

Sky Scientific, Inc.
An Auditing Mine Field

An Auditing Case Study

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Abstract

In 1994, Sky Scientific, Inc. dramatically overstated assets and understated expenses in its financial statements. An SEC investigation into those financial statements led to charges being filed against both the company and its auditors. This case takes a detailed look into the independent audit of Sky's financial statements for the purpose of understanding how the auditors failed to see the extent to which Sky's financial reporting was misleading and to adequately challenge the assertions presented in the financial statements before Sky filed them with the SEC. This case provides an opportunity to examine numerous issues related to the audit engagement process, including audit planning, the evaluation of management representations, audit evidence and the confirmation process. The roles and responsibilities of the concurring auditor and an outside specialist are also discussed. This case is appropriate for use in either undergraduate or graduate auditing courses.

Key words: Sky Scientific, auditing standards, audit failures, overstatement of assets

Sky Scientific, Inc.

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Sky Scientific, Inc. (Sky) was founded by William Dorow in 1991 as a privately held mining and processing company, which operated five mining properties in the Western United States.¹ In 1993 the company went public with a market capitalization of \$2 million. At that time American Capital Network (ACN), the firm hired to promote Sky's stock, began circulating tout sheets under the titles "Wall Street Watch" and "Chicago Financial Services Inc." to generate interest in the company and its stock. These efforts were successful as its stock price increased 600%, from \$0.75 to \$4.50 per share and its market capitalization rose to \$80 million. Sky reported assets of \$69.7 million and estimated revenues of \$31 million in 1994.

The reality of Sky's financial position was much different than what was reported. Assets reported on the balance sheet in 1994 were overstated by at least 95%, since in reality Sky was a company with little to no cash, questionable CDs, no revenues, and substantial doubt about its ability to continue as a going concern. Moreover, none of the mines would be operating for several years. Barry C. Scutillo, CPA of Fort Lauderdale, Fla. served as Sky's independent auditor for 1994. Scutillo retained Mark Jensen, CPA who served as concurring reviewer for the engagement. The auditors issued a 1994 audit report with a going concern qualification, but failed to identify many of the problems with Sky's financial statements presentation.

The United States Securities and Exchange Commission (SEC) initiated an investigation of Sky Scientific, Inc. in August 1994, and eventually charged management officials with fraudulent accounting practices and the broker-dealers of Sky stock with violations of several federal

¹ The material presented in this case was drawn from several SEC accounting and auditing enforcement releases and administrative proceedings.

securities laws. In a separate action, the SEC brought charges against Scutillo and Jenson for engaging in improper professional conduct for failing to conduct the 1994 audit in accordance with generally acceptable auditing standards (GAAS). The charges resulted in an array of penalties for all parties involved, including bans from practicing before the SEC, monetary fines, and cease and desist orders.

Sky's Operating Activities, Financing Activities, and Financial Statement Presentation

Sky Scientific owned and purported to operate as many as five mines with millions of dollars worth of mineral reserves in the Western United States. According to press releases issued by the company the mines were in full production, operating as many as ten hours per day, seven days per week. In reality the mines did not operate at all. While Sky did own the mining properties, it was expressly prohibited by law from conducting any mining activities since they had met neither the regulatory nor the environmental requirements to operate the mines. Indeed, it would be several years before the necessary studies would be completed and the permissions granted. Few, if any, of the mining sites had equipment sufficient to conduct regular mining operations nor was there any scrap or other evidence of recent mining activities. Moreover, Sky never completed any geological analyses of whether or not there were any actual reserves on their sites. In short, the reserves did not appear to be either economically or legally extractable.

Burdened with non-productive assets and essentially no operating revenues, Sky turned to a number of fraudulent activities and accounting practices, apparently in an effort to maintain the price of Sky Scientific's stock. These schemes were largely the work of the Sky chief executive officer W.A. Dorow, Jr.; the principal financial officer Jerry Foster; and Robert Schlien of

American Capital Network, the company that promoted and sold Sky's stock. Dorow worked out of Sky's corporate headquarters in Florida while Foster was located in West Virginia.

The 1994 financial statements reported assets of nearly \$70 million, consisting of \$30 million in mining properties, \$40 million in Russian certificates of deposit (CDs), and remarkably only \$3,000 in cash. With limited cash on hand, Sky issued a large number of shares of preferred and common stock, and used it to make acquisitions and carry out operations. Sky acquired its mining properties by paying for them with preferred shares of stock, issued at \$10 par value per share. Sky reported the mining properties on its balance sheet using one of two methodologies: 1) it booked the assets based on the estimated net present value of future revenues expected to be generated by mining activities, or 2) by multiplying the par value (\$10 per share) of the preferred stock by the number of shares issued. The future revenue estimates were based on assumptions that the mines contained significant mineral deposits and would be operating in full production within one or two months, instead of one to three years. At the same time, the preferred stock had no market value. In short, the properties were overvalued.

Sky acquired \$40 million in Russian CDs from the Bank of Sinektika of Moscow, Russia on February 28, 1994, the last day of its fiscal year in exchange for four million shares of preferred stock. The CDs were recorded as assets on the Sky books and represented more than 50% of Sky's assets. Dorow worked with his good friend Hillel Sher, who served as an agent of the Russian bank, to complete the transaction and three provisions of the deal. First, the deal included a provision that Sky could rescind the transaction at its own discretion at any time for any reason without penalty or payment. Second, the transaction could be revoked if the Sky auditors did not approve the transaction or allow for its full valuation on the balance sheet. Third, the agreement

stated that Sky would receive interest of 11.25% annually on the CDs even though the stated rate was only 2.5%.

It was also Sky's practice to use both common and preferred stock to compensate its employees and consultants to cover operating expenses. Sometimes Sky would issue common stock to consultants in excess of the value of the services rendered and treated the transaction as a financing activity rather than as an expense. This failure to properly report expenses related to the acquisition of assets and ongoing operations caused the company to under-report its losses by \$35 million or 700% in 1994.

