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CASE 1.12

MADOFF SECURITIES

Synopsis

A childhood friend summed up the driving force in Bernie Madoff's life: "Bernie wanted to be rich." As a youngster growing up in New York City, Bernie realized that Wall Street was the greatest wealth creation machine the world had ever known. So, after graduating from college in 1960, he set his sights on joining the exclusive fraternity that ran Wall Street by organizing his own one-man brokerage firm, Madoff Securities.

Madoff was one of the first individuals to recognize that computer technology provided the means to "democratize" Wall Street by establishing a system that made securities trading much more efficient and much cheaper. In the early 1970s, Madoff and several other individuals organized the NASDAQ exchange, which was destined to become the world's largest electronic stock market. Years later, the NYSE would be forced to follow suit and switch to electronic securities trading. Literally hundreds of millions of investors have benefitted from the lower transaction costs of electronic securities trading that were in large part a result of the pioneering efforts of Bernie Madoff.

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Unfortunately, Bernie Madoff will not be remembered as a pioneer of electronic securities trading. Instead, the word "Madoff" will always be associated with the phrase "Ponzi scheme." Although his stock brokerage firm was extremely lucrative, Madoff eventually established a parallel business, investment advisory services. Over a period of several decades, Madoff became known as the "Wizard of Wall Street" for the incredibly consistent and impressive returns that he earned on the billions of dollars entrusted to him by investors. However, those returns and Madoff's secretive investment strategy that produced them were fraudulent.

This case documents the Madoff fraud with a particular focus on its implications for the nation's financial reporting system. Many critics have insisted that the ineffectiveness of the SEC was a major factor that allowed Madoff to sustain his fraud for so long. Likewise, those critics insist that Madoff's independent auditor played a major role in allowing the fraud to go unchecked for decades. Throughout most of its existence, Madoff Securities was audited by a small accounting firm with one professional accountant. That accountant, David Friehling, would become the second individual arrested by federal prosecutors investigating Madoff's massive fraud. Friehling was charged with "flouting" the accounting profession's auditor independence rules and with performing "sham audits" of Madoff Securities.

Madoff Securities--Key Facts

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1. The driving force in Bernie Madoff's life was his desire to become wealthy.

2. Madoff founded Madoff Securities, which was one of the first brokerage firms to employ computer technology to reduce the cost of securities transactions; Madoff is also credited as one of the founders of the NASDAQ, the world's largest electronic stock exchange.

3. The investment advisory division of Madoff Securities grew dramatically over the life of the firm due to the incredibly consistent and impressive rates of return that it earned for investors.

4. In early December 2008, Madoff confessed to family members that his firm's impressive investment results were fraudulent, the product of a massive Ponzi scheme that he had carried out over decades.

5. News of the massive fraud prompted an angry public to question why the nation's "watchdogs" for the capital markets, particularly the independent audit function, had failed once again.

6. Madoff's auditor had been a tiny CPA firm, Friehling & Horowitz, with one professional accountant, David Friehling.

7. Accounting and auditing experts insisted that it was "preposterous" that one person could audit a firm the size of Madoff Securities.

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8. In March 2009, Friehling was arrested and charged with securities fraud and aiding and abetting an investment fraud due to his allegedly "sham audits" of Madoff Securities; federal prosecutors also revealed that Friehling and his firm had a large amount of funds invested with Madoff Securities.

9. The SEC was the target of harsh criticism when it was revealed that Harry Markopolos, a Boston-based financial analyst, had repeatedly told the federal agency that Madoff was operating the "world's largest Ponzi scheme" and had provided evidence apparently proving that allegation.

10. In March 2009, Madoff pleaded guilty to eleven counts of fraud, money laundering, perjury, and theft; in June 2009, Madoff was sentenced to 150 years in federal prison.

11. KPMG became the first of the Big Four firms to be sued as a result of the Madoff fraud; the lawsuit alleged that KPMG failed to properly investigate Friehling & Horowitz while auditing the financial statements of a large "feeder firm" in which the plaintiff was an investor.

12. The SEC announced a series of reforms to prevent or detect future frauds similar to Madoff's; one of those measures subjects investment advisers to annual "surprise audits" to ensure that customer funds are properly safeguarded.

Instructional Objectives

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1. To identify the principal precursors of financial fraud.

2. To identify "red flags" or risk factors typically indicative or symptomatic of fraud.

3. To demonstrate the critical importance of a vigorous independent audit function for a free market economy.

4. To examine the regulatory role and responsibilities of the Securities and Exchange Commission.

5. To identify the nature and purpose of peer reviews.

Suggestions for Use

This case is well suited to "kick off" an auditing course, particularly an undergraduate auditing course. The case is high profile, fairly brief, not highly technical, and most importantly documents how vital the independent audit function is to our economy. After studying this case, students should have a crystal clear understanding of why it is so necessary that every large company, both private and public, undergo a truly independent and vigorous financial statement audit each year. No doubt, almost every business in the United States was affected directly or indirectly by Bernie Madoff's massive fraud. The "sham audits" that David Friehling performed on Madoff Securities' financial statements played a central role in allowing Madoff to sustain his fraud for as long as he did.

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If you don't choose to launch your auditing course with this case, you could use it to compliment your coverage of several important auditing topics including internal controls, auditor independence, and fraud. This case also provides an opportunity to discuss a technical topic that doesn't arise in many alleged audit failures, namely, the audit procedures that should be applied to a client's major stock market investments. Another technical topic in this case that is seldom addressed in other audit cases is peer reviews.

As with all of the "live" cases in this text, you will likely want to have your students research recent developments in this case—see the initial case question. No doubt, there will be interesting revelations and new developments in this case for years to come.

Suggested Solutions to Case Questions

1. Consider having individual students or individual student groups provide updates on the following facets of this case: additional criminal charges filed in the case, developments or additional revelations relating to Friehling and his audits of Madoff Securities, litigation involving the auditors of Madoff's "feeder firms," additional recoveries made by the firm's court-appointed trustee, news items focusing on Harry Markopolos, and additional regulatory reforms emanating from the Madoff fraud.

2. The principal authoritative source in the PCAOB's auditing standards vis-à-vis the auditing of investments is AS 2503, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities." The comparable technical material in the AICPA Professional Standards can be found

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in in AU-C Section 501, "Audit Evidence—Specific Considerations for Selected Items." The AICPA has also issued an accounting and audit guide for investment companies. Understandably, the increasing complexity of securities investments in recent years has greatly complicated the auditing of investments, particularly investments involving options and other "exotic" transactions—as noted in the case, the buying and selling of put and call options was a central feature of Bernie Madoff's alleged investment strategy. Listed next are examples of suggested audit procedures for material investments that are included in AS 2503.

- "Confirmation of settled transactions with the broker-dealer or counterparty."
- "Confirmation of unsettled transactions with the broker-dealer or counterparty."
- "Inspecting underlying agreements and other forms of supporting documentation, in paper or electronic form."
- "Inspecting supporting documentation for subsequent realization or settlement after the end of the reporting period.
- "Performing analytical procedures" to determine, for example, whether recorded interest revenue or expense is reasonable.
- "Inspecting financial instruments and other agreements to identify embedded derivatives."
- "Inspecting documentation in paper or electronic form for activity subsequent to the reporting period."
- "Confirming significant terms" [of the given investment with the third party investee].
- "Reading other information, such as minutes of meetings of the board of directors or finance, asset/liability, investment, or other committees."
- "Assessing the reasonableness and appropriateness of the [fair value] model" used to determine the reported value of the security.
- "Calculating the [fair] value" of the given investment.
- "Comparing the fair value with subsequent or recent transactions."
- Ascertaining whether "the accounting principles selected and applied have general acceptance."
- Determining whether the client's "financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation."

Were these and other audit procedures performed by the auditors of Madoff's "feeder firms"? I have no idea. To date, there has been no public disclosure of the specific audit procedures applied by those feeder firms to their clients' Madoff-held investments. As a point of information, there has also been no public disclosure regarding specific details of the Friehling & Horowitz's "sham audits" of Madoff Securities. Hopefully, the resolution of the pending lawsuits in this case will provide us with some insight on the nature and scope of the feeder firm audits and Friehling & Horowitz's audits of Madoff Securities.

