

**The SEC's Case Against California Micro Devices: A Lesson in Using Professional  
Skepticism and Obtaining Sufficient Appropriate Evidence**

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**Abstract:**

This case involves charges by the Securities and Exchange Commission (SEC) against a partner and a manager for recklessly failing to comply with auditing standards relating to three areas: a \$12 million write-off of accounts receivable; confirmation of accounts receivable, and sales returns and allowances. The SEC believed the auditors didn't exercise due professional care or employ an adequate level of professional skepticism when performing the audit. The SEC also believed that there was insufficient appropriate evidential matter to express an opinion. This case addresses the following auditing content: generally accepted auditing principles, risk of misstatement due to fraud, fraud risks, analytical procedures, estimates, confirmation of accounts receivable, and work papers.

**Keywords:** Accounts Receivable; Audit; Due Professional Care; Evidence; Fraud; Securities and Exchange Commission

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**INTRODUCTION**

Coopers & Lybrand, LLP performed annual audits of California Micro Devices, Inc.'s (CMD)<sup>1</sup> financial statements from 1990 until January, 1995. Michael Marrie was the engagement partner and Brian Berry was the audit manager. Although CMD (a company in the fast-changing technology industry) recorded an increase of \$3 million in net income from fiscal year 1993 (\$2 million) to fiscal year 1994 (\$5 million) on its Form 10K, the Company had some financial issues. CMD lost a large (32% of product sales during the previous period), dependable, credit customer, Apple Computer, Inc. This loss altered the ability to predict future accounts receivable collections. Also, more of the Company's sales were to foreign customers, resulting in more lengthy transit times and longer payment terms. The lengthy transit times affected the amount of time these foreign customers took to pay, as well as the amount of time to return the merchandise to CMD.

Prior to fiscal year 1994, the audits of CMD's financial statements produced some startling information. First, CMD erroneously recognized revenues on products that were ready to be shipped on the last day of the fiscal year, but were actually shipped subsequent to year end. Second, CMD's revenue was not recognized evenly throughout the fiscal year, which could

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<sup>1</sup> The enforcement release issued by the Securities and Exchange Commission (SEC) provided the background for this case. Unless indicated otherwise, the quotations in this case are drawn from the following source: Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 1823* (July 29, 2003).

indicate that revenue was not recorded properly. Historically, the Company would recognize 70% to 90% of its sales in the third month of each quarter. Both of these revenue related items directly affected accounts receivable, an account which Marrie and Berry, had therefore, identified as a critical area during the audit.

Marrie and Berry finished the 1994 fiscal year audit, which resulted in an unqualified audit opinion, even though a few weeks prior, one shareholder filed a lawsuit against CMD for accounting improprieties related to a large write-off of accounts receivable near the end of fiscal year 1994.

### **COOPERS & LYBRAND'S AUDIT OF CMD**

By the time Coopers & Lybrand's auditors began working on CMD's 1994 fiscal year audit, the auditors, including Marrie and Berry, were very familiar with the people and the financial information of CMD. The Company had been an audit client since 1990. Marrie, who had been licensed as a CPA for over twenty years, had always worked on CMD's audit and became the engagement partner in 1992. Berry, who had been licensed as a CPA for nearly ten years, had worked on a few of CMD's audits before becoming the audit manager for the 1994 audit.

For the 1994 audit, the three areas of concern were: (1) write-off of accounts receivable, (2) confirmation of accounts receivable, and (3) sales returns & allowances.

## **Write-off of Accounts Receivable**

Ronald Romito, CMD's chief accounting officer, told Marrie and Berry that the Company would write-off \$12 million in accounts receivable near the end of the fourth quarter, of which \$4 million would be allocated to bad debts expense. This large write-off related to terminated distributors or some of the Company's long distance customers who were unable to pay for the product or who had returned merchandise. Marrie requested supporting documentation from Romito for the large write-off and asked that he prepare a spreadsheet, listing the receivables, along with the reasons for their write-off. Romito failed to provide the requested analysis supporting the write-off of \$4 million to bad debt expense. Marrie and Berry didn't insist on the requested analysis, nor did they further investigate the accounts that were written off (e.g., contact customers to determine that the products were returned or that the customers couldn't pay). The work papers did not make reference to any requested spreadsheet, nor did they include an explanation of the evidence used to arrive at the conclusion.

