ACC 562, Advanced Auditing

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Case 2.5 **General Technologies Group Ltd**

Case Summary:

This case provides an example of inadequate audit planning, poor execution of audit procedures, and unsound quality controls by an independent audit firm.

General Technologies Group Ltd was a company that manufactured electrical components including aircraft instruments, postal vending machines, and a variety of electromechanical products sold principally to the military. In 1980s, three individuals – the company's CEO, VPO and an external accountant, misrepresented General Tech's financial statements. The fraudulent scheme centered primarily on the company's inventory, and more specifically - overstatement of the work-in-process inventory. The labor and overhead costs assigned to each WIP item were inflated, which resulted in understatement of General Tech's cost of goods sold. This fraud converted the company's net loss in 1986, 1987, and 1988 into net income for those three years.

Frederick S. Todman & Company, a New York-based accounting firm, served as General Tech's independent auditor during 1986, 1987, and 1988. Alan Kappel, a partner of Todman was mostly criticized by the SEC. He failed to plan the audit, neglected to supervise the individuals responsible for the fieldwork, and reviewed only a limited number of the audited workpapers.

In late 1987, General Tech replaced its independent auditing firm, Todman with Cooper, Selvin & Strassberg. The new auditing firm discovered the fraud, and therefore General Tech decided to dismiss it and reengaged Todman for future audits. Once again, Todman's poor internal control failed to uncover General Tech's fraud, and they issued unqualified audit opinion for both 1987 and 1988 financial statements. During this period, Paul Young was hired by Todman to serve as its Quality Control Director, who was responsible for completing "pre-issuance reviews". The SEC severely criticized Mr. Young for failing to fulfill his quality review role in a professionally responsible manner.

General Tech filed for bankruptcy in December 1989 and was liquidated in 1994.

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1. When auditing a client's inventory, which of the management assertions identified by *SAS No.31*, "Evidential Matter", is of primary concern to an auditor? Why?

According to *SAS No. 31, "Evidential Matter"*, auditors must have evidence to support the five different assertions embodied in financial statement elements: Existence or occurrence, Completeness, Rights and obligations, Valuation or allocation, and Presentation and disclosure. When auditing a client's inventory, an auditor must pay close attention to the following management assertions:

- *Existence* – the auditor must assure that the assets (inventories) as recorded in the financial statements actually exist.
- *Completeness* – the auditor must assure that all assets (inventories) that exist are recorded in the financial statements, and no omissions occur.
- *Rights and obligations* – the auditor must assure that the client holds or controls the rights to assets (inventories) that are present.
- *Valuation* – the auditor must assure that assets (inventories) are properly valuated, and/or computed. This is especially important for goods in process, obsolete, defective, or partial assets.

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2. General Tech's LIR was a computer-generated report. What steps should auditors take to test the reliability of key accounting software programs of a client?

In order to test the reliability of accounting software programs, auditors may examine a number of control activities for their proper execution. IT controls are often classified as general control activities, application control activities, and user control activities. General control activities apply to all IT applications, and application control activities and user control activities relate only to a specific application (accounting software program). Auditors must consider the general control activities first, because application and user control activities cannot be assumed to be effective if the general control activities are weak.

To test application control activities, the auditors will often use computer-assisted audit techniques, such as test data, integrated test facilities, controlled programs, program analysis techniques, and tagging and tracing transactions. While generalized audit software also may be used to test application controls, it is more often used by auditors to perform substantive tests of computerized records. Audit software may be used to perform such functions as:

- Examining the client's records for overall quality, accuracy, completeness, and valid conditions.
- Rearranging data and performing analysis.
- Selecting audit samples on a random basis.
- Comparing data on separate files.
- Comparing the results of audit procedures with the client's records.

More specifically, a number of input validation checks may be applied, such as:

- *Limit test* – a test of reasonableness of a field of data, using a predetermined upper and/or lower limit.
- *Validity test* – a comparison of data (for example, employee, vendor, and other codes) against a master file or table of accuracy.
- *Self-checking number* - a self-checking number contains redundant information, such as the last two digits being a mathematical combination of the others, permitting a check for accuracy.

In addition, auditors may perform *manual follow-up activities* that consist of review and analysis of outputs that have been generated in the form of *exception reports*. For example, a report might be produced that lists transactions where information was missing, was inconsistent with other information, or appeared to be invalid for some other reason.

3. Identify additional audit tests that the Todman auditors could have, and probably should have, applied to General Tech's year end LIRs.

Todman's auditors could have applied a comparable test to the labor component of the WIP items. If such a test had been performed, the inventory fraud would have been easily detected since the labor extension for each WIP item did not equal the product of the item's labor quantity and per-unit labor cost reported on the LIR. In other words, Todman's auditors should have performed arithmetic test to the labor component on the LIR that would have revealed labor values equal to one-half of the actual amount reported in the total column of the LIR.

Another audit procedure would have been comparing the LIR to the count sheets prepared during General Tech's year-end physical inventory. These count sheets reflected the proper labor charges for each WIP item. A quick comparison of the two records would have revealed that the labor charges reported on the LIR for each WIP item were exactly double the labor charges reported on the count sheets for those items.

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4. List the generally accepted auditing standards that one or more Todman auditors apparently violated. Briefly indicate how each standard was violated.

Todman's auditors violated the following generally accepted auditing standards:

<u>I. General Standards:</u>

- *The auditor must have adequate technical training and proficiency to perform the audit.* Todman's auditors fail to perform the audits with sufficient personnel having adequate technical training and auditing proficiency.
- *The auditor must maintain independence in mental attitude in all matters related to the audit.* Todman used non-independent personnel in General Tech's 1986, 1987, and 1988 audits.