3. A "peer review" is an examination of an accounting firm's quality control system and its compliance with the requirements of that system by one or more accounting professionals. You may want to point out to your students that the PCAOB has established its own inspection program to ensure that auditors of public companies have established and are applying appropriate quality control policies and procedures. Of course, the PCAOB inspection program is technically not a "peer" review program but it serves the same general purpose.

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Assuming that Friehling & Horowitz's audits of Madoff Securities were, in fact, "sham audits" as alleged by federal prosecutors, then it seems reasonable to conclude that a thorough peer review would have revealed that those audits were substandard. The resulting peer review report filed with the relevant regulatory or oversight body would very likely have resulted in Friehling & Horowitz being disqualified as Madoff's audit firm.

As discussed in the case, New York adopted a peer review requirement following the Madoff fraud. However, as pointed out in a footnote to the case, a firm the size of Friehling & Horowitz would be exempt from that requirement!

4. AS 2401, "Consideration of Fraud in a Financial Statement Audit" in the PCAOB's auditing standards, is an authoritative source to refer to in responding to this question. (The corresponding section in the "clarified" AICPA Professional Standards is AU-C Section 240.) AS 2401.07 lists the three "angles" of the so-called fraud triangle: the existence of an incentive and/or pressure to commit a fraud, the opportunity to commit a fraud is present (typically due to ineffective internal controls), and the ability to rationalize fraudulent conduct on the part of the given or potential fraudster. These three "conditions" are effectively precursors to fraud. The presence of these factors does not necessarily mean that fraud will occur but an environment in which these conditions are present is much more likely to spawn fraud.

AS 2110.65 notes that "fraud risk factors" are "events or conditions that indicate" that one or more of the three elements of the fraud triangle are present. [The use of the term "conditions" within the professional auditing standards to refer to both the precursors of fraud and the symptoms or indicators of those precursors is somewhat problematic.] Appendix A of AS 2401 identifies dozens of individual "fraud risk factors." A few examples: a high degree of competition or market saturation in a client's industry (incentive/pressure), negative cash flows (incentive/pressure), need to obtain additional debt or equity capital (incentive/pressure), significant related party transactions (opportunity), and known history of violating securities laws or other laws (ability to rationalize).

Each of the three elements of the fraud triangle were present in the Madoff scandal. The principal incentive for Bernie Madoff to commit the fraud was apparently his need to "be somebody," that is, to become a prominent member of the Wall Street community. Madoff developed an organization that he apparently exercised almost complete control over, which gave him the opportunity to perpetrate and conceal his massive fraud. Finally, Madoff testified ex post that he expected that his scheme would be short-lived and that he would eventually be able to "extricate" himself from it. That "storyline" is among the most common that fraudsters use to justify or rationalize their misconduct.

Listed next are fraud risk factors that were present during the Madoff scandal:

- Excessive pressure exists to meet the requirements or expectations of third parties
- Management has a significant financial interest in the given entity
- Domination of management by a single person
- Ineffective oversight over the financial reporting process and internal control by those charged with governance
- Ineffective accounting and information control systems
- A practice by management of committing to third parties to achieve aggressive or unrealistic financial results
- Domineering management behavior in dealing with external auditor

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5. Financial fraud, including fraudulent accounting, has plagued our nation recently. This question provides your students with an opportunity to come up with their own "answers" to this perplexing problem—maybe their solutions would be more effective than the preventative measures implemented in recent years by so-called experts. Consider placing your students in groups to come up with their recommendations and then have each group present and defend their choices.

Listed next are a few random reforms that regulatory authorities could consider adopting to address the fraud "problem":

- Requiring independent auditors to immediately report suspected fraud to regulatory and/or law enforcement authorities. (This measure has been implemented recently in South Africa.)
- Establishing a government audit agency to "take over" the independent audit function. In the 1930s, Congress initially considered creating a government agency to perform the independent audit function when it passed the federal securities laws.
- More rigorous training programs to ensure that government regulators, such as SEC personnel, have the proper background to carry out their oversight responsibilities.
- Educational programs intended to help investors spot investment opportunities that are "too good to be true."
- Longer prison sentences for convicted fraudsters to serve as a deterrent for potential fraudsters.

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AUDITING: A RISK-BASED APPROACH
12E ||ZEHMS, GRAMLING, RITTENBERG||

Solutions for Chapter 2

Solutions Manual Reconciliation from 11e to 12e

Question # for 11e	Deleted or new questions?	Question # for 12e
1		1
2		2
4	Switched order with former Q4.	3
3	Deleted former question and replaced with a new question on false billing schemes.	4
5		5
6		6
7		7
8		8
9		9
10		10
11	Updated for frauds that happened since 11th edition	11
15		12
14	Removed questions relating to COSO studies and replaced with Anti-Fraud Collaboration study	13
12	Switched order and updated contents of question to reflect updated text content on skepticism.	14
16	Changed order.	15
13	Replaced former question with a new one comparing US and international audit standards re. fraud detection.	16
15	Replaced former question with a new question on related-party transactions.	17
17	Deleted former question.	
18		18
19		19
20		20
21		21
22		22

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23		23
24		24
25		25
	New question about shareholder activism.	26
	New question about Theranos & Elizabeth Holmes fraud.	27
26		28
27		29
28	Deleted.	
29		30
30		31
31	Updated former question on 2013 CAQ report with new question on IAASB going-concern reporting during the Covid pandemic – and the associated need for skepticism.	32
32	Updated former questions on 2007 PCAOB report with new question on more recent PCAOB report on risks associated with cryptocurrency and obligations of auditors and audit committee members. Uses Tesla as an example.	33
33	Deleted.	
34		34
35	Deleted.	
36		35
37	Deleted Academic Research case; eliminating this feature.	
38	Deleted Academic Research case; eliminating this feature	
	New Data Analytics Simulation.	36

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Answers to "Check Your Basic Knowledge" Questions

2-1 F
2-2 T
2-3 b
2-4 b
2-5 T
2-6 F
2-7 b
2-8 e
2-9 T

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2-10 T
2-11 d
2-12 a
2-13 F
2-14 F
2-15 d
2-16 d
2-17 F
2-18 T
2-19 a
2-20 e
2-21 T
2-22 F
2-23 a
2-24 b

Review Questions and Short Cases

2-1

Fraud is an intentional act involving the use of deception that results in a misstatement of the financial statements. Two types of misstatements are relevant to auditors' consideration of fraud: (1) misstatements arising from misappropriation of assets and (2) misstatements arising from fraudulent financial reporting. Intent to deceive is what distinguishes fraud from errors.

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2-2

Three common ways that fraudulent financial reporting can be perpetrated include:

- Manipulation, falsification, or alteration of accounting records or supporting documents
- Misrepresentation or omission of events, transactions, or other significant information
- Intentional misapplication of accounting principles

Common types of fraudulent financial reporting include:

- Improper revenue recognition
- Improper deferral of costs and expenses
- Improper asset valuation
- Concealed liabilities
- Misrepresentations or omissions in financial statement footnotes of the management discussion and analysis section

2-3

a. A Ponzi scheme occurs when the deposits of current investors are used to pay returns on the deposits of previous investors; no real investment is happening.

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b. The key elements of the Bernie Madoff fraud include the following actions Madoff perpetrated, which led to the PCAOB now having oversight of the audits of SEC-registered brokers and dealers:

- Fabricated "gains" of almost $65 billion
- Defrauded thousands of investors
- Took advantage of his high-profile investment leader status to establish trust in his victims
- Accomplished the scheme by keeping all the fraudulent transactions off the real financial statements of the company
- Employed a CPA who conducted a sham audit

c. The Bernie Madoff fraud is primarily a case of asset misappropriation. However, it is important to note that asset misappropriation then led Madoff to commit fraudulent financial reporting to hide the asset misappropriation.

2-4

a. A false-billing scheme is a fraudulent plan in which a company makes a purchase and payment that should not be made or makes an overpayment.

b. The typical fraudster in a false-billing scheme works in the Purchasing Department because that department is responsible for buying goods and services so they are in a position to accomplish the fraud in the normal course of daily activities.

