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# CONTEMPORARY AUDITING



**Michael C. Knapp**



# **CONTEMPORARY AUDITING**

## ***REAL ISSUES AND CASES***

Eleventh Edition



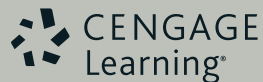
# **CONTEMPORARY AUDITING**

## ***REAL ISSUES AND CASES***

Eleventh Edition

**Michael C. Knapp**

*University of Oklahoma*



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Australia • Brazil • Japan • Korea • Mexico • Singapore • Spain • United Kingdom • United States

**Contemporary Auditing: Real Issues  
and Cases, Eleventh Edition**  
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# DEDICATION

To Emmie, Kasen, Teagan, and Warren



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## **SECTION 1**    **Comprehensive Cases** **1**

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### **Case 1.1**    **Enron Corporation** **3**

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

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

### **Case 1.2**    **Lehman Brothers Holdings, Inc.** **23**

*Wall Street was stunned in September 2008 when this iconic investment banking firm filed for bankruptcy. Lehman’s bankruptcy examiner charged that the company had engaged in tens of billions of dollars of “accounting-motivated” transactions to enhance its apparent financial condition.*

**KEY TOPICS:** “accounting-motivated” transactions, materiality decisions by auditors, responsibility of auditors to investigate whistleblower allegations, auditors’ legal exposure, and communications with audit committee.

### **Case 1.3**    **Just For FEET, Inc.** **39**

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

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

### **Case 1.4**    **Health Management, Inc.** **53**

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

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

**Case 1.5 The Leslie Fay Companies** 71

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

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

**Case 1.6 Le-Nature's Inc.** 83

*Gregory Podlucky founded Le-Nature's in 1989. Over the next 17 years, Le-Nature's consistently ranked among the most rapidly growing beverage companies in the nation. But Le-Nature's financial success was illusory, the product of what a Justice Department official described as a "financial mirage the likes of which I could never even dreamt could have been created."*

**KEY TOPICS:** fraud triangle, COSO internal control framework, corporate governance, auditor changes, quarterly reviews, and forensic accounting.

**Case 1.7 Navistar International Corporation** 93

*The Navistar case resulted in the first formal investigation of a Big Four firm by the PCAOB and played a role in prompting that agency to consider implementing mandatory audit firm rotation. Prior to being dismissed in 2006, Deloitte had served as Navistar's auditor for 98 years.*

**KEY TOPICS:** PCAOB's regulatory responsibilities, auditor rotation, auditor independence, material internal control weaknesses, materiality, quality controls for audit firms, and auditors' civil liability.

**Case 1.8 Livent, Inc.** 107

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

**KEY TOPICS:** identifying audit risk factors, the role and responsibilities of an audit engagement partner, criminal and civil liability of auditors, hiring of auditors by clients, substance-over-form concept, and due diligence investigations by auditors.

**Case 1.9 ZZZZ Best Company, Inc.** 121

*Barry Minkow, the "boy wonder" of Wall Street, created a \$200,000,000 company that existed only on paper.*

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

---

**Case 1.10** DHB Industries, Inc. 135

*“You can’t make up a story like this,” observed a senior legal analyst for CBS News who tracked and reported on this outrageous financial fraud that involved a freewheeling executive who covertly used funds from the company he founded to finance his horse-racing hobby.*

**KEY TOPICS:** auditor changes, management integrity, inventory fraud, SEC regulatory responsibilities, financial reporting controls, materiality, related-party transactions, and audit committee responsibilities.

---

**Case 1.11** New Century Financial Corporation 151

*The collapse of New Century Financial Corporation in April 2007 signaled the beginning of the subprime mortgage crisis in the United States, a crisis that would destabilize securities and credit markets around the globe. New Century’s independent auditors failed to provide advance warning of the mortgage company’s demise.*

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

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**Case 1.12** Madoff Securities 169

*As an adolescent, Bernie Madoff dreamed of “making it big” on Wall Street. Madoff realized his dream by overseeing the world’s largest and possibly longest running Ponzi scheme. Madoff’s auditor pleaded guilty to various criminal charges for his role in that fraud.*

**KEY TOPICS:** factors common to financial frauds, regulatory role of the SEC, nature and purpose of peer reviews, audit procedures for investments, and the importance of the independent audit function.

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**Case 1.13** AA Capital Partners, Inc. 179

*The SEC held the AA Capital audit engagement partner and audit manager responsible for failing to uncover an embezzlement scheme masterminded by one of the company’s executives. A federal judge subsequently cleared the AA Capital audit partner—but not the audit manager.*

**KEY TOPICS:** related-party transactions, the division of responsibilities on audit engagement teams, the nature and purpose of subsequent period audit tests, reliance on a client’s internal controls, and quality control measures for audit firms.

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**Case 2.1** Jack Greenberg, Inc. 191

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

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**Case 2.2** Golden Bear Golf, Inc. 199

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

- Case 2.3** **Take-Two Interactive Software, Inc.** 207  
*Take-Two markets Grand Theft Auto, the sixth best-selling video game “franchise” of all time and easily one of the most controversial. In a span of a few years, Take-Two was forced to restate its financial statements three times after recording bogus sales and back-dating stock options.*
- Case 2.4** **General Motors Company** 215  
*In early 2009, the SEC released the results of a lengthy investigation of GM’s financial statements over the previous several years. A major focus of that investigation was GM’s questionable accounting decisions for its massive pension liabilities and expenses.*
- Case 2.5** **Lipper Holdings, LLC** 221  
*Lipper’s auditors were criticized for failing to uncover a fraudulent scheme used by a portfolio manager to materially inflate the market values of investments owned by three of the company’s largest hedge funds.*
- Case 2.6** **CBI Holding Company, Inc.** 229  
*This case focuses on audit procedures applied to accounts payable, including the search for unrecorded liabilities and the reconciliation of year-end vendor statements to recorded payables balances.*
- Case 2.7** **Bankrate, Inc.** 235  
*In late 2015, the SEC fined Bankrate \$15 million for a large-scale accounting scam that had allowed the company to surpass a consensus earnings forecast issued by Wall Street analysts. Ironically, among the items that Bankrate improperly accounted for were company audit fees and expenditures incurred for control provisions mandated by the Sarbanes-Oxley Act.*
- Case 2.8** **Belot Enterprises** 241  
*Understating discretionary expense accruals is a common method used by self-interested corporate executives to enhance their company’s financial statements. In this case, Belot “juggled” the period-ending balances of five major expense accruals to achieve an earnings goal established by the company’s new chief operating officer.*
- Case 2.9** **Powder River Petroleum International, Inc.** 247  
*A new management team implemented a successful turnaround strategy for Powder River. Unfortunately, the lynchpin of that strategy was an international Ponzi scheme involving the sale of “working interests” in Powder River’s oil and gas properties.*
- Case 2.10** **LocatePlus Holdings Corporation** 257  
*The New Age business model of LocatePlus revolved around a huge database that contained information profiles for 98 percent of all U.S. citizens. In contrast, LocatePlus executives used an old-fashioned fraud scheme to inflate the company’s reported revenues.*

