

Contemporary^{4e} Auditing



Real Issues
& Cases

MICHAEL C. KNAPP

CONTEMPORARY AUDITING REAL ISSUES AND CASES

Fourth Edition

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University of Oklahoma



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DEDICATION

To Carol, Johnny, Lindsay, and Jessi

PREFACE

Criticism of the accounting profession by regulatory authorities, the financial press, and the general public has forced the profession to reassess its societal purpose and future direction. One result of this reassessment has been a call for exploring ways of improving accounting education. Many parties suggest that accounting educators should employ a broader array of instructional resources, particularly experiential resources designed to stimulate active learning by students. In fact, a primary objective of the Accounting Education Change Commission was to encourage the development of those types of materials for use in accounting courses. The fourth edition of my casebook provides instructors with a source of such materials that can be used in both undergraduate and graduate auditing courses.

This casebook stresses the "people" aspect of independent audits. If you review a sample of recent "audit failures," I believe you will find that problem audits seldom result from inadequate audit technology. Instead, deficient audits typically result from the presence of one, or both, of the following two conditions: client personnel who intentionally subvert an audit and auditors who fail to carry out the responsibilities assigned to them. Exposing students to problem audits helps them recognize the red flags that often accompany potential audit failures. An ability to recognize these red flags and experience with discussing and dissecting problem audits should help students cope more effectively with the problematic situations they are certain to encounter in their own careers. In addition, this experiential approach allows students to more readily grasp the relevance of important auditing concepts and procedures.

The cases in this text also acquaint students with the work environment of auditors. After studying these cases, students will better understand how client pressure, peer pressure, time budgets, and related factors complicate the work roles of independent auditors. Also embedded in these cases are the ambiguity and lack of structure that auditors face each day. Missing documents, conflicting audit evidence, auditors' dual obligation to the client and to financial statement users, and the lack of definitive professional standards for many situations are additional aspects of the audit environment woven into these cases.

The fourth edition of this casebook features a new organizational structure. This edition contains eight sections of cases instead of the five sections found in

the three earlier editions. The eight categories of cases include the following: Comprehensive Cases, Audits of High-Risk Accounts, Internal Control Issues, Ethical Responsibilities of Accountants, Ethical Responsibilities of Independent Auditors, Professional Roles, Professional Issues, and Classic Litigation Cases. This new organizational structure will help adopters more readily identify cases best suited for their particular needs.

Numerous cases appearing in earlier editions have been updated for new events and circumstances impacting those cases. For example, this edition updates the ongoing legal travails of Charles Keating (Lincoln Savings and Loan Association) and Eddie Antar (Crazy Eddie, Inc.). You probably will not be surprised to learn that Stanley Goldblum, former chief executive of Equity Funding, is associated with another headline-catching fraud. Other returning cases that contain new material include, but are not limited to, When Auditors Become Lobbyists, *Hopkins v. Price Waterhouse*, and The Fund of Funds, Ltd.

This edition of my casebook contains 13 new cases. These cases include Triton Energy Ltd., a case with an international angle that focuses on the Foreign Corrupt Practices Act. As you are probably aware, law enforcement authorities are once more “cracking down” on multinational companies that violate the anti-fraud and accounting provisions of that important federal statute. The Saks Fifth Avenue case introduces students to control issues relevant to a retail business. Saks’ “zero tolerance” policy for employee theft typically sparks a lively debate among my students. In the Accuhealth, Inc., case, your students will find yet another scenario in which an accounting officer of a large firm faces an ethical dilemma. That officer must decide what to do when he discovers that his superiors are systematically “skimming” cash from the company’s retail operations. A new comprehensive case appearing in this edition is Star Technologies, Inc. That case focuses on accounting and auditing issues pertinent to high-tech companies.

This casebook can be used in several different ways. Adopters can use the casebook as a supplemental text for the undergraduate auditing course or as a primary text for a graduate-level seminar in auditing. The instructor’s manual contains a syllabus for a graduate auditing course organized around this text. Finally, this casebook can be used in the capstone professional practice course incorporated in many five-year accounting programs.

