known as "India's Enron." Company executives retained one of India's most prominent accounting firms to investigate the fraud. The report filed by that accounting firm implicated those same executives. Shortly after the report was released, the accounting firm retracted the report and fired the three partners responsible for it.
**Case 8.10  Baan Company, N.V.**

For the first time in its history, the Securities and Exchange Commission (SEC) sanctioned a foreign audit firm. Moret Ernst & Young Accountants, a Dutch affiliate of Ernst & Young, was sanctioned for having a "joint business relationship" with Baan, a Dutch company with a large U.S. subsidiary. This case also examines a similar situation involving Ernst & Young and one of its audit clients, PeopleSoft Corporation.

**Case 8.11  Institute of Chartered Accountants of India**

The Institute of Chartered Accountants of India (ICAI) is the federal agency that oversees India's accounting profession. In 2002, the ICAI commissioned a study of the alleged takeover of that profession by the major international accounting firms. The resulting 900-page report charged that those firms had used a variety of illicit and even illegal methods to "colonize" India's market for accounting, auditing, and related services to the detriment of the nation's domestic accounting firms.