Because Sky had no positive cash flows resulting from operating activities, it focused its attention on its financing activities as a mechanism to bring cash into the company. Robert Schlien of American Capital Network (ACN) and a cadre of broker-dealers were responsible for promoting and selling Sky stock in the marketplace. ACN distributed 350,000 tout sheets using the fictitious title "Wall Street Watch" during the period June 1993 to August 1994. These tout sheets communicated misleading information, including claims that the mines were currently in full production. These marketing efforts successfully generated new investments into the company. In addition to distributing the fraudulent tout sheets, Schlien and his associates performed a series of wash trades and other activities to stimulate market demand for the stock. Schlien and his colleagues were able to profit by charging undisclosed markups on the sale of the stock to unsuspecting customers.

Dorow and Foster worked with ACN to return cash to the company. The preferred stock issued by Sky included a contract provision through which ACN held the right to liquidate the shares of the preferred stock at any time. Schlien would exercise this right on a regular basis in order to prevent the stock from diluting the market price for Sky common stock. Schlien and each

of his colleagues would get a portion of the proceeds upon sale of the stock; the rest of the proceeds were returned to Sky in an effort to continue to generate cash flows for its operations. Schlien alone made \$2.6 million on these transfers of stock.

In sum, the financial statements for Sky Scientific, Inc. for the year ending February 28, 1994, were misleading. There were substantial issues related to the valuation of its assets and questions about whether period expenses had been properly recorded. In addition, Sky had limited cash on hand and regularly paid its management, employees and consultants with common and/or preferred stock. Finally, there was substantial evidence that its agents were fraudulently manipulating Sky's valuation in the marketplace by various stock transactions.

Sky Finds a New Auditor

Sky had substantial difficulty retaining outside audit firms. In fact, Sky contracted with six firms in a two year period. BDO Seidman audited Sky for the period ending July 31, 1992, when Sky was still a privately held company. As early as April 1993 Ernst & Young added a *going concern* paragraph to its audit opinion and was immediately dismissed by Sky. The successor auditor, Weinberg & Company, initially released an unqualified opinion, but soon thereafter modified it to include a going concern reference. Another auditor, Norman Cutler was dismissed in December 1993 after only three weeks on the job. Joel S. Baum served as Sky auditor following the dismissal of Cutler through May 16, 2004, only to be dismissed two weeks before the SEC filing deadline.

In May 1994, Barry Scuttillo, CPA was offered the job of being Sky's next independent auditor. Barry had been a CPA for thirteen years and his career included audit work at Peat, Marwick & Co. where he had reached the level of senior manager. Scuttillo was a certified fraud

examiner and had taught a number of accounting courses. At the time he was offered the Sky audit job he was a partner in the firm of Scutillo & Blake.

Scutillo knew that Sky had engaged three prior audit firms in the last year and that Sky's financial records were not in good shape. Before accepting the job with Sky, Scutillo made several things clear to Dorow about what he could expect from the audit. First, he let him know that he would need help auditing a mining company because he had no experience with this type of firm. Second, Scutillo let Dorow know that he would need more than a month to complete the audit, and would not be able to meet the SEC deadline, which, at the time, was only two weeks away; therefore, an extension would need to be filed with the SEC. Finally, and perhaps most importantly, Scutillo indicated that a going concern qualification on the 1994 financial statements was likely.

In spite of the problems Scutillo accepted the audit engagement on May 16, 1994. To assist him on the audit he selected two accountants from his firm. Both had only been with Scutillo & Blake for about one year, but each had several years of prior public auditing experience. Scutillo, who had no previous experience auditing mining companies, retained Mark Jensen to serve as concurring reviewer for the Sky audit. Jensen was retained primarily to provide the experience needed for auditing mining companies, although his previous experience was limited to only one mining company engagement. Scutillo began his audit of Sky, Inc. by identifying several critical audit areas. These included valuation of Sky's transaction with the Russian bank, the valuation of Sky's mineral properties, and Sky's issuance of preferred stock. A materiality threshold of \$ 468,000 was established for the audit.

Valuing the Russian Bank Assets on Sky's Balance Sheet

The transaction involving Russian certificates of deposit was very unusual. The transaction had occurred on the last day of the fiscal year and, based on the interest rate differences, was disproportionately beneficial to Sky. Further, the Russian bank was not required to pay interest or principal to Sky for four years, with accrued amounts put into an escrow account for payment at the time the CDs matured. Scuttillo and Jensen knew about these issues and had made the transaction the first of their critical audit areas. The auditors were concerned about whether or not the Russian bank could actually pay Sky the \$40,000,000 plus interest in four years.

Auditing the Russian CDs included four steps. First, Scuttillo inspected the purchase agreement and the CDs. He found it unusual that the CDs stated on their face that they had been purchased for cash when, in fact, they had been obtained for preferred stock. Scuttillo never followed up on this discrepancy. Second, Scuttillo received a faxed copy of a standard bank confirmation on June 9, 1994. Scuttillo was surprised to get the confirmation because he had not actually requested it and did not know if a prior auditor had asked for it. The fax came from Sky's offices. The agent representing the Russian bank had sent the fax and provided a cover sheet in which he promised to send an original confirmation when he received it. Scuttillo was concerned about the fact the bank itself had not sent the fax directly to him. Third, Scuttillo asked Sky for the Russian bank's financial statements. When they arrived they were written in English but did not indicate whether they had been prepared in accordance with GAAP. A brief investigation by Scuttillo led him to conclude that Russian banks were not required to have audited financial statements. Finally, Scuttillo contacted Richard Greene, who was Sky's outside corporate and securities attorney, to find out more about the CDs. Greene provided a great deal of assurance that

the CD transaction was legitimate and claimed to have met with the Russian bank official when the agreements were being completed.

Before the audit work was completed, Scutillo, Jensen, and Dorow participated in a teleconference to discuss the Russian CD transactions and how they should be valued. Both auditors had expressed their serious doubts about the CDs. Jensen said the CDs did not pass the smell test. Then the auditors told Dorow that they were considering doing additional procedures related to the CDs but Dorow reminded them that the June 15th filing deadline was fast approaching. Scutillo and Jensen felt a great deal of pressure from Dorow as he made it very clear that he expected the auditors to agree with his representation of the CDs and their value. Finally, Scutillo said that because there was no evidence that the CDs were invalid, they should remain on Sky's financial statements as assets worth \$40 million. The audited financial statements treated the CDs as a non-current, restricted asset; included a footnote disclosure of the CDs uninsured status; and incorporated the CD transaction into the report's going concern qualification.

