

Auditing

and

Assurance Services

Ninth Edition

AN INTEGRATED APPROACH

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AUDITING AND ASSURANCE SERVICES

An Integrated Approach

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The early years were difficult with Comptronix suffering losses through 1986. Local enthusiasm for the company attracted investments from venture capitalists. One of those investors included a partner in the Massey Burch Investment Group, a venture capital firm located in Nashville, Tennessee, just over a 100 miles to the north. The infusion of venture capital allowed Comptronix to generate strong sales and profit growth during 1987 and 1988. Based on this strong performance, senior management took the company's stock public in 1989, initially selling Comptronix stock at \$5 a share in the over-the-counter markets.³

THE ACCOUNTING SCHEME⁴

According to the SEC's investigation, the fraud began soon after the company went public in 1989 and was directed by top company executives. Mr. Hebding as chairman and CEO, Mr. Shifflett as president and COO, and Mr. Medlin as controller and treasurer used their positions of power and influence to manipulate the financial statements issued from early 1989 through November 1992.

They began their fraud scheme by first manipulating the quarterly statements filed with the SEC during 1989. They misstated those statements by inappropriately transferring certain costs from cost of goods sold into inventory accounts. This technique allowed them to overstate inventory and understate quarterly costs of goods sold, which in turn overstated gross margin and net income for the period. The three executives made monthly manual journal entries, with the largest adjustments occurring just at quarter's end. Some allege that the fraud was motivated by the loss of a key customer in 1989 to the three executives' former employer, SCI.

The executives were successful in manipulating quarterly financial statements partially because their quarterly filings were unaudited. However, as fiscal year 1989 came to a close, the executives grew wary that the company's external auditors might discover the fraud when auditing the December 31, 1989 year-end financial statements. To hide the manipulations from their auditors, they devised a plan to cover up the inappropriate transfer of costs. They decided to remove the transferred costs from the inventory account just before year-end, because they feared the auditors would closely examine the inventory account as of December 31, 1989 as part of their year-end testing. Thus, they transferred the costs back to cost of goods sold. However, for each transfer back to cost of goods sold, the fraud team booked a fictitious sale of products and a related fictitious accounts receivable. That, in turn, overstated revenues and receivables.

The net effect of these activities was that interim financial statements included understated cost of goods sold and overstated inventories, while the annual financial statements contained overstated sales and receivables. Once they had tasted success in their manipulations of year-end sales and receivables, they later began recording fictitious quarterly sales in a similar fashion.

So that the auditors would believe the fictitious sales and receivables were legitimate, the three company executives recorded cash payments on the bogus customer accounts due Comptronix. In order to do this, they developed a relatively complex fraud scheme. First, they recorded fictitious purchases of equipment on account. That, in turn, overstated equipment and accounts payable. Then, Hebding, the chairman and CEO, and Medlin, the controller and treasurer, cut checks to the bogus accounts payable vendors associated with the fake purchases of equipment. But they didn't mail the checks. Rather, they deposited them in Comptronix's disbursement checking account and recorded the phony payments as debits against the bogus accounts payable and credits against the bogus receivables. This accounting scheme allowed the company to eliminate the bogus payables and receivables, while still retaining the fictitious sales and equipment on the income statement and balance sheet, respectively.

This scheme continued over four years, stretching from the beginning of 1989 to November 1992, when the three executives confessed to their manipulations. The SEC investigation noted that the Form 10-K filings for the years ended December 31, 1989, 1990, and 1991 were materially misstated as shown in the table on the next page.

THE COMPANY'S INTERNAL CONTROLS⁵

The three executives were able to perpetrate the fraud by bypassing the existing accounting system. They avoided making the standard entries in the sales and purchases journals as required by the existing internal control, and recorded the fictitious entries manually. Other employees were excluded from the manipulations to minimize the likelihood of the fraud being discovered.

According to the SEC's summary of the investigation, Comptronix employees normally created a fairly extensive paper trail for equipment purchases, including purchase orders and receiving reports. However, none of these documents were created for the bogus purchases. Approval for cash disbursements was typically granted once the related purchase order, receiving report, and vendor invoice were matched. Unfortunately, Mr. Shifflett or Mr. Medlin could approve payments based

³ Source: See footnote 2.

⁴ Source: Accounting and Auditing Enforcement Release No. 543, Commerce Clearing House, Inc., Chicago.

⁵ Source: See footnote 4.

solely on an invoice. As a result, the fraud team was able to bypass internal controls over cash disbursements. They simply showed a fictitious vendor invoice to an accounts payable clerk, who in turn prepared a check for the amount indicated on the invoice.

Internal controls were also insufficient to detect the manipulation of sales and accounts receivable. Typically, a shipping department clerk would enter the customer order number and the quantity to be shipped to the customer into the computerized accounting system. The accounting system then automatically produced a shipping document and a sales invoice. The merchandise was shipped to the customer, along with the invoice and shipping document. Once again, Mr. Medlin, as controller and treasurer, had the ability to access the shipping department system. This allowed him to enter bogus sales into the accounting system. He then made sure to destroy all shipping documents and sales invoices generated by the accounting system to keep them from being mailed to the related customers. The subsequent posting of bogus payments on the customers' accounts were posted personally by Mr. Medlin to the cash receipts journal and accounts receivable subsidiary ledger.

