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Fraud-Related SEC Enforcement Actions Against Auditors: 1987-1997, August 2000

Mark S. Beasley

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Fraud-Related SEC Enforcement Actions Against Auditors: 1987-1997

August 2000

Research Commissioned by the
Auditing Standards Board of the
American Institute of Certified Public Accountants

Research Report Prepared

by

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Preface

This project was commissioned by the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA). The database of fraud cases was developed in preparation of *Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies*, copyright Committee of Sponsoring Organizations of the Treadway Commission (COSO), 1999. We appreciate helpful comments received from Heather Hermanson, Wendy Lu, and the Fraud Standard Steering Task Force of the AICPA's Auditing Standards Board.

Research Team

This research was conducted on behalf of the Auditing Standards Board by a team of three academic researchers: Mark S. Beasley, Joseph V. Carcello, and Dana R. Hermanson. All three team members are co-authors of *Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies* (COSO 1999). All three are Ph.D.s and CPAs who have worked extensively as auditors with a large international accounting firm. Brief biographical summaries for each of the researchers are provided at the back of this monograph.

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SECTION I -- Executive Summary

This study examines fraud-related SEC enforcement actions against auditors from January 1987 - December 1997 to identify the settings in which auditors were cited by the SEC, as well as the alleged deficiencies in the audit process that caused the auditors to be cited. By examining these alleged audit problems, we hope to offer insights for auditors and regulators to consider as they work to continuously improve the auditing profession's ability to detect instances of material financial statement fraud.

The data in this study were obtained from *Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies* (copyright COSO, 1999). The COSO fraud study provided an analysis of 204 financial fraud cases investigated by the SEC from January 1987 - December 1997. The present study examines the 56 of 204 cases from the COSO study in which the auditor was cited by the SEC in an Accounting and Auditing Enforcement Release (AAER).

The key results of the present study are as follows:

- From 1987-1997, SEC enforcement actions against auditors were quite rare, particularly against auditors employed by national audit firms (top 10 firms). The sample used in this study, which comprises two-thirds of the known financial statement fraud cases from 1987-1997, included only 56 fraud cases with SEC actions against auditors. Only 10 of these 56 cases involved auditors employed by national audit firms. None of the actions against national firm personnel was against the audit firm itself (only against individual personnel involved in the audit engagement).

- The subsample of financial fraud cases in which the auditor was cited appears to differ substantially from the overall sample of 204 fraud cases examined in the COSO fraud study (1999). Relative to the 204 cases, the 56 instances in which the auditor was cited by the SEC involved very small companies, a concentration in the mining / oil and gas industries, less top executive (CEO / CFO) involvement in the frauds, larger frauds relative to the size of the companies, and a concentration of asset overstatement frauds.

- Of the 56 cases in which the auditor was named, 11 cases appear to involve "bogus audits" or "bogus auditors." In such cases, either an audit was never performed, or a non-CPA posed as an auditor and issued a phony opinion. The primary penalty in these cases involved barring the perpetrators from practice before the SEC.

- In the other 45 cases, it appears that an audit was attempted, but was deficient. Auditor turnover (58 percent of cases), early stage companies, and new audit engagements were engagement characteristics present in many of these cases. In 5 of the 45 cases (11 percent), it appeared that a key member of the client

management team had come from the audit firm. Auditor penalties primarily involved bars (for a period of time or permanently) from practice before the SEC.

- In the 45 attempted, but deficient, audits, the most common alleged audit problems were:
  - failure to gather adequate audit evidence
  - lack of due professional care
  - lack of appropriate professional skepticism
  - misinterpretation or misapplication of GAAP
  - inadequate audit planning
  - over-reliance on inquiry as a form of evidence
  - failure to obtain adequate evidence in support of management estimates
  - inadequate confirmation of accounts receivable
  - failure to recognize or disclose key related parties
  - over-reliance on internal controls
  - lack of independence (generally due to the auditor performing accounting or management functions for the client)
  - inadequate supervision and review
  - inadequate or inconsistent working papers.

- Differences were identified between national firm audits and non-national firm audits. Over-reliance on internal controls, inadequate cutoff tests of transactions, and improper evaluation of known audit differences were among the most common problems in national firm audits, but not in non-national firm audits. Inadequate confirmation of accounts receivable, failure to recognize or disclose key related parties, and lack of independence were among the most common problems in non-national firm audits, but not in national firm audits (e.g., there were no independence violations at all among national firm auditors).

Based on the pattern of results found, the key implications for auditors and regulators to consider are as follows:

- When assessing the nature of audit problems highlighted in the SEC enforcement actions, it is important to remember the rare nature of these documented audit problems and to carefully consider the costs and benefits of potential responses to the problems.

- Auditors may need to pay particular attention to very small clients (which may lack a baseline level of internal controls) and unique industry risks. Fraud cases in which accounts receivable, oil, gas, and minerals, or investments were misstated appeared to pose the greatest risk to the audit firm. Special care should be taken in auditing such areas, including the need to consider the use of a specialist to assist in assessing asset valuations.

- The SEC recently announced an effort to work more closely with federal criminal prosecutors in bringing criminal charges in egregious financial fraud cases. We would expect future instances of bogus audits or bogus auditors to be prime candidates for criminal prosecution.

- Auditors need to be alert to the unique risks posed at the beginning of a client relationship and should be especially vigilant when making inquiries of predecessor auditors before client acceptance, and during planning and performing the first few annual audits for those accepted client engagements. Also, consistent with the Independence Standards Board's focus on auditors accepting employment with clients, auditors should consider the risks associated with client relationships when an audit firm member joins the client's executive team and adjust the audit approach accordingly to ensure independence and objectivity are maintained.

- The three most common audit deficiencies (inadequate evidence, lack of due care, and inadequate professional skepticism) represent global shortcomings in the audit process or the auditor's frame of mind when performing the audit. Perhaps the most appropriate way to address these global issues is through the audit firms' explicitly sharing their culture and emphasizing their philosophy towards a baseline level of acceptable audit quality (over and above audit profitability goals) with their professionals at all levels. A second area to consider is the types of incentives created by the audit firm's performance measures and compensation system. In many cases, it appeared that auditors simply chose not to pursue or consider *identified* issues due to perceived pressures, such as pressures from tight time schedules and time budgets.

- Numerous specific areas of concern are raised in the other alleged audit deficiencies. Several of these may have implications for specific auditing standards or specific elements of a firm's audit approach. Key auditing standards related to these problems include SAS No. 69 (*The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*), SAS No. 22 (*Planning and Supervision*), SAS No. 82 (*Consideration of Fraud in a Financial Statement Audit*), SAS No. 85 (*Management Representations*), SAS No. 57 (*Auditing Accounting Estimates*), SAS No. 67 (*The Confirmation Process*), and SAS No. 45 (*Related Parties*).

The remainder of this report is organized as follows. Section II briefly outlines the research approach. Section III contains the results from our detailed analysis of 56 alleged cases of fraudulent financial reporting in which the auditor was named in an enforcement action. The detailed analysis in Section III produced numerous insights for further consideration. Section IV highlights implications applicable to external auditors and regulators of the audit market.

We believe that this report will prove helpful to parties concerned with auditor performance. We hope it will stimulate greater awareness of new opportunities for improvements in the auditing process.

SECTION II – Description of Research Approach

In preparing *Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies* (copyright COSO, 1999), we developed a database of alleged financial statement frauds committed by U.S. public companies. To identify instances of fraudulent financial reporting investigated by the SEC in the period 1987-1997, we read all Accounting and Auditing Enforcement Releases (AAERs) issued by the SEC between January 1987 and December 1997. From our reading, we identified all AAERs that involved an alleged violation of Rule 10(b)-5 of the 1934 Securities Exchange Act, Section 17(a) of the 1933 Securities Act, or other federal antifraud statutes.

Our reading of AAERs during this period allowed us to identify nearly 300 companies involved in alleged instances of fraudulent financial reporting. We randomly selected approximately 200 companies to serve as the final sample for analysis in *Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies* (copyright COSO, 1999).