Valuing Sky's Mines

Another critical audit area was the valuation of Sky's mining properties in California and Nevada. Scutillo and Jensen needed to decide if the par value of the issued stock was the correct basis for valuation of the assets. Since these properties had been bought almost exclusively with Sky Inc. preferred stock, it was difficult to determine their market value. The auditors knew that Sky's preferred stock was not publicly traded and because of this it was difficult to determine a market value for it. The audit of the mining properties involved several steps.

Scutillo and Jensen studied estimates provided by Sky's technical staff of estimated ore reserves, ore recovery, and the cost of mining, milling, refining, and overheads per ton at several

of the properties. In addition to these estimates, some independent verification of the staff estimates was provided by an engineering geologist named Charles Schultz, who had been engaged by Sky. The auditors were wary of the fact that Sky's estimates of the net present value of the mines was considerably higher than the face value of the preferred stock it issued to acquire them. Scutillo asked for additional information from Schultz about the estimates, who responded by explaining that the numbers fell within industry standards.

Scutillo and Jensen then visited three mining properties to verify their existence. Several employees of Sky drove the auditors to the sites and explained why each had been selected. The auditors saw no equipment or operations at two of the mines. Moreover, there was no evidence of recent operating activity, such as waste rock or tailings² at either location. In July 1994 Scutillo and Jensen visited the Tallulah mine, where Sky miners staged an operation. As later recounted by a neighboring landowner:

Sky miners waited for the auditors to show up, and at that point the miners turned the mill on. They had about enough water to run the mill for 30 minutes. They really didn't have any material to run through the mill at that time. The configuration of the equipment that they had at that time was not working properly, so they turned it on... (T)he reverse screw wouldn't even turn on so several members of the crew stood next to the screw ... pushing the screw by hand so that it would turn while the auditors were there.... The auditors were there for about 30 minutes, [they] left, and [the miners] turned the mill off. [Initial Decision Release No. 137]

After the site visits the auditors returned their attention to Sky's estimations of the net present value of the mines. Scutillo still could not understand why the valuation of the mines was so much greater than the par value of the preferred stock that was issued to buy the mines. The net present value calculations assumed that full-scale mining operations would begin almost immediately and, based on what he saw at the site visit, he knew this was not likely. Additional evidence that the mines could not start operations in the near future was the lack of cash and

² Tailings are the refuse or dross remaining after ore has been processed.

environmental issues that were still unresolved. Nevertheless, after considerable deliberation Scutillo decided that the net present value calculations were a valid method of determining the fair value of the three mines. He concluded that since the market value of the mines, as shown by the net present value calculations, was higher than the cost as shown by the face value of the preferred stock and notes Sky issued to acquire the mines, he would accept the lower cost valuation as the fair value of the properties in the audited financial statements.

Unrecorded Expenses: Shares Issued for Services Rendered

During the fiscal year 1994, Sky issued over 14.7 million shares of common stock, thereby increasing its outstanding common stock from about 1.6 million shares to about 16.3 million shares. Sky issued the stock to pay for services it received from consultants and to compensate its management and employees. However, Sky did not record as an expense the difference between the prices paid by the recipients of the stock and the market value of the stock when it was issued. Scutillo obtained a schedule from Sky that identified all common stock issued during the year, and the amount paid by the recipient. The management prepared schedule did not calculate the difference between the amount paid and the market price of the stock but Scutillo knew that there were significant differences.

In conducting the audit, Scutillo and Jensen had relied on audit procedure checklists that had been created by McGladrey and Pullen, a national accounting firm. One checklist indicated that there was a requirement to disclose stock issued at a discount. The other checklist alerted auditors to consider the “treatment of deferred compensation resulting from the sale of capital

stock to officers or employees at prices below market.” In what they later described as an oversight in completing the forms, Scutillo and Jensen marked both items as not applicable. The work papers showed that a significant amount was paid to consultants but there was no computation to show how these payments were determined. As a result of this omission no other efforts were made to determine if expenses should be recorded in connection with Sky’s issuance of common stock and no expenses were recorded in the financial statements.

Scutillo & Blake Issue Their Audit Report for Sky, Inc.

On June 13, 1994, Scutillo and Blake issued its independent auditors report addressed to Sky’s board of directors. As they had indicated would be the case when accepting the audit, a going concern qualification was included:

The accompanying financial statements have been prepared assuming that [Sky] will continue as a going concern. As discussed in Note 19 to the financial statements, [Sky’s] principal assets consist of investments in or leases for mineral properties consisting of unpatented mining claims and a restricted \$40,000,000 certificate of deposit that raise substantial doubt about its ability to continue as a going concern.

Before signing off on the audit opinion, Scutillo made several adjustments to the financial statements. Of note, he removed one mining property, valued at \$16 million, from Sky’s balance sheet and debited notes payable and preferred stock to negate the transaction. He also made several other corrections to the statements, collectively reflecting additional losses of \$600,000 for the fiscal year.

SEC Charges

In late July 1994 a senior geologist on the Commission's staff visited some of Sky's California and Nevada mining operations. At three of those properties she found no evidence of current or recent mining activity, no equipment, and no personnel. At another mine she found equipment and personnel but no tailings that might indicate that recent operations had existed. As a result of these observations and the recent filing of Sky's audited financial statements, the SEC opened its investigation of Sky on August 26, 1994.

In 1999 the SEC charged several members of Sky management with fraudulent accounting practices and for filing false and misleading financial statements with the Commission. They also charged American Capital Network and Robert Schlien with violations of several federal securities laws. Barry Scutillo and Mark Jensen were charged with engaging in improper professional conduct in that they *intentionally, knowingly and recklessly* violated the applicable professional standards when auditing a public company. Specifically, Scutillo and Jensen were charged with recklessly failing to see that most of Sky's assets were fictitious or massively overvalued and that millions of dollars in expenses had not been recorded on Sky's books.