During this time period, CMD issued a press release to disclose its fourth quarter earnings, which also included the amount of the accounts receivable write-off of \$8.3 million, not the \$12 million that Romito had discussed with Marrie. Also the stated reason for the write-off had been changed in the press release. After much discussion between Romito and Marrie, the final distribution included \$1.3 million for bad debt expense, as opposed to the \$4 million originally stated. One shareholder ultimately filed a lawsuit against CMD for accounting improprieties related to this write-off. Despite all of these warning signs, the auditors did not make any adjustments to their audit plan, nor did they perform additional procedures or request an explanation for the inconsistencies.

Another effect of the large write-off of accounts receivable near year-end was the impact that the write-off may have had on inventory obsolescence and the collectability of accounts receivable. In terms of the inventory obsolescence issue, the auditors did not consider that the products returned as part of the write-off of accounts receivable may not be able to be resold due to obsolescence. Obsolescence was an issue, especially given CMD's industry. The fast changing technology industry made CMD's inventory vulnerable to rapid changes and technological advancements.

The issue of the collectability of accounts receivable was not investigated by the auditors either, especially after CMD expressed in its press release that a portion of the write-off of accounts applied to customers who were unable to pay. Furthermore, the collectability of accounts receivable was questionable since CMD was selling products to the same customers related to the original write-off.

### **Confirmation of Accounts Receivable**

Marrie and the Coopers & Lybrand audit team identified accounts receivable as a critical audit area, but did not perform adequate procedures. They had mailed confirmations to all accounts with balances greater than or equal to \$100,000. Also, twenty accounts with balances under \$100,000 were randomly selected to confirm. Of the 54 accounts receivable customers who were sent confirmations, twenty five confirmed their full balances, twelve confirmed only a portion of their balance, and seventeen did not confirm any portion of their balances. In these cases, the auditors did not sufficiently document the evidence that they examined when performing the alternative procedures and the auditors accepted CMD's explanations without obtaining corroborating evidence. Some of the discrepancies raised the concern that CMD was

improperly recording revenue on products that had not yet been shipped. For instance, when looking at shipping documents for one customer, Solectron, Inc., the auditor wrote that “she reviewed unidentified shipping documents showing that \$115,050 in product had been shipped ‘right before year end...’” (15). In another instance, the auditor did not document any procedures performed to explain a significant discrepancy reported by another customer, GSS/Array Technology, in the confirmation.

### **Sales Returns & Allowances**

Marrie and Berry analyzed CMD’s sales returns to determine the reasonableness of estimates made by CMD’s management for the allowance for returns amount. In calculating the ratio of returns to sales, the auditors relied on CMD’s premise that almost all of the sales returns were made within two months of the purchase date. This premise was unreasonable for two reasons. First, CMD’s contracts indicated that customers could return merchandise within one year after purchase. Second, since CMD had many foreign customers, the overseas shipments frequently took six weeks to deliver.

Despite contradictory evidence, Marrie and Berry accepted CMD’s amount of sales returns for the fiscal year of approximately \$4.5 million. This amount was not reasonable given that sales returns for the fourth quarter alone were \$5.3 million, as stated in a press release. In addition, when estimating sales returns, Marrie and Berry erroneously accepted a product sales figure of \$7 million for two months, per a management trend report. This amount was significantly less than CMD’s aged trial balance for the end of the fiscal year, which disclosed \$12 million in accounts receivable (thirty days or less). The auditors, therefore, arrived at an estimate for sales returns that was too low based on available evidence.

## **CMD'S FRAUD AND THE SEC'S CASE AGAINST COOPERS & LYBRAND**

Overall, CMD's fraudulent recording of sales applied to goods that were never shipped, to goods sold, which the payment was uncertain, and to selling lower quality goods, where the increase in returns was likely. CMD's cover-up of these fraudulent selling activities was part of the reason for the large write-off of accounts receivable at the end of fiscal year 1994. In addition, CMD's accounting employees, along with some customers, engaged in developing fictitious shipping documents and invoices to cover-up the fraudulent acts.

Coopers & Lybrand ceased to perform audits of CMD after fiscal year 1994, but the auditors didn't make any changes to the audit opinion of CMD's 1994 financial statements. Early in 1995, CMD restated its 1994 financial statements with the SEC. Finally, the SEC "charged" Marrie and Berry with "engaging in improper professional conduct by engaging in intentional or knowing conduct, including reckless conduct, that results in violations of applicable professional standards" (7). The SEC believed that Marrie and Berry didn't exercise due professional care or employ an adequate level of professional skepticism when performing CMD's 1994 fiscal year audit. Also, in the audit, sufficient competent evidential matter was lacking to express an audit opinion as it related to CMD's write-off of accounts receivable, the accounts receivable balance, and the sales returns amount. As a result of these audit deficiencies, the SEC denied Marrie and Berry the privilege of practicing before the SEC.