The fraud scheme was obviously directed from the top ranks of the organization. Like most companies, the senior executives at Comptronix directed company operations on a day-to-day basis, with only periodic oversight from the company's board of directors.

The March 1992 proxy statement to shareholders noted that the Comptronix board of directors consisted of seven individuals, including Mr. Hebding who served as board chairman. Of those seven individuals serving on the board, two individuals, Mr. Hebding, chairman and CEO and Mr. Shifflett, president and COO, represented management on the board. Thus,

| | 1989 | 1990 | 1991 |
|--|----------------|----------------|----------------|
| Sales (in 000's) | | | |
| Reported Sales | \$42,420 | \$70,229 | \$102,026 |
| Restated Sales | <u>37,275</u> | <u>63,444</u> | <u>88,754</u> |
| Overstatement of Sales | 5,145 | 6,785 | 13,272 |
| Percentage Overstatement | 13.8% | 10.7% | 14.9% |
| Net Income (in 000's) | | | |
| Reported Net Income | \$1,470 | \$3,028 | \$5,071 |
| Restated Net Income | <u>(3,524)</u> | <u>(3,647)</u> | <u>(3,225)</u> |
| Overstatement of Net Income | 4,994 | 6,675 | 8,296 |
| Earnings Per Share (EPS) | | | |
| Reported EPS | \$.19 | \$.35 | \$.51 |
| Restated EPS (loss) | <u>(.47)</u> | <u>(.43)</u> | <u>(.34)</u> |
| Overstatement of EPS | .66 | .78 | .85 |
| Property, Plant, & Equipment (in 000's) | | | |
| Reported PP&E | \$18,804 | \$26,627 | \$38,720 |
| Restated Sales | <u>13,856</u> | <u>15,846</u> | <u>20,303</u> |
| Overstatement of PP&E | 4,948 | 10,781 | 18,417 |
| Percentage Overstatement | 35.7% | 68.0% | 90.7% |
| Stockholders' Equity (in 000's) | | | |
| Reported Stockholders' Equity | \$19,145 | \$22,237 | \$39,676 |
| Restated Stockholders' Equity | <u>14,151</u> | <u>10,568</u> | <u>18,778</u> |
| Overstatement of Stockholders' Equity | 4,994 | 11,669 | 20,898 |
| Percentage Overstatement | 35.3% | 110.4% | 111.3% |
| <p>The executives' fraud scheme helped the company avoid reporting net losses in each of the three years, with the amount of the fraud increasing in each of the three years affected.⁶ The fraud scheme also inflated the balance sheet by overstating property, plant, and equipment and stockholders' equity. By the end of 1991, property, plant, and equipment was overstated by over 90%, with stockholders' equity overstated by 111%.</p> | | | |

⁶ Information about fiscal year 1994 was not reported because the fraud was disclosed before that fiscal year ended.

28.6% of the board consisted of inside directors. The remaining five directors were not employed by Comptronix. However, two of those five directors had close affiliations with management. One served as the company's outside general legal counsel and the other served as vice president of manufacturing for a significant customer of Comptronix. Directors with these kinds of close affiliations with company management are frequently referred to as "grey" directors due to their perceived lack of objectivity. The three remaining "outside" directors had no apparent affiliations with company management. One of the remaining outside directors was a partner in the venture capital firm that owned 574,978 shares (5.3%) of Comptronix's common stock. That director was previously a partner in a Nashville law firm and was currently serving on two other corporate boards. A second outside director was the vice chairman and CEO of the local bank originally loaning money to the company. He also served as chairman of the board of another local bank in a nearby town. The third outside director was president of an international components supplier based in Taiwan. All of the board members had served on the Comptronix board since 1984, except for the venture capital partner who joined the board in 1988 and the president of the key customer who joined the board in 1990.

Each director received an annual retainer of \$3,000 plus a fee of \$750 for each meeting attended. The company also granted each director an option to purchase 5,000 shares of common stock at an exercise price that equaled the market price of the stock on the date that the option was granted.

The board met four times during 1991. The board had an audit committee that was charged with recommending outside auditors, reviewing the scope of the audit engagement, consulting with the external auditors, reviewing the results of the audit examination, and acting as a liaison between the board and the internal auditors. The audit committee was also charged with reviewing various company policies, including those related to accounting and internal control matters. Two outside directors and one grey director made up the three-member audit committee. One of those members was an attorney, and the other two served as president and CEO of the companies where they were employed. There was no indication of whether any of these individuals had accounting or financial reporting backgrounds. The audit committee met two times during 1991.

MANAGEMENT BACKGROUND

The March 1992 proxy statement provided the following background information about the three executives allegedly committing the fraud: Mr. Hedding, Mr. Shifflett, and Mr. Medlin.

William J. Hedding served as the Comptronix Chairman and CEO. He was responsible for sales and marketing, finance and general management of the company. He also served as a director from 1984 until 1992 when the fraud was disclosed. He was the single largest shareholder of Comptronix common stock by beneficially owning 6.7% (720,438 shares) of Comptronix common stock as of March 2, 1992. Before joining Comptronix, Mr. Hedding worked for SCI Systems Inc., from 1974 until October 1983. He held the title of Treasurer and CFO at SCI from December 1976 to October 1983. In October 1983, Mr. Hedding left SCI to form Comptronix. He graduated from the University of North Alabama with a degree in accounting, and was a certified public accountant. Mr. Hedding's 1991 cash compensation totaled \$187,996.

