

SOFTNET SYSTEMS: FRAUD OR EXPERTISE

It was in December 2002, and Peter Sullivan, partner in charge of the audit engagement at Softnet Systems was becoming uneasy with their client's accounting practices. Peter was a partner at John Sanders LLP, a global public accounting firm that had been appointed as the new auditors of Softnet. Although the firm was a new client to John Sanders LLP, Peter's firm regarded Softnet as a very important client, primarily due to the size of the client and its place in the industry. Peter was worried that any problems with Softnet's accounting practices could lead to disagreements with the client and jeopardize the relationship between John Sanders LLP and Softnet. Regarding the Softnet audit engagement, Peter had this to say, "Softnet is an important client to us and I want this audit to go smoothly. However, issues with our client's accounting practices may lead to problems." What worried Peter the most was that source and other supporting documents needed to confirm a significant portion of Softnet's revenues and accounts receivable were missing under strange circumstances. Furthermore, Softnet's management was not cooperating with the auditors' scrutiny of their revenue recognition practices as well as their judgments on accounts receivable collectibility.

Softnet was doing very well during a period when other firms in the software services industry were experiencing a slump. Softnet had consistently reported increasing revenues and gross profits well above the industry average, and the firm's stock price clearly reflected that increase. The stock price had been constantly outperforming the S&P 500 and the Goldman Sachs software index.

The performance of the stock was specifically worrisome to Peter because management's compensation package was based to a large extent on stock performance. Peter thought to himself, "Is Softnet's performance a reflection of management's stewardship or is it due to questionable accounting practices?" Peter also wondered whether Softnet's Board was effectively monitoring the firm's management. Two independent directors on the Board had resigned recently and they had been replaced by Softnet's executive vice president and a former CEO, who also served as a consultant to the firm. As he got ready to go home that day, Peter thought, "Why did the two independent directors resign? Were their replacements orchestrated by management to facilitate their control of the firm and make it easy for them to pursue their interests? Are any of these issues an indication of questionable accounting practices at Softnet?"

COMPANY BACKGROUND

Softnet Systems was incorporated in California in 1984 and the firm was a global player in the software services industry. It was a public company with shares listed on the NASDAQ. The firm's executive offices were located in San Francisco, California. Softnet provided software services to U.S. and international market. Its products and services covered infrastructure resource management, employee resource management, and ecommerce technologies and services. Softnet was organized as three groups, which were the infrastructure management group (IMG), e-markets group (EMG), and integrated solutions group (ISG). The three groups catered to the needs of the different customers of Softnet from small enterprises to large

multinational enterprises and provided integrated and comprehensive solutions for both infrastructure management, employee resource management and e-transaction management.

The IMG, provided a unique service, they facilitated the establishment of new business areas through an internal incubator process. Through its incubator process, Softnet introduced many innovative products such as the real estate portfolio manager, a web-based technology that served as a hosted solution to large real estate owners, operators, leasing companies, and lessors. The real estate portfolio manager was a popular product because it reduced the costs of managing real estate investments.

Softnet supplied products and services to the U.S. and international markets. When asked about Softnet's operations, James Daley, CEO and Chairman of the Board of Softnet said, "Our firm is a major player in the software services industry. Softnet provides a very supporting and rewarding work environment; therefore, we have never experienced labor disruptions. We employ 2,956 persons with 1,074 in sales and marketing, 413 handling customer support, 465 in professional services, 503 at the research and development division and 501 in systems and administration. Softnet's operations are globalized with a sizeable portion of our operations outside the U.S. Indeed, 778 of our employees are located outside North America, mostly in Europe."

The software services industry was very competitive. Old products were constantly improved while new and innovative products were consistently introduced by new entrants as well as existing firms in the industry. According to James Daley, "the major determining factors for success in the industry are product features such as adaptability, scalability, ability to integrate with third party products, functionality, and ease of use, product reputation, quality, performance, price, customer service and support, effectiveness of sales and marketing efforts, and company reputation." On the competition, James Daley had this to say "We face competition from many companies offering products that compete with one or more of our products and services. Our infrastructure management products face competition from products of software companies as well as information technology and system management companies. Our major competitors in this area are Applix, Blue Ocean, Computer Associates, Microsoft, Nortel, and PeopleSoft. In the e-commerce enablement technology market, our products face competition from firms such as Aspect Communications, Requisite Technology, and webMethods, while our products in the employee relationship management market face competition from firms such as Ariba, and CommerceOne."