Of the 200 fraud cases examined in detail, 56 of the cases involved some type of SEC action against the auditor. These 56 cases serve as the sample examined in the present study. For each of these 56 cases, we collected extensive information from our reading of (a) AAERs related to the alleged fraud, (b) selected Form 10-Ks filed before and during the period the alleged financial statement fraud occurred, (c) proxy statements issued during the alleged fraud period, and (d) business press articles written about the sample companies after the fraud was revealed. The purpose of this data collection is to provide a description of company characteristics, fraud characteristics, auditor characteristics, and apparent deficiencies in auditor performance.

In examining the apparent deficiencies in the audit process, we focused on the following aspects of the audit:

- Engagement acceptance
- General GAAS standards (e.g., independence, competence, due care)
- Audit planning
- Understanding internal controls
- Sufficient competent evidence
- Reporting
- Other matters identified in the AAERs.

The goal is to understand which areas of the audit process appear to be causing SEC enforcement actions against auditors. In other words, "where are the auditing problems?"

Readers should recognize that, despite our best efforts to collect complete data for all 56 cases, the data sources used often were incomplete. For example, AAERs were uneven in their level of disclosure, and other sources (e.g., Form 10-Ks, etc.) often were not available.

In addition to data availability issues, readers also should recognize that a great deal of professional judgment was necessary as we collected and synthesized the data. We believe that we have been reasonable and consistent in our judgments, but the research approach is limited by the quality of our judgments.

Finally, it is important to note that the sample of audit problems examined in this study relies on the enforcement strategies and efforts of the SEC -- both enforcement regarding financial fraud in general (which is the basis for the 204 company sample) and regarding auditor problems (which is the basis for the 56 company sample). In light of the SEC's constrained resources, it is possible that there are financial statement fraud cases not represented in the population of SEC enforcement actions, and it is possible that some auditor problems are not reflected in SEC enforcement actions.

SECTION III -- Detailed Analysis of Fraud-Related SEC Enforcement Actions Against Auditors: 1987-1997

This section contains a summary of the key findings from our reading of AAERs related to each of the 56 cases, Form 10-Ks filed before and during the period the alleged financial statement fraud occurred, proxy statements issued during the alleged fraud period, and business press articles written about the sample companies after the fraud was disclosed.

The results are presented as follows: (a) nature of the 56 sample companies, (b) nature of the control environment (top management and the audit committee), (c) nature of the frauds, (d) consequences of the frauds, (e) comparison of the 56 companies to the full COSO fraud study sample of 204 companies, and (f) auditor issues, including alleged deficiencies in auditor performance.

A. NATURE OF 56 SAMPLE COMPANIES

Financial Profile of Sample Companies

We were able to obtain the "last clean" financial statements (last financial statements before the fraud period) for 24 of the 56 sample companies.[1] Table 1 highlights selected financial statement information for these 24 companies.

The sample companies are small in size. While total assets, total revenues, and stockholder's equity averaged $62 million, $54 million, and $27 million, respectively, the median of total assets was only $5.4 million, the median of total revenues was only $1.4 million, and the median of stockholder's equity was only $2.7 million in the period ending before the fraud began. Most of the sample companies operated well under the $50 million size range.

Many of the sample companies were financially stressed in the period preceding the fraud period. The median net income was near zero, with over half of companies facing net losses.

[1] Some last clean financial statements were not publicly available, as the fraud involved the financial statements included with the initial public offering.

Table 1 – Financial Profile of Sample Companies (n=24 companies)
Last Financial Statements Prior to Beginning of Fraud Period

	(in 000's)			
	Total Assets	Total Revenues	Net Income (Loss)	Stockholders' Equity (Deficit)
Mean	$62,288	$54,199	$5,715	$26,732
Median	$5,371	$1,373	($1)	$2,737
Minimum Value	$0	$0	($8,484)	($424)
1st Quartile	$1,338	$309	($270)	$741
3rd Quartile	$37,931	$18,219	$1,350	$8,661
Maximum Value	$837,235	$924,294	$120,413	$457,252

Stock Exchange Listings

We reviewed the AAERs and the last clean financial statements to identify the stock exchange where each of the companies' stock traded. We were able to identify the stock exchange listing for 37 of the 56 sample companies. As indicated in Table 2, most (87 percent) were traded in over-the-counter markets.[2] Approximately 8 percent of the companies' stock traded on the New York Stock Exchange, and approximately 5 percent of the companies' stock traded on the American Stock Exchange.

Table 2 – Sample Companies' Stock Exchange Listing

Stock Exchange	Number of Companies	Percentage of Companies
New York Stock Exchange	3	8%
American Stock Exchange	2	5%
Over-the-counter markets	32	87%
Number of sample companies with available stock exchange information	37	100%

[2] Over-the-counter markets include stocks traded on the NASDAQ National Market System, the NASDAQ Small-Cap Market, electronic bulletin boards, pink sheets, and other situations where investors contact dealers (brokers) when they want to buy or sell a security.

Industries for Companies Involved

We reviewed the information included in the AAERs to determine the primary industry in which the fraud companies operated. We were able to identify the primary industry for 49 of the 56 sample companies. For the companies where we were able to identify the primary industry, the industries affected most frequently included mining / oil and gas (16 percent), computer hardware and software (12 percent), and financial services (12 percent). See Table 3.

Table 3 – Primary Industries of Sample Companies

Industry Classification	Number of Fraud Companies in Industry	Percentage of Fraud Companies
Mining / Oil and gas	8	16%
Computer hardware / software	6	12%
Financial service providers	6	12%
Healthcare and health products	4	8%
Retailers / Wholesalers	4	8%
Other service providers	4	8%
Insurance	4	8%
Other manufacturers	2	4%
Telecommunication companies	2	4%
Miscellaneous	9	20%
Total	49	100%

B. NATURE OF THE CONTROL ENVIRONMENT (TOP MANAGEMENT AND THE AUDIT COMMITTEE)

Individuals Named in the AAERs

From our reading of the AAERs related to the 56 sample companies, we captured information about the types of company representatives and outsiders named in an AAER related to each instance of alleged fraudulent financial reporting. We captured all individuals listed in any of the AAERs related to an instance of fraudulent financial reporting, whether these individuals were charged with fraud or charged with other lesser violations. Even though these individuals were named in an AAER, there is no certain evidence that all the named participants violated the antifraud statutes. In addition, most of the named participants explicitly admitted no guilt of any kind, although they frequently consented to the SEC's actions.

Using the highest managerial title for an individual, we summarized the typical employee positions involved. For example, if one individual had the titles of chief financial officer

(CFO) and controller, we report that as involving strictly the CFO position in our reporting in Table 4 below. As noted in Table 4, the senior executive most frequently named in an AAER was the chief executive officer (CEO). The CEO was named as one of the parties involved in 61 percent of the cases. The second most frequently identified senior executive named was the CFO. The CFO was named in 29 percent of the cases. When considered together, the CEO and/or CFO were named in 68 percent of the frauds.

Table 4 – Types and Frequencies of Individuals Named

Individual's Relation to Company	# of Companies	Percentage of Fraud Cases
Chief executive officer (CEO)	34	61%
Chief financial officer (CFO)	16	29%
Either or both CEO or CFO involved	*38*	*68%*
Controller	7	13%
Chief operating officer (COO)	3	5%
Other vice president positions	8	14%
Board of Director (non-management)	5	9%
Lower level personnel	4	7%
Auditors	56*	100%*
No titles given	11	20%
Other titles	5	9%

* This study addresses only those cases in which the auditor was named in an AAER.

Audit Committee Characteristics

We gathered information on the audit committee from the proxy statements, which were available for 19 of the sample fraud companies. The proxies used were those closest to the end of the fraud period, so as to capture the nature of the audit committee during the fraud period.

Throughout this section, the following definitions are used:

- Inside director – Officer or employee of the company or a subsidiary; officer of an affiliated company.
- Gray director – Former officers or employees of the company, a subsidiary, or an affiliate; relatives of management; professional advisors to the company; officers or owners of significant suppliers or customers of the company; interlocking directors; officers or employees of other companies controlled by the CEO or the company's majority owner; owners of an affiliate company; those who are creditors of the company.

- Outside director – No disclosed relationship (other than stock ownership) between the director and the company or its officers.

As reported in Table 5, 68 percent of the fraud companies ostensibly had an audit committee. These audit committees generally had three members, and they were typically composed of outside directors. On average, outside directors represented over 65 percent of the audit committee members. Overall, the audit committees appear to be reasonably independent, although the average audit committee composition of 67 percent outside directors is not consistent with the views of most reform proponents who call for audit committees composed entirely of outside directors.