<b>Case 2.11</b>	<b>Overstock.com, Inc.</b>	<b>263</b>
	<i>Patrick Byrne, a bon vivant and protégé of Warren Buffet, founded Overstock in 1999. A decade later, a questionable gain contingency recorded by Overstock sparked a dispute between Byrne and his company’s audit firm. That dispute spawned a series of public and contentious exchanges between the two parties.</i>	
<b>Case 2.12</b>	<b>Parker-Halsey Corporation</b>	<b>271</b>
	<i>An inventory observation involving two teams of auditors from different accounting firms produces an angry, three-way confrontation when significant errors are uncovered in the client’s recorded inventory quantities.</i>	
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<b>Case 3.1</b>	<b>The Trolley Dodgers</b>	<b>287</b>
	<i>Control deficiencies in the Dodgers’ payroll transaction cycle allowed an accounting manager to embezzle several hundred thousand dollars.</i>	
<b>Case 3.2</b>	<b>Howard Street Jewelers, Inc.</b>	<b>289</b>
	<i>Given the susceptibility of cash to theft, retail companies typically establish rigorous internal controls for their cash processing functions. This case documents the high price of failing to implement such controls.</i>	
<b>Case 3.3</b>	<b>Avon Products, Inc.</b>	<b>291</b>
	<i>In December 2014, the SEC levied almost \$135 million of fines against Avon for violating the bribery and internal control provisions of the Foreign Corrupt Practices Act. The scandal also cost five senior Avon executives their jobs, including CEO Andrea Jung, one of the most influential women in Corporate America.</i>	
<b>Case 3.4</b>	<b>First Keystone Bank</b>	<b>299</b>
	<i>Three tellers of a First Keystone Bank branch embezzled more than \$100,000 from the branch’s ATM. The district attorney who prosecuted the tellers commented on the need for businesses to not only establish internal controls to protect their assets but also on the importance of ensuring that those controls are operational.</i>	
<b>Case 3.5</b>	<b>Goodner Brothers, Inc.</b>	<b>303</b>
	<i>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.</i>	
<b>Case 3.6</b>	<b>Buranello’s Ristorante</b>	<b>311</b>
	<i>The general manager of Buranello’s set up a “sting” operation—with the owner’s approval—to test the honesty of the employee who he believed was stealing from the business. But the plan backfired, and Buranello’s eventually found itself on the wrong end of a “malicious prosecution” lawsuit.</i>	



<b>Case 3.7</b>	<b>Saks Fifth Avenue</b>	<b>317</b>
	<i>A sales clerk tested Saks' "zero tolerance" policy for employee theft in this case. After being dismissed, the employee tested Saks again by suing the firm for wrongful termination.</i>	
<b>Case 3.8</b>	<b>The Boeing Company</b>	<b>321</b>
	<i>Two Boeing internal auditors disclosed information regarding alleged problems in their employer's internal controls to a newspaper reporter. After being fired, the two individuals filed lawsuits against Boeing under the whistleblowing provisions embedded in the Sarbanes–Oxley Act.</i>	
<b>Case 3.9</b>	<b>Walmart de Mexico</b>	<b>327</b>
	<i>A Pulitzer Prize-winning article in the New York Times charged that Walmart became Mexico's dominant mass merchandiser by routinely bribing government officials.</i>	
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<b>Case 4.1</b>	<b>Creve Couer Pizza, Inc.</b>	<b>335</b>
	<i>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.</i>	
<b>Case 4.2</b>	<b>F&amp;C International, Inc.</b>	<b>339</b>
	<i>A financial fraud spelled the end of a company with a proud history and tested the ethics of several of its key management and accounting personnel.</i>	
<b>Case 4.3</b>	<b>Suzette Washington, Accounting Major</b>	<b>343</b>
	<i>Suzette Washington, a college senior majoring in accounting, faces an ethical dilemma. 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?</i>	
<b>Case 4.4</b>	<b>Freescale Semiconductor, Inc.</b>	<b>345</b>
	<i>Partners and employees of accounting firms often have access to confidential client information that they could use to gain an unfair advantage over other investors. In recent years, law enforcement authorities have filed insider trading charges against several public accountants, including a partner assigned to a professional services engagement for Freescale.</i>	
<b>Case 4.5</b>	<b>Wiley Jackson, Accounting Major</b>	<b>349</b>
	<i>"To tell or not to tell" was the gist of an ethical dilemma faced by Wiley Jackson while completing a preemployment document for his future employer, a major accounting firm.</i>	

- Case 4.6** Arvel Smart, Accounting Major 351  
*Should an accounting major accept an internship position offered to him by a prospective employer when he has already decided to accept a job offer for a permanent position with another firm following graduation?*
- Case 4.7** Zane Corbin, Accounting Major 353  
*In recent years, “resume padding” has been costly to many politicians and other public officials. In this case, Zane Corbin faces an academic misconduct charge for allegedly embellishing the vita he submitted to a faculty awards committee after he was nominated for a prestigious undergraduate honor.*
- Case 4.8** Dell Inc. 359  
*This case explores ethical issues raised by a pervasive earnings management scheme masterminded by Dell executives, including Michael Dell.*
- SECTION 5 Ethical Responsibilities of Independent Auditors 363**
- Case 5.1** Cardillo Travel Systems, Inc. 365  
*Cardillo’s chief executive pressured and manipulated three accountants—the company’s controller and two audit engagement partners—to conceal the fraudulent nature of an accounting entry.*
- Case 5.2** American International Group, Inc. 371  
*AIG is best known for receiving more federal “bailout” funds than any other company during the economic crisis that engulfed the U.S. economy beginning in the fall of 2008. Several years earlier, AIG had been widely criticized for helping companies develop special purpose entities (SPEs) to “window dress” their financial statements. Surprisingly, Ernst & Young partnered with AIG in developing and marketing that SPE “service.”*
- Case 5.3** Caesars Entertainment Corporation 375  
*The advisory partner assigned to the Caesars audit engagement team “gambled” with his firm’s independence when he borrowed funds on multiple occasions from a Caesars casino.*
- Case 5.4** IPOC International Growth Fund, Ltd. 379  
*In this case, a KPMG employee became an unwitting pawn in an international chess match of corporate espionage and murder involving a close associate of Vladimir Putin, the Russian president at the time.*
- Case 5.5** Le-Nature’s Inc., Part II 385  
*An audit partner of a major accounting firm faced tax evasion charges after deducting fraudulent travel expenses on his federal income tax returns for three consecutive years.*

<b>Case 5.6</b>	<b>Richard Grimes, Staff Accountant</b>	<b>389</b>
	<i>An entry-level auditor overhears a private conversation between two corporate executives who intend to withhold critical information from their company's audit team. What should the young auditor do?</i>	
<b>SECTION 6</b>	<b>Professional Roles</b>	<b>391</b>
<b>Case 6.1</b>	<b>Leigh Ann Walker, Staff Accountant</b>	<b>393</b>
	<i>A staff accountant employed by a large accounting firm is dismissed after serious questions arise regarding her integrity.</i>	
<b>Case 6.2</b>	<b>Bill DeBurger, In-Charge Accountant</b>	<b>395</b>
	<i>To "sign off" or "not sign off" was the issue Bill DeBurger wrestled with after he completed the audit procedures for a client's most important account. An angry confrontation with the audit engagement partner made Bill's decision even more difficult.</i>	
<b>Case 6.3</b>	<b>Hamilton Wong, In-Charge Accountant</b>	<b>399</b>
	<i>"Eating time," or underreporting time worked on audit engagements, has serious implications for the quality of audit services and for the quality of auditors' work environment. Hamilton Wong came face-to-face with these issues when a colleague insisted on understating the number of hours she had worked on her assignments.</i>	
<b>Case 6.4</b>	<b>Tommy O'Connell, Audit Senior</b>	<b>403</b>
	<i>A new audit senior is quickly exposed to the challenging responsibilities of his professional work role when he is assigned to supervise a difficult audit engagement. During the audit, the senior must deal with the possibility that a staff accountant is "signing off" on audit procedures that he has not completed.</i>	
<b>Case 6.5</b>	<b>Avis Love, Staff Accountant</b>	<b>407</b>
	<i>Auditors sometimes develop close friendships with client personnel. Such friendships can prove problematic for auditors, as demonstrated by this case.</i>	
<b>Case 6.6</b>	<b>Charles Tollison, Audit Manager</b>	<b>411</b>
	<i>Audit managers occupy an important role on audit engagements and are a critical link in the employment hierarchy of public accounting firms. Similar to other professional accountants occupying this position, however, Charles Tollison aspired to being promoted to partner.</i>	
<b>Case 6.7</b>	<b>Madison Wells, Audit Manager</b>	<b>415</b>
	<i>Madison Wells discovers an error in a client's financial statements—three days after the client filed those financial statements with the SEC. That discovery prompts the audit engagement partner to verbally abuse Madison.</i>	