Listed next are brief descriptions of the eight groups of cases included in this casebook. The casebook’s Table of Contents presents an annotated description of each case.

Comprehensive Cases

Most of these cases deal with highly publicized problem audits performed by large, international accounting firms. Among the clients involved in these audits are Mattel, ESM Government Securities, ZZZZ Best Company, and Lincoln Savings and Loan Association. These cases address a wide range of auditing, accounting, and ethical issues.

Audits of High-Risk Accounts

In contrast to the cases in the prior section, these cases typically highlight contentious accounting and auditing issues posed by a single account or group of accounts. For example, the Doughtie’s Foods case focuses primarily on inventory

audit procedures. The CapitalBanc case raises audit issues relevant to cash, while the Giant Stores case focuses on auditing accounts payable.

Internal Control Issues

Audit strategies increasingly emphasize the need for auditors to thoroughly understand their clients' internal control policies and procedures. The cases in this section introduce students to control issues in a variety of contexts. Goodner Brothers, Inc., raises control issues for a wholesaler, while both Saks Fifth Avenue and Howard Street Jewelers center on important control issues for retail businesses.

Ethical Responsibilities of Accountants

Integrating ethics into an auditing course requires much more than simply discussing the *AICPA Code of Professional Conduct*. This section presents actual situations in which accountants in private practice have faced perplexing ethical dilemmas. By requiring students to study real world contexts in which important ethical issues arise, they will be better prepared to cope with similar situations in their own professional careers. One of the cases in this section, Rocky Mount Undergarment Company, focuses on the accountants of a company who had to face the eternal question of whether the end justifies the mean. A new case in this edition, F&C International, profiles three corporate executives who had to decide whether to compromise their personal code of ethics in the face of a large scale fraud masterminded by their firm's chief executive.

Ethical Responsibilities of Independent Auditors

The cases in this section highlight common ethical dilemmas faced by independent auditors. An audit partner for the PTL Club maintained a check register for that organization, a check register through which Jim Bakker funneled various questionable disbursements. Was that an appropriate responsibility for an independent auditor to assume? Consider the dilemma faced by Michael Goodbread, an audit partner with a major accounting firm. His firm acquires a company in which he has a small but direct financial interest. What should he do? No doubt, any auditing textbook will provide the easy answer to that question. But, auditors in public practice don't always "go by the book."

Professional Roles

Cases in this section examine specific work roles in public accounting. These cases explore the responsibilities associated with these roles and related challenges that professionals in these roles encounter. Hopefully, introducing students to these roles in a meaningful way, that is, in a real world context, will better prepare them to transition successfully into these roles in the future. The Tommy O'Connell case involves a young auditor recently promoted to audit senior. Shortly following his promotion, Tommy finds himself assigned to supervise a small but difficult audit. Tommy's sole subordinate on that engagement happens to be a young man whose integrity and work ethic have been questioned by seniors he has worked for previously. Three cases in this section spotlight the staff

accountant work role, the initial position typically assumed by recent college graduates who enter public accounting.

Professional Issues

The dynamic nature of the public accounting profession continually impacts the work environment of public accountants and the nature of the services they provide. The cases in this section explore this changing work environment. For example, the *Hopkins v. Price Waterhouse* case discusses the unique problems faced by women pursuing careers in public accounting. The Scott Fane and Stephen Gray cases focus on recent changes in the profession's ethics code that impact accounting practitioners. Both of these young practitioners became involved in legal disputes with their state boards. These disputes centered on the type of marketing efforts CPAs are allowed to use and the types of services CPAs are allowed to offer to clients, respectively.

Classic Litigation Cases

Auditing textbooks concentrate almost exclusively on the legal liability issues inherent in the classic audit litigation cases that have arisen over the past several decades. This text addresses the underlying auditing issues embedded in these cases in addition to the relevant legal liability issues. Cases in this section include Fred Stern & Company (Ultramares), 1136 Tenants, and First Securities Company of Chicago (Hochfelder).