Most of the audit committee members did not appear to be experts in accounting or finance. Only 30 percent of the audit committee members were certified as a Certified Public Accountant (CPA) or Certified Financial Analyst (CFA) or had current or prior work experience in serving as a CFO, VP of finance, controller, treasurer, auditor, banker, investment banker, financial consultant, investment manager, or venture capitalist.

The average number of audit committee meetings per year was 1.9, with a median of 1.5. Some may question whether audit committees that meet only one or two times per year are functioning effectively when a public company at a minimum files financial statements with the SEC four times per year.

Finally, the audit committee disclosures provided evidence of an internal audit function only 10 percent of the time. Such a percentage appears reasonable in light of the small size of the sample companies.

Table 5 - Audit Committee Profile

Item	# of Companies With Information	Result
Existence of audit committee	19	68% had audit committee
Number of audit committee members	12	Mean = 3.1
Type of audit committee member:	12	
Insider		Mean = 11%
Gray		Mean = 22%
Percentage of audit committee members with accounting or finance expertise	12	29.7%
Number of audit committee meetings per year	10	Mean = 1.9 Median = 1.5
Audit committee disclosures provide evidence of an internal audit function	10	10% mentioned internal audit function

C. NATURE OF THE FRAUDS

Total Amount of the Fraud

In an attempt to obtain a judgmental measure of the typical size of the financial statement frauds, we accumulated information from the AAERs that provided some indication of the amounts involved. In many cases, the AAERs did not disclose the dollar amounts involved. As a result, we were only able to obtain some measure of the dollar amounts involved for 43 of the 56 sample companies. As reported in Table 6, on an overall cumulative basis, the average fraud involved $33 million of cumulative misstatement or misappropriation over the fraud period, while the median fraud involved $4.4 million. The smallest fraud was $29,000, while the largest totaled $362 million.

Table 6 – Cumulative Dollar Amount of Fraud Per Company

	# of Sample Companies With Information	Mean Cumulative Misstatement or Misappropriation (in $ millions)	Median Cumulative Misstatement or Misappropriation (in $ millions)
Cumulative Amount of Fraud Per Company	43	$33.0	$4.4
Minimum = $29,000 Maximum = $362 million 1st quartile = $1.6 million 3rd quartile = $26 million			

Typical Length of Fraud Period

The financial statement frauds generally involved multiple fiscal periods. Information to determine the number of months from the beginning of the first fraud period to the end of the last fraud period was available for 55 of the 56 sample companies. For those 55 companies, the time from the beginning of the first fraud period to the end of the last fraud period averaged 27.2 months with a median of 24 months. Most of the fraud periods overlapped a portion of two fiscal years by misstating either the annual or quarterly financial statements in at least two fiscal periods. Many of the frauds began with misstatements of interim financial statements that were continued in annual financial statement filings.

Methods of Fraudulently Reporting Financial Statement Information

Based upon information included in the AAERs, we made our best attempt at identifying the methods used to fraudulently report the financial statement information. As noted in Table 7, the two most common techniques used to fraudulently misstate financial statement information involved improper techniques to overstate assets and improper revenue recognition techniques to overstate revenues.

Sixty-eight percent of the sample companies overstated assets, primarily by overvaluing existing assets.[3] Thirty-four percent of the sample companies recorded revenues inappropriately primarily by recording revenues prematurely or by creating fictitious revenue transactions. Sixteen percent of the companies' financial statements were misstated through the understatement of expenses or liabilities. Most of the financial statement fraud instances involved intentionally misstating financial statement information, with only 13 percent of the fraud cases involving misappropriation of company assets.

[3] To avoid double-counting, the information about the overstatement of assets does not include overstatements of accounts receivable due to the revenue recognition frauds.

Four percent of the companies issued statements or press releases with inappropriate disclosures (without financial statement line item effects). There were a variety of other miscellaneous fraud techniques used. Because the financial statement frauds at the sample companies often involved more than one fraud technique, the sum of the percentages reported exceeds 100 percent.

Table 7 – Common Financial Statement Fraud Techniques

Methods Used to Misstate Financial Statements	Percentage of the 56 Sample Companies Using a Fraud Method
Overstatement of Assets (excluding accounts receivable overstatements due to revenue fraud): [a] Overstating existing assets – 54% Recording fictitious assets or assets not owned – 16% Capitalizing items that should be expensed – 7%	68%
Improper Revenue Recognition: [a] Recording fictitious revenues – 18% Recording revenues prematurely – 11% No description / "overstated" – 11%	34%
Understatement of Expenses/Liabilities	16%
Misappropriation of Assets	13%
Inappropriate Disclosure (with no financial statement line item effects)	4%
Other Miscellaneous Techniques	33%

[a] Note: The subcategories such as premature revenues or fictitious revenues and assets do not sum to the category totals due to multiple types of fraud employed at a single company.

Over two-thirds of the sample companies misstated the financial statement information by overstating assets. Table 8 highlights the typical asset accounts overstated by sample companies. Even excluding the effects of misstating accounts receivable due to the revenue recognition frauds, the most common asset account misstated was accounts receivable (issues primarily related to assessing collectibility). Other asset accounts misstated included

investments; oil, gas, and mineral assets; property, plant, and equipment; and patents, copyrights, and designs.

Table 8 – Asset Accounts Frequently Misstated

Asset Accounts Typically Overstated	# of Sample Companies Involved
Accounts Receivable (other than revenue fraud)	10
Investments	7
Oil, Gas, & Minerals	7
Property, Plant, & Equipment	6
Patents, Copyrights, & Designs	6
Inventory	5
Cash	4
Marketable Securities	3
Loans/Notes Receivable	2

D. CONSEQUENCES OF THE FRAUDS

We identified 21 (38 percent) of the 56 sample companies that either filed for Chapter 11 bankruptcy, were described as "defunct" in the AAER, or were taken over by a state or federal regulator after the fraud occurred.[4] We also found that an additional five companies (9 percent) either sold a large portion of their assets, merged with another company, or had a new controlling shareholder following the occurrence of the financial statement fraud. Thus, nearly 50 percent of the companies were no longer in existence or were under a substantially different form of ownership and existence following the fraud period. We identified 10 companies (18 percent) whose stock was delisted from the national stock exchange where the stock was traded. See Table 9.

[4] Frequencies of consequences reported in this section are inherently understated given that we were only able to identify consequences explicitly noted in an AAER or in business press articles. Given that the business press often does not cover smaller or otherwise less visible companies, there are likely to be consequences that occurred that we were unable to identify for our sample firms (which tend to be very small).

Table 9 – Status of Companies After Fraud Disclosed

Company Status Subsequent to the Fraud	Number of Sample Companies Affected	Percentage of Sample Companies Affected
Bankrupt, defunct, taken over by regulator	21	38%
Changed ownership (Sold large portion of assets, merged with another company, or experienced change in controlling shareholders)	5	9%
Total	26	47%
Delisted from national stock exchange	10	18%

E. COMPARISON OF 56 SAMPLE COMPANIES TO 204 COMPANY SAMPLE IN COSO FRAUD STUDY (1999)

The preceding sections have presented various descriptions of the 56 fraud cases in which the auditor was named in an AAER. These 56 cases appear to be quite different from the full sample of 204 fraud cases examined in *Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies*. Key differences are summarized below.

- **Nature of the Companies** - The sample of 56 consists of much smaller companies than the full sample. For example, median revenues for the 56 were $1.4 million, versus $13 million for the full sample. In addition, the sample of 56 has a concentration of mining / oil and gas companies (16 percent), the most frequent industry in this subsample. This industry represents only 6 percent of the full sample examined in the COSO fraud study.

- **Nature of the Control Environment** - The sample of 56 has less frequent CEO and CFO involvement in the frauds (68 percent) than does the full sample (83 percent).

- **Nature of the Frauds** - The cumulative amounts of the frauds appear larger in the sample of 56 (median fraud of $4.4 million is almost as large as median assets of $5.4 million) than in the full sample (median fraud of $4.1 million is much smaller than median assets of $15.7 million). Also, in the sample of 56, the frauds were weighted toward asset frauds (68 percent) and away from revenue frauds (34 percent). Asset and revenue frauds each were found in 50 percent of the full sample of cases in the COSO fraud study. Finally, in the sample of 56, the asset accounts misstated were more likely to be accounts receivable; oil, gas, and minerals; or investments; whereas in the COSO study the accounts involved inventory, accounts receivable, and property, plant, and equipment.