OPERATIONS

Softnet sold its software and services in the U.S. as well as globally, and the firm had been doing very well over the past three years. The firm used a direct sales strategy as well as partnerships with other organizations to sell its products and services. Its direct sales strategy involved contacting the customer directly and providing a demonstration of their product capabilities. Through its partnership strategy, Softnet established relationships with other software service providers and sold its products indirectly through other firms. The firm sold its products in the North American market and also in Europe and in Asia. Most of the firm's revenues were from

product licensing and services. The licenses usually included a one-year warranty period that was part of the license agreement. Maintenance, professional services, network services, and training were the main source of service revenue. Revenues had been increasing rapidly over the past three years and were far above the averages for the software services industry averages. Revenues for fiscal year end 2001, 2000, and 1999 were \$564.7 million, \$253.3 million and \$138.1 million respectively (see Exhibit 1B). The Revenue in 2000 and 2001 increased 83% and 123% respectively, (see Exhibit 1). James Daley, commenting on the firm's growth said "We are very satisfied with our firm's performance. We recorded strong revenues over the period 1999 to 2001 and we expect to report higher revenues in subsequent years. The performance of our stock over the past three years has been far better than that of our competitors, and this indicates that our firm's future prospects are very bright. We believe that our stockholders have been adequately rewarded as a result of the strong performance of our firm and I can confidently say that they are satisfied with our performance."

THE MERGER

Softnet improved its competitiveness through an internal development strategy as well as a merger and acquisition strategy. Through these strategies, the firm increased the scope of its range of products. When asked about Softnet's mergers and acquisitions, James Daley responded, "Through a strategy of product acquisitions and mergers, our firm has acquired important products that have enabled us to be a global leader in the software services industry. In addition to the technologies and products we have obtained through acquisitions, we have also focused substantial resources on internal product and technology development." Some of the products obtained through this strategy were asset management, fleet management, facilities management, rail management, and telecommunication management solutions. In June 2000, Softnet acquired General Software, and through that acquisition, the firm acquired products and services that enabled it to form its e-markets group. On June 11, 2001, Softnet announced that it had entered into a stock for stock merger with Resource Technology Inc, a supplier of information technology service management and customer relationship management solutions. Under the merger agreement, Softnet acquired all the outstanding common stock of Resource Technology Inc, Each outstanding Resource common stock was exchanged for \$9.00 in cash and 0.9065 shares of Softnet common stock. Furthermore, Softnet assumed the options outstanding under Resource's employee stock incentive plans. Regarding Softnet's merger with Resource, James Daley had this to say "Our merger with Resource is an important milestone for Softnet. We committed significant resources to this merger because we believed that Softnet would derive substantial benefits from this merger. We issued approximately 28 million shares of our common stock in connection with the merger and we paid Resource stockholders approximately \$274.5 million. We expect to improve our capabilities and competitiveness tremendously as well as extend into new markets."

CURRENT SITUATION

It was at the end of December 2002, and Peter and his audit team were auditing Softnet's fiscal year 2002 financial statements. The major issues relating to the audit were Softnet's revenue

recognition practices and related party transactions between some Board members and the firm. There were 11 members on Softnet's Board and four of them were independent. The independent Board members served on either the audit or compensation committee or both committees. The audit and compensation committees each had three members.

Based on the evidence they had gathered so far, Peter and his team believed that Softnet's license revenues were overstated, however, they were unable to obtain conclusive evidence because of the uncooperative attitude of Richard Drew, the chief accounting officer. Although they had discovered that a few of the firm's license revenues were based on revocable license agreements, they were unsure of the extent of this problem because most of the source documents relating to these transactions were missing. A related problem was that the firm had extended agreements with many customers who had consistently defaulted. Peter suspected a problem with Softnet's receivables because over 60 percent of the firm's receivables were based on these extended agreements. Regarding the related party transactions, Softnet had entered into a questionable lease agreement with BTS Services, an investment management company. The CEO of BTS Services was Mr. Morales, a member of Softnet's Board, audit and compensation committees. Softnet had subleased approximately 15,000 square feet of office space to BTS Services for a comparatively low and uncompetitive rate. Furthermore, Softnet had also leased a suite from the Parsons Baseball Club at an unusually high rate. Parsons Baseball Club was owned by George Lucas, another Softnet Board member who was also a member of Softnet's compensation committee. Peter felt that these transactions as well as Softnet's accounting practices were questionable. As he entered the elevator to go home that day, he thought, "Softnet's management may be committing financial statement fraud."