Customize Your Own Casebook

To maximize the flexibility of using these cases, South-Western College Publishing has included *Contemporary Auditing, Issues and Cases* in its customized publishing program. Adopters have the option of creating a customized version of this casebook ideally suited for their specific needs. For more information on how to design your customized casebook, please contact your South-Western sales representative.

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SECTION 1 COMPREHENSIVE CASES 1

SECTION 2 AUDITS OF HIGH-RISK ACCOUNTS 147

v

SECTION 3 INTERNAL CONTROL ISSUES 191

Case 3.1	The Trolley Dodgers	193
Case 3.2	Howard Street Jewelers, Inc.	195
Case 3.3	E.F. Hutton & Company, Inc.	199
Case 3.4	Saks Fifth Avenue	209
Case 3.5	Triton Energy Ltd.	215
Case 3.6	Goodner Brothers, Inc.	225
Case 3.7	Troberg Stores	235

**SECTION 4 ETHICAL RESPONSIBILITIES
OF ACCOUNTANTS 243**

Case 4.1	Creve Couer Pizza, Inc.	245
Case 4.2	Laurel Valley Estates	249
Case 4.3	Suzette Washington, Accounting Major	253
Case 4.4	Rocky Mount Undergarment Company, Inc.	255
Case 4.5	Oak Industries, Inc.	259
Case 4.6	F&C International, Inc.	265
Case 4.7	Accuhealth, Inc.	271

**SECTION 5 ETHICAL RESPONSIBILITIES OF
INDEPENDENT AUDITORS 277**

Case 5.1	Cardillo Travel Systems, Inc.	279
Case 5.2	The PTL Club	285
Case 5.3	Phillips Petroleum Company	289
Case 5.4	Mariner Corporation	293
Case 5.5	Koger Properties, Inc.	297
Case 5.6	American Fuel & Supply Company, Inc.	301
Case 5.7	Mallon Resources Corporation	305

SECTION 6 PROFESSIONAL ROLES 311

Case 6.1	Leigh Ann Walker, Staff Accountant	313
----------	------------------------------------	-----

Case 6.2	Bill DeBurger, In-Charge Accountant	317
Case 6.3	Sarah Russell, Staff Accountant	321
Case 6.4	Tommy O'Connell, Audit Senior	325
Case 6.5	Avis Love, Staff Accountant	331
Case 6.6	Charles Tollison, Audit Manager	335

SECTION 7 PROFESSIONAL ISSUES 339

Case 7.1	<i>Hopkins v. Price Waterhouse</i>	341
Case 7.2	When Auditors Become Lobbyists	351
Case 7.3	Maurice Stans, CPA	361
Case 7.4	Scott Fane, CPA	365
Case 7.5	Barringer Resources, Inc.	371
Case 7.6	National Medical Transportation Network	379
Case 7.7	Stephen Gray, CPA	387

SECTION 8 CLASSIC LITIGATION CASES 393

Case 8.1	Fred Stern & Company, Inc. (<i>Ultramares Corporation v. Touche et al.</i>)	395
Case 8.2	BarChris Construction Corporation	403
Case 8.3	1136 Tenants Corporation	411
Case 8.4	Yale Express System, Inc.	415
Case 8.5	First Securities Company of Chicago (<i>Ernst & Ernst v. Hochfelder et al.</i>)	423
Case 8.6	Equity Funding Corporation of America	431
Case 8.7	National Student Marketing Corporation	437
Index		453

CONTENTS

SECTION 1 COMPREHENSIVE CASES 1

Case 1.1 Mattel, Inc. 3

To sustain Mattel's impressive sales and earnings trends in the early 1970s, the company's top executives engaged in a massive fraudulent scheme to distort the company's operating results.

Key Topics: assessment of inherent risk, revenue recognition, the use of sales cut-off tests, effectiveness of the audit review process, auditing the reserve for inventory obsolescence, and auditor-client disagreements regarding year-end adjusting entries.