F. AUDITOR ISSUES, INCLUDING ALLEGED DEFICIENCIES IN AUDITOR PERFORMANCE

Audit Opinions

We reviewed the auditor's opinion on the last set of financial statements that were fraudulently misstated to determine whether the auditor's report contained any modifications or qualifications. For the 36 sample fraud companies where we were able to review the auditor's report, we determined that 18 of those audit reports (50 percent) contained unqualified auditor opinions ("clean" opinions). The remaining reports (50 percent) departed from the standard unqualified report for a variety of reasons (in some cases more than one reason caused the modification). Eight reports mentioned going-concern issues, and only one report mentioned GAAP departures. See Table 10.

Table 10 – Types of Audit Reports on Last Fraudulent Financial Statements

Type of Audit Report	Number of Reports by Type	Percentage of Audit Reports by Type
Unqualified opinions	18	50%
Modified or qualified reports	17	47%
Going concern – 8 reports		
Litigation uncertainties – 2 reports		
Other uncertainties – 4 reports		
Change in accounting principle – 3 reports		
Change in auditor across comparative reporting periods – 3 reports		
GAAP departures – 1 report		
Note: The above do not sum to equal the 17 modified or qualified reports because some of the reports addressed more than one modification/qualification issue.		
Disclaimers of opinion	1	3%
Number of audit reports available for review	36	100%

Alleged Auditor Involvement in the Frauds

Of the 56 cases in which the auditor was named, 11 cases appear to involve "bogus audits" or "bogus auditors." In such cases, either an audit was never performed, or a non-CPA posed as an auditor and issued a phony opinion. In the other 45 cases, it appears that an audit was attempted, but was deficient. Three types of auditors were cited – those employed by

national (top 10) audit firms (10 cases), those employed by non-national audit firms (42 cases), and non-CPAs posing as auditors (4 cases). See Table 11.

Table 11 – Alleged Auditor Involvement by Auditor Type

Type of Case	Number of Cases Naming National Firm Auditors	Number of Cases Naming Non-National Firm Auditors	Number of Cases Involving Non-CPAs Posing as Auditors	Total
Bogus audit or auditor	0	7	4	11
Attempted audit, but audit was deficient	10	35	0	45
Total	10	42	4	56

Bogus Audits or Auditors

Eleven of the 56 cases involved instances in which an actual auditor did not perform an audit (but still issued an opinion) or someone posed as an auditor and issued a phony opinion. These 11 cases do not represent failures in the performance of actual audits. Rather they represent situations in which a valid audit was not attempted. See Table 12.

Table 12 – Bogus Audits or Auditors (n = 11)

Item	Result
Type of "auditor" violation	All antifraud violations (Rule 10(b)-5)
"Auditor" paid civil penalty	In 2 cases (fines of $50,000 and $10,000)
"Auditor" disgorged gains	In 1 case ($15,000)
Criminal prosecutions	None
Barred from SEC practice	In 5 cases (three permanent, one for 5 years, one for 3 years)

These 11 cases may represent the most egregious violations of the anti-fraud statutes, particularly Rule 10(b)-5. Despite the seriousness of the violations, the penalties imposed on the perpetrators by the SEC appear to be fairly light. Only limited fines were imposed and no criminal convictions resulted from these 11 cases. The primary penalty involved barring the perpetrators from practice before the SEC.

Audit Problems in Attempted Audits

The remaining 45 cases represent instances of alleged failure in attempted audits. Tables 13-18 present information on these 45 cases as follows:

- Table 13 – Overview of Attempted Audits and Sanctions (n = 45)
- Table 14 – Detailed Listing of Alleged Audit Problems by Audit Area (n = 45)
- Table 15 – Key Problems in Attempted Audits (Full sample, n = 45)
- Table 16 – Key Problems in *National Firm* Attempted Audits (n = 10)
- Table 17 – Key Problems in *Non-National Firm* Attempted Audits (n = 35)
- Table 18 – Other Alleged Audit Problems

Table 13 – Overview of Attempted Audits and Sanctions (n = 45)

Item	Result
Type of auditor violation	19 antifraud violations (Rule 10(b)-5), all against non-national firm auditors 26 citations for negligent audits
Auditor change	An auditor change had taken place in 11 of 19 cases (58%) containing enough information to evaluate
Company was new or audit in question was initial audit	17 of 45 cases
Former auditor worked for client	In 5 of 45 cases (two in CFO position, two in controller position, one other relationship)
Auditor paid civil penalty	In 1 case (fine of $29,000)
Auditor disgorged gains	In 2 cases (small amounts)
Criminal prosecutions	In 1 case (for contempt and misappropriation)
Auditor barred from SEC practice	In 38 cases (12 permanent, others averaged approximately 3 years)

As noted in Table 13 above, in 19 of the 45 attempted audits, the auditor was cited for violating Rule 10(b)-5 or aiding and abetting a 10(b)-5 violation. In the other 26 cases, the auditor was cited for negligence in performing the audit.

Of the 19 cases in which there was adequate information to evaluate whether a recent auditor change had occurred, there were 11 instances (58 percent) where such a change had occurred. In addition, there was evidence that 17 of the 45 companies either were relatively new or the audit in question was the initial audit. Overall, it appears that engagements involving auditor turnover, early stage companies, and new audit engagements may present increased risk to the auditor.

Another issue of interest today (e.g., an Independence Standards Board initiative) is whether there were former audit personnel (i.e., from the company's external audit firm) employed in key management positions at the client firm. We found evidence of such relationships in 5 of

the 45 cases (11 percent). In two cases the former auditor was the CFO, and in another two cases the former auditor was the controller. In the final case, the AAER stated that a person had worked for the client and for the audit firm (at different times), but the discussion was not very detailed.

In terms of sanctions against auditors, civil fines, disgorgement of gains, and criminal prosecution were quite rare. Auditor penalties primarily involved bars from SEC practice. Of the 38 cases in which an auditor was barred from practicing before the SEC, 12 (32 percent) involved permanent bars, while the remaining SEC bars averaged approximately 3 years.

Table 14 presents a comprehensive listing of all alleged audit problems noted in the AAERs organized by issues related to engagement acceptance, the general standards of GAAS, the fieldwork standards of GAAS, and the reporting standards of GAAS so readers can focus on audit areas of interest and determine the extent of problems in those areas. For each area, three numbers are presented – the total number of cases (out of 45) in which this area represented an audit problem, the number of *National Firm* audits (out of 10) in which this area represented an audit problem, and the number of *Non-National Firm* audits (out of 35) in which this area represented an audit problem. The split between national and non-national firms is provided due to the different nature of these two groups of audit firms. Also note that if there were no problems in an audit area (e.g., referencing work performed by other auditors), the area is not listed in Table 14. Following this comprehensive listing of all noted problems, we present and discuss information in later tables about the most frequently observed audit problems for the full sample and then for each of the two sub-samples, national and non-national firms.