Conclusion

The case of The United States Securities and Exchange Commission vs. Barry C. Scutillo and Mark F. Jensen (Initial Decision Release No. 183) was decided by an SEC administrative law judge in May 2001. In making his decision Judge James T. Kelly considered the definition of *recklessness* as it applies to the auditing profession. He noted that "recklessness is narrowly defined. It involves not merely simple, or even inexcusable negligence, but an extreme departure from the standard of ordinary care which presents a danger of misleading buyers or sellers that is

either known to the actor or is so obvious that the actor must have been aware of it.” Judge Kelly identified four key issues pertaining to the establishment of recklessness: (a) Was the audit conducted in accordance with generally accepted auditing standards? (b) Were the financial statements presented in conformity with generally accepted accounting principles? (c) Were the misrepresentations material? and (d) Did the Commission establish *scienter* (i.e., did the auditor knowingly commit fraud)?

Judge Kelly determined that while the issue was a close one, Scutillo’s audit of Sky’s mining properties was not shown to be reckless. Kelly concluded that Scutillo did not follow GAAS and that the Sky financials statements were not presented in accordance with GAAP. However, he determined that the SEC failed to present evidence sufficient to establish materiality or *scienter*.

Still, Scutillo was denied the privilege of appearing and practicing before the Commission for a period of three years. He appealed the decision, but the initial decision was affirmed in 2003. Jensen negotiated a settlement, which also included a three-year ban from practicing before the Commission. Scutillo continued to practice accounting in Florida.

SEC enforcement proceedings against Sky officials were held in 1997 and 1998. One or more Sky officials failed to show up and were deemed fugitives; other participants invoked the Fifth Amendment and refused to testify. The SEC action resulted in monetary fines (up to \$5 million), public censure, cease and desist orders, and disbarment for over thirty participants in the scheme. CFO Jerry Foster was fined \$120,000 and prevented from serving as a CFO for a public company. Schlien was ordered to return \$ 2.6 million. Sky Scientific, Inc. eventually declared bankruptcy.

Questions

1. The administrative law judge determined that Scutillo and Jensen violated “generally acceptable auditing standards” in the performance of the Sky audit. Sky violated *several* of the 10 “generally accepted auditing standards.” In your opinion, which of the 10 “generally accepted auditing standards” were violated? Support your answer with specific examples from the case. As part of your answer, recognize that if the auditors had acquired a better knowledge of their client’s business they may have recognized that this was an audit area that needed special consideration. What level of knowledge does an auditor need to obtain about a client’s business and how does this help the auditor in planning and conducting the audit? (Even though the events of the case occurred prior to the revision of the wording of the standards, use the revised wording of the auditing standards. The wording of the “general standards” and the “standards of reporting” was changed by *SAS No. 113*, effective for audits of periods beginning on or after 12/15/06; the wording of the “fieldwork standards” was changed by *SAS No. 105*, effective for audits of periods beginning on or after 12/15/06).
2. Mark Jensen served as concurring reviewer for the Sky audit. What are the qualifications and roles of the concurring reviewer, especially in regard to completing audits of SEC-regulated companies? In your opinion, were these requirements met as part of the Sky audit? Defend your answer. [Hint: See the AICPA’s SEC Practice Section Reference Manual at <http://ftp.aicpa.org/public/download/members/div/secps/referencemanual/Ref1000App.pdf>]
3. What is meant by maintaining control of confirmation procedures when collecting audit evidence? What is the relationship between auditing procedures and auditing standards? In the case of Sky, Inc., what were some of the mistakes made related to the confirmation of the Russian CDs?
4. When is it appropriate for an auditor to bring in a specialist in a given field? Why is this important to do? What is the duty of the auditor to determine whether the specialist is qualified? What responsibility does the auditor have before accepting the specialist’s findings?
5. The auditors of Sky, Inc. were accused by the SEC of not obtaining sufficient audit evidence. When can an auditor make the determination that he or she has sufficient evidence?
6. Scutillo reasoned that the Russian CDs were valid because there was insufficient evidence to persuade him that they were invalid. Evaluate this argument.
7. Define *scienter* and identify the considerations which help determine whether *scienter* is present during the completion of an audit. What is the relationship between *scienter* and an auditor’s civil liability? What defenses, if any, does an auditor have to defend him or herself from legal liability?

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Sky Scientific, Inc.

An Auditing Mine Field

TEACHING NOTES

INTRODUCTION

This case draws information from several SEC Accounting Enforcement and Administrative Proceedings Releases to examine an interesting real-life instance of audit failure.

Learning objectives specific to this case include:

- Identification of audit risks
- Evaluation of management representations
- Knowledge of auditing standards, audit procedures, and audit evidence
- Understanding the audit confirmation process
- Identification of the proper role of concurring auditors and specialists
- Understanding the role of regulatory and other authorities

For ease of use by instructors, these teaching notes repeat each question, followed by our suggested solutions.

CASE QUESTIONS AND SUGGESTED SOLUTIONS

Questions

1. **The administrative law judge determined that Scutillo and Jensen violated “generally acceptable auditing standards” in the performance of the Sky audit. Sky violated *several* of the 10 “generally accepted auditing standards.” In your opinion, which of the 10 “generally accepted auditing standards” were violated? Support your answer with specific examples from the case. As part of your answer, recognize that if the auditors had acquired a better knowledge of their client’s business they may have recognized that this was an audit that needed special consideration. What level of knowledge does an auditor need to obtain about a client’s business and how does this help the auditor in planning and conducting the audit?**

(Even though the events of the case occurred prior to the revision of the wording of the 10 generally accepted auditing standards, use the revised wording of the auditing standards. The wording of the “general standards” and the “standards of reporting” was changed by SAS No. 113, effective for audits of periods beginning on or after 12/15/06, and the wording of the “fieldwork standards” was changed by SAS No. 105, effective for audits of periods beginning on or after 12/15/06).