### **Questions**

1. Professional Standards: The SEC concluded that the auditors engaged in improper professional conduct as a result of their reckless failure to comply with professional

standards. Identify one general standard and one standard of fieldwork that was violated.

Explain the nature of the violations. Organize your response according to the three specific areas of the audit discussed in the case.

2. Risk Assessment: The auditors' assessment of risk of material misstatement due to fraud should be ongoing throughout the audit. Read SAS No. 99 (AU316A), Consideration of Fraud in a Financial Statement Audit. Describe conditions that existed during this audit that were indicative of such risk.
3. Fraud Risk: When auditors have identified fraud risk, describe the actions they should take in response to these risks. Did these auditors respond appropriately? Use specific examples from the case to explain your answer.
4. Analytical Procedures: The first step in performing analytical procedures is to develop an expectation of an account or ratio balance. Trend analysis, or reviewing the changes in an account balance over time, is one technique used in developing such expectation. Explain the challenges in using financial information from previous periods in this audit.
5. Estimates: The SEC challenged the steps taken by the auditors in evaluating the reasonableness of accounting estimates. Using authoritative standards, describe how auditors should evaluate the reasonableness of estimates. Identify the specific items in this audit where the auditors were deficient in evaluating the reasonableness of accounting estimates.

6. Confirmations: When confirming accounts receivable balances, describe alternative procedures that should be performed after replies to second requests have not been received. *Optional*: Obtain the actual Accounting and Auditing Enforcement Action (Release No. 1823) on the SEC website ([www.sec.gov](http://www.sec.gov)) to describe the deficiencies with respect to the specific cases where the SEC has challenged the adequacy of procedures performed. You will find the details in section III.B.2. (“Marie and Berry Recklessly Failed to Comply with Applicable Standards in their Confirmation of CMD’s Accounts Receivable”).
7. Work papers: The auditors work papers were deficient in several respects. Had the audit occurred more recently, they would have had to adhere to standards of the Public Company Accounting Oversight Board (PCAOB). Consult PCAOB Standard No. 3 paragraph 2 to explain the objectives of audit documentation. Describe the specific deficiencies with the work papers in this audit.

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## **LEARNING OBJECTIVES / IMPLEMENTATION GUIDELINES**

### **Overview**

This case is based on an actual SEC Accounting and Auditing Enforcement Release involving numerous auditing deficiencies. It is designed to supplement the use of an auditing textbook. By using a real life example, we hope to make the topics in this case more interesting for the students and, as a result, increase student comprehension.

### **Learning Objectives**

At the conclusion of the case, students should be able to:

- Explain and apply generally accepted auditing principles.
- Identify risk of material misstatement due to fraud.
- Identify appropriate responses to fraud risks.
- Identify limitations of analytical procedures
- Describe how auditors should evaluate the reasonableness of estimates.
- Describe alternate procedures that should be performed relative to the confirmation of accounts receivable.
- Describe the objectives of work papers.

Core competencies addressed by this case include the following: research, critical thinking, problem solving/decision making, communication, and teamwork skills (if completed in groups).

## Implementation in Class

The case can be used in either an undergraduate or graduate auditing course. There are numerous ways that instructors can control the level of difficulty in assigning the case.

- **Timing/magnitude of the assignment:** To make the material more suitable for introductory level, instructors should consider distributing the case during the early part of the semester and completing the case in pieces. Thus, each question can be separately assigned after introducing the applicable topic in class. Alternatively, the case can be assigned toward the end of the semester and can, therefore, serve as a more comprehensive assignment. This would be the preferred style for a graduate course. Regardless of the timing of the assignment, the instructor has the option of covering all or only select questions in the case based on desired topics appropriate for the specific course.
- **Degree of research:** This case requires students to research topics using auditing standards and other professional sources. This focus on research coincides with the increased emphasis on research skills by the profession and, as a result, on the CPA exam. Depending on the level of sophistication of the students, the instructor may 1) have the students research all of the standards assigned in the questions on their own (or in groups); 2) handout select standards applicable to the case; or 3) guide the students in locating the relevant standards. For a more advanced approach, the instructor may have the students obtain the actual Accounting and Auditing

Enforcement Action (Release No. 1823) on the SEC website ([www.sec.gov](http://www.sec.gov)) rather than distribute the scenario summarized in this case.