(Exhibit 1A)

**SOFTNET SYSTEMS
BALANCE SHEET****Fiscal Year 2001 and 2000 (in thousands, except per share amounts)**

| ASSETS | 2001 | 2000 |
|--|--------------|-----------|
| | ---- | ---- |
| Current Assets: | | |
| Cash and cash equivalents..... | \$ 286,658 | 33,511 |
| Accounts receivable, net of allowance for doubtful accounts of \$11,511 and \$2,179, respectively..... | 180,372 | 69,940 |
| Other current assets..... | 62,811 | 22,826 |
| Total current assets..... | 529,841 | 126,277 |
| Property and equipment, net | 82,717 | 29,537 |
| Goodwill, net of accumulated amortization of \$334,178 and \$54,406, respectively..... | 1,192,855 | 233,504 |
| Other intangible assets, investments and other, net of accumulated amortization of \$24,015 and \$1,398, respectively | 198,353 | 134,112 |
| Total assets..... | \$ 2,003,766 | 523,430 |
| | ===== | ===== |
| LIABILITIES AND STOCKHOLDER'S EQUITY | | |
| Current liabilities: | | |
| Accounts payable..... | \$ 36,024 | \$ 19,850 |
| Accrued expenses..... | 200,886 | 49,064 |
| Current portion of deferred revenue..... | 86,653 | 36,779 |
| Current portion of long-term debt..... | 1,731 | 74 |
| Total current liabilities..... | 325,294 | 105,767 |
| Deferred revenue, net of current portion..... | 8,299 | 4,556 |
| Other long-term liabilities..... | 17,197 | -- |
| Long-term debt, net of current portion..... | 884 | 1,257 |
| Convertible subordinated notes..... | 262,327 | -- |
| Total liabilities..... | 614,001 | 111,580 |
| Stockholder's equity: | | |
| Preferred stock, \$0.001 par value, 5,000 shares authorized, no shares issued or outstanding..... | -- | -- |
| Common stock, \$0.001 par value, 500,000 shares authorized, 160,359 and 109,501 shares issued and outstanding, respectively..... | 160 | 110 |

| | | |
|---|-------------|-----------|
| Additional paid-in capital..... | 2,342,235 | 480,957 |
| Accumulated deficit..... | (917,104) | (64,863) |
| Unearned portion of deferred compensation..... | (22,151) | (678) |
| Cumulative translation adjustment..... | (3,950) | (666) |
| Treasury stock, at cost..... | (9,425) | (3,010) |
| Total stockholders' equity..... | 1,389,765 | 411,850 |
| | ----- | ----- |
| Total liabilities and shareholder's equity..... | \$2,003,766 | \$523,430 |
| | ===== | ===== |

(Exhibit 1B)

SOFTNET SYSTEMS
STATEMENT OF OPERATIONS
Fiscal Year 2001, 2000, and 1999 (in thousands, except per share amounts)

| | 2001 | 2000 | 1999 |
|--|--------------|-------------|-------------|
| | --- | --- | --- |
| Revenues: | | | |
| Licenses..... | \$ 354,610 | \$168,467 | \$ 87,362 |
| Services..... | 210,073 | 84,833 | 50,701 |
| | ----- | ----- | ----- |
| Total revenues..... | 564,683 | 253,300 | 138,063 |
| | ----- | ----- | ----- |
| Costs and Expenses: | | | |
| Cost of licenses..... | 2,582 | 1,426 | 1,020 |
| Cost of services..... | 111,165 | 51,441 | 31,561 |
| Amortization of purchased technology..... | 11,844 | 1,338 | 50 |
| Sales and marketing..... | 223,966 | 101,443 | 50,803 |
| Research and development..... | 61,957 | 28,517 | 13,919 |
| General and administrative..... | 48,420 | 19,871 | 10,482 |
| Acquisition costs and other..... | 918,156 | 57,920 | 43,967 |
| | ----- | ----- | ----- |
| Total costs and expenses..... | 1,378,090 | 261,956 | 151,802 |
| | ----- | ----- | ----- |
| Loss from operations before interest (net) and income tax expense..... | (813,407) | (8,656) | (13,739) |
| Interest income (expense), net..... | (538) | 38 | 664 |
| | ----- | ----- | ----- |
| Loss from operations before income tax expense..... | (813,945) | (8,618) | (13,075) |
| Income tax expense..... | 38,296 | 16,452 | 10,295 |
| | ----- | ----- | ----- |
| Net loss..... | \$ (852,241) | \$ (25,070) | \$ (23,370) |

| | | | |
|---------------------------------------|-----------|-----------|-----------|
| Net loss per share basic and diluted: | | | |
| Net loss per share..... | \$ (6.16) | \$ (0.24) | \$ (0.27) |
| Shares used in computation..... | 138,447 | 102,332 | 87,166 |