Case 1.2 ESM Government Securities, Inc. 15

The ESM scandal rocked the international financial markets and resulted in one state imposing the first "banking holiday" in the United States since the Depression.

Key Topics: performance pressure exerted on auditors, the use of audit confirmation procedures, quality control in an auditing practice, and discovery of financial statement errors following the issuance of an audit report.

Case 1.3 United States Surgical Corporation 29

An SEC investigation revealed that officials of this company went to great lengths to conceal pervasive irregularities 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 1.4 ZZZZ Best Company, Inc. 41

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 1.5 Lincoln Savings and Loan Association 57

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 1.6 Crazy Eddie, Inc. 71

"Crazy Eddie" Antar oversaw a highly 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 1.7 Penn Square Bank 83

The collapse of Penn Square Bank in 1982 triggered a series of financial crises at some of the nation's largest financial institutions.

Key Topics: opinion shopping, client confidentiality, internal control reporting, and auditor independence.

Case 1.8 Star Technologies, Inc. 93

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 1.9 The Fund of Funds, Ltd. 105

Bernie Cornfeld, John McCandish King, and Robert Vesco were among the parties associated with this once high-flying mutual fund.

Key Topics: detection of fraud, client confidentiality, materiality of financial statement errors, and auditors' legal exposure under the Securities Exchange Act of 1934.

Case 1.10 AMRE, Inc. 119

AMRE's chief financial officer arranged a secret meeting with the company's independent auditors in a subtle but unsuccessful effort to focus their attention on a fraudulent scheme masterminded by his superiors.

Key Topics: hiring of former auditors by audit clients, client-imposed audit scope limitations, auditors' responsibility for unaudited quarterly financial data, and auditing large and suspicious write-offs by clients.

Case 1.11 General Technologies Group Ltd. 129

The quality control director retained by General Technologies' audit firm at the insistence of the SEC uncovered evidence suggesting that the client's inventory and receivables were materially overstated.

Key Topics: quality control for accounting firms, SEC oversight of independent audit function, auditing inventory in a manufacturing environment, and opinion shopping.

Case 1.12 Regina Company 139

To reach forecasted sales and earnings targets, Regina executives intentionally misrepresented their company's operating results.

Key Topics: auditing sales and sales returns, the use of analytical procedures, and the extent to which auditors should trust client management.

SECTION 2 AUDITS OF HIGH-RISK ACCOUNTS 147

Case 2.1 Doughtie's Foods, Inc. 149

Inadequate inventory observation procedures prevented this company's auditors from discovering a materially overstated inventory balance.

Case 2.2 Flight Transportation Corporation 153

This company's auditors failed to investigate major weaknesses in its internal controls, which prevented them from uncovering a fraudulent scheme conceived by the firm's top executives.

Case 2.3 J.B. Hanauer & Co. 159

This case focuses on audit objectives related to confirmation procedures and illustrates inappropriate methods of applying these procedures.

Case 2.4 Berkshire Hathaway, Inc. 165

The lack of a definitive accounting rule for recognizing profits on "proportionate redemptions" of stock led to a stormy confrontation between this company's independent auditors and its famous chief executive.

Case 2.5 IFG Leasing 169

The spectacular growth of this company in the early 1980s was largely a result of unsound business decisions by management. A staff auditor documented in her workpapers suspicious circumstances she uncovered in the company's financial records. Later, a superior told her to erase those comments.

Case 2.6 Giant Stores Corporation 179
Numerous intentional understatements of this company's accounts payable and the failure of its auditors to discover these misrepresentations was the focus of an intensive SEC investigation.

Case 2.7 CapitalBanc Corporation 187
What is the most important asset of a bank? Cash, of course. This case focuses on an audit that failed to uncover a large embezzlement scheme perpetrated by a bank's chief executive officer.

SECTION 3 INTERNAL CONTROL ISSUES 191

Case 3.1 The Trolley Dodgers 193
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. 195
Given the susceptibility of cash to theft, companies typically establish rigorous internal controls for their cash processing functions. This case documents the high cost of failing to implement such controls.