<u>II. Standards of Field Work:</u>

- *The auditor must adequately plan the work and must properly supervise any assistants.* Todman's audits were not adequately planned and the staff auditors assigned to the engagements were not properly supervised.

- *The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control …* Todman's auditors did not performed a proper study and evaluation of client's internal control during the audits.
- *The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.* Todman's auditors relied on management representations in the face of records and information evidencing those representations to be false. Further they issued unqualified audit opinions despite their unsound audit procedures.
- The workpapers for the client audits did not adequately document the procedures performed and the conclusions drawn. More specifically, there was a lack of documentation for the audit procedures Todman's auditors applied to General Tech's inventory.

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5. Do you believe that General Tech's auditor change disclosure shown in Exhibit 2 was sufficient? Are investors, creditors, and other third partied entitled to "full and fair disclosure" regarding auditor changes? Defend your answer.

The auditor change disclosure in Exhibit 2 did not provide sufficient information to why the change was made. This disclosure simply mentioned weaknesses in internal controls and concerns about the reliability of management information. However, the disclosure did not go into details and failed to specifically reveal Cooper Selvin's (the predecessor auditor) concern regarding the valuation of General Tech's inventory. Therefore, I may conclude that the auditor change disclosure in Exhibit 2 was vague and lacked transparency.

SEC regulations require prompt disclosure of auditor changes. According to these regulations*, "A registrant must notify the public by filing certain information on Form 8-K within four days of the change. The company must disclose the following information:*

- *Whether the auditors resigned, declined to stand for reelection, or were dismissed, as well as the date of this action.*

- *The type of report issued for the last two years, and whether it contained anything other than an unqualified, clean opinion.*
- *Whether the decision to change accountants was recommended or approved by the board of directors or the audit committee.*
- *Whether there were any disagreements with the auditors, and the nature of such disagreements.*
- *Whether any of the following reportable events occurred, and the nature of such:*
  ~ Internal controls necessary to develop reliable financial statements do not exist;
  ~ Management's representation cannot be relied upon, or the auditors are unwilling to be associated with the financial statements prepared by management;
  ~ Audit scope needs to be expanded;
  ~ Other information has arisen that materially impacts previous audit reports or their underlying financial statements, or subsequent financial statements.
- *Any consultation with the new auditors regarding accounting principles, potential opinions, or any matter that was subject to the disagreements or reportable events with the predecessor auditors as outlined above. If any of these have occurred, the nature of each must be described and possibly filed as an exhibit."*

Investors should always be cautious when a company announces an auditor change, as it may be related to underlying but undisclosed problems in the company's financial reporting and accounting practices. Focusing on these issues is likely to provide better understanding of an auditor change, as well as insight into a company's state of affairs. Companies often attempt to hide the real reason behind an auditor change, and investors may have to read the disclosure carefully to "ferret out" the true reasons behind the change.

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6. Define "quality audit". Identify three important quality control procedures, other than those mentioned in the case, that audit firms can implement.

According to Wikipedia, "*Quality audit* is the process of systematic examination of a quality system carried out by an internal or external quality auditor or an audit team." It is an important part of organization's quality management system, and is typically performed at predefined time intervals to ensure that the institution has clearly-defined internal quality monitoring procedures linked to effective action.

AICPA has issued *Statements on Quality Control Standards* which identify five areas where quality control procedures are appropriate:

- *Independence, integrity, and objectivity* – Personnel maintain independence in all required circumstances, perform all professional services with integrity, and maintain objectivity in discharging professional responsibilities.
- *Personnel management* – Individuals supervising audit engagements and signing reports must have the needed competences. Those hired possess appropriate characteristics to perform competently. Work is assigned to those with technical training and proficiency. Personnel participate in appropriate continuing education and other professional development activities. Personnel selected for advancement have the necessary qualifications.
- *Acceptance and continuance of clients and engagements* – The likelihood of association with a client whose management lacks integrity is minimized.
- *Engagement performance* – Work performed meets applicable professional standards, regulatory requirements, and the firm's standards of quality.
- *Monitoring* – Policies and procedures established for each of other elements are suitably designed and effectively applied.

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7. Briefly describe the SEC's oversight responsibilities for the financial reporting domain. Do you believe the SEC took appropriate measures when dealing with the parties involved in the General Technologies fraud?

As directed by Title IV "Enhanced Financial Disclosures" of the Sarbanes-Oxley Act of 2002, the SEC is adopting rules requiring registrants to include in their annual reports a report of management on the company's internal control over financial reporting. According to Section 404 "Management Assessment of Internal Controls", the internal control report must include:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company;

- A management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year;
- A statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting;
- A statement that the registered public accounting firm that audited the company's financial statements included in the annual report has issued an attestation report on management's assessment of the company's internal control over financial reporting.

Under these rules, a company is required to file the registered public accounting firm's attestation report as part of the annual report. Furthermore, SEC is adding a requirement that management evaluate any change in the company's internal control over financial reporting that occurred during a fiscal quarter that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

I think that the SEC's position on financial reporting is pretty strong. In the case of General Technologies Group Ltd, the SEC took appropriate measures when they uncovered the management fraud. For example, the SEC publicly censured Todman for the deficient audits and required the firm to retain an "independent reviewer", who would study Todman's audit practices and procedures. The SEC also required Todman to implement any recommendations made by that reviewer, such as to establish a sound quality control function. When Todman's auditors failed to fulfill these recommendations, the SEC charged them with defrauding General Tech's investors. Each individual, who actively participated in the fraud or was aware of it, was banned from practicing before the SEC.

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