(Exhibit 1C)**SOFTNET SYSTEMS****STATEMENT OF CASH FLOWS****Fiscal Year 2001, 2000, and 1999 (in thousands, except per share amounts)**

| | 2001 | 2000 | 1999 |
|---|--------------|-------------|-------------|
| | --- | --- | --- |
| Cash flows from operating activities: | | | |
| Net loss..... | \$ (852,241) | \$ (25,070) | \$ (23,370) |
| Adjustments to reconcile net loss to net cash (used in) provided by operating activities: | | | |
| Depreciation, amortization, acquisition costs and other... | 954,231 | 68,293 | 47,781 |
| Increase (decrease) in cash resulting from changes in: | | | |
| Accounts receivable..... | (100,474) | (24,364) | (18,984) |
| Other current assets..... | (25,955) | 1,485 | (5,678) |
| Other assets..... | 7,648 | 2,717 | (245) |
| Accounts payable and other liabilities..... | 18,563 | 4,755 | 2,939 |
| Accrued expenses..... | (32,794) | 17,328 | 12,486 |
| Deferred revenue..... | 20,851 | 12,467 | 4,874 |
| | ----- | ----- | ----- |
| Net cash (used in) provided by operating activities..... | (10,171) | 57,611 | 19,803 |
| | ----- | ----- | ----- |
| Cash flows from investing activities: | | | |
| Acquisitions and investments, net of cash acquired..... | 17,974 | (41,249) | (11,128) |
| Purchases of short-term investments..... | -- | -- | (49,000) |
| Maturities of short-term investments..... | -- | 2,000 | 54,027 |
| Purchases of property and equipment..... | (49,031) | (20,713) | (12,426) |
| | ----- | ----- | ----- |
| Net cash used in investing activities..... | (31,057) | (59,962) | (18,527) |
| | ----- | ----- | ----- |
| Cash flows from financing activities: | | | |
| Issuance (repayments) of long-term debt..... | 1,284 | (7,832) | (1,174) |
| Issuance of common stock..... | 42,501 | 23,427 | 7,921 |
| Issuance of notes receivable..... | (1,611) | -- | -- |
| Treasury stock purchased..... | (6,415) | (1,285) | (1,463) |

| | | | |
|---|-------------|-----------|-----------|
| Issuance of convertible subordinated notes..... | 261,900 | -- | -- |
| | ----- | ----- | ----- |
| Net cash provided by financing activities..... | 297,659 | 14,310 | 5,284 |
| | ----- | ----- | ----- |
| Effect of exchange rate changes on cash..... | (3,284) | 7 | 35 |
| | ----- | ----- | ----- |
| Net increase in cash and cash equivalents..... | 253,147 | 11,966 | 6,595 |
| Cash and cash equivalents, beginning of period..... | 33,511 | 21,545 | 14,950 |
| | ----- | ----- | ----- |
| Cash and cash equivalents, end of period..... | \$ 286,658 | \$ 33,511 | \$ 21,545 |
| | ===== | ===== | ===== |
| Cash paid during the period for: | | | |
| Interest..... | \$ 1,069 | \$ 451 | \$ 26 |
| Income taxes..... | \$ 1,587 | \$ 3,015 | \$ 155 |
| Supplemental Disclosure of Noncash Investing Activities: | | | |
| Stock issued and other noncash consideration for acquisitions and investments..... | \$1,762,952 | \$253,209 | \$105,499 |

(Exhibit 2)