<b>Case 6.8</b>	<b>Tillman Rollins, Office Managing Partner</b>	<b>425</b>
	<i>Tillman Rollins oversees a small and remote practice office of a Big Four accounting firm. As OMP, the “buck” stops with Rollins when it comes to employment decisions for his office. In this case, the loss of a major client forces him to dismiss a well-liked and industrious staff accountant.</i>	
<b>SECTION 7</b>	<b>Professional Issues</b>	<b>431</b>
<b>Case 7.1</b>	<b>Ligand Pharmaceuticals</b>	<b>433</b>
	<i>Ligand’s auditor was the first Big Four firm sanctioned by the Public Company Accounting Oversight Board (PCAOB).</i>	
<b>Case 7.2</b>	<b>Sarah Russell, Staff Accountant</b>	<b>439</b>
	<i>Sexual harassment is a sensitive subject that many companies and professional firms have been forced to contend with in recent years. This case recounts the experiences of a staff accountant who was harassed by an audit partner.</i>	
<b>Case 7.3</b>	<b>Washington Council Ernst &amp; Young</b>	<b>443</b>
	<i>In 2012, investigative reporters for Reuters, the London-based international news agency, discovered that a division of Ernst &amp; Young had provided lobbying services to multiple audit clients of the Big Four accounting firm.</i>	
<b>Case 7.4</b>	<b>Internet Infamy</b>	<b>449</b>
	<i>Email reigned as the first “killer app” of the Internet. Unfortunately, improper email etiquette can serve to “kill” or, at least, severely hamper the careers of accountants as proven by the anecdotes woven into this case.</i>	
<b>Case 7.5</b>	<b>Fred Stern &amp; Company, Inc. (Ultramares Corporation v. Touche et al.)</b>	<b>453</b>
	<i>This 1931 legal case established the Ultramares Doctrine that, decades later, has a pervasive influence on auditors’ civil liability under the common law.</i>	
<b>Case 7.6</b>	<b>First Securities Company of Chicago (Ernst &amp; Ernst v. Hochfelder et al.)</b>	<b>461</b>
	<i>In this case, the Supreme Court defined the degree of auditor misconduct that must be present before a client can recover damages from an auditor in a lawsuit filed under the Securities Exchange Act of 1934.</i>	
<b>Case 7.7</b>	<b>Texas Drug Warehouse</b>	<b>467</b>
	<i>In the late 1990s, KPMG found itself a defendant in a lawsuit filed by a former client. Among other allegations, the former client charged that KPMG had engaged in “deceptive business practices” by failing to inform client management that it planned to change the scope and nature of its annual audit of the company.</i>	

**Case 7.8** Frank Coleman, Staff Accountant 471

*In recent years, the major international accounting firms have been confronted with huge class-action lawsuits alleging that they did not properly compensate certain employees for the overtime hours that they had worked.*

**Case 7.9** Olivia Thomas, Audit Senior 475

*Intra-office dating is a taboo topic in many, if not most, professional services firms. This case demonstrates how intra-office dating can impact the performance of independent audits and complicate the personal and professional lives of auditors.*

**SECTION 8 International Cases 483**

**Case 8.1** Longtop Financial Technologies Limited 485

*The Longtop fraud focused attention on an issue that had been simmering within the regulatory system of the U.S. capital markets for several years, namely, the refusal of the Chinese government to allow the PCAOB to inspect Chinese accounting firms that audit companies with securities traded on U.S. stock exchanges.*

**Case 8.2** Kaset Thai Sugar Company 491

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

**Case 8.3** Republic of Somalia 495

*PricewaterhouseCoopers (PwC) accepted a lucrative, unusual, and controversial engagement for the transitional government established for the Republic of Somalia by the United Nations. The case questions require students to consider the significant risks and thorny ethical issues that engagement posed for PwC.*

**Case 8.4** Republic of the Sudan 499

*In 2004, the SEC began requiring domestic and foreign registrants to disclose any business operations within, or other relationships with, Sudan and other countries identified as state sponsors of terrorism. Three years later, the SEC included a webpage on its EDGAR website that listed all such companies. This SEC “blacklist” proved to be extremely controversial and triggered a contentious debate over the federal agency’s regulatory mandate and its definition of “materiality.”*

**Case 8.5** Shari’a 505

*Islamic companies are prohibited from engaging in transactions that violate Shari’a, that is, Islamic religious law. To ensure that they have complied with Shari’a, Islamic companies have their operations subjected to a Shari’a compliance audit each year. Recently, Big Four firms have begun offering Shari’a audit services.*

**Case 8.6** Olympus Corporation 515

*This case documents the long-running Olympus accounting fraud that shocked the Japanese business community. In addition to other issues, the case examines systemic weaknesses in Japan's independent audit function.*

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# PREFACE

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The past two decades have been one of the most turbulent time periods in the history of the accounting profession and the independent audit function. Shortly after the turn of the century, the Enron and WorldCom fiascoes focused the attention of the investing public, the press, Wall Street, and, eventually, Congress, on our profession. The Enron and WorldCom scandals resulted in the passage of the Sarbanes–Oxley Act of 2002 (SOX) and the creation of the Public Company Accounting Oversight Board (PCAOB). The SOX statute imposed a litany of new responsibilities and constraints on auditors of public companies, including the need to audit their clients’ internal controls and prohibiting them from providing certain consulting services to their clients.

Next came the campaign to replace U.S. generally accepted accounting principles (GAAP) with International Financial Reporting Standards (IFRS). That campaign stalled when the subprime mortgage crisis in the United States caused global stock markets to implode and global credit markets to “freeze” during the fall of 2008. This economic downturn claimed many companies that had been stalwarts of the U.S. economy, the prime example being Lehman Brothers. Most of these companies, including Lehman Brothers, had received “clean” audit opinions on their financial statements one year or less before they collapsed.

As Congress and regulatory authorities struggled to revive the U.S. economy, news of the largest Ponzi scheme in world history grabbed the headlines in early 2009. Investors worldwide were shocked to learn that Bernie Madoff, an alleged “wizard of Wall Street,” was a fraud. Law enforcement authorities determined that billions of dollars of client investments supposedly being held by Madoff’s company, Madoff Securities, did not exist. The business press was quick to report that for decades Madoff Securities’ financial statements had received unqualified audit opinions each year from a New York accounting firm. The auditing discipline absorbed another body blow in 2010 when a court-appointed bankruptcy examiner publicly singled out Lehman Brothers’ former audit firm as one of the parties allegedly most responsible for the massive financial losses produced by the collapse of that Wall Street investment bank.