1. An argument could be made that nine out of 10 of the generally accepted auditing standards were violated! (Refer to Appendix A for a summary of the 10 generally accepted auditing standards). The only standard that didn't appear to be violated was the second reporting standard, regarding the consistency of the application of GAAP. Explanations regarding the violation of each of the other standards are as follows:

General Standards (SAS No. 113)

First General Standard

The auditor must have adequate technical training and proficiency to perform the audit.

The firm performing the audit did not have experience in the mining industry, and the concurring review partner had only audited one other mining company.

Second General Standard

The auditor must maintain independence in mental attitude in all matters relating to the audit.

It can be argued that Scutillo didn't maintain his independence, since he relied too heavily on management's representations, and didn't have an attitude of professional skepticism, as discussed under the third general standard. Further, there is evidence that, due to management's desire to submit the audit report to the SEC by the June 15th deadline, the auditors may have foregone additional necessary audit procedures.

Third General Standard

The auditor must exercise due professional care in the performance of the audit and the preparation of the report.

Scutillo and Jensen definitely violated the third general standard of GAAS. SAS No. 1 interprets due professional care in terms of a tort obligation for the auditor. Basically, an auditor should possess “the degree of skill commonly possessed” by other auditors and should exercise it with “reasonable care and diligence.” The matter of due professional care concerns what the independent auditor does and how well he or she does it. Due professional care requires adherence to all of the general and fieldwork standards, and adds an additional element of professionalism.

Standards of Fieldwork (SAS No. 105)

First Standard of Fieldwork

The auditor must adequately plan the work and must properly supervise any assistants.

It appears that this particular office of the audit firm was not qualified to perform the audit, since the partner felt compelled to obtain the assistance of a “concurring” partner. In planning the audit, Scutillo should have realized that completing the audit in a competent manner would require expertise in the mining industry. In addition, Jenson’s extensive participation in some of the fieldwork, instead of sticking to his concurring auditor role, suggests that Scutillo did not adequately plan the work or identify the staff resources necessary to complete the audit. See Question #2 in regard to appropriate roles for the concurring auditor.

Second Standard of Fieldwork

The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, to design the nature, timing, and extent of further audit procedures.

Auditors should obtain a level of knowledge of the entity's business that will enable them to plan and perform their audit in accordance with generally accepted auditing standards. At a minimum, this understanding of the entity and its environment includes aspects of the following: (a) industry, regulatory, and other external factors; (b) the nature of the entity; (c) business objectives, strategies, and other risks that may result in a material misstatement of the financial statements; (d) historical financial performance; and (e) internal control, and the selection of accounting policies (SAS No. 109). SAS No. 109, *Appendix A* provides substantial guidance and examples of what the auditor might use to formulate an understanding. This level of knowledge should enable the auditor to obtain an understanding of the events, transactions, and practices that, in his or her judgment, have a significant effect on the financial statements. Knowledge of the entity's business helps the auditor in:

1. Identifying areas that may need special consideration
2. Assessing conditions under which accounting data are produced, processed, reviewed and accumulated within the organization
3. Evaluating the reasonableness of estimates such as valuation of inventories, depreciation, allowance for doubtful accounts, and percentage of completion for long term contracts
4. Evaluating the reasonableness of management assertions
5. Making judgments of the appropriateness of the accounting principles applied and the adequacy of disclosures; and
6. Making judgments on the adequacy of internal controls.

Third Standard of Fieldwork

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.

As will be noted more specifically in some of the other questions to this case, the auditors did not obtain sufficient appropriate evidence in order to express an opinion on the financial statements. For example, the auditors accepted weak evidence on the legitimacy of the Russian CDs, and didn't obtain the appropriate evidence, given that the CDs were recorded the last day of the fiscal period, and given that the confirmation was not sent out or received directly by the auditors.

Standards of Reporting (SAS No. 113)

First Standard of Reporting

The auditor must state in the auditor's report whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).

This standard was violated because there were many instances when assets were not accounted for in accordance with GAAP, contrary to the opinion expressed on Sky's financial statements.

Third Standard of Reporting

When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report.

The third standard of reporting was violated since the issues regarding valuing the Sky stock issued for employee compensation and consulting services was not adequately disclosed in the notes to the financial statements.

Fourth Standard of Reporting

The auditor must either express an opinion regarding the financial statements, taken as a whole, or state that an opinion cannot be expressed, in the auditor's report. When the auditor cannot express an overall opinion the auditor should state the reasons therefor in the auditor's report. In all cases where an auditor's name is associated with financial statements, the auditor should clearly indicate the character of the auditor's work, if any, and the degree of responsibility the auditor is taking, in the auditor's report.

This standard was violated since the auditors expressed an unqualified opinion when in fact there were material misstatements in the financial statements.

- 2. Mark Jensen served as concurring reviewer for the Sky audit. What are the qualifications and roles of the concurring reviewer, especially in regard to completing audits of SEC-regulated companies? In your opinion, were these requirements met as part of the Sky audit? Defend your answer. [Hint: See the AICPA's SEC Practice Section Reference Manual at <http://ftp.aicpa.org/public/download/members/div/secps/referencemanual/Ref1000App.pdf>]**

The AICPA's SEC Practice Section (SECPS) Reference Manual requires that the audits of SEC-regulated companies are reviewed by a concurring auditor prior to the release of the audit report. The purpose of the concurring review is to provide additional assurance that the financial statements of SEC companies are presented in conformity with GAAP and that the audit is conducted in accordance with GAAS (SECPS Reference Manual 1000.39). Usually, these reviews are part of the quality control standards internal to the auditing firm. Because Scuttillo & Blake was a small firm and lacked specific expertise related to auditing mining operations, Scuttillo decided to go outside the firm and recruit Jensen to perform the role of concurring auditor.