**Comparison of Cumulative Total Return
Among Softnet Systems, the S&P 500 Index, and the Goldman Sachs Software Index**

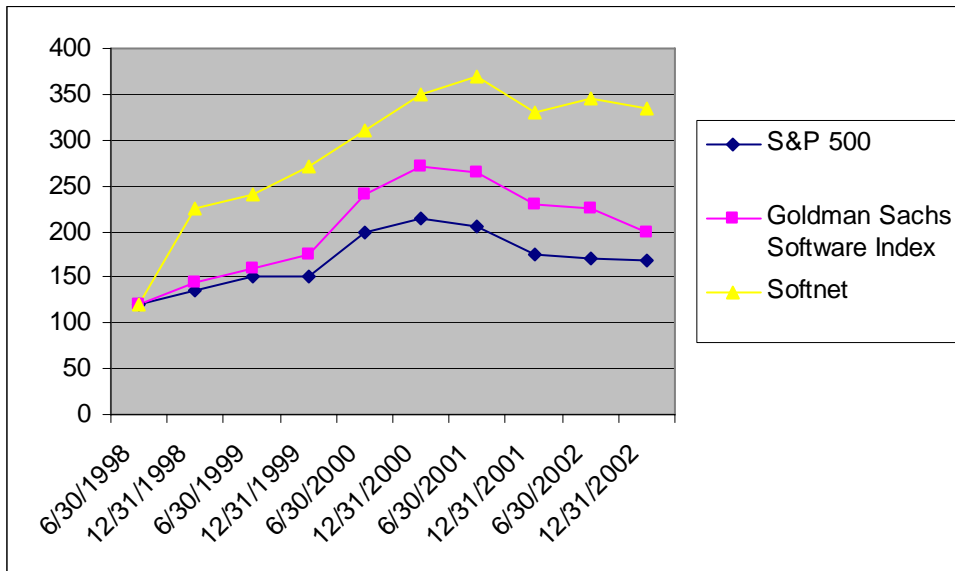


Exhibit 3
(Source: Compustat)

| Selected Financials* and Ratios | Softnet | Industry |
|--|----------------|-----------------|
| Sales[Y00] | 253.3 | 152.048 |
| Sales[Y01] | 564.683 | 168.252 |
| Sales[Y02] | 441.195 | 174.423 |
| Gross Profit[Y00] | 209.468 | 93.614 |
| Gross Profit[Y01] | 439.092 | 103.994 |
| Gross Profit[Y02] | 251.679 | 109.338 |
| Sales 3 Yr CAGR** [Y01] | 108.974 | 62.124 |
| Sales 3 Yr CAGR** [Y02] | 47.294 | 42.658 |
| Receivables-Total[Y00] | 69.94 | 41.313 |
| Receivables-Total[Y01] | 180.372 | 45.722 |
| Receivables-Total[Y02] | 97.231 | 39.8 |
| Debt Ratio [00] | 0.213171 | 0.441272 |
| Debt Ratio [01] | 0.306424 | 0.310898 |
| Debt Ratio [02] | 1.739852 | 0.403886 |
| Current Ratio [00] | 1.193917 | 2.457808 |
| Current Ratio [01] | 1.628807 | 2.680232 |
| Current Ratio [02] | 0.416811 | 1.319981 |
| Gross Margin [00] | 0.826956 | 0.615687 |
| Gross Margin [01] | 0.77759 | 0.618085 |
| Gross Margin [02] | 0.570448 | 0.626855 |
| Total Liabilities [00] | 111.58 | 80.356 |
| Total Liabilities [01] | 614.001 | 91.035 |
| Total Liabilities [02] | 823.665 | 92.321 |
| Current Liabilities [00] | 105.767 | 45.921 |
| Current Liabilities [01] | 325.294 | 53.198 |
| Current Liabilities [02] | 525.795 | 55.03 |
| Current Assets [00] | 126.277 | 112.865 |
| Current Assets [01] | 529.841 | 142.583 |
| Current Assets [02] | 219.157 | 121.862 |
| Total Assets [00] | 523.43 | 182.101 |
| Total Assets [01] | 2003.766 | 292.813 |
| Total Assets [02] | 473.411 | 228.582 |

* In millions

** Cumulative average growth rate

SOFTNET SYSTEMS – INSTRUCTOR’S MANUAL

I. CASE SYNOPSIS

It was in December 2002, and Peter Sullivan, partner in charge of the audit engagement at Softnet Systems was becoming uneasy with their client’s accounting practices. Peter was a partner at John Sanders LLP, a global public accounting firm that had been appointed as the new auditors of Softnet. Although the firm was a new client to John Sanders LLP, Peter’s firm regarded Softnet as a very important client, primarily due to the size of the client and its place in the industry. Peter was worried that any problems with Softnet’s accounting practices could lead to disagreements with the client and jeopardize the relationship between John Sanders LLP and Softnet. Regarding the Softnet audit engagement, Peter had this to say, “Softnet is an important client to us and I want this audit to go smoothly. However, issues with our client’s accounting practices may lead to problems.” What worried Peter the most was that source and other supporting documents needed to confirm a significant portion of Softnet’s revenues and accounts receivable were missing under strange circumstances. Softnet’s management had adopted a cool attitude towards attempts to scrutinize their firm’s revenue recognition practices as well as their judgments on accounts receivable collectibility.

Softnet was doing very well during a period when other firms in the software services industry were experiencing a slump. Softnet had consistently reported increasing revenues and gross profits well above the industry average, and the firm’s stock price clearly reflected that increase. The stock price had been constantly outperforming the S&P 500 and the Goldman Sachs software index. What was specifically worrisome to Peter was that management’s compensation package was based to a large extent on stock performance.