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c. To implement the scheme, the fraudster will create another company (Company B) whose sole purpose is to accept fraudulent payments. The fraudster will also set up the fraudulent company on the purchasing company's master file, which is a permanent file containing all relevant data about a supplier of a good or service (Company B). The fraudster will arrange to issue a purchase order to buy a good or service from the fraudulent company. The purchase order will be recorded in a transaction file, which is a temporary file that a company uses to record data from a purchase order, a supplier invoice, or a payment. The fraudulent company will then issue an invoice and request payment. If the purchasing company's internal controls fail to discover the false-billing scheme, the fraudster will have succeeded in accomplishing the misappropriation of assets.

d. Most commonly, the fraudster will issue an invoice for a service rather than a physical product. Why? Since the transaction is fictitious, there is no actual physical product. As such, there will be no freight charges or record of the physical receipt of the good. Claiming that a service was performed is easier for the fraudster to conceal.

2-5

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a. Management perpetrated the fraud by filling large containers with water and placing a layer of salad oil on top. Furthermore, they transferred the oil from tank to tank in the order in which they knew the auditors would proceed through the location.

b. The goal was to overstate inventory assets, thereby understating cost of goods sold and overstating income.

c. The Great Salad Oil Swindle is primarily a case of fraudulent financial reporting.

2-6

Incentives relate to the rationale for the fraud (e.g., need for money, desire to enhance stock price). Opportunities relate to the ability of the fraudster to actually accomplish the fraud (e.g., through weak internal controls, complex transactions). Rationalization is the psychological process of justifying the fraud.

2-7

Common incentives for fraudulent financial reporting include:

- Management compensation schemes
- Other financial pressures for either improved earnings or an improved balance sheet
- Debt covenants
- Pending retirement or stock option expirations
- Personal wealth tied to either financial results or survival of the company
- Greed—for example, the backdating of stock options was performed by individuals who already had millions of dollars of wealth through stock

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2-8

Factors, or red flags, that would be strong indicators of opportunity to commit fraud include:

- Inadequate segregation of duties
- Opportunities for management override
- Absence of monitoring controls
- Complex organizational structure
- Unauthorized access to physical assets
- Inadequate reconciliations of key accounts, especially bank accounts
- Access to cash that is not supervised or reconciled by someone else

2-9

The ability to rationalize is important. Unless fraudsters are outright criminals, they will often want to come up with an excuse for their behavior. “Accounting rules don’t specifically disallow it” or “the company owes me” are potential rationales. Other common rationalizations include:

- Unfair financial treatment (perceived) in relationship to other company employees

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- "It is only temporary" or "it's a loan from the company"
- "I deserve it"
- "The company is so big, it won't miss anything"
- "The company is unethical"
- "The company comes by its profits in a way that exploits people"

2-10

a. incentive
b. incentive
c. opportunity
d. incentive
e. rationalization
f. opportunity

2-11

Nikola	Fraudulent financial reporting
Luckin Coffee	Fraudulent financial reporting
Steinhoff Int'l	Fraudulent financial reporting
Wirecard	Both
Theranos	Fraudulent financial reporting
Desarrolladora Homex	Fraudulent financial reporting
Malaysia Development Berhad	Asset misappropriation
Lime Energy	Fraudulent financial reporting
Weatherford Int'l	Fraudulent financial reporting
Wells Fargo	Asset misappropriation
Diamond Foods	Fraudulent financial reporting
Sino-Forest Corporation	Fraudulent financial reporting
Peregrine Financial	Asset misappropriation
Longtop Financial	Fraudulent financial reporting
Olympus	Fraudulent financial reporting
Koss Corp.	Both
Dell	Fraudulent financial reporting
HealthSouth	Fraudulent financial reporting
Parmalat	Fraudulent financial reporting
Worldcom	Fraudulent financial reporting
Enron	Fraudulent financial reporting

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2-12

a. The various failures and environmental characteristics during the time of the Enron fraud include:

- Weak management accountability

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- Weak corporate governance
- Accounting became more rule oriented and complex
- The financial analyst community was unduly influenced by management pressure
- Bankers were unduly influenced by management pressure
- Arthur Andersen was unduly influenced by management pressure, especially since consulting revenues at Enron were very high

b. In terms of the fraud triangle:

- Incentives: Management was very concerned about managing stock prices through keeping debt off the balance sheet; the underlying business model of the company was not working; the company had strayed too far away from its "utility" roots; and employees were taking significant risks in the financial markets that did not yield expected profits, thereby creating strong incentives for top management to conduct the fraud.

- Opportunity: Corporate governance and external auditor accountability were lacking.

- Rationalization: Although not discussed in the text specifically, there have been speculations in the press that management thought they were smarter than everyone else and that they were very confident that they could get away with the fraud. It is difficult to know the internal rationalizations of top management.

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2-13

a. The Anti-Fraud Collaboration (*https://antifraudcollaboration.org*) is a group effort among the Center for Audit Quality, Financial Executives International, the National Association of Corporate Directors, and the Institute of Internal Auditors to provide thought leadership, education, and research on fraud. The Anti-Fraud Collaboration promotes the idea that protecting society from fraud requires all members of the financial reporting ecosystem to demonstrate vigilance, exercise skepticism, and maintain a focus on appropriate corporate culture and risk taking.

b. Insights from the Anti-Fraud Collaboration Study are as follows:

- The most common industry sector involved in fraud was technology services, followed by finance, energy, manufacturing, and health care. Technology services frauds typically involved premature recognition of revenue, whereas finance and energy company frauds typically involved reserves (e.g., allowance for doubtful accounts) and impairment-related issues. Manufacturing and health care frauds often involved revenue recognition and inventory misstatement frauds.

- Smaller companies are more likely to receive an AAER. For example, about 40% of the AAERs during the sample period were from companies with less than $250 million in market capitalization. These smaller companies are more likely to also have restatements and material weaknesses in their internal control systems.

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- Companies' motivation for financial manipulation often involved meeting analysts' earnings estimates and/or year-end financial targets.

- Perpetrators typically included the highest-ranking individuals in the company, including the CEO, CFO, and accounting officials. These individuals commonly circumvented the internal controls of the company in order to perpetrate the frauds.

- The culture at companies committing fraud usually involved weak tone-at-the-top from management, a high-pressure environment, challenges to the business model (increased supplier costs and slowing product demand), and accounting personnel who lacked sufficient accounting experience or training.

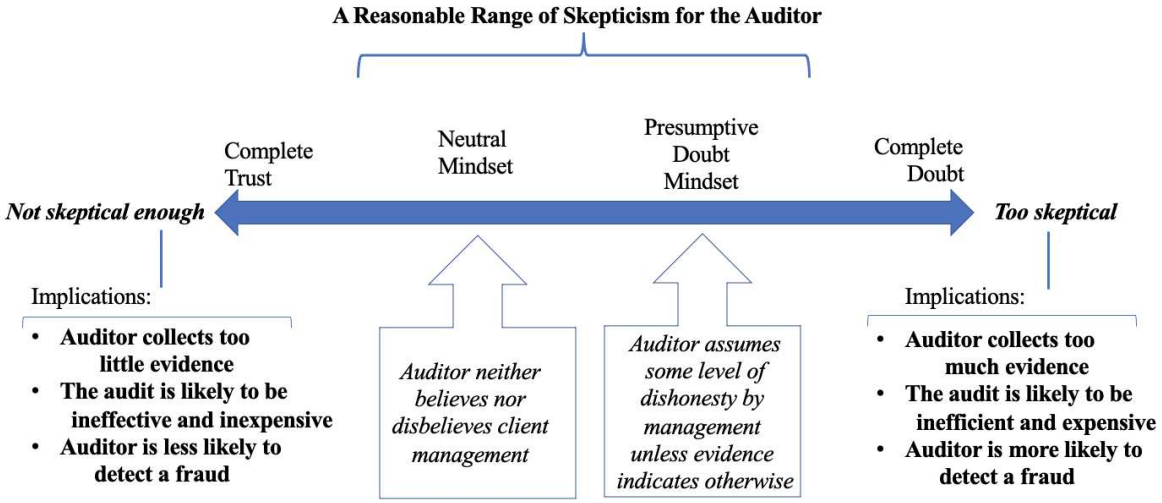
- Commonly cited motivations for the frauds include the need to meet internal or external earnings expectations, an attempt to conceal the company's deteriorating financial condition, the need to increase the stock price, the need to bolster financial performance for pending equity or debt financing, or the desire to increase management compensation based on financial results.