- **Critical thinking:** We recommend that instructors have the students write their own question/answer (s) to supplement the material already provided in this case. Previous experience indicates that students can be perceptive and creative when asked to write their own questions. This approach also reveals to the instructor areas on which students are focusing. The instructor can focus on varying degrees of learning outcomes to tailor this part of the assignment to the level of sophistication desired. For instance, at the most introductory level, the student may be asked to identify a particular fact in the case. At the more advanced level, the student may be asked to more critically analyze such fact. Alternatively, the student may be asked to use several real examples located using research techniques.

Students can complete this assignment individually or in groups, and may prepare their responses in writing or as class presentation. There are advantages to assigning group presentations. Some students in class have reported that group discussion has helped them to more clearly understand the issues in the case. Furthermore, based on experience, students have been more thorough when discussing the case in class rather than when preparing written responses.

## TEACHING NOTES/SOLUTIONS

Below are the questions repeated in bold and suggested solution for each question.

1. **Professional Standards: The SEC concluded that the auditors engaged in improper professional conduct as a result of their reckless failure to comply with professional standards. Identify one general standard and one standard of fieldwork that was violated. Explain the nature of the violations. Organize your response according to the three specific areas of the audit discussed in the case.**

The following two generally accepted auditing standards were violated:

- The third general standard, which indicates that auditors must exercise due professional care when performing the audit and preparing the report. This standard implies that auditors should plan and perform the audit with an attitude of professional skepticism.
- The third standard of fieldwork, which indicates that auditors must obtain sufficient appropriate evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements.

The SEC believes that the auditors did not comply with either of these standards with respect to three specific areas of the audit: 1) the write-off of accounts receivable; 2) confirmation of accounts receivable; and 3) sales returns and allowances for sales returns.

- 1) Write-off of accounts receivable

The auditors were aware that the write-off of accounts receivable was unusually large and had occurred near year end. However, the auditors did not perform additional procedures to determine the validity of such a write-off. When the client failed to provide requested analysis supporting the write-off, the auditors did not follow up on this. Furthermore, there was a discrepancy between the amount of and reason for the write-off as stated by the client versus a press release.

The SEC also concluded that the auditors failed to consider the impact of the write-off with respect to two areas: inventory obsolescence and the collectability of accounts receivable. Despite a strong indication of a risk of error in management's estimate, the auditors did not perform additional steps to adequately evaluate inventory valuation. Furthermore, the collectability of accounts receivable was questionable since the client was selling products to the same customers related to the original write-off.

## 2) Confirmation of Accounts Receivable

Prior problems with revenue recognition, along with the high rate of non-confirming responses and significant discrepancies reported during the confirmation process, should have raised questions about the reliability of the confirmation process. Specific confirmations raised the risk that the client was improperly recording products that had not yet been shipped as revenue. The auditors did not appropriately follow up on discrepancies and inappropriately accepted management's explanations.

### 3) Sales Returns and Allowances for Sales Returns

The auditors failed to investigate numerous discrepancies and seek corroborative evidence from customers. Specifically, in developing their own estimate, the auditors relied on the client's estimated time frame for sales returns, which conflicted with other evidence. They also accepted sales and sales returns amounts per the client, despite contradicting evidence per relevant documents and per the aged trial balance.

## 2. **Risk Assessment: The auditors' assessment of risk of material misstatement due to fraud should be ongoing throughout the audit. Read SAS No. 99 (AU316A), Consideration of Fraud in a Financial Statement Audit. Describe conditions that existed during this audit that were indicative of such risk.**

SAS No. 99 (AU316A) indicates that certain conditions may be identified during fieldwork that impact the auditor's assessment of the risk of material misstatement due to fraud. Some of the conditions present in this audit include the following:

- A history of premature revenue recognition. The auditors had been aware that during the previous two years, CMD had recognized revenue when products had been ready for shipping on the last day of the reporting period, but hadn't actually been shipped until after year end. As a result, CMD had falsely inflated revenue.
- Difficulty with revenue linearity. In the past, CMD had reported 70-90 percent of its sales in the third month of each quarter.
- A shareholder lawsuit alleging accounting improprieties.

- Discrepancies in the accounting records. Specifically, product sales per the aged trial balance did not agree with management reports relied upon by the auditors.
- A significant and unsupported write-off of accounts receivable near year end. CMD failed to provide support for the write-off despite the auditors' requests for detailed analysis. Furthermore, the amount and explanation for the write-off conflicted with information revealed in a press release
- An unusually high rate (i.e., over one half) of non-confirming accounts receivable responses.