Allen L. Shifflett served as the Comptronix's president and chief operating officer (COO) where he was responsible for manufacturing, engineering, and programs operations. He also served as a board of director from 1984 until 1992 when the fraud unfolded. He owned 4.0% (433,496 shares) of Comptronix common stock as of March 2, 1992. Like Mr. Hedding, he joined the company after previously being employed at SCI as a plant manager and manufacturing manager from October 1981 until April 1984 when he left to help form Comptronix. Mr. Shifflett obtained his B.S. degree in industrial engineering from Virginia Polytechnic Institute. Mr. Shifflett's 1991 cash compensation totaled \$162,996.

Paul Medlin served as Comptronix controller and treasurer. He also previously worked at SCI as Mr. Hedding's assistant after graduating from the University of Alabama. Mr. Medlin did not serve on the Comptronix board. The 1992 proxy noted that the board of directors approved a company loan to him for \$79,250 on November 1, 1989 to provide funds for him to repurchase certain shares of common stock. The loan, which was repaid on May 7, 1991, bore interest at an annual rate equal to one percentage point in excess of the interest rate designated by the company's bank as that bank's "Index Rate." The 1992 proxy did not disclose Mr. Medlin's 1991 cash compensation.

The company had employment agreements with Mr. Hedding and Mr. Shifflett, which expired April 1992. Those agreements provided that if the company terminated employment with them prior to the expiration of the agreement for any reason other than cause or disability, they would each receive their base salary for the remaining term of the agreement. If terminated for cause or disability, each would receive their base salary for one year following the date of such termination.

The company had both an Employee Stock Incentive Plan and an Employee Stock Option Plan that the compensation committee of the board of directors administered. The committee made awards to key employees at its discretion. The compensation committee consisted of three non-employee directors. One of these directors was an attorney who served as Comptronix's outside counsel on certain legal matters. Another served as an officer of a significant customer of Comptronix. The third member of the committee was a partner in the venture capital firm providing capital for Comptronix.

The SEC's investigation noted that during the period of the fraud, the three men each sold thousands of shares of Comptronix common stock. Their knowledge of material non-public information about Comptronix's actual financial position allowed them to avoid trading losses in excess of \$500,000 for Mr. Hedding and Mr. Shifflett, and over \$90,000 for Mr. Medlin. Each also received bonuses: \$198,000 for Mr. Hedding, \$148,000 for Mr. Shifflett, and \$46,075 for Mr. Medlin. These bonuses were granted during the fraud years as a reward for the supposed strong financial performance.

After the fraud was revealed, newspaper accounts reported that red flags had been present. The New York Times reported that Mr. Hebding and Mr. Shifflett created reputations in the local community that contrasted with their conservative professional reputations. Mr. Hebding purchased a home worth over \$1 million, often described as a mansion with two boathouses, a pool, a wrought-iron fence with electric gate, and a red Jaguar in the driveway. The Atlanta Journal and Constitution reported that Mr. Hebding's marriage had failed, and that he had led an active bachelor's life that led to some problems in town. He also had a major dispute with another company founder who was serving as executive vice president. That individual was suddenly fired from Comptronix in 1989. Later it was revealed that he was allegedly demoted and fired for trying to investigate possible wrongdoing at Comptronix.⁷

Mr. Shifflett, too, had divorced and remarried. He and his second wife purchased an expensive scenic lot in an exclusive country club community in a neighboring town. Mr. Shifflett reportedly had acquired extensive real estate holdings in recent years.⁸

Others were shocked, noting that they were the last to be suspected of any kind of fraud. In the end, it was unclear why the three stunned the board with news of the fraud. There was some speculation that an on-going IRS tax audit triggered their disclosure of the shenanigans.

EPILOGUE

After the fraud was revealed, all three men were suspended and the board appointed an interim CEO and an interim president to take over the reins. The SEC's investigation led to charges being filed against all three men for violating the antifraud provisions of the Securities Act of 1933 and the Securities and Exchange Act of 1934, in addition to other violations of those securities acts. None of the men admitted or denied the allegations against them. However, all three men agreed to avoid any future violations of the securities acts. They also consented to being permanently prohibited from serving as officers or directors of any public company. The SEC ordered them to pay back trading losses avoided and bonuses paid to them by Comptronix during the fraud period, and directed Mr. Hebding and Mr. Shifflett to pay civil penalties of \$100,000 and \$50,000, respectively. The SEC did not impose civil penalties against Mr. Medlin due to his inability to pay.

The company struggled financially. They sold their San Jose operations in 1994 and eventually filed for Chapter 11 bankruptcy protection in August 1996. Chapter 11 allowed the company to continue operating while developing a restructuring plan. In September 1996, the company announced that it sold substantially all of its assets to a California-based leading electronics manufacturer. As a result of the sale, the secured creditors of Comptronix were fully repaid; however, the unsecured creditors received less than 10 cents on the dollar.