2-14

a. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence; requires ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. Professional skepticism is helpful in detecting fraud because without it the external auditor will be easily convinced of alternative explanations that management will provide to conceal the fraud.

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b.



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A neutral mindset exists when the auditor neither believes nor disbelieves client management. A presumptive doubt mindset exists when the auditor assumes some level of dishonesty by management unless evidence indicates otherwise.

c. The key behaviors necessary to successfully exercise professional skepticism include validating information through probing questions, critically assessing evidence, and paying attention to inconsistencies.

d. It is difficult to exercise professional skepticism in practice for a variety of reasons, including the natural tendency to trust people (especially client personnel with whom you have worked), lack of repeated exposure to fraud, and many repeated exposures to situations that do *not* involve fraud.

e. If the auditor is too skeptical, there is a risk that the auditor will collect too much evidence; the audit is likely to be inefficient and expensive, but the auditor is more likely to detect a fraud. If the auditor is not skeptical enough, there is a risk that the auditor will collect too little evidence; the audit is likely to be ineffective and inexpensive, but the auditor is less likely to detect a fraud.

2-15

Auditing standards historically have reflected a belief that it is not reasonable for auditors to detect cleverly implemented frauds. However, it is increasingly clear that the general public expects that auditors have a responsibility to detect and report on material frauds. Professional auditing standards do require the auditor to plan and perform an audit that will detect material misstatements resulting from fraud. As part of that requirement, auditors will begin an audit with a brainstorming session that focuses on how and where fraud could occur within the organization. Auditors also need to communicate with the audit committee and management about the risks of fraud and how these risks are addressed. The auditor should then plan the audit to be responsive to an organization's susceptibility to fraud.

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2-16

a. Auditing standards for the PCAOB differ from the AICPA and IAASB in terms of management's responsibilities for preventing and detecting fraud in that PCAOB standards only discuss management's role in this regard, whereas AICPA and IAASB standards also refer to "those charged with governance" in addition to management.

b. Users of the financial statements and audit report may disagree with auditing standards regarding auditors' responsibilities for detecting fraud because the standards acknowledge that there is an unavoidable risk that some material misstatements may remain undetected; users will typically prefer that the auditor provide assurance around detecting *all* material misstatements. Users will typically disregard the unavoidable risk that some material misstatements will go undetected by the auditor.

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c. AICPA and IAASB standards state that the auditor may accept records and documents as genuine but should investigate if the auditor believes that such an assumption is not appropriate, whereas PCAOB standards do not make this statement.

d. Both the PCAOB and the AICPA and IAASB focus on having the auditor use some unpredictable procedures because doing so is very effective in deterring fraud (it makes management nervous!) and detecting fraud.

2-17

The following are indications that the auditor might observe, which may reveal that management is entering into related-party transactions:

- Buying or selling goods or services at prices that are different from market value (e.g., recording sales are prices that are higher than market value or recording expenses that are lower than market value)
- Buying or selling goods or services with unusual payment terms (e.g., extending credit for a sale but not requiring payment for a long subsequent period of time)
- Borrowing or lending money with no recorded payment terms and/or no interest

2-18

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a. The financial literacy, integrity, and reputation of board members enhance credibility of the regulation and oversight of the auditing profession. Inspections by the PCAOB act as a highly visible enforcement mechanism, hopefully leading to higher quality audits. Furthermore, information that is learned through the inspection process can be used as a basis for modifying and enhancing auditing standards.

b. These sections improve auditor independence by separating consulting and auditing by the same audit firm. The partner rotation requirement ensures that a "fresh set of eyes" will be responsible for oversight on the engagement.

c. The "cooling-off" period helps to avoid conflicts of interest between top members of the engagement team and the client. By requiring a cooling-off period, an auditor will not be unduly influenced (or appear to be unduly influenced) by the possibility of high-level employment with the client.

d. Audit committees clearly serve the role of the "client" of the auditor. They act as surrogates for the shareholders who are the actual audit client. They act as the liaison between management and the external auditor. By being independent, they gain credibility and ensure that the external auditor can rely on them to perform their governance role. By requiring that audit committees can hire their own attorneys and by ensuring that they have adequate monetary resources, the external auditor has confidence that they will act as truly independent monitors of management.

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e. The certification requirements of the Sarbanes-Oxley Act of 2002 (SOX) help address the risk of fraud by forcing the CEO and CFO to take internal controls and high-quality financial reporting seriously. The Act requires the CEO and CFO to affirmatively sign the financial statements. As such, the certification requirements will likely require individuals below the CEO and CFO to provide assurance that those departments or organizational units are each committed to internal controls and high-quality financial reporting as well. Of course, a signature is just a signature! So, the likelihood that a CFO who is committing fraud will certify falsely is probably 100%. Thus, this mechanism is not without practical flaws.

f. It addresses off-balance-sheet transactions and special-purpose entities, which were the main mechanisms used to conduct the Enron fraud.

g. A strong internal control system is critical to preventing fraud. These sections of SOX mandate the disclosure of weak internal controls, thereby providing a strong motivation to managers to ensure that controls are effective. By requiring external auditor assurance on management's assessment, financial statement users can believe in management's assertions about controls.

h. One member of the audit committee needs to be a financial expert to ensure that there is the knowledge necessary on the audit committee to critically evaluate management's financial reporting and internal control choices. Without that knowledge, the committee may be unduly influenced by management's preferences.

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2-19

No, nonpublic organizations are not required to abide by SOX. However, many organizations view these requirements as "best practice," and so nonpublic organizations sometimes voluntarily adhere to certain requirements of SOX

2-20

Refer to *Exhibits 2.8* and *2.9*.

2-21

These principles include:

- The board's fundamental objective should be to build long-term sustainable growth in shareholder value for the corporation.
- Successful corporate governance depends on successful management of the company, since management has the primary responsibility for creating a culture of performance with integrity and ethical behavior.
- Effective corporate governance should be integrated with the company's business strategy and not viewed as simply a compliance obligation.

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- Transparency is a critical element of effective corporate governance, and companies should make regular efforts to ensure that they have sound disclosure policies and practices.
- Independence and objectivity are necessary attributes of board members; however, companies must also strike the right balance in the appointment of independent and nonindependent directors to ensure an appropriate range and mix of expertise, diversity, and knowledge on the board.

2-22

a. Independent directors are more likely to stand up to management and report fraud than those directors that are not independent.

b. Holding meetings without management present enables a frank and open discussion, including enabling board members with concerns about potential fraud or weak management to alert other board members and express these concerns.

c. By having a nominating/corporate governance committee composed of independent directors, the organization is more likely to attract high-quality board members that are not unduly influenced by management. And by having a corporate governance committee, this important element of control achieves prominence in the organization and acts as a deterrent to fraud.

d. Having a written charter and an annual performance evaluation ensures that the committee responsibilities are appropriate and that the responsibilities are actually accomplished (or shareholders are alerted if they are not accomplished). Accomplishing such activities acts as a deterrent to fraud.

e. By having an independent compensation committee, top management will be less able to inappropriately influence compensation decisions for themselves.

f. Having a written charter and an annual performance evaluation ensures that the committee responsibilities are appropriate and that the responsibilities are actually accomplished (or shareholders are alerted if they are not accomplished). Accomplishing such activities acts as a deterrent to fraud.

g. This requirement ensures an adequate size and independence of the audit committee, which acts to strengthen governance and deter fraud.

h. Having a written charter and an annual performance evaluation ensures that the committee responsibilities are appropriate and that the responsibilities are actually accomplished (or shareholders are alerted if they are not accomplished). Accomplishing such activities acts as a deterrent to fraud.

i. These requirements encourage a high-quality set of corporate governance behaviors, which taken together act as a deterrent to fraud.

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j. By making the ethics issue a prominent disclosure, it encourages management and other individuals within the organization to take it more seriously. It acts to encourage a high-quality "tone at the top."

k. By requiring this disclosure, users of the financial statements can evaluate for themselves whether the foreign companies' governance is adequate or gain an appreciation for governance differences. This knowledge encourages companies to adopt corporate governance mechanisms that they otherwise may not, thereby affecting the control environment and the opportunity for fraud. It also helps users know where deficiencies may exist, making them more skeptical.

l. It attempts to ensure that top-level executives place appropriate importance on corporate governance and that they would be required to disclose if their company is not compliant, which would alert users to heightened fraud risk.

m. An internal audit function is important to the control environment. Having that oversight internally improves internal control, thereby deterring fraud.