The concurring reviewer "should not assume any of the responsibilities of the audit partner-in-charge of the engagement" (SECPS Reference Manual 1000.39b). Rather, his or her responsibility is to provide "an objective review of significant auditing, accounting, and financial reporting matters" that comes to his or her attention. In an effort to fulfill these responsibilities, the concurring reviewer is required to:

- Discuss significant accounting, auditing and financial reporting procedures as well as high-risk transactions and account balances with the engagement partner;
- Review audit documentation, particularly as it relates to key accounting issues, and ensure that the treatment of these issues is consistent with GAAP and the regulations of pertinent standards-setters;

- Review summaries of unadjusted audit differences;
- Read the financial statements and auditor’s report before they are released; and
- Confirm with the lead auditor that there were no significant unresolved issues. (SECPS Reference Manual 1000.39b)

In order to carry out these functions, the SECPS Reference Manual requires concurring partners to have “sufficient technical expertise” and knowledge both of “relevant specialized industry practices” and SEC rules and regulations.

There is substantial evidence to suggest that Jensen did not meet these requirements. While Jensen did have previous experience auditing the mining industry, his experience was limited to one other engagement. He apparently did not have enough knowledge of mining operations to prevent him from being misled during the Tallulah site visit. Further, Jensen was directly involved in the audit, having contributed approximately 20% of the total billable services on the audit. Jensen never did receive, nor did he review, a full set of the original audit work papers. Finally, the release of an erroneous audit opinion and significant deficiencies in the audits suggest that Jensen did little to fulfill his obligation to review the financial statements, the audit report, or to challenge Scuttilo on key accounting and auditing issues.

3. What is meant by maintaining control of confirmation procedures when collecting audit evidence? What is the relationship between auditing procedures and auditing standards? In the case of Sky, Inc. what were some of the mistakes made related to the confirmation of the Russian CDs?

Obtaining confirmations is an auditing procedure used to validate other forms of evidence, particularly if the entity has entered into complex or unusual transactions, and/or when the level of audit risk is high. Maintaining control of confirmation procedures means establishing direct communication between the intended recipient and the auditor to minimize the possibility that the

results will be biased because of interception and alteration of the confirmation requests or responses (SAS No. 67). The use of confirmations in the Sky Inc. case demonstrates the important relationship between auditing procedures and auditing standards. Auditing procedures are the acts that the auditor performs during the course of an audit to comply with auditing standards (SAS No. 95).

The Sky auditors were correct to seek confirmation pertaining to the nature and terms of the Russian CDs for several reasons: 1) the CDs represented a substantial portion of Sky's assets, 2) the terms of the agreement were disproportionately beneficial to Sky, and 3) the transaction occurred on the last day of the fiscal year. GAAS requires auditors to maintain control of the confirmation process. There were several elements of the Sky confirmation procedures which did not meet this requirement:

- The confirmation request was not sent out by the auditor. Rather, it was assumed that the confirmation came as a result of the work of a previous auditor.
 - The confirmation was not obtained directly from the bank in Moscow. Rather, a facsimile from Sky's own offices was accepted. An original copy of the confirmation was never received nor was there follow-up with the bank.
 - Irregularities between the information generated via the confirmation and information from other audit evidence sources were ignored and the underlying transactions were not adequately investigated.
- 4. When is it appropriate for an auditor to bring in a specialist in a given field? Why is this important to do? What is the duty of the auditor to determine whether the specialist is qualified? What responsibility does the auditor have before accepting the specialist's findings?**

The first standard of fieldwork requires that the auditor “adequately plan the work and must properly supervise any assistants” (SAS No. 113). The principal responsibility to adequately plan the audit falls on the audit partner, who should obtain a level of knowledge of the entity’s business that will enable him or her to plan and perform the audit in accordance with generally accepted accounting standards. When needed in order to effectively carry out his or her responsibilities, the auditor has the ability and the responsibility to rely on the work of a specialist with knowledge in a particular field outside of accounting (SAS No. 73).

The selection of a specialist requires the auditor to consider a number of issues. First, the auditor needs to consider the nature of the specialist’s relationship to the client. Specifically, the auditor needs to determine whether an existing relationship with the client might impair the specialist’s objectivity or create circumstances where management would have significant influence over the specialist (SAS No. 73). As part of the Sky audit, Scuttilo relied on Charles Schultz, an engineering geologist contracted by Sky, to assist with the valuation of the mining properties. Schultz reviewed and confirmed estimates of ore reserves, ore recovery, and the cost of mining provided by Sky’s technical staff. However, it is clear that Schultz was referred to Scuttilo by Sky’s management. While there was no specific evidence suggesting that Schultz was unduly influenced by Dorow or other Sky officials, it was Scuttilo’s responsibility to show that he at least considered the possibility of such undue influence.

Second, the auditor should evaluate whether the specialist has sufficient professional qualifications to competently complete the work assigned to him or her. The work of a specialist is a type of audit evidence, and like any evidence, the auditor must evaluate the *quality* of the evidence received from the specialist. Such an evaluation should include a review of any professional certifications or licensures; the specialist’s reputation and standing in the field; and

experience with the specific type of work required (SAS No. 73). As part of its investigation of Scutillo and Jensen, the SEC brought into question whether Schultz was in fact competent to assist with the valuation of the mines. Specifically, the SEC showed that while he was licensed as an *engineering* geologist, Schultz did not possess the skills of an *economic* geologist, whose skills were more relevant to the valuation of the mining properties.

Third, the auditor is responsible for reviewing the work of the specialist to determine whether the specialist's reports are consistent with other evidential matter (SAS No. 73). The auditor is to obtain an understanding of the methods used by the specialist, test selected data, and determine whether the information supports the financial statement assertions. If the data is consistent with other findings, then the auditor may conclude that sufficient evidential matter has been obtained. If there is a discrepancy between the expert's findings and other audit findings that cannot be resolved, then the auditor is required to express a qualified or adverse opinion (SAS No. 73).

5. The auditors of Sky, Inc. were accused by the SEC of not obtaining sufficient audit evidence. When can an auditor make the determination that he or she has sufficient evidence?

The purpose of an audit is to provide an opinion as to whether the financial statements for an entity are fairly presented in accordance with GAAP. The third standard of fieldwork requires the auditor to "obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit" (SAS No. 105).