**3. Fraud Risk: When auditors have identified fraud risk, describe the actions they should take in response to these risks. Did these auditors respond appropriately? Use specific examples from the case to explain your answer.**

According to SAS No. 99, auditors should respond to fraud risk in the following three ways:

- 1) Modify the overall audit approach (e.g., obtain more corroborating evidence; assign more senior personnel; further consider management's application of accounting principles; use less predictable auditing procedures)
- 2) Alter the nature, timing, and extent of specific procedures (e.g., obtain more reliable audit evidence, shift procedures to year-end; increase sample sizes).

3) Perform procedures to further address the risk of management override of internal control (e.g., review suspicious journal entries; review accounting estimates for biases; evaluate the business rationale for significant unusual transactions).

In this audit, numerous such risks were obvious and the auditors did not appropriately respond. A few such examples are as follows. (Note: Students may choose to select other examples in the case).

- The auditors accepted CMD's write-off of over \$4 million in accounts receivable to bad debt despite not receiving requested supporting analysis. The auditors had recognized the importance of accounts receivable as a critical audit area and had noted that the write-off near year-end was unusual. They had questioned CMD's initial proposal of the write-off and had requested a line by line analysis with reasons for writing off each receivable for each customer. When CMD failed to produce the requested analysis, the auditors did not insist on this evidence, nor did they perform additional procedures (e.g., contact customers) to determine the basis for the write-off.
- The auditors were aware of a shareholder lawsuit alleging accounting improprieties in connection with the write-off. In addition, the amount of and reason for the write-off conflicted with information revealed in a press release. Despite these red flags, the auditors did not make any adjustments to the audit plan, did not perform additional procedures, and did not request an explanation for the inconsistencies.
- The auditors had identified accounts receivable as a critical area, especially given prior problems with premature revenue recognition. Despite a high rate of non-

confirming responses (over one half), the auditors did not appropriately follow-up on questionable responses.

4. **Analytical Procedures:** The first step in performing analytical procedures is to develop an expectation of an account or ratio balance. Trend analysis, or reviewing the changes in an account balance over time, is one technique used in developing such expectation. Explain the challenges in using financial information from previous periods in this audit.

The challenges involved in trend analysis during this audit include the following:

- The write-off of \$12 million in accounts receivable and the loss of Apple Computer, Inc. as a major customer. Apple Computer, Inc. had accounted for 32% of product sales during the previous period. As a result of both of these events, the auditors could not depend on the past collectability of its accounts receivable to predict future collectability.
- The increase in net product sales to foreign customers. The change in customer base resulted in more lengthy transit times and extended payment terms. The lengthy transit times affected the amount of time customers took to pay, as well as the return of merchandise to CMD.

5. **Estimates:** The SEC challenged the steps taken by the auditors in evaluating the reasonableness of accounting estimates. Using authoritative standards, describe how auditors should evaluate the reasonableness of estimates. Identify the specific items in

**this audit where the auditors were deficient in evaluating the reasonableness of accounting estimates.**

The applicable authoritative standard is as follows:

AU Section 342 - Auditing Accounting Estimates

Source: SAS No. 57; SAS No. 113

.09 In evaluating the reasonableness of an estimate, the auditor normally concentrates on key factors and assumptions that are

- a.* Significant to the accounting estimate.
- b.* Sensitive to variations.
- c.* Deviations from historical patterns.
- d.* Subjective and susceptible to misstatement and bias.

The auditor normally should consider the historical experience of the entity in making past estimates as well as the auditor's experience in the industry. However, changes in facts, circumstances, or entity's procedures may cause factors different from those considered in the past to become significant to the accounting estimate.

.10 In evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate. Based on that understanding, the auditor should use one or a combination of the following approaches:

- a.* Review and test the process used by management to develop the estimate.

- b. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.
- c. Review subsequent events or transactions occurring prior to the date of the auditor's report.

The standards also indicate that in reviewing and testing management's process, the auditors should analyze historical data to assess whether the data is comparable and consistent with data of the period under audit.

The specific areas in this audit where the auditors were deficient involve three areas:

1) Realizable value of accounts receivable:

CMD had written off a portion of accounts receivable relating to terminated distributors or others who had not been able to pay for products or who had returned the merchandise. There was a risk that some of the present accounts receivable balances would not be collected since they had been made to these same customers. The auditors did not adequately consider the impact of the write-off on the collectability of the accounts receivable.