2-23

a. This requirement forces audit committees to take internal controls seriously and to consider any potential independence impairments for the external auditor. Both internal controls and high-quality external auditing are critical for the prevention and/or detection of fraud.

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b. This requires the audit committee to be engaged and informed about financial accounting at the company; being engaged and informed enhances the ability of the audit committee to detect fraud.

c. Analyst interactions and the pressure to meet their expectations provide incentives for fraud. By requiring that the audit committee discuss the earnings release process, this ensures that audit committees have more control over how management engages with analysts, and this control should assist in deterring fraud.

d. Understanding risk assessment and risk management should alert the audit committee to weaknesses in the company, thereby encouraging positive change, which should thereby deter fraud.

e. Meeting separately with these groups encourages frank conversations about concerns, and such communication is helpful to deterring or detecting fraud.

f. By understanding the nature of any problems that the external auditor is having with management, the audit committee gets a good sense of potential management aggressiveness and the sources of disagreement between the auditor and management. In addition, this requirement gives the external auditor someone to turn to in reporting fraud on the part of management.

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g. By setting hiring policies pertaining to employees of the external audit firm, the audit committee can ensure that management is not exerting undue influence over the members of the audit team by possibly promising them employment at the company.

h. By reporting regularly to the board of directors, the audit committee is put in a position of power in the organization, thereby giving it the clout necessary to oversee management and deter fraud.

2-24

a. The audit committee must be comprised of "outside" independent directors, one of whom must be a financial expert. The audit committee now has the authority to hire and fire the external auditor and will therefore serve as the auditor's primary contact, especially for accounting and audit-related issues. In addition, at many organizations the audit committee sets the scope for and hires internal auditors. It would also review the work of both internal and external auditors.

b. The audit committee certainly takes on much more responsibility with the new regulation. It will now be much more informed about the audit function and financial reporting processes within the company it evaluates. The auditor must report all significant problems to the audit committee. For auditors, the reporting relationship should reinforce the need to keep the third-party users in mind in dealing with reporting choices.

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c. The audit committee is basically in a position of mediator but not problem-solver. One member must be a financial expert, but all members must be well versed in the field. This financial knowledge can help the audit committee to understand the disagreement. Ultimately, the company would like to receive an unqualified audit opinion. If the external auditor believes a certain accounting treatment to be wrong, the committee does not have to give an unqualified opinion. The audit committee's responsibility is to assist in resolution of the dispute so that financial reporting is accurate. Skills of audit committee members that would assist in this type of situation include interpersonal skills, negotiation skills, and communication skills.

2-25

Factors	Explain Your Reasoning and Indications of Poor Governance
a. The company is in the financial services sector and has a large number of outstanding consumer loans, including mortgages.	This is not necessarily poor governance. However, the auditor needs to determine the amount of risk that is inherent in the current loan portfolio and whether the risk could have been mitigated through better risk management by the organization. The lack of good risk management by the organization increases the risk that the financial statements will be

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Factors	Explain Your Reasoning and Indications of Poor Governance
	misstated because of the difficulty of estimating the allowance for loan losses.
b. The CEO's and CFO's compensation is based on three components: (1) base salary, (2) bonus based on growth in assets and profits, and (3) significant stock options.	This is a rather common compensation package and, by itself, is not necessarily poor corporate governance. However, in combination with other things, the use of "significant stock options" may create an incentive for management to potentially manage reported earnings in order to boost the price of the company's stock. The auditor can determine if it is poor corporate governance by determining the extent that other safeguards are in place to protect the company.
c. The audit committee meets semi-annually. It is chaired by a retired CFO who knows the company well because she had served as the CFO of a division of the firm before retirement. The other two members are local community members: one is the president of the Chamber of Commerce and the other is a retired executive from a successful local manufacturing firm.	This is a strong indicator of poor corporate governance. If the audit committee meets only twice a year, it is unlikely that it is devoting appropriate amounts of time to its oversight function, including reports from both internal and external audits. There is another problem in that the chair of the audit committee was previously employed by the company and would not meet the definition of an independent director. Finally, the other two audit committee members may not have adequate financial experience. This is an example of poor governance because (1) it signals that the organization has not made a commitment to independent oversight by the audit committee and (2) the lack of financial expertise means that during the course of the audit the auditor does not have someone independent with whom controversial accounting or audit issues can be discussed. If there is a disagreement with management, the audit committee does not have the expertise to make independent judgments on whether the auditor or management has the appropriate view of the accounting or audit issues.
d. The company has an internal auditor who reports directly to the CFO and makes an annual report to the audit committee.	The good news is that the organization has an internal audit function. However, the reporting relationship is not ideal. Furthermore, the bad news is that a staff of one isn't necessarily as large or as diverse as it needs to be to cover the major risks of the organization.

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Factors	Explain Your Reasoning and Indications of Poor Governance
e. The CEO is a dominating personality—not unusual in this environment. He has been on the job for six months and has decreed that he is streamlining the organization to reduce costs and centralize authority (most of it in him).	A dominant CEO is not especially unusual, but the centralization of power in the CEO creates a risk that many aspects of governance, as well as internal control, could be overridden, which of course increases the risk of fraud and the risk faced by the external auditor.
f. The company has a loan committee. It meets quarterly to approve, on an ex-post basis, all loans that are over $300 million (top 5% for this institution).	There are a couple of elements in this statement that yield great risk to the audit and to the organization and that are indicative of poor governance. First, the loan committee only meets quarterly. Economic conditions change more rapidly than once a quarter, and thus the review is not timely. Second, the only loans reviewed are large loans that have already been made. Thus, the loan committee does not act as a control or a check on management or the organization. The risk is that many more loans than would be expected could be delinquent and need to be written down.
g. The previous auditor has resigned because of a dispute regarding the accounting treatment and fair value assessment of some of the loans.	This is a very high-risk indicator that is indicative of poor governance. The auditor would look extremely bad if the previous auditor resigned over a valuation issue and the new auditor failed to adequately address the same issue. Second, this is a risk factor because the organization shows that it is willing to get rid of auditors with whom it does not agree. This is a problem of auditor independence and coincides with the above identification of the weakness of the audit committee.

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2-26

a. Shareholder activism includes activities that shareholders engage in to bring about changes that they deem necessary for the success of the company (e.g., enhancing a commitment to sustainability, improving corporate culture, altering the business model, among others). Shareholder activists usually purchase a minority stake in the company and then apply pressure via the media or litigation to achieve their goals.

b. Shareholder activism relates to corporate governance because it provides another avenue by which users of the financial statements can exert control over management, despite being physically distant from management and organizational decision making. Shareholder activism helps safeguard users' interests because it gives them, as a group, the ability to make their demands and preferences known to other users, management, regulators, and auditors.

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Activism puts management on notice that users are serious about certain demands.

c. Answers to this question will depend on the date that students access the Internet.

Fraud Focus: Contemporary and Historical Cases

2-27

a. The Theranos fraud provides ample examples to illustrate the three elements of the fraud triangle:
   - Incentive – these include wanting to "help" society, wanting the company to succeed, achieving personal wealth, avoiding embarrassment upon failure, greed, an erroneous belief that more time/money will enable the company/product to succeed
   - Opportunity – the lack of internal controls, poor tone at the top from Holmes and Balwani, weak governance, lack of scientific oversight, and shareholders who were unwilling to ask difficult questions
   - Rationalization – the quote from Holmes provides an excellent source of rationalization. It seems that she views herself and Theranos as offering a groundbreaking service to society, which will change the world. Perhaps she views the technology as "the ends justifying the means" (i.e., that while she is being untruthful to investors she is doing so with the overall good of society in mind, so she is not a "bad" person). In addition, at trial Holmes rationalized some of her behavior as the result of being supposedly abused by Balwani during the course of their romantic relationship.

b. Diadem is a company that is similar to Theranos in that it is using an innovative scientific product in order to earn revenue. See the company's website for current information about the technology at *http://diademdx.com*.

As of the date of writing this solution, there were six board members and every one of them had extensive scientific knowledge. This contrasts sharply with Theranos. For up-to-date information on the board, see *http://diademdx.com/Board*.