More recently, the aggressive regulatory stance taken by the PCAOB has resulted in public reprimands for several of the large accounting firms that dominate the auditing discipline. Additionally, the PCAOB’s proposal to consider mandatory rotation for public company audit firms stirred a far-reaching controversy in the profession that ultimately prompted the U.S. Congress to weigh in on the issue.

As academics, we have a responsibility to help shepherd our profession through these turbulent times. Auditing instructors, in particular, have an obligation to help restore the credibility of the independent audit function that has been adversely impacted by recent events. To accomplish this latter goal, one strategy we can use is to adopt the reforms recommended years ago by the Accounting Education Change



Commission (AECC), many of which have been embraced by the more recent Pathways Commission, a joint project of the American Institute of Certified Public Accountants and the American Accounting Association. Among the AECC's recommendations was that accounting educators employ a broader array of instructional resources, particularly experiential resources, designed to stimulate active learning by students. 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," 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 or auditors who fail to carry out the responsibilities assigned to them. Exposing students to problem audits will help them recognize the red flags that often accompany audit failures. An ability to recognize these red flags and the insight gained by discussing and dissecting problem audits will allow students to cope more effectively with the problematic situations they are certain to encounter in their own careers. In addition, this experiential approach provides students with context-specific situations that make it much easier for them to grasp the relevance of important auditing topics, concepts, and procedures.

The cases in this text also acquaint students with the work environment of auditors. After studying these cases, students will better appreciate how client pressure, peer pressure, time budgets, and related factors complicate the work roles of independent auditors. Also embedded in these cases is the ambiguity and lack of structure that auditors face each day. Aspects of the audit environment representing those two conditions that are woven into my cases include 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.

The eleventh edition of my casebook contains the following eight sections of cases: Comprehensive Cases, Audits of High-Risk Accounts, Internal Control Issues, Ethical Responsibilities of Accountants, Ethical Responsibilities of Independent Auditors, Professional Roles, Professional Issues, and International Cases. This organizational structure helps adopters readily identify cases best suited for their particular needs.

My 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. This casebook can also be used in the capstone professional practice course incorporated in many five-year accounting programs. Customized versions of this casebook are suitable for a wide range of accounting courses as explained later.

In preparing this edition, I retained those cases that have been among the most widely used by adopters. These cases include, among others, Enron Corporation,

Golden Bear Golf, Lehman Brothers, Leigh Ann Walker, Madoff Securities, The Trolley Dodgers, and ZZZZ Best Company. You will find that many of the “returning” cases have been updated for relevant circumstances and events that have occurred since the publication of the previous edition.

**New To This Edition** This edition features 15 new cases. One of these new cases, Le-Nature’s Inc., is a Comprehensive case. Gregory Podlucky, a former CPA, founded Le-Nature’s in 1989 as a water-bottling business but soon expanded the company’s product line to include flavored water, fruit, and tea drinks. Despite operating in the hypercompetitive beverage industry, Le-Nature’s revenues grew rapidly with reported sales of nearly \$300 million by 2005. Podlucky financed his company’s rapid growth almost exclusively with debt capital including high-yield “junk” bonds, a large revolving line of credit, and innovative equipment leases. Trouble appeared on the horizon in late 2003 when two senior executives resigned and then informed the company’s Ernst & Young audit engagement partner that they doubted the reliability of Le-Nature’s accounting records. A subsequent forensic accounting investigation demanded by Ernst & Young resulted in a clean bill of health for the company—and the dismissal of Ernst & Young as Le-Nature’s audit firm. Three years later, allegations of accounting fraud surfaced again. A court-appointed custodian quickly discovered that Le-Nature’s accounting records were, in fact, fraudulent. In 2005, for example, Podlucky and his co-conspirators fabricated approximately 90 percent of the company’s reported revenues. Subsequent criminal charges resulted in Podlucky and several of his family members and business associates receiving prison sentences. In addition to exploring a range of accounting and auditing issues, this case highlights the corporate governance responsibilities of Le-Nature’s management team and how those responsibilities articulated with the professional responsibilities of the company’s accountants, forensic accountants, and independent auditors.

Five of the new cases in this edition are included in two sections of my casebook that historically have been among the most popular among adopters: Audits of High-Risk Accounts and Internal Control Issues. New cases in the Audits of High-Risk Accounts section include Bankrate, Overstock.com, and Parker-Halsey Corporation. The Bankrate case highlights the immense pressure imposed on corporate executives to reach or surpass the quarterly earnings forecasts issued for their companies by Wall Street analysts. Bankrate executives used a variety of creative methods to conceal the company’s overstated profits from their independent auditors. Overstock’s senior management and the company’s former auditors engaged in a contentious and public war of words over a dispute that arose regarding the proper accounting treatment for a revenue transaction. The Parker-Halsey case introduces students to inventory observation procedures. An audit manager in that case refuses to wilt under relentless pressure after discovering apparent irregularities in the client’s recorded quantities for a valuable inventory item.

Avon Products and Saks Fifth Avenue are the new cases in the Internal Control Issues section. The SEC slapped Avon with fines totaling nearly \$135 million for violating

the anti-bribery and internal control provisions of the Foreign Corrupt Practices Act. Casualties of the Avon scandal included Andrea Jung, the company's prominent CEO. Saks Fifth Avenue is a refurbished case that appeared in an earlier edition of my casebook. This case examines Saks' "zero tolerance" policy for employee theft and the measures that companies should have in place to protect and promote the civil rights of their employees.

This edition of my casebook includes three new cases in the two sections that focus on ethical issues. Zane Corbin, Accounting Major is new to Section 4, Ethical Responsibilities of Accountants. Mr. Corbin finds himself in "hot water" after being chosen the outstanding senior of his graduating class. Why? Because the vita he submitted to the faculty awards committee had been embellished. The new Caesars Entertainment case in Section 5 focuses on a Deloitte & Touche audit partner who also served as the Chief Risk Officer for Deloitte's parent firm. Unknown to his fellow partners, this individual borrowed significant funds from a Caesars casino while he was serving as the advisory partner on the Caesars audit engagement team. Section 5 also includes Le-Nature's Inc., Part II, which focuses on a feature of the Le-Nature's accounting scandal not dealt with by the related Comprehensive case in Section 1. As the brouhaha over Le-Nature's fraud churned, federal authorities launched a parallel criminal investigation of the company's audit engagement partner. That investigation resulted in the partner being charged with filing fraudulent income tax returns with the IRS.

Section 6 contains two cases new to this edition: Madison Wells, Audit Manager, and Tillman Rollins, Office Managing Partner. The Madison Wells case revolves around a perfect storm of circumstances that culminated in an audit engagement team failing to discover that the audit client had violated certain debt covenants at year-end, violations that should have resulted in the company's long-term debt being reclassified as a current liability. When Madison Wells learned of this material error following the filing of the company's financial statements with the SEC, she knew that her immediate superior on that engagement would be angry—and he was. Tillman Rollins serves as the office managing partner (OMP) of a small and remote Big Four practice office. A vexing and recurring problem facing Rollins is ensuring that the professional staff of his office is "right-sized." Rollins upsets key subordinates when a staff shortage prompts him to hire a young man with questionable credentials. Those same staff members are even more distressed when Rollins fires that young man at the conclusion of the office's winter busy season.