The nature of, and procedures for, obtaining audit evidence are discussed in SAS No. 106: *Audit Evidence*. Audit evidence is "all the information used by the auditor in arriving at the conclusion on which the audit opinion is based" (SAS No. 106). It is cumulative in nature and is the result of audit procedures performed in the course of the audit. Sufficiency measures the

quantity of the audit evidence; and appropriateness is a measure of the quality of the audit evidence. Appropriateness is the degree to which the evidence is both relevant and reliable in “providing support for, or detecting misstatements in, the classes of transactions, account balances, and disclosures and related assertions” (SAS No. 106).

The nature, extent, and timing of the specific audit procedures undertaken are largely a matter of professional judgment. Acceptable audit procedures include the inspection of records and documents; the inspection of tangible assets; observation; inquiry; confirmation; recalculation; re-performance; and analytical procedures. The auditor “obtains more assurance from consistent audit evidence obtained from different sources... of a different nature than from items of audit evidence considered individually. ... Conversely, when audit evidence obtained from one source is inconsistent with that obtained from another, the auditor should determine what additional audit procedures are necessary to resolve the inconsistency” (SAS 106).

Scuttilo failed to secure audit evidence which was either sufficient or appropriate to justify the existence or the value of the Russian CDs. There was little, if any, documentation of the value of the CDs outside the representations made by Sky management. Attempts at third-party confirmation were not successful, nor was information about the Russian bank received by the auditor. Scuttilo also failed to follow up to investigate inconsistencies in what little evidence he did have in his possession.

6. Scuttilo reasoned that the Russian CDs were valid because there was insufficient evidence to persuade him that they were invalid. Evaluate this argument.

The Sky Inc. auditors were incorrect to reason that a lack of evidence contrary to an assertion is equivalent to positive evidence in support of an assertion. SAS No. 110, which includes criteria for evaluating audit evidence, provides clear guidance to the auditor: “If the auditor has not

obtained sufficient appropriate audit evidence as to a material financial assertion, the auditor should attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate evidence, the auditor should express a qualified opinion or a disclaimer of opinion.”

The value of the Russian CDs was a material assertion by management for which the auditors needed to find sufficient evidence. The lack of sufficiency of evidence *validating the transaction*, rather than the insufficiency of evidence discrediting the transaction, should have caused Scuttillo to reason that the value of the CDs was not supported. As an analogy, a “positive” confirmation is stronger evidence than a “negative” confirmation. Further, the professional skepticism of the auditors should have been increased, since the CDs were recorded the last day of the fiscal period.

7. Define *scienter* and identify the considerations which help determine whether *scienter* is present during the completion of an audit. What is the relationship between *scienter* and an auditor’s civil liability? What defenses, if any, does an auditor have to defend him or herself from legal liability?

The Securities and Exchange Act of 1934 established the Securities and Exchange Commission and gave it broad authority over all aspects of the securities industry. Section 10(b) of the Act, which is still in force today, allows any purchaser or seller of securities to sue an accountant involved in filing fraudulent financial reports with the Commission. In order to recoup damages from the auditor, the plaintiff must (a) prove damage or loss; (b) show evidence that the financial statements were misleading; (c) prove the plaintiff relied on the financial statements and were the direct cause of loss; and (d) prove that the accountant knew about the fraudulent scheme (Louwers, 2007).

The concept of *scienter* has evolved in case law in the United States, and is an essential aspect of proving that the auditor knew about a fraudulent scheme. The term *scienter* refers to “a mental state embracing intent to deceive, manipulate, or defraud” (*Hochfelder*, in SEC Release No.

183). Case law suggests that the SEC can establish *scienter* by proving that the auditor had actual knowledge of the fraudulent accounting activities, or was reckless in conducting the audit. The presentation of a clean (unqualified) audit opinion in cases where there was a clear violation of GAAP in and of itself is not sufficient for proving *scienter*. However, *scienter* may be present when violations of both GAAP and GAAS are combined with other circumstantial evidence of recklessness. These other determinants include situations where: (a) the auditor ignores multiple red flags that should heighten his or her professional skepticism; (b) there were unusual transactions completed at the end of the accounting period; or (c) there is consideration of the magnitude of the reporting errors, especially when the auditor was in a position to detect them (SEC Release No. 183).

In order to defend against potential liability, the auditor must prove that he or she acted in good faith and had no knowledge of the misleading statements, or that the plaintiff's loss was the result of something other than the misleading financial statements (Louwers, 2007). The auditor can show that he is not liable for damages by offering a *due diligence* defense. Essentially, this defense allows the auditor to show that a reasonable examination of the financial statements was completed, consistent with generally accepted auditing standards. Alternatively, the auditor can show that any loss incurred by the plaintiff was the result of something other than the misleading financial statements. Pertaining to the case against Scuttillo and Jensen, the SEC failed to show that the auditors knew about the fraudulent financial statements or otherwise met the criteria necessary to establish recklessness on their part.

CONCLUDING COMMENTS

The rich context of the case provides the opportunity to initiate discussions or build upon

previous discussions of several auditing topics related to the Sky Scientific, Inc. case. For instance, a question could be posed regarding *why* a CPA would risk the loss of his or her reputation when conducting an audit? Was the CPA in this case in over his head? Did the CPA not have sufficient experience to conduct the Sky Scientific audit? Other questions that could be posed to students would be to have them consider whether an audit failure such as the one described in the Sky Scientific case could occur in today's audit climate, post-Sarbanes-Oxley.

Appendix A – The 10 Generally Accepted Auditing Standards

General Standards*

1. The auditor must have adequate technical training and proficiency to perform the audit.
2. The auditor must maintain independence in mental attitude in all matters relating to the audit.
3. The auditor must exercise due professional care in the performance of the audit and the preparation of the report.

Standards of Fieldwork**

1. The auditor must adequately plan the work and must properly supervise any assistants.
2. The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, to design the nature, timing, and extent of further audit procedures.
3. 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.