Table 14 – Detailed Listing of Alleged Audit Problems by Audit Area (n = 45)

Audit Area	Number of Cases With Problems [Total (out of n = 45) / National Firms (out of n = 10) / Non-National Firms (out of n = 35)]
Panel A: Engagement Acceptance	
a. Failure to conduct adequate predecessor / successor communications	5 Total / 0 National / 5 Non-National
b. Failure to obtain understanding with client (e.g., engagement letter)	1 / 1 / 0
c. Inadequate assessment / consideration of management's integrity	7 / 2 / 5
Panel B: General GAAS Standards	
a. Lack of independence from client	10 / 0 / 10 • 6 involved auditor performing accounting or management functions for client • 2 involved auditor ownership of company stock
b. Inadequate competence and technical training to conduct engagement	6 / 0 / 6
c. Failure to exercise due professional care	32 / 9 / 23
d. Inappropriate level of professional skepticism applied	27 / 10 / 17

Table 14 – Continued

Audit Area	Number of Cases With Problems [Total (out of n = 45) / National Firms (out of n = 10) / Non-National Firms (out of n = 35)]
Panel C: Audit Planning – Fieldwork GAAS Standard	
a. Inadequate design of audit programs and poor assessment of engagement risk (inherent risk issues, non-routine transactions)	20 / 5 / 15 • 7 involved failure to write an audit program
b. Failure to recognize / ensure disclosure of key related parties	12 / 1 / 11
c. Inadequate supervision and review of engagement	10 / 3 / 7
Panel D: Understanding Internal Controls – Fieldwork GAAS Standard	
a. Failure to obtain adequate understanding of internal control	7 / 1 / 6
b. Over-reliance on internal controls (over-relying / failing to react to known control weaknesses)	11 / 5 / 6
c. Failure to consider particular risks related to the control environment	1 / 0 / 1

Table 14 – Continued

Audit Area	Number of Cases With Problems [Total (out of n = 45) / National Firms (out of n = 10) / Non-National Firms (out of n = 35)]
Panel E: Sufficient Competent Evidence – Fieldwork GAAS Standard	
a. Inappropriate confirming of accounts receivable	13 / 2 / 11 • 5 involved failure to confirm • 5 involved lax procedures leading to client falsifying confirmations • 4 involved failure to perform alternate procedures
b. Inappropriate confirming of cash or investments	5 / 2 / 3
c. Inadequate observation of inventories	4 / 1 / 3
d. Poor performance of substantive analytical procedures	2 / 1 / 1
e. Failure to perform adequate cutoff tests of transactions	5 / 3 / 2 • 3 involved sales • 1 involved cash • 1 involved investments
f. Failure to seek / obtain adequate supporting evidence (failing to gather sufficient evidence)	36 / 10 / 26
g. Failure to obtain adequate evidence related to the evaluation of significant management estimates (failing to gather sufficient evidence)	16 / 7 / 9

Table 14 – Continued

Panel E (continued):	
h. Over-reliance on / failure to obtain work of specialists (e.g., failing to obtain understanding of methods and assumptions)	6 / 2 / 4
i. Incorrect sampling techniques (failing to project results to population)	2 / 1 / 1
j. Inadequately considering responses from client's legal counsel / attorney letters	2 / 1 / 1
k. Using inquiry as sole form of evidence (over-relying on this form of evidence)	18 / 8 / 10
l. Not obtaining or over-relying on management's letter of representation	6 / 1 / 5 • 4 involved failure to obtain letter • 2 involved over-reliance on letter
m. Inadequate or inconsistent preparation of working paper documentation (inadequate or inconsistent working papers)	10 / 3 / 7 • 7 involved inadequate working papers • 3 involved material inconsistencies in the working papers

Table 14 – Continued

Audit Area	Number of Cases With Problems [Total (out of n = 45) / National Firms (out of n = 10) / Non-National Firms (out of n = 35)]
Panel F: Reporting GAAS Standards	
a. Incorrect interpretation or application of requirements of GAAP	22 / 7 / 15
b. Failure to report changes in accounting principle	1 / 1 / 0
c. Inadequate evaluation of impact of uncertainties	1 / 0 / 1
d. Inadequate evaluation of entity's going concern status	1 / 1 / 0
e. Inappropriate consideration of material subsequent events	5 / 1 / 4
f. Failure to evaluate known audit differences / improperly concluding that "passed" audit adjustments were immaterial	7 / 3 / 4
g. Failure to communicate reportable conditions (and other required communications) to the audit committee	2 / 0 / 2
h. Failure to evaluate adequacy of disclosure or willful concealing of material items (not including RPTs)	8 / 2 / 6

Note: Audit areas are listed only if there were alleged problems in those areas.

The next three tables take the detailed information presented in Table 14 above and sort it to highlight the most common alleged audit problems – for the full sample of 45 cases, the national firm sample of 10 cases, and the non-national firm sample of 35 cases.

Table 15 – Key Problems in Attempted Audits (Full Sample, n = 45)

Problem Area	Percentage (Number) of Cases
• Seeking / obtaining adequate supporting evidence (failing to gather sufficient evidence)	80% (36 cases)
• Due professional care	71% (32)
• Appropriate level of professional skepticism	60% (27)
• Interpreting or applying requirements of GAAP	49% (22)
• Designing audit programs and planning engagement (inherent risk issues, non-routine transactions)	44% (20)
• Using inquiry as form of evidence (over-relying on this form of evidence)	40% (18)
• Obtaining adequate evidence related to the evaluation of significant management estimates (failing to gather sufficient evidence)	36% (16)
• Confirming accounts receivable	29% (13)
• Recognizing / disclosing key related parties	27% (12)
• Relying on internal controls (over-relying / failing to react to known control weaknesses)	24% (11)
• Independence from client	22% (10)
• Supervising and reviewing engagement	22% (10)
• Preparing working paper documentation (inadequate or inconsistent working papers)	22% (10)

As shown in Table 15, the most common audit problem involved the failure to gather adequate audit evidence. In some cases, this was a pervasive statement by the SEC, while in

other cases the AAERs highlighted specific areas for which the evidence gathered by the auditor was insufficient. For example, many of the cases involved inadequate evidence in the areas of asset valuation, asset ownership (assets were not owned by the company), and management representations (not corroborated). In addition, some cases involved the auditor's failure to examine relevant supporting documents (e.g., examining draft sales contracts instead of final sales contracts) or the failure to perform steps in the audit program. It appears that in the SEC's opinion, the evidence-gathering deficiencies generally involved situations in which the auditor's failure to gather key evidence precluded him or her from detecting a material misstatement.

The second and third most common problems related to lack of due professional care and lack of appropriate professional skepticism. These represent violations of two of the General GAAS Standards, and the SEC's statements were of a global, general nature in most cases with no specific comments on areas where the skepticism and due care were lacking. Often when the SEC cited a specific audit problem (e.g., failure to obtain sufficient competent evidence), the SEC also noted that the auditor failed to exercise due professional care and/or appropriate professional skepticism. In other cases, the auditor clearly failed to exercise appropriate due care or professional skepticism because he or she merely accepted management assertions (e.g., about the valuation of a difficult to measure asset account) at face value or ignored known management integrity issues.

The fourth most common problem involved misinterpretation or misapplication of GAAP. The auditor failed to consult or understand the GAAP provisions, or he or she did not apply GAAP properly. In a number of cases, the AAER cited specific FASB statements or AICPA guidance that had not been consulted or followed. For example, there were problems related to APB 20, APB 16, SFAS 34, various AICPA guides, and numerous basic violations of GAAP (improper asset recording or improper revenue recognition). Often the GAAP violations related to unusual assets with unique accounting valuation issues. From the discussion in the AAERs, generally it was difficult to determine whether the GAAP violation resulted from the auditor's lack of awareness of GAAP or from the auditor's improper application of GAAP.

Audit planning issues represented the fifth most common problem. Three issues that often were cited in this area were failure to properly consider inherent risks (industry turmoil, company and management red flags, or difficult accounting issues), failure to recognize risks associated with non-routine transactions (where the fraud often occurred -- often in a period-end adjustment), and failure to prepare a written audit program. In addition, some cases involved the auditor's use of a prior-year or standard audit program without making any adjustments for issues unique to the current audit (e.g., the company just began to sell to foreign customers with foreign sales constituting a majority of current year sales). Finally, one case involved an auditor's agreement to audit certain material items with an eight-day deadline in order to file financial statements timely with the SEC. This extremely tight time frame may have contributed to the inadequate planning.

The sixth most common problem was over-reliance on inquiry as a form of evidence. Auditors often were cited for failing to corroborate management explanations (placing sole

reliance on the representations of management) and for failing to challenge inconsistent explanations or explanations that were refuted by other evidence that the auditor already had gathered. Often the over-reliance on management representations related to subjective valuations of account balances.

Failure to obtain adequate evidence in support of management estimates represented the seventh most common problem. Auditors often were cited for failing to gather corroborating evidence and for failing to challenge key assumptions or methods. Accounts typically involved in such cases were accounts receivable, investments, loans receivable, inventory (lower of cost or market issues), plant assets (valuation issues), and natural resources.