GERALD MÖLLER

Chairman of the Board

He has over 40 years' experience in the pharmaceutical and diagnostics industry. He served as CEO in Boehringer Mannheim and as Head of Development and Strategic Marketing Pharmaceuticals in Roche. He has been an investment advisor at HBM Partners for 12 years. He was also a board member with Illumina Inc. until 2015. Currently he is in the Board of various Life Science companies.



PAUL KINNON

CEO

Paul has over 30 years of experience in the global life sciences industry, with the past 20 years of his executive career focused on Clinical Diagnostics and innovative products to improve patients' lives. He has held leadership positions within PredictImmune, Transgenomic, ZyGEM Corp., Life Technologies (now ThermoFisher), Guava Technologies and Cellomics, raising more than $70m in funding, creating global partnerships and increasing shareholder return. Paul has spent half of his career living and working in the USA running global businesses, which gives him a novel and unique outlook on the global industry; additionally he sits on a number of Boards as non-executive director (NED) for Life Science companies.

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DIANA SARACENI

Member of the Board

She is Founder and Managing Partner of Panakes Partners SGR one of the major Med Tech venture investors in Europe. She brings almost 20 years of experience in Venture Capital investments on a large portfolio of successful companies in Italy and Europe.



FRANCESCO GRANATA

Member of the Board

He is Chairman of Circassia LtD. Francesco is Senior Advisor at Warburg Pincus. Prior, he was Executive VP at Biogen Idec, and Group VP and President for Canada and European markets at Schering-Plough Corporation. He served as Regional President for Northern Europe, Middle East and Africa at Pfizer. Currently a Board member of Italfarmaco SpA, pharmaceutical and chemical leading Italian group, Prismic Pharmaceuticals, Quanta, and a member of the strategic advisory committee at Lupin, an Indian global pharmaceutical company.



SIMONA PICCIRELLA

PhD, VP Product Development and Operations

PhD, VP Product Development and Operations Experienced manager with profound knowledge of life science sector. In 2009 she co-founded the company VisMederi srl and she was COO until 2016, serving clients such as Sanofi, Novartis, GSK, Takeda in vaccine immunogenicity evaluation and analytical assay validation.



ANTONIO BONIOLO

Member of the Board

He served as CEO of DiaSorin SpA, a multinational diagnostics company of 4.1 billion $ market cap. He led the company through growth and brings over thirty years of experience in operational, technical and business aspects in the IVD sector. Currently co-founder and Chairman of Jointherapeutics Srl, a start-up Company focused at developing innovative approaches for the management of osteoarticular pathologies.

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c. Numerous aspects of SOX would have helped investors in the case of Theranos. These include:

- The Act would have required that the company obtain an external audit.
- Section 301 would have required an audit committee.
- Section 302 would have required that the CEO and CFO certify the accuracy of the financial statements and disclosures.
- Section 401 would have required accurate disclosures about the state of the company's finances.
- Section 403 would have provided information about the nature of any transactions that Holmes or Balwani engaged in with respect to owning or trading company stock.
- Section 404 would have required that management assess internal controls and that the external auditor report on the status of those internal controls.
- Section 406 would have required a code of ethics for senior financial officers.
- Section 407 would have required disclosure of an audit committee financial expert, thus encouraging financial expertise on the audit committee.

2-28

a. Management at Koss may have placed a high level of trust in Sachdeva because they knew her for a long period of time and she did not exhibit behaviors that caused concern. Furthermore, management at the company was reportedly quite relaxed in its approach to

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monitoring and control. These behaviors led to a lack of professional skepticism on the part of management.

b. Grant Thornton was obligated to uncover the fraud in the sense that it ignored red flags (weakening financial condition, poor internal control and monitoring) that should have alerted it to problems in the company. Grant Thornton experienced an audit failure because it issued unqualified audit opinions on materially misstated financial statements. It appears that Grant Thornton may not have employed an appropriate level of professional skepticism.

c. Sachdeva's lavish lifestyle should have raised suspicions because her level of conspicuous consumption far exceeded her apparent ability to pay, given her relatively modest salary. However, her lifestyle may have been explained away or ignored because of her husband's prominent medical practice. People likely assumed that Sachdeva's lifestyle was none of their business and that she simply used her family's joint money to fund her expensive purchases. Even when confronted with a known fraud, individuals that know a fraudster often have difficulty believing that it is true. Denial is a common factor even in the face of seemingly obvious signs of fraud.

d. Management and the audit committee should have been skeptical of Sachdeva because of the weak internal controls in place, coupled with deteriorating financial conditions at the company. The auditors should have been more skeptical of her explanations for the company's financial condition. They should have collected more audit evidence to better understand the increase in cost of goods sold. Also, the auditors should have realized that there was a risk of fraud given the lack of monitoring and the high-level access to corporate bank accounts that Sachdeva had.

e. The audit committee plays an important oversight role in any organization. The benefit of the audit committee should be that it is independent from the daily operations of the organization and should therefore be in a position to more critically evaluate the personalities and behaviors of senior management, including the CFO in this particular case. Furthermore, audit committees of public companies are required to have at least one financial expert, and it is the obligation of that individual to consider and initiate investigation of anomalies in the financial statements. Clearly this oversight did not occur in the case of Koss.

f. Whenever an organization uses corporate credit cards, there should be controls over their use. Most typically, such controls involve review and approval of payment by a senior official. In Sachdeva's case, senior management allowed her to use the credit cards without review, and she was the individual in charge of making payments on the cards. Thus, basic controls involving review and segregation of duties were not used at Koss.

g. Top-level managers should have been skeptical about the reasons for Sachdeva's behavior. In retrospect, it seems that she was purposely trying to intimidate her subordinates through this dominating behavior. Management may have questioned why she was trying to intimidate her subordinates. Was there something that she was trying to

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cover up? This tactic was also used at Enron, whereby top-level management would explicitly indicate that any questioning of its actions (from employees, external analysts, etc.) was an indication of how dense the questioner was. Top-level managers should have wondered why Sachdeva felt the need to behave in this manner, and they should have objected to it in person or at least told her in private to eliminate the behavior if for no other reason than to establish and maintain a more professional tone in the workplace. This kind of behavior puts subordinates in a very awkward position. In Sachdeva's case, she reportedly acted domineering to the vast majority of her subordinates. In such a setting where one individual is not singled out, it should be easier for the group to act cohesively and approach senior management privately to complain about the situation. In a setting where one individual is singled out, that individual should consider finding a formal or informal mentor to provide assistance in deciding how to garner the support to approach senior management with concerns.

2-29

a. Yes, the members of the audit committee appear to be professionally qualified. They have all held financially responsible leadership positions at large companies in industries similar to those as Koss Corporation. The committee meets less frequently than quarterly, which is fairly infrequent. Prior to SOX, this level of audit committee involvement was common, but it is now more likely for audit committees of public companies to meet at least bimonthly, if not monthly. Without frequent meetings, committee members are not able to generate sufficient questions and then gather sufficient evidence in order to develop a professionally skeptical view of the true situation at the company, and that is what appears to have happened at Koss. You might consider gathering evidence to support your conclusions about the professional qualifications of audit committee members. For example, you might observe the questions that they ask during meetings and their level of preparedness. You might inquire about their continuing professional education and experiences. You will obtain this information in various ways, but personal observation will likely be very important.

b. Lawrence Mattson is the audit committee financial expert. He is the retired president of a large consumer products company, which should make him financially knowledgeable. However, the fact that he has clearly been retired for quite some time (he is in his late 70s) calls into question whether he is currently "up to speed" on the financial reporting demands faced by a public company. Without adequate financial knowledge, it is nearly impossible to exercise adequate professional skepticism. Knowledge is one of the bases upon which skepticism rests. Financial expertise is important for audit committee members because they play a significant role in corporate governance over financial matters; they are a key defense in potential problems with financial reporting.

c. Their compensation is very low given the important role that they play in the company and the fact that this is a public board. Furthermore, many audit committee members at public companies receive stock options or stock grants to align their interests with the long-term goals of stockholders. These audit committee members receive no stock options and hold very few (if any) shares.