Peter thought “Is Softnet’s performance a reflection of management’s stewardship or is it due to questionable accounting practices?” Peter also wondered whether Softnet’s Board was effectively monitoring the firm’s management. Two independent directors on the Board had resigned recently and they had been replaced by Softnet’s executive vice president and a former CEO, who also served as a consultant to the firm. As he got ready to go home that day, Peter thought, “Why did the two independent directors resign? Were their replacements orchestrated by management to facilitate their control of the firm and make it easy for them to pursue their interest? Are all these issues an indication of questionable accounting practices at Softnet?”

II. THEORY APPLICATION

The case illustrates that in order to perform an effective audit; an auditor must understand a client’s business and industry and assess a client’s business risk. It also shows the significance of analytical procedures in the planning and testing stages of an audit.

III. RESEARCH METHODS

This is a field-researched case. The names of all firms and individuals involved have been altered to protect their privacy.

IV. KEY ISSUES

1. Peter Sullivan and his audit team must determine whether Softnet's financial statements are materially misstated.
1. A related issue is whether Softnet's reported strong performance is due to financial statement fraud.
2. Is the audit evidence persuasive?

V. TEACHING OBJECTIVES

This case has four primary learning objectives. On completing this case, students must be able to:

1. Understand the determinants of audit evidence persuasiveness.
2. Recognize fraud symptoms and assess the likelihood of financial statement fraud.
3. Perform analytical procedures.
4. Understand the timing and purpose of analytical procedures.

VI. COURSE SUGGESTIONS

The case was written for business school undergraduate and graduate courses in auditing. It is best suited for the sections on audit evidence, analytical procedures, and financial statement fraud.

VII. TEACHING SUGGESTIONS

The recommended approach for teaching this case is the three-stage learning process (Naumes, P., and Naumes, W., 1999). The three-stage learning process is implemented by first requiring students to analyze the case individually. After the individual analyses, students could be assigned the case in groups. The final stage of this process is a general class discussion, and at this stage, groups could be asked to present the case.

The group case analyses should clearly identify the critical issues, provide alternatives, recommend a solution and provide justification for the recommended solution. The time for each presentation should be structured such that there is sufficient time for class discussion and the instructor's summary. The instructor may assign the following discussion questions before or during the class discussion.

VIII. DISCUSSION QUESTIONS

1. Discuss whether the related party transactions and Board of Directors composition are in compliance with the provisions of Sarbanes-Oxley Act?
2. Based on the provisions of SOX and COSO, discuss the effectiveness of Softnet's internal control system?
3. Discuss the risks of material misstatements from an assessment of Softnet's business and industry environment?
4. Using the fraud triangle, discuss the Softnet management's motivations for financial statement fraud?

5. Discuss whether the audit evidence relating to Softnet's license revenues, receivables, and related party transactions are persuasive?
6. Based on the case facts, discuss whether Softnet's accounting practices and related party transactions relate to possible fraud?
7. Based on the facts of the case and analytical procedures, discuss Softnet's performance and assess the possibility of material misstatements?
8. Discuss the usefulness of analytical procedures in the planning of the Softnet audit and in the auditor's assessment of the likelihood of material misstatement?

IX. ANSWERS TO DISCUSSION QUESTIONS

1. Discuss whether the related party transactions and Board of Directors composition are in compliance with the provisions of Sarbanes-Oxley Act?

The Sarbanes Oxley Act (SOX) requires disclosure of Softnet's related party transactions and Board independence. According to the case, one of the related party transactions was the sublease of office space to BTS Services. The other related party transaction was that Softnet leased a suite from the Parsons Baseball Club. These two transactions qualified as related party transactions because the CEO of BTS Services was Mr. Morales, a member of Softnets' Board, audit and compensation committees while Parsons Baseball Club was owned by George Lucas, another Softnet Board member who was also a member of the firm's compensation committee. Although, these Board members were listed as independent in compliance with the SOX Board independence criteria, the questionable related party transactions could compromise their effectiveness as independent Board members.

Based on the SOX provisions, Softnet was required to report the related party transactions in their financial statements. Any misrepresentation or non-disclosure of these transactions would be in breach of SOX because based on Section 302 of SOX, the CEO and CFO must certify that the financial statement and other financial information are fairly presented.