New cases in Section 7, Professional Issues, include Washington Council Ernst & Young, Internet Infamy, and Texas Drug Warehouse. In early 2012, three investigative reporters for Reuters discovered that a division of Ernst & Young had provided lobbying services to certain audit clients of the Big Four firm. That discovery ultimately led to the SEC fining Ernst & Young \$4 million. The Internet Infamy case weaves together a series of anecdotes involving poor email etiquette by several young members of the accounting profession. Those individuals quickly learned that social miscues made on the information superhighway can be extremely damaging to one's career.

Texas Drug Warehouse is the second and final refurbished case in this edition of my casebook. In this case, a former audit client sues KPMG for negligence and for engaging in “deceptive business practices.” The basis of the latter complaint was KPMG’s failure to inform the client of major staffing and budgeting changes for the client’s annual audit.

The final case new to this edition is an international case, Olympus Corporation. In 2011, Michael Woodford, a British citizen, became the first foreign-born CEO of a Nikkei 225 company when he assumed the reins of Tokyo-based Olympus, which is best known for its line of digital cameras. Woodford’s tenure lasted all of two weeks. Olympus’s board dismissed Woodford after he insisted on investigating a series of large and suspicious transactions that he discovered in the company’s accounting records. The former CEO then became a corporate whistleblower. His accusations resulted in the disclosure of a massive accounting fraud within the multinational company. Among the parties that Woodford held responsible for the fraud was Olympus’s Big Four audit firm. Woodford characterized that firm’s Olympus audits as “completely meaningless.”

**Casebook Organization** Listed next are brief descriptions of the eight groups of cases included in this text. 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 the major international accounting firms. Among the clients involved in these audits are Enron Corporation, Lehman Brothers, The Leslie Fay Companies, Livent, Madoff Securities, and ZZZZ Best Company. Each of these cases addresses 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 highlight contentious accounting and auditing issues posed by a single account or group of accounts. For example, the Jack Greenberg case focuses primarily on inventory audit procedures. The Take-Two Interactive Software case raises audit issues relevant to accounts receivable, while the Belot Enterprises case examines auditing issues pertinent to period-ending expense accruals.

*Internal Control Issues* The cases in this section introduce students to internal control topics relevant to the performance of independent audits. These topics are examined in a variety of different client contexts. For example, the Goodner Brothers case focuses on internal control issues for a wholesaler, while the Howard Street Jewelers case provides students an opportunity to discuss control issues relevant to retail businesses.

*Ethical Responsibilities of Accountants* Integrating ethics into an auditing course requires much more than simply discussing the AICPA’s *Code of Professional Conduct*. This section presents specific scenarios in which accountants have been forced to deal with perplexing ethical dilemmas. By requiring students to study actual situations in which important ethical issues have arisen, they will be better prepared to resolve similar situations in their own professional careers. Four of the cases in

this section will “strike close to home” for your students since they involve accounting majors. For example, in the Wiley Jackson case, a soon-to-graduate accounting major must decide whether to disclose in a preemployment document a minor-in-possession charge that is pending against him. Another case in this section, Freescale Semiconductor, addresses an embarrassing series of insider trading cases involving professional accountants.

*Ethical Responsibilities of Independent Auditors* The cases in this section highlight ethical dilemmas encountered by independent auditors. In the Cardillo Travel Systems case, two audit partners face an ethical dilemma that most audit practitioners will experience at some point during their careers. The two partners must decide whether to accept implausible explanations for a suspicious client transaction fed to them by client executives or, alternatively, whether to “complicate” the given engagement by insisting on fully investigating the transaction.

*Professional Roles* Cases in this section examine specific work roles in the auditing discipline. These cases explore the responsibilities associated with those roles and related challenges that professionals occupying them commonly encounter. 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 challenging 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. Two cases in this section spotlight the staff accountant work role, which many of your students will experience firsthand following graduation.

*Professional Issues* These cases address sensitive but important topics in the auditing domain. Two “classic” cases, Fred Stern and First Securities Company, help students understand the significant legal liability facing accounting firms in the present litigious environment. The amount of overtime worked by independent auditors, the “scope of services” issue faced by major accounting firms, and the overarching quality control issues that those same firms must consider are among other topics dealt with by cases in this section.

*International Cases* These cases provide your students with an introduction to important issues facing the global accounting profession and auditing discipline. Several of these cases document unique challenges that must be dealt with by auditors and accountants in certain countries or regions of the world. For example, the Kaset Thai Sugar Company case vividly demonstrates that auditors and accountants may be forced to cope with hostile and sometimes dangerous working conditions in developing countries where their professional roles and responsibilities are not well understood or appreciated. Likewise, the Longtop Financial Technologies case documents how cultural differences across the globe may impact the performance of independent audits.

*Customize Your Own Casebook* To maximize your flexibility in using these cases, Cengage Learning has included *Contemporary Auditing: Real Issues and Cases* in its

customized publishing program, Custom Solutions. Adopters have the option of creating a customized version of this casebook ideally suited for their specific needs. At the University of Oklahoma, a customized selection of my cases has been used to add an ethics component to the undergraduate managerial accounting course. In fact, since the cases in this text examine ethical issues across a wide swath of different contexts, adopters can develop a customized ethics casebook to supplement almost any accounting course.

This casebook is ideally suited to customization for the undergraduate auditing course. For example, auditing instructors who want to add a strong international component to their courses can develop a customized edition of this text that includes a series of international cases. Likewise, to enhance the coverage of ethical issues in the undergraduate auditing course, instructors could choose a series of cases from this text that highlight important ethical issues. Following are several examples of customized versions of this casebook that could be easily integrated into the undergraduate auditing course.

*International Focus:* Longtop Financial Technologies Limited (8.1), Kaset Thai Sugar Company (8.2), Republic of Somalia (8.3), Shari'a (8.5), and Olympus Corporation (8.6). This custom casebook would provide your students with insight on some of the most important issues that major accounting firms face when they enter foreign markets.

*Ethics Focus (I):* Suzette Washington, Accounting Major (4.3), Wiley Jackson, Accounting Major (4.5), Arvel Smart, Accounting Major (4.6), Leigh Ann Walker, Staff Accountant (6.1), Hamilton Wong, In-Charge Accountant (6.3), Avis Love, Staff Accountant (6.5). The first three cases give students an opportunity to discuss and debate ethical issues directly pertinent to them as accounting majors. The final three cases expose students to important ethical issues they may encounter shortly after graduation if they choose to enter public accounting.

*Ethics Focus (II):* Creve Couer Pizza, Inc. (4.1), F&C International, Inc. (4.2), Freescale Semiconductor, Inc. (4.4), American International Group, Inc. (5.2), Richard Grimes, Staff Accountant (5.6). This selection of cases is suitable for auditing instructors who have a particular interest in covering a variety of ethical topics relevant to the AICPA's *Code of Professional Conduct*.

*Applied Focus:* Enron Corporation (1.1), Livent, Inc. (1.8), ZZZZ Best Company, Inc. (1.9), Belot Enterprises (2.8), Cardillo Travel Systems, Inc. (5.1), Caesars Entertainment Corporation (5.3). This series of cases will provide students with a broad-brush introduction to the real world of independent auditing. These cases raise a wide range of technical, professional, and ethical issues in a variety of client contexts.

*Professional Roles Focus:* Leigh Ann Walker, Staff Accountant (6.1), Bill DeBurger, In-Charge Accountant (6.2), Tommy O'Connell, Audit Senior (6.4), Avis Love, Staff Accountant (6.5), Charles Tollison, Audit Manager (6.6), Tillman Rollins, Office Managing Partner (6.8). This custom casebook would be useful for auditing instructors who choose to rely on a standard textbook to cover key technical topics in auditing—but who also want to expose their students to the everyday

ethical and professional challenges faced by individuals occupying various levels of the employment hierarchy within auditing firms.