Various problems were found with confirmation of accounts receivable, the eighth most common area. Some cases involved a failure to confirm any or enough receivables, and others involved lax procedures in the confirmation process that allowed the client to falsify the confirmation requests. A few cases involved deficiencies with faxed confirmations. The client provided phony customer fax numbers, intercepted the confirmations, completed them, and then faxed them back to the auditor. In these cases, the SEC often noted that the auditor failed to independently verify the legitimacy of the fax telephone number supplied by the client. In another case, the auditor relied on the client to deliver overnight confirmation request packages directly to the overnight carrier with no auditor involvement in the process. Then, when the response rate to the overnight requests far exceeded the response rate to traditionally mailed requests, the auditor failed to investigate reasons for the drastic change. Finally, a number of auditors were cited for failing to perform alternate procedures when confirmations were not returned or were returned with material exceptions.

The ninth most common problem involved failure to recognize or disclose key related parties. In some cases, the auditor simply was unaware of the related party, while in others the auditor appeared to willfully conceal the related party's existence. Often, related party transactions were used to artificially increase asset values.

The tenth most common problem was over-reliance on internal controls, particularly a failure to expand testing in light of known control weaknesses. In a number of cases, the auditor had documented significant control problems in specific areas and then had failed to alter the audit testing in response to the heightened risk. In other cases, the auditor proceeded with a fairly typical audit which assumes the presence of an acceptable baseline-level of internal control despite documenting that the client essentially had no formal controls whatsoever.

The final problems in Table 15 are lack of independence (generally due to the auditor performing accounting or management functions for the client – often allegedly involved in recording the fraudulent entries), inadequate supervision and review (generally involving inadequate partner and second partner reviews; inadequate supervision of staff auditors was cited in a number of cases), and inadequate or inconsistent working papers.

Tables 16 and 17 present the most common audit problems in audits performed by national audit firms (Table 16) and non-national audit firms (Table 17).

Table 16 – Key Problems in *National Firm* Attempted Audits (n = 10)

Problem Area	Percentage (Number) of Cases
• Seeking / obtaining adequate supporting evidence (failing to gather sufficient evidence)	100% (10 cases)
• Appropriate level of professional skepticism	100% (10)
• Due professional care	90% (9)
• Using inquiry as form of evidence (over-relying on this form of evidence)	80% (8)
• Obtaining adequate evidence related to the evaluation of significant management estimates (failing to gather sufficient evidence)	70% (7)
• Interpreting or applying requirements of GAAP	70% (7)
• Designing audit programs and planning engagement (inherent risk issues, non-routine transactions)	50% (5)
• Relying on internal controls (over-relying / failing to react to known control weaknesses)	50% (5)**
• Supervising and reviewing engagement	30% (3)
• Preparing working paper documentation (inadequate or inconsistent working papers)	30% (3)
• Performing cutoff tests of transactions	30% (3)**
• Evaluating known audit differences / improperly concluding that "passed" audit adjustments were immaterial	30% (3)**

** Item does not appear in Table 17, Key Problems in Non-National Firm Attempted Audits.

Table 17 – Key Problems in *Non-National Firm* Attempted Audits (n = 35)

Problem Area	Percentage (Number) of Cases
• Seeking / obtaining adequate supporting evidence (failing to gather sufficient evidence)	74% (26 cases)
• Due professional care	66% (23)
• Appropriate level of professional skepticism	49% (17)
• Interpreting or applying requirements of GAAP	43% (15)
• Designing audit programs and planning engagement (inherent risk issues, non-routine transactions)	43% (15)
• Confirming accounts receivable	31% (11)**
• Recognizing / disclosing key related parties	31% (11)**
• Using inquiry as form of evidence (over-relying on this form of evidence)	29% (10)
• Independence from client	29% (10)**
• Obtaining adequate evidence related to the evaluation of significant management estimates (failing to gather sufficient evidence)	26% (9)
• Supervising and reviewing engagement	20% (7)
• Preparing working paper documentation (inadequate or inconsistent working papers)	20% (7)

** Item does not appear in Table 16, Key Problems in National Firm Attempted Audits.

Tables 16 and 17 above separately highlight the most common audit problems involving national firm auditors and non-national firm auditors. While the findings in the two tables are fairly consistent, there were some problems that appeared in only one of the two tables.

Three problems were among the most common in cases involving national firm audits, but not in cases involving non-national firms – over-reliance on internal controls, inadequate performance of cutoff tests of transactions, and improper evaluation of known audit

differences. Over-reliance on internal controls might be more common among national firm auditors due to the nature of the client base generally served by national firms (larger clients where reliance on controls is a common strategy) and the nature of the audit approaches employed by the national firms (likely to focus more on risk assessments and control testing, as opposed to choosing not to rely at all on controls). Cutoff testing issues generally involved sales transactions. Problems with evaluations of known audit differences centered around client / management negotiations regarding the materiality of misstatements or the auditor's improper treatment of misstatements as immaterial. For cutoff testing and evaluation of known audit differences, it is not clear why these were more common problems in the national firm sample.

Three problems were among the most common in cases involving non-national firm audits, but not in cases involving national firms – inadequate confirming of accounts receivable, failure to recognize or disclose key related parties, and lack of independence (no violations at all among national firm auditors).[5] The accounts receivable confirmation problems described earlier represent fundamental errors in the performance of basic audit procedures. Failure to recognize or disclose key related parties also represents a basic failure on the part of the auditor. Finally, the independence violations generally involved the auditor's performance of accounting or management functions for the client, a scenario probably more likely in a small client / small audit firm setting.[6]

Finally, Table 18 presents a host of other alleged audit problems described in the AAERs. These instances are rare, unusual events, but they provide some insight into the variety of problems that are possible.

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[5] Despite the recent scrutiny of the independence of the Big 5 audit firms (recent SEC sanctions against a Big 5 firm for independence violations), the present study did not identify a single case of fraudulent financial reporting from 1987-1997 that involved a non-independent Big 5 auditor.

[6] The 10 national firm clients were substantially larger (median assets of $25 million) than the 35 non-national firm clients (median assets of $3 million).

Table 18 – Other Alleged Audit Problems

- Inadequate interim reviews (2 cases)
- Inadequate review of documents containing audited financial statements
- Auditor misappropriation of $13,000
- Auditor assisted in setting up company to conceal criminal's role in public works projects
- Misleading audit firm letterhead (implied a certain geographic location and certification -- neither was true)
- Audit opinion misrepresented scope of work
- Auditor issued going-concern report to one government agency and later issued clean opinion with SEC filing
- Auditor failed to withdraw audit opinion even after knowing of fraud
- Auditor failed to comply with prior SEC sanctions
- Auditor prepared the fraudulent entries
- Auditor made false and misleading statements about company history, owner, and financial condition
- Auditor failed to disclaim opinion despite material scope limitation

SECTION IV -- Implications of the Study

Based on the pattern of results found, in this section we offer implications for auditors and regulators to consider. These implications are based on the authors' analysis of the data, as well as our personal judgment.

A. RELATED TO THE INCIDENCE OF AUDITOR SANCTIONS

Our review of two-thirds of the financial statement fraud cases from 1987-1997 revealed only 56 financial statement fraud cases in which an auditor was sanctioned by the SEC. Given the large number of public companies and audit firms associated with quarterly and annual financial statements filed with the SEC in each of the eleven years, the auditor "defect rate" in this particular setting is arguably extremely low. When assessing the nature of audit problems highlighted in the SEC enforcement actions, it is important to remember the rare nature of these documented audit problems and to carefully consider the costs and benefits of potential responses to the noted problems.

B. RELATED TO THE NATURE OF THE COMPANIES AND THE FRAUDS

The clients and fraud types involved when auditors were sanctioned by the SEC are quite different from the larger sample of over 200 frauds examined in the COSO fraud study. Based on these differences, auditors may want to pay particular attention to several issues.

Nature of the Companies

Due to the very small size of the clients involved when auditors were cited by the SEC, audit firms should pay particular attention to the risks involved in serving this market segment. Very small clients may present unique challenges due to a potential lack of baseline-level internal controls and the potential for domination by one individual in the client's top management. In addition, the concentration of companies in the mining / oil and gas industries highlights the importance of industry expertise and recognition of unique industry risks, including complex / specialized GAAP treatment issues. As audit firms evaluate potential new client engagements, they may need to seriously challenge whether existing firm personnel have the ability to obtain a sufficient level of technical competence to ensure that the firm can appropriately exercise due professional care in the performance of the engagement. Policies and guidelines that assist the potential new engagement partner in conducting an *objective* assessment (e.g., set aside personal benefits from being the "rainmaker") of whether the audit firm has the technical ability to adequately perform the engagement may be warranted.