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d. Theodore Nixon is the only audit committee member who is still an active, working financial professional. The other members of the audit committee are relatively older and are no longer working in the public sector. This certainly does not disqualify them but, coupled with the relatively few meetings that the committee has, it calls into the question whether the audit committee is really functioning in a strong oversight capacity. The responsibilities that the proxy statement outlines seem reasonable, but it seems impossible that an audit committee with these characteristics could carry out those responsibilities in so few meetings.

2-30

a. Yes, auditors can commit fraud through their deliberate, negligent actions. When auditors sign an audit opinion, they are asserting that they have complied with professional auditing standards in arriving at their conclusion. In this case, it is clear that Uniack failed to comply with professional auditing standards; thus, we can conclude that he provided a knowingly false and misleading audit report, which constitutes fraud.

b. See paragraph 12 of the enforcement action, which reads as follows:

"In connection with the audit, Respondents failed to exercise due professional care, including professional skepticism, and failed to plan and perform the audit in accordance with PCAOB standards. During audit planning, Respondents failed to develop and document an audit plan that included a description of the planned nature, timing, and extent of risk assessment procedures. Consistent with this planning deficiency, Respondents failed to identify and assess the risks of material misstatement at the financial statement and assertion levels. Respondents also failed to plan and perform any analytical procedures as risk assessment procedures. Respondents also failed to identify any risks with respect to revenue recognition and management override of controls, even though PCAOB standards provide that the auditor should presume that there is a fraud risk involving improper revenue recognition and should include the risk of management override of controls in his identification of fraud risks. Respondents also failed to perform audit procedures in a manner that addressed the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure."

c. Some auditing firms try to "game the system" by providing an audit report without really conducting an audit. This is called a "sham audit," whereby the audit firm is essentially providing its opinion without performing the appropriate procedures. Clients that desire a low-quality audit hire these types of very low-quality auditors because they know that the auditor will not do a quality audit. So, there is really fraud going on with both the client and the audit firm.

2-31

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a. The student will be able to obtain insights on this case from a variety of online news sources. News accounts of this case indicate the following red flags: Beazer's culture was to "make the numbers" during a time when housing sales had significantly slowed; the company's employees were dealing with unrealistic budgets and pressure to achieve financial goals; the company had weak internal controls; Beazer was likely not recording impairments on its land assets in a timely manner; and Beazer's financial periods were regularly held open or reopened.

b. When red flags are present, auditors need to alter the nature, timing, and extent of auditing procedures to adequately address the heightened risk of misstatement indicated by the red flags. In the case of many red flags, auditors should employ a heightened degree of professional skepticism.

c. Students will likely vary in their reactions to Deloitte's settlement. Some will take the position provided by the firm's spokesperson. Others will suggest that Deloitte was indeed liable and that a court case would have resulted in a guilty verdict, thereby subjecting Deloitte to even higher settlement costs.

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a. The types of events or conditions that may exist as a result of the pandemic that might call into question an organization's ability to remain a going concern include the following:	b. What matters should auditors consider with respect to evaluating disclosures relevant to the pandemic? How will professional skepticism play a part in evaluating such management disclosures?	
• Loss of a major market, key customer, revenue, labor shortages	• Asking whether management has considered plans to address shortfalls, supply-chain issues, labor shortages, government relief, etc.	The auditor must be especially skeptical in evaluating all disclosures given that management may have the incentive to downplay the potential effects of the pandemic.
• Significant deterioration in the value of assets used to generate cash flows	• The reasonableness of management's assumptions in valuation calculations and insight from valuation experts	
• Delay in the launch of new products or services	• Has management taken into account the financial impact of the delay and	

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	developed plans to address it?	
• The organization's solvency	• Assessing management's plans for maintaining solvency and considering the ability to repay loans	

c. Those charged with governance (e.g., the audit committee) can assist management and the auditor by facilitating communication in an open and honest manner so that the auditor is fully aware of the difficulties that management is encountering in dealing with the pandemic. The auditor will need to exercise a lot of professional skepticism when evaluating whether management is being forthcoming and accurate.

d. This question will be excellent for generating class discussion. Some students will argue that since the outcomes of the pandemic are not certain and are difficult to measure, having management provide minimal disclosures is acceptable. Other students will argue the opposite: this is the best time for maximum disclosures so that users are fully aware of all potential downside risks. Ultimately, however, failing to report a material going-concern problem would constitute financial reporting fraud since it violates GAAP.

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This research question asks students to summarize the PCAOB's concerns with respect to problems their inspection teams have noted in auditors' performance in each of the following areas.

a. The risks associated with cryptocurrency include the following. First, business risk associated with cryptocurrency relates to a potential loss of confidence by the market in cryptocurrency in general, and the resulting likelihood of valuation declines. Since cryptocurrencies are not backed by a central bank or international organization, their value is based solely on what market participants will pay on a given day. Second, fraud risk relating to cryptocurrency concerns the potential for sophisticated criminals to electronically steal the currency from the legitimate owner. Third, operational risk relates to the inability to reverse a monetary transaction initiated in cryptocurrency; thus, returns may be difficult. Fourth, regulatory risk for cryptocurrency includes the fact that some countries may prevent its use. Finally, market risks associated with cryptocurrency concern its price volatility, which can be exacerbated by speculative demand and hoarding.

b. Audit committee members should ask the following types of questions about cryptocurrency transactions and associated disclosures:

- What is the experience of the engagement partner and other senior engagement team members with cryptoassets? Would the firm be able to supplement the engagement team's expertise, if necessary (e.g., by engaging relevant specialists)?

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- What is the auditor's understanding of the technology underlying the issuer's cryptoasset-related activities?
- Are specialized technology-based audit tools needed to identify, assess, and respond to risks of material misstatement?
- What is the auditor's understanding of the legal and regulatory (including KYC and AML) implications of the issuer's cryptoasset-related activities?
- How does the audit firm monitor auditor independence considerations associated with audit engagements involving cryptoassets (e.g., monitoring whether its staff invests in cryptoassets)?
- What policies and procedures does the audit firm have regarding conducting and monitoring audit engagements involving cryptoassets, including considering the risks associated with performing such audits?

c. The FYE 2021 10-K of Tesla provides the following disclosures about the risks associated with cryptocurrency (see *https://www.sec.gov/ix?doc=/Archives/edgar/data/1318605/000095017022000796/tsla-20211231.htm*), along with impairment losses resulting from changes to the carrying value of bitcoin, along with gains on the sales of bitcoin.

We hold and may acquire digital assets that may be subject to volatile market prices, impairment and unique risks of loss.

In January 2021, we updated our investment policy to provide us with more flexibility to further diversify and maximize returns on our cash that is not required to maintain adequate operating liquidity, allowing us to invest a portion of such cash in certain alternative reserve assets including digital assets, gold bullion, gold exchange-traded funds and other assets as specified in the future. Thereafter, we invested certain of such cash in bitcoin and also accepted bitcoin as a form of payment for sales of certain of our products in specified regions, subject to applicable laws, and suspended this practice in May 2021. We believe in the long-term potential of digital assets both as an investment and also as a liquid alternative to cash. As with any investment and consistent with how we manage fiat-based cash and cash equivalent accounts, we may increase or decrease our holdings of digital assets at any time based on the needs of the business and on our view of market and environmental conditions.

The prices of digital assets have been in the past and may continue to be highly volatile, including as a result of various associated risks and uncertainties. For example, the prevalence of such assets is a relatively recent trend, and their long-term adoption by investors, consumers and businesses is unpredictable. Moreover, their lack of a physical form, their reliance on technology for their creation, existence and transactional validation and their decentralization may subject their integrity to the threat of malicious attacks and technological obsolescence. Finally, the extent to which securities laws or other regulations apply or may apply in the future to such assets is unclear and may change in the future. If we hold digital assets and their values decrease relative to our purchase prices, our financial condition may be harmed.

Moreover, digital assets are currently considered indefinite-lived intangible assets under applicable accounting rules, meaning that any decrease in their fair values below our carrying values for such assets at any time subsequent to their acquisition will require us to recognize impairment charges, whereas we may make no upward revisions for any market price increases until a sale, which may adversely affect our operating results in any period in which such impairment occurs. Moreover, there is no guarantee that future changes in GAAP will not require us to change the way we account for digital assets held by us.