*High-Risk Accounts Focus:* Each of the cases in Section 2, Audits of High-Risk Accounts. This series of cases will provide your students with relatively intense homework assignments that focus almost exclusively on the financial statement line items that pose the greatest challenges for auditors.

Of course, realize that you are free to choose any “combination” of my cases to include in a customized casebook for an undergraduate auditing course or another accounting course that you teach. For more information on how to design your customized casebook, please contact your Cengage Learning sales representative or visit the textbook website: <http://compose.cengage.com/content/home>

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Ethics, David Ross Boyd Professor,  
and Professor of Accounting  
*University of Oklahoma*

# SECTION 1

# COMPREHENSIVE CASES

A large, bold, black number '1' is centered within a white circle. The circle is set against a dark gray background and has a thin white border.

<b>Case 1.1</b>	Enron Corporation
<b>Case 1.2</b>	Lehman Brothers Holdings, Inc.
<b>Case 1.3</b>	Just for FEET, Inc.
<b>Case 1.4</b>	Health Management, Inc.
<b>Case 1.5</b>	The Leslie Fay Companies
<b>Case 1.6</b>	Le-Nature's Inc.
<b>Case 1.7</b>	Navistar International Corporation
<b>Case 1.8</b>	Livent, Inc.
<b>Case 1.9</b>	ZZZZ Best Company, Inc.
<b>Case 1.10</b>	DHB Industries, Inc.
<b>Case 1.11</b>	New Century Financial Corporation
<b>Case 1.12</b>	Madoff Securities
<b>Case 1.13</b>	AA Capital Partners, Inc.





## CASE 1.1

# Enron Corporation

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John and Mary Andersen immigrated to the United States from their native Norway in 1881. The young couple made their way to the small farming community of Plano, Illinois, some 40 miles southwest of downtown Chicago. Over the previous few decades, hundreds of Norwegian families had settled in Plano and surrounding communities. In fact, the aptly named Norway, Illinois, was located just a few miles away from the couple's new hometown. In 1885, Arthur Edward Andersen was born. From an early age, the Andersens' son had a fascination with numbers. Little did his parents realize that Arthur's interest in numbers would become the driving force in his life. Less than one century after he was born, an accounting firm bearing Arthur Andersen's name would become the world's largest professional services organization with more than 1,000 partners and operations in dozens of countries scattered across the globe.

### Think Straight, Talk Straight

Discipline, honesty, and a strong work ethic were three key traits that John and Mary Andersen instilled in their son. The Andersens also constantly impressed upon him the importance of obtaining an education. Unfortunately, Arthur's parents did not survive to help him achieve that goal. Orphaned by the time he was a young teenager, Andersen was forced to take a full-time job as a mail clerk and attend night classes to work his way through high school. After graduating from high school, Andersen attended the University of Illinois while working as an accountant for Allis-Chalmers, a Chicago-based company that manufactured tractors and other farming equipment. In 1908, Andersen accepted a position with the Chicago office of Price Waterhouse. At the time, Price Waterhouse, which was organized in Great Britain during the early nineteenth century, easily qualified as the United States' most prominent public accounting firm.

At age 23, Andersen became the youngest CPA in the state of Illinois. A few years later, Andersen and a friend, Clarence Delany, established a partnership to provide accounting, auditing, and related services. The two young accountants named their firm Andersen, Delany & Company. When Delany decided to go his own way, Andersen renamed the firm Arthur Andersen & Company.

In 1915, Arthur Andersen faced a dilemma that would help shape the remainder of his professional life. One of his audit clients was a freight company that owned and operated several steam freighters that delivered various commodities to ports located on Lake Michigan. Following the close of the company's fiscal year but before Andersen had issued his audit report on its financial statements, one of the client's ships sank in Lake Michigan. At the time, there were few formal rules for companies to follow in preparing their annual financial statements and certainly no rule that required the company to report a material "subsequent event" occurring after the close of its fiscal year—such as the loss of a major asset. Nevertheless, Andersen insisted that his client disclose the loss of the ship. Andersen reasoned that third parties who would use the company's financial statements, among them the company's banker, would want to be informed of the loss. Although unhappy with Andersen's position, the client eventually acquiesced and reported the loss in the footnotes to its financial statements.

Two decades after the steamship dilemma, Arthur Andersen faced a similar situation with an audit client that was much larger, much more prominent, and much more profitable for his firm. Arthur Andersen & Co. served as the independent auditor for the giant chemical company DuPont. As the company's audit neared completion one year, members of the audit engagement team and executives of DuPont quarreled over how to define the company's operating income. DuPont's management insisted on a liberal definition of operating income that included income earned on certain investments. Arthur Andersen was brought in to arbitrate the dispute. When he sided with his subordinates, DuPont's management team dismissed the firm and hired another auditor.

Throughout his professional career, Arthur E. Andersen relied on a simple, four-word motto to serve as a guiding principle in making important personal and professional decisions: "Think straight, talk straight." Andersen insisted that his partners and other personnel in his firm invoke that simple rule when dealing with clients, potential clients, bankers, regulatory authorities, and any other parties they interacted with while representing Arthur Andersen & Co. He also insisted that audit clients "talk straight" in their financial statements. Former colleagues and associates often described Andersen as opinionated, stubborn, and, in some cases, "difficult." But even his critics readily admitted that Andersen was point-blank honest. "Arthur Andersen wouldn't put up with anything that wasn't complete, 100% integrity. If anybody did anything otherwise, he'd fire them. And if clients wanted to do something he didn't agree with, he'd either try to change them or quit."<sup>1</sup>

As a young professional attempting to grow his firm, Arthur Andersen quickly recognized the importance of carving out a niche in the rapidly developing accounting services industry. Andersen realized that the nation's bustling economy of the 1920s depended heavily on companies involved in the production and distribution of energy. As the economy grew, Andersen knew there would be a steadily increasing need for electricity, oil and gas, and other energy resources. So he focused his practice development efforts on obtaining clients involved in the various energy industries. Andersen was particularly successful in recruiting electric utilities as clients. By the early 1930s, Arthur Andersen & Co. had a thriving practice in the upper Midwest and was among the leading regional accounting firms in the nation.

The U.S. economy's precipitous downturn during the Great Depression of the 1930s posed huge financial problems for many of Arthur Andersen & Co.'s audit clients in the electric utilities industry. As the Depression wore on, Arthur Andersen personally worked with several of the nation's largest metropolitan banks to help his clients obtain the financing they desperately needed to continue operating. The bankers and other leading financiers who dealt with Arthur Andersen quickly learned of his commitment to honesty and proper, forthright accounting and financial reporting practices. Andersen's reputation for honesty and integrity allowed lenders to use with confidence financial data stamped with his approval. The end result was that many troubled firms received the financing they needed to survive the harrowing days of the 1930s. In turn, the respect that Arthur Andersen earned among leading financial executives nationwide resulted in Arthur Andersen & Co. receiving a growing number of referrals for potential clients located outside of the Midwest.