Standards of Reporting*

1. The auditor must state in the auditor's report whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).
2. The auditor must identify in the auditor's report those circumstances in which such principles (GAAP) have not been consistently observed in the current period in relation to the preceding period.
3. When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report.
4. The auditor must either express an opinion regarding the financial statements, taken as a whole, or state that an opinion cannot be expressed, in the auditor's report. When the auditor cannot express an overall opinion the auditor should state the reasons therefor in the auditor's report. In all cases where an auditor's name is associated with financial statements, the auditor should clearly indicate the character of the auditor's work, if any, and the degree of responsibility the auditor is taking, in the auditor's report.

* Wording of the general standards and standards of reporting changed by *SAS No. 113*, effective for audits of periods beginning on or after 12/15/06.

** Wording of the fieldwork standards changed by *SAS No. 105*, effective for audits of periods beginning on or after 12/15/06

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Sky Scientific, Inc.

An Auditing Mine Field

Learning Objectives and Implementation Guidelines

Overview

This case draws information from several SEC Accounting Enforcement and Administrative Proceedings Releases to examine a remarkable real-life occurrence of audit failure. The information presented about the 1994 audit of Sky Scientific, Inc. is instructive because it reveals many of the ways that audit evidence gathering procedures can be compromised, and the case provides a memorable reminder that audit evidence is the basis for issuing a correct audit opinion.

The case provides material that can be used in introductory, advanced, or graduate auditing classes, and is designed to address a number of issues related to different steps in audit process. The case involves Sky Scientific, Inc., a mining company that operated in the Western United States during the 1990s. The case presents information about the company's operating and financing activities, the work of the auditors, and investigations of the Securities and Exchange Commission (SEC). The case material is sufficiently flexible, such that students would have the ability to apply concepts generally presented in introductory auditing text books; advanced or graduate students would be able to complete more in-depth research.

This case provides an opportunity to examine numerous issues involved in planning for and conducting an audit. The case materials describe several audit risks and how these risks impact the audit engagement process and audit program. Next, students are asked to identify issues related to management representations, and evaluate the adequacy of the audit procedures used, as well as the quality of the audit evidence gathered. Specific issues related to asset

valuation and expense recognition are presented. Further, the confirmation process and other evidence gathering techniques presented in the case raise questions about information sources, related parties, and undue influence on the part of management. The case also provides the opportunity to discuss the roles and responsibilities of both a concurring auditor and a specialist in a given field. The elements of the case add to an understanding of the roles and responsibilities of these audit participants beyond what is often included in the introductory or even advanced auditing courses.

Sky Scientific is conducive to a discussion of facets related to the involvement of regulatory authorities (e.g., the SEC), and civil and legal liability. Finally, the case provides a framework for either introducing students to the revised wording of the 10 generally accepted auditing standards and the recently issued Statements on Auditing Standards, or provides an opportunity to review and apply the standards if students have already been exposed to the revised standards.

Learning Objectives

This case is designed to introduce the student to a variety of issues related to the planning and conduct of an audit. It provides students with the opportunity to apply their knowledge of basic auditing principles and practices to a specific situation. Further, it provides them with a chance to consider some of the complications and challenges associated with an audit engagement, and the decisions an auditor needs to make to respond to these challenges. Learning objectives specific to this case include:

- Identification of audit risks: The introductory material provides sufficient information to identify a number of potential risks associated with entering into and conducting the audit.

Students are asked to identify these risks and evaluate their impact on the auditor's decision to accept the engagement and the audit program.

- Evaluation of management representations: Students are asked to identify questionable management representations. Valuation of assets and expense recognition are two issues specifically discussed in the case.
- Knowledge of auditing standards, audit procedures, and audit evidence: Students are asked to identify where it appears the auditors failed to follow the ten (10) generally accepted auditing standards (GAAS). Further, they are asked to understand the relationship between auditing standards and procedures, and the nature of sufficient appropriate audit evidence.
- Understanding of the confirmation process: Students are asked to understand the role of the confirmation process in obtaining audit evidence. Particular attention is given to the importance of maintaining control of the confirmation process.
- Identification of the proper role of concurring auditors and specialists: Students are asked to identify the roles and responsibilities of both concurring auditors and specialists in a given field.
- Understanding the role of regulatory and other authorities: Reference to the SEC investigation and proceedings introduce the student to the role of the Securities and Exchange Commission (SEC), differences between civil and criminal liability, and the concept of *scienter*.

Implementation Guidelines

The case is sufficiently flexible to accommodate varying degrees of research requirements. Undergraduate students would have the opportunity to refer to an introductory auditing text book

in order to gain a basic understanding of issues identified in this case. Advanced or graduate students would be able to complete more in-depth research using source material available through the AICPA Statements of Auditing Standards (SASs), SEC proceedings, and other sources.

Using the Case with Graduate Students

The case was successfully used in a graduate auditing class. The class was a discussion-based class, and since the case was presented at towards the end of the semester, students were familiar with the research they needed to do to prepare to discuss the case in class. Two students were assigned to lead the discussion of the case, and to solicit answers to the questions presented in the case. This method worked well in a graduate student environment, especially since the students are graded on class participation. Alternatively, the students could be instructed to provide a written analysis of the case, including answering each of the questions posed at the end of the case.

Using the Case with Undergraduate Students

The case was also successfully used in two different undergraduate auditing classes as an introduction to working on auditing cases. These classes were primarily lecture-based, with students often being given class time to work on short team exercises related to various auditing issues in class. The students were provided with a copy of the case and the questions at the end of the case and instructed to read the case and consider possible answers to all of the questions. To help ensure a good classroom discussion, groups of students were assigned primary responsibility for each of the questions. In other words, when the students were given the case a week before it was to be discussed in class, the students were assigned to teams. Team #1 was assigned Question #1, Team #2 was assigned Question #2, etc. The day the case was discussed in class the teams

were given a brief amount of class to confer about their answers before the discussion of the case began.

Of course, alternatively, the students could have been instructed to provide a written analysis of the case. There is a great deal of flexibility that can be exercised in using the case; the questions at the end of the case could all be assigned, or only a portion of the questions could be assigned, depending on the material covered in the course, the level of understanding of the students, etc.