Furthermore, Section 301 of the SOX requires publicly traded corporations to establish audit committees and requires all audit committee members to be independent and one member to have accounting or financial management expertise. Because the audit committee is a subcommittee of the Board, it implies that the Board must include independent members. Although the resignation of two independent Board members and their replacement with affiliated Board members could be perceived as making the Board less independent and ineffective, it did not constitute non-compliance with SOX because there were four independent Board members. Furthermore, the composition of the audit committee complied with the SOX independence criteria because all members were independent.

2. Based on the provisions of SOX and COSO, discuss the effectiveness of Softnet's internal control system?

Section 404 of SOX, requires Softnet's management to report their evaluation of the effectiveness of internal controls over financial reporting. It also requires the firm's auditors to attest to management's assessment of internal controls. An assessment of Softnet's internal control based on the COSO framework involves evaluating the effectiveness of the five components of the internal control framework. The five components of COSO's internal control framework are control environment, risk assessment, control activities, information and communication and monitoring. According to the COSO internal framework, the five components have to be consistently monitored to ensure that they continue operating properly over time.

Based on the COSO internal control framework, Softnet's internal control system was weak. Softnet's internal control deficiencies could be inferred from the problems associated with its revenue recognition practices and related party transactions. From the facts of the case, evidence of internal control weakness could be inferred from the inadequate accounting system, lack of proper documents and records, and lack of independent checks that resulted in questionable related party transactions and the loss of source and supporting documents relating to the license revenues.

Based on the case, Softnet's control environment could be regarded as ineffective because it appeared that some of the top management lacked integrity. In addition, the Board did not seem to effectively monitor management and the financial reporting process. The chief accounting officer's uncooperative attitude, which hindered the auditors' search for conclusive evidence regarding Softnet's license revenues suggested that management integrity was a problem. The questionable related party transactions and extended license agreements also raised issues about the "tone at the top."

3. Discuss the risks of material misstatements from an assessment of Softnet's business and industry environment?

The risks of material misstatements can be determined from an assessment of the Softnet's business and industry environment. The firm's business and industry environment includes the business processes, management objectives and strategies, as well corporate governance structures. From the facts of the case, the risks of material misstatements were high because the firm was under pressure to perform because of the highly competitive business and industry environment. Furthermore, Softnet's business processes that involved developing new products through a strategy of mergers and acquisitions also increased the risks of material misstatements. The mergers and acquisitions involved substantial investments and because success was not guaranteed, Softnet's risk exposure as well as the pressure on the firm to succeed was high. The high risk exposure and pressure increased the risks of material misstatements. Finally, the intense competitiveness in the software industry increased the pressure on Softnet to maintain the firm's strong performance and increased the risks of material misstatements.

4. Using the fraud triangle, discuss the Softnet management's motivations for financial statement fraud?

Based on the facts of the case, Softnet's management was sufficiently motivated to commit financial statement fraud. Motivations for committing fraud can be analyzed using the fraud triangle. The fraud triangle consists of pressure, opportunity, and rationalization. Based on the case, Softnet was under pressure to sustain its strong performance because of the market's expectation and the competitiveness of the software services industry. According to the case, the software services industry was very competitive with old products being constantly improved while new and innovative products were consistently introduced by new entrants as well as existing firms in the industry. Softnet's management was thus under pressure to sustain the firm's high revenues and strong stock performance.

If Softnet was sufficiently motivated to commit fraud, then there had to be opportunity to perpetrate the fraud. Because the firm's board was not independent, it was very likely that it was not effectively monitoring management. An ineffective board provides "opportunity" because it makes it easier for management to perpetrate fraud. The third element of the fraud triangle is rationalization, and according to the case, Softnet's management could rationalize financial statement fraud from the need to sustain their firm's strong performance and satisfy stockholders.

5. Discuss whether the audit evidence relating to Softnet's license revenues, receivables, and related party transactions are persuasive?

Persuasive evidence must be competent and sufficient. Competent evidence implies timely and relevant evidence from an independent provider. Independence of the provider of information as well as the auditor's direct knowledge increases the competence of evidence. Sufficiency implies evidence that is enough to enable the auditor to form an opinion as to whether financial statements are materially misstated. According to the case, the auditor's evidence relating to the recognition of license revenues was based on direct knowledge because it was obtained from some of the source documents. This documentary evidence showed that some of the license revenues were based on revocable license agreements. However, most of the source documents relating to the license agreements were unavailable; therefore the evidence was not sufficient. On the other hand, evidence relating to the receivables was not persuasive because it was not competent and sufficient.