During the later years of his career, Arthur Andersen became a spokesperson for his discipline. He authored numerous books and presented speeches throughout the nation regarding the need for rigorous accounting, auditing, and ethical standards for the emerging public accounting profession. Andersen continually urged

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1. R. Frammolino and J. Leeds, "Andersen's Reputation in Shreds," *Los Angeles Times* (online), 30 January 2002.

his fellow accountants to adopt the public service ideal that had long served as the underlying premise of the more mature professions such as law and medicine. He also lobbied for the adoption of a mandatory continuing professional education (CPE) requirement. Andersen realized that CPAs needed CPE to stay abreast of developments in the business world that had significant implications for accounting and financial reporting practices. In fact, Arthur Andersen & Co. made CPE mandatory for its employees long before state boards of accountancy adopted such a requirement.

By the mid-1940s, Arthur Andersen & Co. had offices scattered across the eastern one-half of the United States and employed more than 1,000 accountants. When Arthur Andersen died in 1947, many business leaders expected that the firm would disband without its founder, who had single-handedly managed its operations over the previous four decades. But, after several months of internal turmoil and dissension, the firm's remaining partners chose Andersen's most trusted associate and protégé to replace him.

Like his predecessor and close friend who had personally hired him in 1928, Leonard Spacek soon earned a reputation as a no-nonsense professional—an auditor's auditor. He passionately believed that the primary role of independent auditors was to ensure that their clients reported fully and honestly regarding their financial affairs to the investing and lending public.

Spacek continued Arthur Andersen's campaign to improve accounting and auditing practices in the United States during his long tenure as his firm's chief executive. "Spacek openly criticized the profession for tolerating what he considered a sloppy patchwork of accounting standards that left the investing public no way to compare the financial performance of different companies."<sup>2</sup> Such criticism compelled the accounting profession to develop a more formal and rigorous rule-making process. In the late 1950s, the profession created the Accounting Principles Board (APB) to study contentious accounting issues and develop appropriate new standards. The APB was replaced in 1973 by the Financial Accounting Standards Board (FASB).

Another legacy of Arthur Andersen that Leonard Spacek sustained was requiring the firm's professional employees to continue their education throughout their careers. During Spacek's tenure, Arthur Andersen & Co. established the world's largest private university, the Arthur Andersen & Co. Center for Professional Education located in St. Charles, Illinois, not far from Arthur Andersen's birthplace.

Leonard Spacek's strong leadership and business skills transformed Arthur Andersen & Co. into a major international accounting firm. When Spacek retired in 1973, Arthur Andersen & Co. was arguably the most respected accounting firm not only in the United States, but worldwide as well. Three decades later, shortly after the dawn of the new millennium, Arthur Andersen & Co. employed more than 80,000 professionals, had practice offices in more than 80 countries, and had annual revenues approaching \$10 billion. However, in late 2001, the firm, which by that time had adopted the one-word name "Andersen," faced the most significant crisis in its history since the death of its founder. Ironically, that crisis stemmed from Andersen's audits of an energy company, a company founded in 1930 that, like many of Arthur Andersen's clients, had struggled to survive the Depression.

## The World's Greatest Company

Northern Natural Gas Company was founded in Omaha, Nebraska, in 1930. The principal investors in the new venture included a Texas-based company, Lone Star Gas Corporation. During its first few years of existence, Northern wrestled with the problem

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2. *Ibid.*

of persuading consumers to use natural gas to heat their homes. Concern produced by several unfortunate and widely publicized home “explosions” caused by natural gas leaks drove away many of Northern’s potential customers. But, as the Depression wore on, the relatively cheap cost of natural gas convinced increasing numbers of cold-stricken and shallow-pocketed consumers to become Northern customers.

The availability of a virtually unlimited source of cheap manual labor during the 1930s allowed Northern to develop an extensive pipeline network to deliver natural gas to the residential and industrial markets that it served in the Great Plains states. As the company’s revenues and profits grew, Northern’s management launched a campaign to acquire dozens of its smaller competitors. This campaign was prompted by management’s goal of making Northern the largest natural gas supplier in the United States. In 1947, the company, which was still relatively unknown outside of its geographical market, reached a major milestone when its stock was listed on the New York Stock Exchange. That listing provided the company with greater access to the nation’s capital markets and the financing needed to continue its growth-through-acquisition strategy over the following two decades.

During the 1970s, Northern became a principal investor in the development of the Alaskan pipeline. When completed, that pipeline allowed Northern to tap vast natural gas reserves it had acquired in Canada. In 1980, Northern changed its name to InterNorth, Inc. Over the next few years, company management extended the scope of the company’s operations by investing in ventures outside of the natural gas industry, including oil exploration, chemicals, coal mining, and fuel-trading operations. But the company’s principal focus remained the natural gas industry. In 1985, InterNorth purchased Houston Natural Gas Company for \$2.3 billion. That acquisition resulted in InterNorth controlling a 40,000-mile network of natural gas pipelines and allowed it to achieve its long-sought goal of becoming the largest natural gas company in the United States.

In 1986, InterNorth changed its name to Enron. Kenneth Lay, the former chairman of Houston Natural Gas, emerged as the top executive of the newly created firm that chose Houston, Texas, as its corporate headquarters. Lay quickly adopted the aggressive growth strategy that had long dominated the management policies of InterNorth and its predecessor. Lay hired Jeffrey Skilling to serve as one of his top subordinates. During the 1990s, Skilling developed and implemented a plan to transform Enron from a conventional natural gas supplier into an energy-trading company that served as an intermediary between producers of energy products, principally natural gas and electricity, and end users of those commodities. In early 2001, Skilling assumed Lay’s position as Enron’s chief executive officer (CEO), although Lay retained the title of chairman of the board. In the management letter to shareholders included in Enron’s 2000 annual report, Lay and Skilling explained the metamorphosis that Enron had undergone over the previous 15 years:

*Enron hardly resembles the company we were in the early days. During our 15-year history, we have stretched ourselves beyond our own expectations. We have metamorphosed from an asset-based pipeline and power generating company to a marketing and logistics company whose biggest assets are its well-established business approach and its innovative people.*

Enron’s 2000 annual report discussed the company’s four principal lines of business. Energy Wholesale Services ranked as the company’s largest revenue producer. That division’s 60 percent increase in transaction volume during 2000 was fueled by the rapid development of EnronOnline, a B2B (business-to-business) electronic marketplace for the energy industries created in late 1999 by Enron. During fiscal 2000 alone,

	<u>2000</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>	<u>1996</u>
Revenues	\$100,789	\$40,112	\$31,260	\$20,273	\$13,289
Net Income:					
Operating Results	1,266	957	698	515	493
Items Impacting Comparability	(287)	(64)	5	(410)	91
Total	<u>979</u>	<u>893</u>	<u>703</u>	<u>105</u>	<u>584</u>
Earnings Per Share:					
Operating Results	1.47	1.18	1.00	.87	.91
Items Impacting Comparability	(.35)	(.08)	.01	(.71)	.17
Total	<u>1.12</u>	<u>1.10</u>	<u>1.01</u>	<u>.16</u>	<u>1.08</u>
Dividends Per Share:	.50	.50	.48	.46	.43
Total Assets:	65,503	33,381	29,350	22,552	16,137
Cash from Operating Activities:	3,010	2,228	1,873	276	742
Capital Expenditures and Equity Investments:	3,314	3,085	3,564	2,092	1,483
NYSE Price Range:					
High	90.56	44.88	29.38	22.56	23.75
Low	41.38	28.75	19.06	17.50	17.31
Close, December 31	83.12	44.38	28.53	20.78	21.56

**EXHIBIT 1**  
ENRON CORPORATION  
2000 ANNUAL  
REPORT FINANCIAL  
HIGHLIGHTS TABLE  
(IN MILLIONS EXCEPT  
FOR PER SHARE  
AMOUNTS)

EnronOnline processed more than \$335 billion of transactions, easily making Enron the largest e-commerce company in the world. Enron's three other principal lines of business included Enron Energy Services, the company's retail operating unit; Enron Transportation Services, which was responsible for the company's pipeline operations; and Enron Broadband Services, a new operating unit intended to be an intermediary between users and suppliers of broadband (Internet access) services. Exhibit 1 presents the five-year financial highlights table included in Enron's 2000 annual report.