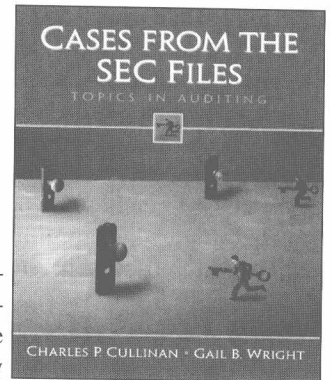
REQUIREMENTS

1. Professional auditing standards present the audit risk model, which is used to determine the nature, timing, and extent of audit procedures. Describe the components of the model and discuss how changes in each component affect the auditor's need for evidence.
2. One of the components of the audit risk model is inherent risk. Describe typical factors that auditors evaluate when assessing inherent risk. With the benefit of hindsight, what inherent risk factors were present during the audits of the 1989 through 1992 Comptronix financial statements?
3. Another component of the audit risk model is control risk. Describe the five components of internal control. What characteristics of Comptronix's internal control increased control risk for the audits of the 1989 – 1992 year-end financial statements?
4. The board of directors, and its audit committee, can be an effective corporate governance mechanism. Discuss the pros and cons of allowing inside directors to serve on the board. Describe typical responsibilities of audit committees. What strengths or weaknesses were present related to Comptronix's board of directors and audit committee?
5. Public companies must file quarterly financial statements in Form 10-Qs. Professional standards allow CPAs to perform timely reviews of those statements. Briefly describe the key requirements of SAS No. 71, Interim Financial Statements. Why wouldn't all companies engage their auditors to perform SAS No. 71 reviews?
6. Do you think Comptronix's executive team was inherently dishonest from the beginning? How is it possible for otherwise honest people to become involved in frauds like the one at Comptronix?

⁷ Source: "A Comptronix founder, in 1989 suit, says he flagged misdeeds," The Wall Street Journal, December 7, 1992, A:3.

⁸ Sources: See footnote 2 and "In town, neighbors saw it coming," The New York Times, December 4, 1992, D:1.

**RICHARD VALADE, CPA
(PERRY DRUG)**
**From: Cullinan/Wright Cases from the SEC Files:
Topics in Auditing**



SYNOPSIS:

Perry Drug, while conducting periodic rolling inventories, discovered a material (\$20 million) discrepancy between its inventory records and the physical inventory. The inventory records overstated the inventory balance, and therefore, overstated net income. Perry personnel disclosed the issue to Richard Valade, a partner at Arthur Andersen. Valade sought to investigate the issue by performing analytical review, and by physically observing the inventory at a sample of stores. The analytical review disclosed no material changes in the cost of goods sold percentage (despite Perry having changed inventory reporting method twice). The physical observation supported the client's counts which showed a material overstatement. Valade issued an unqualified audit opinion on Perry financial statements, which were not adjusted for the inventory discrepancy.

SEC FINDINGS:

On the basis of this Order and Valade's Offer of Settlement, the Commission finds that¹

A. RESPONDENT AND OTHER RELATED PARTIES

1. Respondent

Richard Valade (Valade), age 48, is a partner with Arthur Andersen, LLP (AA) based in its Detroit, Michigan Office. Valade was the engagement partner at AA for the 1991, 1992 and 1993 audits of Perry Drug Stores, Inc. (Perry). Valade also served as an engagement manager on the 1984 through 1987 Perry audits. He has been a Certified Public Accountant (CPA) licensed in the state of Michigan since 1979.

2. Other Related Party

Perry Drug Stores, Inc. (Perry) was a Michigan corporation which operated a chain of drugstores located primarily in Michigan. Perry was a publicly traded company whose common stock was registered pursuant to Section 12(b) of the Securities Exchange Act of 1934 (Exchange Act). As of October 31, 1992, the end of Perry's fiscal year, Perry operated 205 retail drugstores. In January 1993, Perry filed a Form 10-K with the Commission pursuant to Section 13(a) of the Exchange Act. Perry attached a copy of AA's Report of Independent Public Accountants which contained an unqualified opinion signed by Richard Valade dated December 15, 1992, and which accompanied Perry's October 31, 1992 financial statements.

B. SUMMARY

Valade, the engagement partner on the Perry audit for the year ended October 31, 1992, issued an unqualified audit report on Perry's financial statements without obtaining sufficient competent evidential matter. Valade knew that Perry's valuation of physical inventory counts during the year generated results that were approximately \$20 million less than the inventory carried on Perry's books and records and reflected in its financial statements. Nevertheless, Valade, relying on the results of other audit procedures and analytic data, agreed with Perry's decision to include the \$20 million in inventory as an asset and signed the unqualified audit report. Perry later determined that this inventory did not exist.

C. BACKGROUND

In fiscal year 1990, Perry began using a base cost method to value inventory at its stores. Perry employed an outside service to conduct physical inventory counts of its stores on a cyclical basis during each fiscal year. Perry conducted a physical inventory of a percentage of its stores each month from February through September until it had completed an inventory of all stores. Beginning in late 1991 and throughout fiscal year 1992 Perry changed to a last received cost method.²

In order to value inventory and calculate cost of goods sold in the books and records, between each physical count, Perry used the gross profit method typical to retail merchants. Using this method, Perry would add to the amount of the beginning

¹ The findings herein are made pursuant to Valade's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

² Pursuant to the last received cost method, inventory is valued by multiplying the number of units of a particular product by the cost of the most recently purchased unit of that product.

inventory the actual cost of its goods purchased through its accounts payable system (cost of goods acquired for sale). Perry would then reduce the inventory by an estimate of the cost of goods sold calculated using the estimated gross profit margin³ Perry included the estimated inventory balance on its general ledger, until the actual inventory was verified through a new physical count. Perry would then adjust this inventory figure to reflect the results of the physical inventory.