Based on the facts of the case, the auditors had documentary evidence that over 60 percent of the receivables were based on extended agreements with defaulting customers; however, this evidence did not constitute an independent confirmation that the receivables were uncollectible. Reliable evidence from other sources that the receivables were uncollectible was necessary for the evidence to be persuasive and to conclude that the receivables were materially overstated. Finally, the related party transactions involving the two board members was competent and sufficient because it was based on source documents available to the auditors and it appeared that the auditors had independently assessed competitive rates for the two leases.

6. Based on the case facts, discuss whether Softnet's accounting practices and related party transactions relate to possible fraud?

Softnet's license revenue and receivable recognition as well as related party transactions raise the issue of possible fraud. Financial statement fraud is rarely seen and is difficult to prove, however, fraud indicators indicate the possibility of fraud. Financial statement fraud can be inferred from fraud indicators and the presence of the elements of fraud elements. Based on the preceding the facts of the case, there were fraud indicators in relation to Softnet's revenue and receivable recognition. The fraud indicators included the uncooperative attitude of the Chief Accounting Officer and the missing documents relating to those transactions.

Regarding the related party transactions, evidence from the case shows that the management of Softnet was probably committing fraud because the management knowingly leased the office space and suite at uncompetitive rates. Furthermore, the three elements of fraud, which are theft, concealment, and conversion, were present in the transactions. Based on the facts of the case, the uncompetitive rates that were favorable to the two board members resulted in loss of Softnet's assets; therefore the loss could be regarded as theft. Because Softnet's management did not report that the transactions were not competitive, the element of concealment was present and finally, because the assets involved was cash, conversion of the assets was not an issue.

7. Based on the facts of the case and analytical procedures, discuss Softnet's performance and assess the possibility of material misstatements?

Based on the facts of the case and analytical procedures, it was likely that Softnet's strong performance was due to material misstatements. Some of the facts of the case that indicated the possibility of material misstatements included license revenues being based on revocable license agreements and receivables being based on extended payment agreements between Softnet and consistent defaulters. Other indicators of the possibility of material misstatements such as the competitiveness of the software services industry and the pressure to sustain Softnet's strong performance have already been discussed. Based on analytical procedures, it was likely that Softnet's financial statements were materially misstated.

Comparative analyses of the ratios of Softnet and the software services industry indicated that although the firm's performance was very strong, it had liquidity and solvency problems. Softnet's revenues between 1998 and 2001 and its gross profits between 1998 and 2000 were far above the industry averages. Softnet's gross margin in 2001 was slightly below the industry average, indicating that the firm was under pressure to sustain performance. Furthermore, the firm's liquidity and solvency ratios did not compare favorably with the industry averages. Softnet's current ratio was 1.19 in 1999, 1.63 in 2000, and 0.42 in 2001 while the industry averages were 2.46, 2.68, and 1.32 respectively. The firm's debt to asset ratio was 0.21 in 1999, 0.31 in 2000, and 1.74 in 2001 while the industry averages were 0.44, 0.31, and 0.40 respectively. The comparison of Softnet's liquidity and solvency ratios with the industry showed that the firm had liquidity and solvency problems particularly based on the financial statements for fiscal 2001, which showed a dramatic decline in liquidity and solvency. The ratio analyses as well as accounting anomalies such as missing documents indicated that it was likely that Softnet's financial statements were materially misstated.

8. Discuss the usefulness of analytical procedures in the planning of the Softnet audit and in the auditor's assessment of the likelihood of material misstatement?

Statement on Auditing Standards No. 56 defines analytical procedures as evaluations of financial information based on a study of plausible relationships between both financial and non-financial data. Generally Accepted Auditing Standards requires the use of analytical procedures in the planning stage of an audit. Analytical procedures enable the auditor to determine the nature, timing and extent of the substantive testing and in forming an overall opinion about the reasonableness of recorded account balances.

Preliminary analytical procedures such as comparison of Softnet's ratios to industry ratios provides an indication of the firm's performance and facilitates audit planning because it enables the auditors to gain an understanding of Softnet's business and industry as well as its business risk. Furthermore, it focuses the auditor's attention on possible misstatements and facilitates the determination of the extent of testing of various financial statement items. It also enables the auditor to assess the firm's ability to continue as a going concern.

X. EPILOGUE

On May 6, 2002 the board of directors of Softnet announced that the CFO, CEO, and board chairman had resigned. They also announced an internal investigation into accounting inaccuracies of about \$100 million. In a press release on May 23, 2002, the firm announced that it was restating its results for 2000 and 2001. Softnet also announced that the SEC had begun investigating the firm's accounting practices. The firm's stock plummeted and on September 22, 2002, Softnet filed a voluntary chapter 11 bankruptcy petition

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