Nature of the Control Environment

Cases in which the auditors were cited by the SEC exhibited less frequent CEO and CFO involvement in the frauds (68 percent of these cases versus 83 percent of the full sample). It is possible that the SEC is somewhat more forgiving of the audit firm when the fraud has gone to the highest levels of the organization, given that such frauds may be particularly

difficult for auditors to detect. In any event, thorough assessment of management integrity and audit committee oversight is critical. Assessments of top management including detailed assessments of board of director and audit committee effectiveness may be especially useful if performed as a part of the client acceptance or continuance evaluation process rather than waiting to make those assessments after the engagement has been accepted and the auditor is obtaining the understanding of internal controls. In other words, assessments about the overriding aspects of the control environment may need to part of client acceptance process, including discussions about these aspects during successor and predecessor auditor communications.

Nature of the Frauds

Frauds involving auditor citation by the SEC were weighted toward asset frauds (68 percent) and away from revenue frauds (only 34 percent). During the time period examined (1987-1997), it appears that the SEC viewed auditors' failure to detect asset overstatement frauds particularly harshly. Fraud cases in which accounts receivable, oil, gas, and minerals, or investments were misstated appeared to pose the greatest risk to the audit firm. Special care should be taken in auditing unique investments, particularly when there are specific generally accepted accounting principles that address those types of investments. As audit clients move into specialized investment opportunities, such as derivative and hedge transactions and foreign investments in developing countries, auditors may need to consider whether they have the ability to competently assess existence, valuation, and rights assertions without the assistance of an investment specialist.

Despite the SEC's apparent focus on asset frauds from 1987-1997, there is some indication that the SEC now is shifting its focus toward revenue frauds. For example, the SEC recently released Staff Accounting Bulleting No. 101, *Revenue Recognition in Financial Statements*, and many recent SEC enforcement actions have involved revenue recognition problems. As the U.S. economy continues to move away from companies with a large amount of recorded assets toward companies with off balance sheet assets (intellectual capital, etc.), this also may serve to reduce the prominence of asset frauds in enforcement actions against auditors as we move into the 21st century. Investments in e-business, especially, may create new risk areas.

C. RELATED TO THE ALLEGED AUDIT DEFICIENCIES

Bogus Audits or Auditors

Given the infrequent nature of bogus audits or auditors (11 cases), this does not appear to be a pervasive problem in the financial community. However, one noteworthy item in this area is the apparent absence of criminal prosecutions in the 11 such cases examined in this study. The SEC recently announced an effort to work more closely with federal criminal prosecutors in bringing criminal charges in egregious financial fraud cases. We would expect future instances of bogus audits or bogus auditors to be prime candidates for criminal prosecution.

Auditor Changes and Early Stage Companies

In the 45 attempted but deficient audits, there was a high instance of auditor changes and early stage companies. Some unscrupulous managers may attempt to "churn" the audit firms so as to minimize the probability that the fraud is detected. In other cases, it is simply difficult for the auditor to maximize the effectiveness of the audit when there is no history to work from. Auditors need to be alert to the unique risks posed at the beginning of a client relationship and should be especially vigilant in planning and performing the first few audits, including rigorous communications with predecessor auditors about management integrity issues and control environment issues, as discussed previously. Extensive client continuance processes which involve more than the engagement partners may be warranted in the early years of a client engagement where the perceived audit risk is viewed as high. And, when engagement partners obtain information through background checks and other procedures, they may want to ensure that all audit firm personnel assigned to the engagement are confidentially informed about any concerns related to management integrity issues. If information about management integrity concerns is only shared between the engagement partner, concurrent partner, or managing partner, then lower level engagement staff are at a disadvantage in having the ability to exercise appropriate levels of due professional care and professional skepticism.

Former Auditors Employed by the Client

In 11 percent of the 45 attempted audits, there was evidence that a former auditor was employed in a key financial management position (often CFO or controller). One AAER explicitly stated that the auditor over-relied on the false representations of his former colleague. Consistent with the Independence Standards Board's focus on this issue, auditors should consider the risks of such relationships and adjust their audit approach accordingly, particularly when there is some concern that knowledge of the audit firm's strategy can be used to mask the presence of a particular type of fraud.

Alleged Audit Problems of a Global Nature

Table 15 summarizes the key problems identified in the 45 attempted audits. The three most common issues (inadequate evidence, lack of due care, and inadequate professional skepticism) represent global shortcomings in the audit process or the auditor's frame of mind in performing the audit. Perhaps the most appropriate way to address these global issues is through the audit firms' sharing of their culture with their professionals. A philosophy such as "our audit work is high quality, we do not cut corners, and we are skeptical" would address many of the issues raised in the enforcement releases. A second area to consider here is the types of incentives created by the audit firm's performance measurement and compensation system. In many cases, it appeared that auditors simply chose not to pursue or consider *identified* issues because of career advancement or firm compensation pressures. It is possible that time pressures or other factors (client relations, etc.) contributed to the auditors' lack of diligence. And third, as noted previously, communications among engagement team members about any perceived concerns about management integrity and

fraud risk should be encouraged to ensure that no audit team member withholds noted concerns for fear of being considered "over-reactive, paranoid, judgmental, etc."

Alleged Audit Problems of a Specific Nature

The other 10 problems highlighted in Table 15 all represent more specific audit problems that may have more specific solutions.

- **Interpreting or applying requirements of GAAP** - Technical accounting problems were cited frequently in the enforcement releases. In addressing this issue, audit firms may benefit from promoting greater consultation with other auditors (in-house industry experts, in-house accounting experts) and intranet access to AICPA / FASB / SEC guidance and GAAP-related publications (covering all levels of GAAP). Continuing firm training in accounting requirements and industry nuances is critical. Audit firm personnel may need to be reminded to consider lower level accounting pronouncements as specified in SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report.*

- **Designing audit programs and planning engagement (inherent risk issues, non-routine transactions)** - Audit planning problems highlight the need for early planning and thorough documentation. Auditors may need to be reminded to focus on the provisions contained in SAS No. 22, *Planning and Supervision*, to ensure that they meet the basic responsibilities (e.g., prepare a written audit program) of the professional standards related to engagement planning. Again, to ensure effective audit engagement team communications, all engagement team personnel may need to be encouraged to read audit planning memoranda and other planning documents, which help alert all team personnel to unique engagement issues. In addition, it is critical for auditors to address new or emerging client risks (inherent risk factors) and to very carefully consider the planned audit effort regarding non-routine transactions, particularly those recorded at or near period end outside the normal accounting system (i.e., often manual adjusting entries). Particular focus on fraud risk characteristics contained in SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, is warranted each year throughout the conduct of the engagement.

- **Using inquiry as form of evidence (over-relying on this form of evidence)** - The clear message with respect to using inquiry as a form of evidence is that the auditor needs to carefully support and consider the quality of this evidence. When the evidence is inconsistent with other audit evidence (including other evidence based on inquiry), the auditor's skepticism should be at a maximum level. It may be necessary to remind auditors that relying on inquiry without any corroboration at all generally is not acceptable, as described more fully in SAS No. 85, *Management Representations*. Once again, auditors should be challenged to ensure that they do not over-rely on client judgments about complex account

valuation issues when obtaining independent verification is difficult and time-consuming.

- **Obtaining adequate evidence related to the evaluation of significant management estimates (failing to gather sufficient evidence)** - Given the complexity and magnitude of many management estimates, it is imperative that the auditor challenge the underlying data, the assumptions made, and the methods used by management or their experts. It is important for the auditor also to incorporate his or her knowledge of the external environment (industry conditions, local market conditions, etc.) when evaluating the fairness of key management estimates as described more fully in SAS No. 57, *Auditing Accounting Estimates*. Furthermore, auditors may need to more frequently engage their own industry experts (either in-house experts or outsiders) to assist in the evaluation of estimates involving unique assets or transactions less frequently observed across most audit engagements.

- **Confirming accounts receivable** - Given the problems noted with confirmations, auditors should be sensitive to confirming an adequate portion of the receivables balance, being very cautious with faxed confirmations (see SAS No. 67, *The Confirmation Process*), *independently* gathering addresses and telephone numbers of client customers, and performing rigorous alternate procedures when discrepancies arise.