Perry reconciled the recorded inventory at each store with the results of the physical inventory for that store when it conducted the next cyclical count. If the recorded inventory was greater than the value of the physical inventory, Perry increased the cost of goods sold and decreased the recorded inventory to reflect the results of the physical inventory. If the physical count revealed that a store had more inventory than was recorded in the books and records, Perry adjusted the general ledger to reflect the additional inventory.

D. DISCUSSION

1. Perry's Inventory Discrepancies in Fiscal 1992 Totaled over \$20 Million

During the second quarter of fiscal year 1992 (February through April), Perry conducted cycle counts of its inventory at approximately 48% of its stores. The valuations of these inventory counts were available in May and June 1992 and reflected store inventory in the general merchandise categories substantially less than those reflected in the recorded estimates of inventory on Perry's books. By the end of the second quarter of fiscal year 1992, Perry identified a discrepancy of approximately \$8.5 million between the value of the physical inventory and the recorded inventory. Perry identified an additional discrepancy of approximately \$7.6 million at the end of the third quarter and another approximately \$4 million at the end of the year. Combined, these discrepancies, or "shrinks," totaled over \$20 million for fiscal year 1992. The amount of these discrepancies was far in excess of discrepancies identified in prior fiscal years.

As described above, Perry had historically adjusted the inventory balances recorded in its books and records by writing off the amount of the discrepancy as a part of its cost of sales. However, in fiscal year 1992, because it did not believe that the unusually large store inventory discrepancies were reasonable, Perry's management did not follow its usual course of conduct. Instead of writing off the discrepancy to cost of sales, Perry recorded it in a suspense account, which was called the "Store 100" inventory account, while it investigated the source of the discrepancy. Perry then reflected the balance of the Store 100 account in its overall store inventory in its second and third quarter and year end fiscal 1992 financial statements.

In order to determine the cause of the unusually large discrepancy, Perry conducted numerous tests on its inventory systems and processes during and after fiscal year 1992. Perry also hired AA's computer risk management group to analyze the inventory related systems to determine whether systems problems were the cause of the discrepancy. Perry also hired private investigators and internal auditors to discover whether any large-scale theft had occurred. Perry also tried to determine whether the change, in fiscal year 1990, from the retail method of valuing inventory to a base cost method caused the discrepancy. Perry also conducted a more detailed internal audit of one its stores which used a point of sale ("POS") system.⁴ Despite all of these procedures, Perry was unable to explain, nor was it able to determine, the cause of the physical inventory discrepancies during fiscal year 1992.

2. The Fiscal Year 1992 Audit Conducted by Valade Failed to Verify Perry's Inventory

Before the audit of Perry's 1992 financial statements began, Perry notified Valade of the inventory discrepancies described above. Perry also informed Valade of the status and results of its on-going investigation. Accordingly, as part of its fieldwork, the audit team expanded its audit work in this area and conducted numerous tests to verify the value of Perry's inventory.

Under Valade's direction, the audit team conducted various analytical tests including tests to assess the validity of the gross profit margins as well as tests which examined warehouse and store data. Among other things, the team also examined margin and quantity data from warehouse shipments, available POS data, comparable industry wide margin data and Perry's historical margin data, all of which was inconsistent with the size of the shrink indicated by the physical inventory results. The audit team also investigated the possibility that thefts at the warehouse or changes in Perry's merchandising and business plans were the cause of the inventory discrepancies.

The audit team also observed and tested the physical count at five Perry stores which confirmed that the value of the physical inventory at those stores was much smaller than the estimated value reflected in Perry's general ledger. However, the audit team did not recommend that Perry record the shrink at the five stores as a cost of goods sold. Instead, Perry recorded the book-to-physical differences from these five stores as an asset in the Store 100 account, along with the results of the other physical counts.

³ The estimated gross profit margin was based upon factors such as merchandising plans and physical inventory results and generally was reviewed and adjusted more than once a year.

⁴ The "POS" system was new to Perry's stores in 1992 and had only been installed in about one-third of its stores by fiscal 1992 year end. The POS system permitted a more accurate accounting of actual products sold and related gross margins on those sales than was possible using Perry's former "department key" method. Traditionally, Perry accumulated sales information by classifying merchandise into six register keys. Key 1, the largest category, encompassed general non-pharmacy items.

None of the tests or analyses conducted by Valade and the audit team explained the cause of the inventory discrepancies. Nevertheless, Valade relied upon the results of the testing and analyses summarized above instead of the physical inventory results.

3. Valade was Aware of the Inventory Discrepancies Prior to Issuing the Audit Report

In September 1992, Valade and the Senior Accountant on the Perry engagement drafted a General Risk Analysis Memorandum (GRA) for the fiscal year 1992 Perry audit. Valade noted in the GRA the significant inventory discrepancies and the need to evaluate the problem during the audit. The GRA concluded that the risk of the overall audit would be "moderate" with emphasis placed on auditing inventory and payables. A "moderate" risk assessment reflects that the auditor expects errors but has reason to believe they are not likely to be material in relation to the financial statements. In the GRA, the audit team also set a materiality standard of \$700,000. At the time Valade drafted the GRA with a "moderate" risk rating, he was aware that: (1) Perry had discovered at least \$17 million in inventory discrepancies, (2) Perry had not recorded, as cost of sales, any of the inventory discrepancies; and (3) neither Perry nor anyone on the audit team could explain the cause of the inventory discrepancies.