2) Valuation of inventory:

CMD wrote off \$12 million in accounts receivable and instructed customers to return products, some of which had been defective. Given the nature of these products, the inventory was vulnerable to rapid changes and technological advancements. The auditors did not consider the impact of the write-off on inventory obsolescence.

### 3) Allowance for sales returns

In reviewing CMD's sales returns and calculating a ratio of returns to sales, the auditors relied on CMD's representation that almost all returns were made within two months of purchase. This premise was not reasonable since contracts indicated that customers could return merchandise within one year after purchase and since shipments to foreign customers frequently took six weeks to deliver.

In addition, amounts used by the auditors in their analysis were not reasonable based on other evidence. The amount of sales returns for the fiscal year per the financial statement (\$4.5 million) was less than the amount of sales returns for just one quarter, as stated in a press release (\$5.3 million). In addition, the product sales amount (\$7.0 million) the auditors had used to estimate sales returns based on a CMD report conflicted with the aged trial balance (\$12 million).

- 6. Confirmations: When confirming accounts receivable balances, describe alternative procedures that should be performed after replies to second requests have not been received. *Optional:* Obtain the actual Accounting and Auditing Enforcement Action (Release No. 1823) on the SEC website ([www.sec.gov](http://www.sec.gov)) to describe the deficiencies with respect to the specific cases where the SEC has challenged the adequacy of procedures performed. You will find the details in section III.B.2. ("Marie and Berry Recklessly Failed to Comply with Applicable Standards in their Confirmation of CMD's Accounts Receivable").**

Alternative procedures may include examining subsequent cash receipts (including matching receipts with the items being paid), shipping documents, or other client documentation.

- **Soletron, Inc.:** This customer reported that two shipments had not been received. The auditors noted examining unidentified shipping documents showing that products had been shipped “right before year end”. The auditors should have examined purchase orders to determine if the customers had ordered such items. Furthermore, they should have noted details (e.g., exact dates and numerical sequences) per the shipping documents.
- **Analogic, Inc.:** This company disputed over one third of the accounts receivable balance. The auditor determined that a portion of the disputed amount related to a sale that had been previously paid. The auditor should have matched gross cash receipts with the actual items being paid. With respect to the remaining disputed balance, the auditor reviewed shipping documents, but did not inquire why the products had not been received forty-eight days later.
- **National Semiconductor Corp.:** This company was unable to confirm the complete balance due to problems with its own internal records. The auditor merely reviewed subsequent payments, but did not match the gross cash receipts with the actual items being paid.
- **GSS/Array Technology:** This company initially confirmed the full amount, but later denied most of the amount. The auditors accepted the client’s explanation without further investigation of the customers’ response.

7. **Work papers:** The auditors work papers were deficient in several respects. Had the audit occurred more recently, they would have had to adhere to standards of the Public Company Accounting Oversight Board (PCAOB). Consult PCAOB Standard No. 3 paragraph 2 to explain the objectives of audit documentation. Describe the specific deficiencies with the work papers in this audit.

The following excerpt is taken from PCAOB Standard No. 3:

#### Objectives of Audit Documentation

*Audit documentation* is the written record of the basis for the auditor's conclusions that provides the support for the auditor's representations, whether those representations are contained in the auditor's report or otherwise. Audit documentation also facilitates the planning, performance, and supervision of the engagement, and is the basis for the review of the quality of the work because it provides the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. Among other things, audit documentation includes records of the planning and performance of the work, the procedures performed, evidence obtained, and conclusions reached by the auditor. Audit documentation also may be referred to as *work papers* or *working papers*.

Specific deficiencies with the work papers in this audit relate to the write-off of accounts receivable and procedures performed to confirm accounts receivable.

- Write-off: Although the write-off of accounts receivable was significant, the work papers do not provide sufficient detail. They include neither the spreadsheet detailing

the write-off, nor an explanation of the evidence used to arrive at a conclusion documented by the senior accountant that the write-off appeared reasonable.

- Confirmations: Although there appeared to be discrepancies with numerous confirmations of accounts receivable, the auditor did not sufficiently document evidence examined when performing alternative procedures. Specifically, when looking at shipping documents for Solectron, Inc., the auditor wrote that “she reviewed unidentified shipping documents showing that \$115,050 in product had been shipped "right before year end..." In addition, the work papers do not explain procedures performed to explain the discrepancies in amount per GSS/Array Technology.

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