- **Recognizing / disclosing key related parties** - Related party problems sometimes arise due to a failure to recognize such parties. To address this issue, it is important for audit firms to highlight RPT issues to the entire audit team as described in SAS No. 45, *Related Parties*. The entire team should understand the importance of identifying RPTs and should have full knowledge of which parties are related to the client in order to ensure that the client's financial statements materially comply with the provisions of FASB Statement No. 57, *Related Party Disclosures.*

- **Relying on internal controls (over-relying / failing to react to known control weaknesses)** - A number of cases involved auditors documenting significant control problems and then failing to adjust the audit plan in light of the control problems. Two issues that deserve consideration from audit firms are (a) does the audit approach force the auditor to "map" control problems forward into additional testing?, and (b) does the emphasis on time budgets create a strong incentive for auditors not to adjust other audit testing even when control problems are documented? It is possible that additional decision aids or some change in the weight placed on meeting the time budget could be helpful in this area to ensure the audit team complies with the guidance contained in SAS No. 55, *Consideration of Internal Control in Financial Statement Audit*, as amended by SAS No. 78.

- **Independence from client** - Most of the independence violations involved smaller audit firms that provided management or accounting services to audit clients. Audit firms need to carefully consider the nature of bookkeeping services provided to clients to ensure that the audit firm is not auditing its own work.

- **Supervising and reviewing engagement** - Inadequate supervision of staff auditors was cited in a number of cases. Such cases often involved over-reliance on staff auditors with no prior audit experience. Continuous oversight of staff auditors is critical, as described in SAS No. 22, *Planning and Supervision.* In terms of review, most of the issues dealt with inadequate partner review or second partner review. In some cases, the engagement partner and the second partner both were sanctioned by the SEC. Other research in accounting also has suggested that working paper review by partners sometimes may be inadequate. In one case the audit manager reluctantly signed-off on audit workpapers due to perceived pressures being placed on the manager by the engagement partner to complete the audit. In that case, the audit manager voiced concerns about high risks of misstatements, but conceded to the pressures being imposed to finish the engagement. Audit firms may need to evaluate what types of procedures, incentives, and lack of penalties are noted in firm policies and procedures to ensure that lower level personnel do not succumb to pressures from more senior engagement personnel to sign-off on working papers when there are known concerns about management integrity and fraud risk.

- **Preparing working paper documentation (inadequate or inconsistent working papers)** - Given the apparent trend away from extensive working paper documentation on the part of some audit firms today, the implication of the SEC sanctions involving working papers is unclear. At a minimum, it is important for auditors to review their files for inconsistencies and for areas where a reader would not be able to assess what testing was done. Guidance contained in SAS No. 31, *Evidential Matter*, and SAS No. 41, *Working Papers*, is pertinent to this issue, particularly when evidence collected exists or is documented exclusively in electronic form.

This analysis of fraud-related SEC enforcement actions occurring from January 1987 – December 1997 summarizes common engagement characteristics and highlights recurring deficiencies in the audit process. This study updates knowledge of alleged audit failures related to financial statement fraud by focusing on alleged audit problems throughout most of the 1990s. We hope that the summary of findings and the related analysis of implications will be useful to practitioners who desire to increase audit quality, particularly their detection of material misstatements due to fraud, and to standard-setters who continually evaluate the relevance of existing professional guidance on the audit process.

SECTION V -- Research Team

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Mark S. Beasley is an Associate Professor in the Department of Accounting at North Carolina State University where he teaches auditing courses in the undergraduate and masters programs. He is a member of NC State's Academy of Outstanding Teachers.

Dr. Beasley has actively conducted research related to the problem of financial statement fraud by examining the relation between board of director characteristics and instances of financial statement fraud. That study, published in *The Accounting Review*, was the recipient of the American Accounting Association's Competitive Manuscript Award. He has also conducted research addressing other board of director and audit committee issues, auditor quality issues, and the use of analytical procedures in multilocation companies. His work has been published in journals such as the *Journal of Accounting Research, Auditing: A Journal of Practice & Theory, Journal of the American Taxation Association, Journal of Accountancy, Strategic Finance, Internal Auditing,* and *The CPA Journal*. He currently serves on the editorial boards of *Auditing: A Journal of Practice & Theory* and *Journal of Forensic Accounting.*

Dr. Beasley is the co-author of several continuing education courses designed for accounting practitioners, which provide technical updates on emerging auditing issues. He also is the co-author of an auditing textbook and an auditing casebook. In addition, he is currently serving on the Fraud Standard Steering Task Force of the AICPA's Auditing Standards Board. That task force is charged with coordinating research related to the effectiveness of SAS No. 82. Dr. Beasley is also a Fellow of the Corporate Governance Center in the Coles College of Business at Kennesaw State University.

Prior to beginning his career at NC State, Dr. Beasley served as a Technical Manager in the Audit and Attest Division of the AICPA. In that role he assisted the Auditing Standards Board during the issuance of the "expectation gap" Statements on Auditing Standards, which included SAS No. 53. Before joining the AICPA, he was an Audit Manager in the Nashville, Tennessee office of Ernst & Young.

Dr. Beasley is a member of the American Accounting Association and the American Institute of Certified Public Accountants. He currently serves as Treasurer of the Auditing Section of the American Accounting Association. Dr. Beasley received a BS in accounting from Auburn University and a Ph.D. from Michigan State University.

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Dr. Carcello is an active researcher who has authored or co-authored over 20 refereed journal articles in journals such as *The Accounting Review*, *Journal of Accounting Research, Contemporary Accounting Research, Auditing: A Journal of Practice & Theory*, *Accounting Horizons, Behavioral Research in Accounting*, and the *Journal of Accountancy*. He has conducted extensive research involving fraud, corporate bankruptcy filings by publicly-held companies, and audit committee issues. He currently serves on the editorial boards of *Auditing: A Journal of Practice & Theory, Issues in Accounting Education,* and *Journal of Forensic Accounting.*

Dr. Carcello has led professional development sessions for two of the Big 5 firms. He is the co-author of the 2000 *Miller GAAP Implementation Manual.* Dr. Carcello is serving as a member of the Independence Standards Board's task force, "Accepting Employment with an Audit Client." He is also a Fellow of the Corporate Governance Center in the Coles College of Business at Kennesaw State University.

Dr. Carcello is an active member of the American Accounting Association where he has served as the Treasurer of the Auditing Section. He is also a member of the American Institute of Certified Public Accountants, the Institute of Internal Auditors, the Institute of Management Accountants, and the Association of Certified Fraud Examiners. Dr. Carcello received a BS in accounting from SUNY - Plattsburgh, a MACC degree from The University of Georgia and a Ph.D. from Georgia State University. Prior to joining the faculty at the University of Tennessee, he was a faculty member at the University of North Florida after previously working in the Atlanta office of Ernst & Young.

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Dr. Hermanson's research addresses issues related to auditor reporting, financial fraud, audit quality, internal control, information technology, and accounting education. His publications include approximately 40 articles in refereed journals. He has published in such journals as *Contemporary Accounting Research, Auditing: A Journal of Practice & Theory, Accounting Horizons, Behavioral Research in Accounting, Journal of Information Systems, Issues in Accounting Education,* and *Journal of Accountancy*. He currently serves on the editorial boards of *Auditing: A Journal of Practice & Theory, Issues in Accounting Education,* and *Journal of Forensic Accounting.*

Dr. Hermanson was a member of the National Association of Corporate Directors' *Blue Ribbon Commission on Audit Committees*. The Commission's report contains recommendations and practical guidelines for improving audit committee effectiveness. Dr. Hermanson also serves on the Professional Issues Committee of the Institute of Internal Auditors.

Through the Corporate Governance Center, Dr. Hermanson has provided director education programs to U.S. and international groups. He has received several awards for his contributions in research, teaching, and professional service, including the *1999 Kennesaw State University Distinguished Scholar Award* and the *2000 Kennesaw State University Distinguished Service Award.*

Dr. Hermanson is a member of the American Accounting Association, American Institute of Certified Public Accountants, Institute of Internal Auditors, Institute of Management Accountants, and National Association of Corporate Directors. Dr. Hermanson received a BBA (First Honor Graduate) in accounting from The University of Georgia and a Ph.D. from The University of Wisconsin. Prior to joining the faculty at Kennesaw State University, he worked in the Atlanta office of Ernst & Young.

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