In addition, Valade was aware of the study conducted by his firm's computer risk management group. The group concluded that while the inventory systems were operating as designed, the systems might not provide an accurate estimate of the value of the inventory in all circumstances.

Finally, Valade was aware of extensive month-long testing done on one of Perry's stores identified as "Store 152." In this testing Perry audited all shipments and followed all deliveries to the store to ensure that shipments were delivered. The company also did an extensive analysis regarding inventory reconciliations. Valade felt that these results verified the accuracy of the gross profit margin. However, this testing also showed the existence of an unusually large inventory discrepancy which was consistent with the physical counts done at other stores. Valade relied on the results of the analytic work rather than the data which showed the existence of the shrink in inventory.

4. Despite Uncertainties as to the Inventories' Existence, Valade Caused an Unqualified Audit Opinion to be Issued on the 1992 Financial Statements

In December 1992, Perry's management recommended to its board of directors and its audit committee that the company continue to include the \$20 million in Store 100 inventory as an asset on its October 31, 1992 balance sheet. During the audit, Valade consulted with a number of his partners concerning the inventory issue, including the Regional Practice Director. After further audit tests and additional discussions with his partners, Valade and two of his partners, attended Perry's Audit Committee meeting on this issue, which was also attended by Perry's outside counsel. At that meeting, Valade reported that he did not object to including the Store 100 inventory as an asset on Perry's balance sheet and that he would sign an unqualified opinion.

Valade acknowledged the possibility that the unexplained inventory discrepancy could have resulted from several changes in costing procedures over the previous three years. The minutes of the December 1992 Board Meeting reflect "uncertainties" as to the reasons for the inventory discrepancy. The minutes also reflect that Valade recommended that Perry conduct additional tests, including a simultaneous chain-wide inventory, as soon as possible to discover the reasons for the discrepancy.

Pursuant to the discussions at the Board Meeting, including a separate discussion by the outside directors with outside counsel, Perry's Board approved the filing of financial statements filed with Perry's 1992 Form 10-K which included the \$20 million of inventory in the Store 100 account as an asset. This represented over fourteen percent of the approximately \$140 million in inventory that Perry carried on its books and reported in its balance sheet and over seven percent of its assets of approximately \$270 million. Had Perry followed its normal procedure of expensing inventory shrinks to cost of sales, Perry would have reported a net loss of close to \$6 million for fiscal year 1992 instead of the net income of \$8.3 million it originally reported.

Indeed, despite uncertainties as to the Store 100 inventory's existence that led to Valade's recommendations for further testing, Valade signed an unqualified audit opinion on Perry's 1992 financial statements, which included the \$20 million of Store 100 inventory as an asset. As previously stated, Valade recommended that Perry conduct additional inventory counts and value the physical inventory using both the cost and retail methods at 20 stores. Valade also recommended that Perry conduct a simultaneous inventory of all its stores to reduce the number of variables that could have skewed the results of the inventories taken at the stores. Perry accepted Valade's recommendation for a simultaneous chain-wide physical store inventory, and scheduled it to be taken early in calendar 1993, shortly after the Christmas sales season. Valade also recommended that Perry reduce the gross profit margin being used in fiscal year 1993.

5. Perry Continued to Improperly Account for the Inventory Shrinkage in Fiscal Year 1993

In January 1993, pursuant to Valade's recommendation, Perry took sample physical inventories at cost and retail at 19 stores to determine whether its change in accounting methodology contributed to the shrinkages. Pursuant to Valade's suggestion, Perry began the full chain-wide physical inventory in February 1993. Reconciliation of book-to-physical results from the full chain inventory were completed in May 1993. These results confirmed the inventory shrink.

As a result of full chain inventories, Perry concluded that it could not verify the existence of the inventory in the Store 100 account. Near the end of fiscal year 1993, Perry disclosed a non cash charge of \$33.4 million relating to, among other things, an adjustment of store inventory. Approximately two-thirds of the charge taken in 1993 had been discovered by Perry during fiscal year 1992. Nevertheless, Perry, without objection from Valade, inappropriately categorized the adjustment as a "change in estimate" and did not restate the 1992 financial statements at that time. However, on July 27, 1994, upon the insistence of the Commission's Division of Corporation Finance, Perry restated its 1992 and 1993 financial statements. The 1992 and 1993 financial statements were restated to reflect a portion of this adjustment as a "correction of error" resulting in an additional \$20 million cost of sales for fiscal year 1992.

E. ACCOUNTING PRINCIPLES AND AUDITING STANDARDS

The auditor's role is to express an opinion about whether the audited financial statements fairly present the required information in conformity with Generally Accepted Accounting Principles (GAAP). The audit must be conducted in accordance with Generally Accepted Auditing Standards (GAAS). In reaching an opinion, auditors are required to obtain sufficient competent evidential matter. The third standard of field work of GAAS, states that sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit. Auditing Standards, AU326.01. The auditing standards specifically require those auditing inventory "to make, or observe, some physical counts of the inventory . . ." unless certain conditions, which are not applicable to the Perry Audit, are present. Auditing Standards, AU331.12. Section 326.19 of the Auditing Standards states that evidence obtained through physical examinations is more persuasive than information obtained indirectly, such as analytical results.

To the extent that the auditor remains in substantial doubt about any assertion of material significance, he or she must refrain from forming an opinion until such time as the auditor has obtained sufficient competent evidential matter to remove such substantial doubt, or he must express a qualified opinion or a disclaimer of opinion. Auditing Standards, AU326.23.