The New Economy business model that Enron pioneered for the previously staid energy industries caused Kenneth Lay, Jeffrey Skilling, and their top subordinates to be recognized as skillful entrepreneurs and to gain superstar status in the business world. Lay's position as the chief executive of the nation's seventh-largest firm gave him direct access to key political and governmental officials. In 2001, Lay served on the "transition team" responsible for helping usher in the administration of President-elect George W. Bush. In June 2001, Skilling was singled out as "the No. 1 CEO in the entire country," while Enron was hailed as "America's most innovative company."<sup>3</sup> Enron's chief financial officer (CFO) Andrew Fastow was recognized for creating the

3. K. Eichenwald and D. B. Henriques, "Web of Details Did Enron In as Warnings Went Unheeded," *New York Times* (online), 10 February 2002.

financial infrastructure for one of the nation's largest and most complex companies. In 1999, *CFO Magazine* presented Fastow the Excellence Award for Capital Structure Management for his "pioneering work on unique financing techniques."<sup>4</sup>

Throughout their tenure with Enron, Kenneth Lay and Jeffrey Skilling continually focused on enhancing their company's operating results. In the letter to shareholders in Enron's 2000 annual report, Lay and Skilling noted that "Enron is laser-focused on earnings per share, and we expect to continue strong earnings performance." Another important goal of Enron's top executives was increasing their company's stature in the business world. During a speech in January 2001, Lay revealed that his ultimate goal was for Enron to become "the world's greatest company."<sup>5</sup>

As Enron's revenues and profits swelled, its top executives were often guilty of a certain degree of chutzpah. In particular, Skilling became known for making brassy, if not tacky, comments concerning his firm's competitors and critics. During the crisis that gripped California's electric utility industry during 2001, numerous elected officials and corporate executives criticized Enron for allegedly profiteering by selling electricity at inflated prices to the Golden State. Skilling brushed aside such criticism. During a speech at a major business convention, Skilling asked the crowd if they knew the difference between the state of California and the Titanic. After an appropriate pause, Skilling provided the punch line: "At least when the Titanic went down, the lights were on."<sup>6</sup>

Unfortunately for Lay, Skilling, Fastow, and thousands of Enron employees and stockholders, Lay failed to achieve his goal of creating the world's greatest company. In a matter of months during 2001, Enron quickly unraveled. Enron's sudden collapse panicked investors nationwide, leading to what one *Newsweek* columnist described as the "the biggest crisis investors have had since 1929."<sup>7</sup> Enron's dire financial problems were triggered by public revelations of questionable accounting and financial reporting decisions made by the company's accountants. Those decisions had been reviewed, analyzed, and apparently approved by Andersen, the company's independent audit firm.

### Debits, Credits, and Enron

Throughout 2001, Enron's stock price drifted lower. Publicly, Enron executives blamed the company's slumping stock price on falling natural gas prices, concerns regarding the long-range potential of electronic marketplaces such as EnronOnline, and overall weakness in the national economy. By mid-October, the stock price had fallen into the mid-\$30s from a high in the lower \$80s earlier in the year.

On October 16, 2001, Enron issued its quarterly earnings report for the third quarter of 2001. That report revealed that the firm had suffered a huge loss during the quarter. Even more problematic to many financial analysts was a mysterious \$1.2 billion reduction in Enron's owners' equity and assets that was disclosed seemingly as an afterthought in the earnings press release. This write-down resulted from the reversal of previously recorded transactions involving the swap of Enron stock for notes receivable. Enron had acquired the notes receivable from related third parties who had invested in limited partnerships organized and sponsored by the company. After studying those transactions in more depth, Enron's accounting staff and its Andersen auditors concluded

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4. E. Thomas, "Every Man for Himself," *Newsweek*, 18 February 2002, 25.

5. Eichenwald and Henriques, "Web of Details."

6. *Ibid.*

7. N. Byrnes, "Paying for the Sins of Enron," *Newsweek*, 11 February 2002, 35.

that the notes receivable should not have been reported in the assets section of the company's balance sheet but rather as a reduction of owners' equity.

The October 16, 2001, press release sent Enron's stock price into a free fall. Three weeks later on November 8, Enron restated its reported earnings for the previous five years, wiping out approximately \$600 million of profits the company had reported over that time frame. That restatement proved to be the death knell for Enron. On December 2, 2001, intense pressure from creditors, pending and threatened litigation against the company and its officers, and investigations initiated by law enforcement authorities forced Enron to file for bankruptcy. Instead of becoming the nation's greatest company, Enron instead laid claim to being the largest corporate bankruptcy in U.S. history, imposing more than \$60 billion of losses on its stockholders alone. Enron's "claim to fame" would be eclipsed the following year by the more than \$100 billion of losses produced when another Andersen client, WorldCom, filed for bankruptcy.

The massive and understandable public outcry over Enron's implosion during the fall of 2001 spawned a mad frenzy on the part of the print and electronic media to determine how the nation's seventh-largest public company, a company that had posted impressive and steadily rising profits over the previous few years, could crumple into insolvency in a matter of months. From the early days of this public drama, skeptics in the financial community charged that Enron's balance sheet and earnings restatements in the fall of 2001 demonstrated that the company's exceptional financial performance during the late 1990s and 2000 had been a charade, a hoax orchestrated by the company's management with the help of a squad of creative accountants. Any doubt regarding the validity of that theory was wiped away—at least in the minds of most members of the press and the general public—when a letter that an Enron accountant sent to Kenneth Lay in August 2001 was discovered. The contents of that letter were posted on numerous websites and lengthy quotes taken from it appeared in virtually every major newspaper in the nation.

Exhibit 2 contains key excerpts from the letter that Sherron Watkins wrote to Kenneth Lay in August 2001. Watkins' job title was vice president of corporate development, but she was an accountant by training, having worked previously with Andersen, Enron's audit firm. The sudden and unexpected resignation of Jeffrey Skilling as Enron's CEO after serving in that capacity for only six months had prompted Watkins to write the letter to Lay. Before communicating her concerns to Lay, Watkins had attempted to discuss those issues with one of Lay's senior subordinates. When Watkins offered to show that individual a document that identified significant problems in accounting decisions made previously by Enron, Watkins reported that he rebuffed her. "He said he'd rather not see it."<sup>8</sup>

Watkins was intimately familiar with aggressive accounting decisions made for a series of large and complex transactions involving Enron and dozens of limited partnerships created by the company. These partnerships were so-called SPEs or special purpose entities that Enron executives had tagged with a variety of creative names, including Braveheart, Rawhide, Raptor, Condor, and Talon. Andrew Fastow, Enron's CFO who was involved in the creation and operation of several of the SPEs, named a series of them after his three children.

SPEs—sometimes referred to as SPVs (special purpose vehicles)—can take several legal forms but are commonly organized as limited partnerships. During the 1990s, hundreds of large corporations began establishing SPEs. In most cases, SPEs

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8. T. Hamburger, "Watkins Tells of 'Arrogant' Culture; Enron Stifled Staff Whistle-Blowing," *Wall Street Journal* (online), 14 February 2002.