Case 3.3 E.F. Hutton & Company, Inc. 199
This brokerage firm's auditors were criticized by regulatory authorities and the financial press for failing to expose an illegal cash management system used by the firm. Hutton's aggressive accounting and operating policies were fostered by its notoriously weak control environment.

Case 3.4 Saks Fifth Avenue 209
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 3.5 Triton Energy Ltd. 215
Recent years have witnessed a renewed interest by regulatory authorities in enforcing the Foreign Corrupt Practices Act of 1977 (FCPA). Key executives of Triton Energy ignored the FCPA, including its internal control provisions.

Case 3.6 Goodner Brothers, Inc. 225
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 3.7 Troberg Stores 235

An important and often overlooked internal control objective is ensuring “compliance with applicable laws and regulations.” The management of this company violated the provisions of a federal statute, imposing a heavy monetary cost on the company in the process.

**SECTION 4 ETHICAL RESPONSIBILITIES
OF ACCOUNTANTS** 243

Case 4.1 Creve Couer Pizza, Inc. 245

Intrigue and espionage seem far removed from accounting . . . but not in this case. Creve Couer’s CPA was actually a double agent. While providing accounting services to his client, the CPA also supplied incriminating evidence regarding the client to the IRS.

Case 4.2 Laurel Valley Estates 249

A staff accountant wrongfully accused a client official of criminal conduct. The false accusation resulted in the young accountant’s firm being sued by the client official.

Case 4.3 Suzette Washington, Accounting Major 253

Suzette Washington was a college senior majoring in accounting when she came face-to-face with an important ethical decision. Since accounting majors are entering a profession with a rigorous code of ethics, do they have a greater responsibility than other students to behave ethically?

Case 4.4 Rocky Mount Undergarment Company, Inc. 255

You are the accountant of a company experiencing severe financial problems. Company executives suggest that several hundred employees will lose their jobs unless you misrepresent the company’s financial condition. Three employees of Rocky Mount faced this unpleasant dilemma during the mid-1980s.

Case 4.5 Oak Industries, Inc. 259

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.

Case 4.6 F&C International, Inc. 265

A financial fraud spells the end of a company with a proud history and tests the ethics of several of its key management and accounting personnel.

- Case 4.7 Accuhealth, Inc.** 271
“Skimming” cash receipts ranks as one of the most common financial frauds. Accuhealth’s chief accountant discovered that his superiors were skimming cash at certain of the company’s retail outlets. The chief accountant resigned from the firm before being required to sign off on its annual 10-K statement.

SECTION 5 ETHICAL RESPONSIBILITIES OF INDEPENDENT AUDITORS 277

- Case 5.1 Cardillo Travel Systems, Inc.** 279
A top executive of Cardillo pressured and manipulated three accountants, the company’s controller, and two partners of public accounting firms, in an unsuccessful attempt to conceal the true nature of a fraudulent entry in the company’s accounting records.

- Case 5.2 The PTL Club** 285
PTL officials convinced a partner of their independent audit firm to maintain a secret check register in his office to record illicit disbursements being made by the organization.

- Case 5.3 Phillips Petroleum Company** 289
Rather than compromise the confidentiality of his client’s accounting records, Phillips’ audit engagement partner was found in contempt of court and jailed.

- Case 5.4 Mariner Corporation** 293
This case involves the acceptance of contingent fees by public accountants, a practice that has long posed contentious ethical issues for the accounting profession.

- Case 5.5 Koger Properties, Inc.** 297
An audit partner’s firm obtains a client in which he has a small but direct financial interest. The partner is then assigned to supervise the annual audit of that company. What should he do?

- Case 5.6 American Fuel & Supply Company, Inc.** 301
This case focuses on the responsibility of auditors to recall an audit report when they discover previously undetected errors in a client’s audited financial statements.

- Case 5.7 Mallon Resources Corporation** 305
The common practice of auditors “changing sides” by accepting positions with clients raises several difficult-to-resolve issues for the accounting profession. Many of these issues are posed by this case that involves Mallon hiring one of its independent auditors for a key management position.