F. CONCLUSION

Valade understood the significance of the discrepancy between the value of the physical inventory and the recorded inventory and accordingly, using various audit procedures, sought to determine whether there was any flaw in the valuations of either the physical inventory or the recorded inventory. Valade was unable to verify the accuracy of the recorded inventory through physical observations. In fact, the results of the physical inventories which the audit team observed confirmed the existence of inventory shrinks at those locations.

Valade failed to identify an appropriate basis for selecting the recorded inventory over the physical inventory. He could not point to any error generated by either system of computing the inventory. Despite Valade's consultations with his partners and the additional audit procedures he performed, he nevertheless failed to obtain sufficient competent evidential matter to resolve the inventory discrepancy issue. Valade failed to either: (a) require Perry to reconcile the recorded inventory and the physical inventory and record the proper adjustment to the books and records; (b) discredit either the recorded inventory or the physical inventory and require Perry to adjust the books and records accordingly; (c) issue a qualified opinion; or (d) refrain from issuing an audit opinion until the matter was resolved.

Accordingly, for the reasons set forth above, Valade failed to comply with GAAS and failed to require Perry to comply with GAAP when he signed an unqualified audit report despite the fact that he had not obtained sufficient competent evidential matter to verify the existence of the store inventory. Thus, Valade engaged in improper professional conduct within the meaning of Rule 102(e)(1)(ii) of the Commission's Rules of Practice.

DISCUSSION QUESTIONS

1. Demonstrate, using a journal entry format (numbers not necessary), a) the gross profit estimation method for valuing inventory and b) the adjustment that should have resulted from the physical count. Did Perry Drug make the adjustment in b)? If not what entry did they make?
2. Does Perry's write-off of differences between recorded and physical inventory to CGS prior to 1992 obscure possible theft? Why/why not? What other problems might the write-off of differences obscure?

3. What do you believe might be another name for "last received cost method?" What is the likely effect of Perry's change to this method on net income in 1990 from the "base cost" method (what ever that is) when prices are rising and inventory is stable or rising?
4. Identify how the inclusion of "Store 100" in ending inventory affects net income.
5. Given the \$17 million discrepancy at the point of the GRA memorandum in 1992 and assuming the "quick and dirty" 5% of income rule for determining materiality, what would income have to be for this discrepancy to fall below the materiality threshold? If the discrepancy falls below the 5% of income level, would the misstatement necessarily be immaterial?
6. In the Perry Drug Case, what factors may prevent the auditor from forming clear expectations for the relevant account balances and linking them to the results of analytical tests?
7. Evaluate the relative competence of the analytical review evidence Valade gathered and the physical observation evidence obtained with regard to the inventory balance. Which evidence type is stronger? Why?
8. If financial statements knowingly contained the inventory error, what audit report(s) might be appropriate and why? What if the auditor was unable to satisfy him or herself as to whether the inventory discrepancy represented a material misstatement?
9. Does soliciting and obtaining the advice from his colleagues in the firm relieve Valade of professional responsibility for his audit opinion?
10. Explain thoroughly how Valade violated GAAS. In addition to violating GAAS, do you believe Valade may have violated the Code of Professional Conduct?
11. Do you believe the client applied undo pressure to the auditor to permit filing of misstated financial statements for 1992? For 1993? Do you believe there was a threat of losing this client if Valade had reacted differently? Why or why not?

PREFACE

OBJECTIVE

The ninth edition of *Auditing and Assurance Services: An Integrated Approach* contains numerous changes and revisions, but the objectives and emphasis remain essentially the same.

The book is an introduction to auditing and other assurance services for students who have not had significant experience in providing such services. It is intended for either a one-quarter or one-semester course at the undergraduate or graduate level. This book is also appropriate for introductory professional development courses for CPA firms, internal auditors, and government auditors.

The primary emphasis in this text is on the auditor's decision-making process. We believe that the most fundamental concepts in auditing relate to determining the nature and amount of evidence the auditor should accumulate after considering the unique circumstances of each engagement. If a student of auditing understands the objectives to be accomplished in a given audit area, the circumstances of the engagement, and the decisions to be made, he or she should be able to determine the appropriate evidence to gather and how to evaluate the evidence obtained.

Thus, as the title of this book reflects, our purpose is to integrate the most important concepts of auditing and other assurance services as well as certain practical aspects in a logical manner to assist students in understanding audit decision making and evidence accumulation. For example, internal control is integrated into each of the chapters dealing with a particular functional area and is related to tests of controls and substantive tests of transactions; tests of controls and substantive tests of transactions are, in turn, related to the tests of details of financial statement balances for the area; and audit sampling is applied to the accumulation of audit evidence rather than treated as a separate topic. Technology and e-commerce issues are integrated throughout all chapters.

MOST IMPORTANT CHANGES IN THE NINTH EDITION

The two new co-authors for the ninth edition are Randy Elder (Syracuse University) and Mark Beasley (North Carolina State University). Both served as contributing authors in the last edition and have joined the team to enhance current coverage in all aspects of this book, but especially technology and e-commerce. Randy and Mark have significant auditing and other assurance professional experience, regularly teach auditing courses at the undergraduate and graduate levels, actively conduct research on relevant audit related practice issues, and serve on national committees and task forces for organizations such as the American Accounting Association, the AICPA Auditing Standards Board, and the Committee of Sponsoring Organizations of the Treadway Committee (COSO).

Two important content changes in this edition emphasize (1) the importance of obtaining an understanding of the client's business and environment to effectively identify client business risks and (2) the effects of information technology and e-commerce on the audit process. Chapter 8 on audit planning has been completely revised to highlight the importance of understanding the client's business and industry to identify client business risks that may ultimately lead to increased likelihood of material misstatements in financial statements. The process of obtaining an understanding of key client business objectives and

New Co-Authors

Client Business Risk and E-Commerce



Hillsburg Hardware
Integration

Internet Problems and
Margin Links



Chapter 4 on
Professional Ethics

strategies to identify related client business risks is also now integrated throughout the remaining chapters that address specific transaction cycle audit issues. The effects of information technology and e-commerce on the audit process have been integrated throughout the book, including new chapter sections and specific homework problems. The new problems are highlighted by an e-commerce symbol. Chapters 1 and 24 also include expanded coverage of *WebTrust* and *SysTrust* assurance services.

The case example used throughout the book, Hillsburg Hardware, has been updated to reflect a larger, more sophisticated public company. Hillsburg Hardware examples have been integrated throughout the chapter material, rather than appearing in a separate section at the end of certain chapters, to better illustrate chapter concepts through an integrated case example.

All chapters now include an Internet-based case/homework assignment that requires students to use the Internet to research relevant auditing issues. New and updated Internet-based margin links appear in every chapter, providing information on current events, companies, and professional standards.

Chapter 4 has been revised in this edition for major changes affecting auditor independence recently implemented by the SEC and the AICPA. The chapter also includes a new section that provides a broader conceptual framework of factors affecting auditor independence before examining specific independence rules.

ORGANIZATION

The text is divided into six parts.

Part 1, The Auditing Profession (Chapters 1–5) This book begins with a study of the demand for audit and other assurance services. Chapter 1 emphasizes new assurance services being offered by CPA firms such as *WebTrust* and *CPA ElderCare Services*. Chapter 2 covers the CPA profession including organization of CPA firms, the AICPA, and the SEC. In Chapter 3, there is a detailed discussion of audit reports. It emphasizes the conditions affecting the type of report the auditor must issue and the type of audit report applicable to each condition under varying levels of materiality. Chapter 4 explains ethical dilemmas, professional ethics, and the AICPA *Code of Professional Conduct*. Chapter 5 ends this part with an investigation of auditors' legal liability.

Part 2, The Audit Process (Chapters 6–12) The first two of these chapters deal with auditors' and managements' responsibilities, audit objectives, general concepts of evidence accumulation, and audit documentation. Chapter 8 deals with planning the engagement and using analytical procedures as an audit tool. Chapter 9 introduces materiality and risk and shows their effect on the audit. The study of internal control and assessment of control risk are discussed in Chapter 10, which emphasizes a proper methodology for obtaining an understanding of the five components of internal control. Chapter 11, *The Impact of Information Technology on the Audit Process*, addresses the most important effects of information technology on internal controls in businesses, risks the auditor must consider, and audit evidence changes. This chapter also addresses such issues as computer uses by auditors, auditing network environments, database management systems, e-commerce systems, and outsourced computer service centers. Chapter 12 summarizes Chapters 6 through 11 and integrates them with the remainder of the text.

Part 3, Application of the Audit Process to the Sales and Collection Cycle (Chapters 13–16) These chapters apply the concepts from Part 2 to the audit of sales, cash receipts, and the related income statement and balance sheet accounts. The appropriate audit procedures for accounts in the sales and collection cycle are related to internal control and audit objectives for tests of controls, substantive tests of transactions, and tests of details of balances. Students learn to apply audit sampling to the audit of sales, cash receipts, and accounts receivable.

In response to an increased emphasis on nonstatistical sampling by practitioners, Chapters 14 and 16 emphasize nonstatistical sampling rather than statistical methods. Chapter 14 begins with a general discussion of audit sampling for tests of controls and substantive tests of transactions. Similarly, Chapter 16 begins with general sampling concepts for tests of details of balances. The next topic in each chapter is extensive coverage of nonstatistical sampling. The last part of each chapter covers statistical sampling techniques.

Part 4, Application of the Audit Process to Other Cycles (Chapters 17–22) Each of these chapters deals with a specific transaction cycle or part of a transaction cycle in much the same manner as Chapters 13 through 16 cover the sales and collection cycle. Each chapter in Part IV is meant to demonstrate the relationship of internal controls, tests of controls, and substantive tests of transactions for each broad category of transactions to the related balance sheet and income statement accounts. Cash in the bank is studied late in the text to demonstrate how the audit of cash balances is related to most other audit areas.

Part 5, Completing the Audit (Chapter 23) This part includes only one chapter, which deals with summarizing all audit tests, reviewing audit documentation, and all other aspects of completing an audit.

Part 6, Other Assurance and Nonassurance Services (Chapters 24 and 25) The last two chapters deal with various types of engagements and reports, other than the audit of financial statements using generally accepted accounting principles. Topics covered include *WebTrust*, *SysTrust*, other assurance services, review and compilation services, agreed-upon procedures engagements, attestation engagements, other audit engagements, internal financial auditing, governmental financial auditing, and operational auditing.

SUPPLEMENTS

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Supplements for the
Instructor

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