Finally, as intangible assets without centralized issuers or governing bodies, digital assets have been, and may in the future be, subject to security breaches, cyberattacks or other malicious activities, as well as human errors or computer malfunctions that may result in the loss or destruction of private keys needed to access such assets. While we intend to take all reasonable measures to secure any digital assets, if such threats are realized or the measures or controls we create or implement to secure our digital assets fail, it could result in a partial or total misappropriation or loss of our digital assets, and our financial condition and operating results may be harmed.

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Sources and Conditions of Liquidity

Our sources to fund our material cash requirements are predominantly from our deliveries and servicing of new and used vehicles, sales and installations of our energy storage products and solar energy systems, proceeds from debt facilities and proceeds from equity offerings, when applicable.

As of December 31, 2021, we had $17.58 billion of cash and cash equivalents. Balances held in foreign currencies had a U.S. dollar equivalent of $7.22 billion and consisted primarily of Chinese yuan, euros and Canadian dollars. In addition, we had $1.11 billion of unused committed amounts under our credit facilities as of December 31, 2021. Certain of such unused committed amounts are subject to satisfying specified conditions prior to draw-down (such as pledging to our lenders sufficient amounts of qualified receivables, inventories, leased vehicles and our interests in those leases, solar energy systems and the associated customer contracts or various other assets). For details regarding our indebtedness, refer to *Note 11, Debt* to the consolidated financial statements included elsewhere in this Annual Report on Form 10-K.

We continue adapting our investment strategy to meet our liquidity and risk objectives, such as investing in U.S. government and other marketable securities, digital assets and providing product related financing. In the first quarter of 2021, we invested an aggregate $1.50 billion in bitcoin. The fair market value of our bitcoin holdings as of December 31, 2021 was $1.99 billion. We believe in the long-term potential of digital assets both as an investment and also as a liquid alternative to cash. As with any investment and consistent with how we manage fiat-based cash and cash equivalent accounts, we may increase or decrease our holdings of digital assets at any time based on the needs of the business and our view of market and environmental conditions. However, digital assets may be subject to volatile market prices, which may be unfavorable at the times when we may want or need to liquidate them. Additionally, we held short-term marketable securities of $131 million as of December 31, 2021.

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Operating Expense Trends

As long as we see expanding sales, and excluding the potential impact of macroeconomic conditions including increased labor costs and impairment charges on certain assets as explained below, we generally expect operating expenses relative to revenues to decrease as we continue to increase operational efficiency and process automation. We expect operating expenses to grow in 2022 as we are expanding our operations globally.

In the first quarter of 2021, we invested an aggregate $1.50 billion in bitcoin. We believe in the long-term potential of digital assets both as an investment and also as a liquid alternative to cash. As with any investment and consistent with how we manage fiat-based cash and cash-equivalent accounts, we may increase or decrease our holdings of digital assets at any time based on the needs of the business and our view of market and environmental conditions. Digital assets are considered indefinite-lived intangible assets under applicable accounting rules. Accordingly, any decrease in their fair values below our carrying values for such assets at any time subsequent to their acquisition will require us to recognize impairment charges, whereas we may make no upward revisions for any market price increases until a sale. For any digital assets held now or in the future, these charges may negatively impact our profitability in the periods in which such impairments occur even if the overall market values of these assets increase. For example, in the year ended December 31, 2021, we recorded approximately $101 million of impairment losses resulting from changes to the carrying value of our bitcoin and gains of $128 million on certain sales of bitcoin by us.

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d. The proxy statement dated August 26, 2021, reveals that the audit committee has the following responsibilities:

The Audit Committee is responsible for, among other things:

- reviewing and approving the selection of Tesla's independent auditors, and approving the audit and non-audit services to be performed by Tesla's independent auditors;
- providing oversight, recommendations, and under specified thresholds, approvals, regarding significant financial matters and investment practices, including any material acquisitions and divestitures;
- monitoring the integrity of Tesla's financial statements and Tesla's compliance with legal and regulatory requirements as they relate to financial statements or accounting matters;
- reviewing the adequacy and effectiveness of Tesla's internal control policies and procedures in addition to Tesla's risk management, data privacy and data security;
- discussing the scope and results of the audit with the independent auditors and reviewing with management and the independent auditors Tesla's interim and year-end operating results; and
- preparing the audit committee report that the SEC requires in Tesla's annual proxy statement.

Audit committee members' names and bios are as follows (with cryptocurrency-relevant attributes highlighted in bold italics):

Robyn Denholm has been a member of the Board since August 2014 and its Chair since November 2018. Since January 2021, Ms. Denholm has been an operating partner of Blackbird Ventures, a venture capital firm. From January 2017 through June 2019, Ms. Denholm was with Telstra Corporation Limited, a telecommunications company ("Telstra"), where she served as Chief Financial Officer and Head of Strategy from October 2018 through June 2019, and Chief Operations Officer from January 2017 to October 2018. Prior to Telstra, from August 2007 to July 2016, Ms. Denholm was with Juniper Networks, Inc., a manufacturer of networking

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equipment, serving in executive roles including Executive Vice President, Chief Financial Officer and Chief Operations Officer. Prior to joining Juniper Networks, Ms. Denholm served in various executive roles at Sun Microsystems, Inc. from January 1996 to August 2007. Ms. Denholm also served at Toyota Motor Corporation Australia for seven years and at Arthur Andersen & Company for five years in various finance assignments. Ms. Denholm previously served as a director of ABB Ltd. from 2016 to 2017. Ms. Denholm is a Fellow of the Institute of Chartered Accountants of Australia/New Zealand, a member of the Australian Institute of Company Directors, and holds a Bachelor's degree in Economics from the University of Sydney, and a Master's degree in Commerce and a Doctor of Business Administration (honoris causa) from the University of New South Wales. We believe that Ms. Denholm possesses specific attributes that qualify her to serve as a member of the Board and as its Chair as well as the chair of each of our Audit Committee and Disclosure Controls Committee, such as her executive leadership experience and her financial and accounting expertise with international companies, including in the technology and automotive industries.

Antonio Gracias has been a member of the Board since May 2007 and served as our Lead Independent Director from September 2010 to April 2019. Since 2003, Mr. Gracias has been Chief Executive Officer of Valor Management LLC, a private equity firm. Mr. Gracias is a director of SpaceX, and was a director of SolarCity until its acquisition by us in November 2016. Mr. Gracias holds a joint B.S. and ***M.S. degree in international finance and economics*** from the Georgetown University School of Foreign Service and a J.D. from the University of Chicago Law School. We believe that Mr. Gracias possesses specific attributes that qualify him to serve as a member of the Board, including his management experience with a nationally recognized private equity firm and his operations management and supply chain optimization expertise.

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Hiromichi Mizuno has been a member of the Board since April 2020. Since January 2021, Mr. Mizuno has served as the United Nations Special Envoy on ***Innovative Finance and Sustainable Investments***. From January 2015 to March 2020, Mr. Mizuno was Executive Managing Director and Chief Investment Officer of Japan's Government Pension Investment Fund, the largest pension fund in the world. Previously, Mr. Mizuno was a ***partner at Coller Capital, a private equity firm***, from 2003. In addition to being a ***career-long finance and investment professional***, Mr. Mizuno has served as a board member of numerous business, government and other organizations, currently including the Mission Committee of Danone S.A., a global food products company, and the World Economic Forum's Global Future Council. Mr. Mizuno is also involved in academia, having been named to leadership or advisory roles at Harvard University, Oxford University, University of Cambridge, Northwestern University and Osaka University. Mr. Mizuno holds a B.A. in Law from Osaka City University and an M.B.A. from the Kellogg Graduate School of Management at Northwestern University. We believe that Mr. Mizuno possesses specific attributes that qualify him to serve as a member of the Board, including his ***deep understanding of international economics, financial markets and government policies.***

James Murdoch has been a member of the Board since July 2017. Mr. Murdoch has been the Chief Executive Officer of Lupa Systems, a private investment company that he founded, since March 2019. Previously, Mr. Murdoch held a number of leadership roles at Twenty-First Century Fox, Inc., a media company ("21CF"), over two decades, including its Chief Executive Officer from 2015 to March 2019, its Co-Chief Operating Officer from 2014 to 2015, its Deputy

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Chief Operating Officer and Chairman and Chief Executive Officer, International from 2011 to 2014 and its Chairman and Chief Executive, Europe and Asia from 2007 to 2011. Previously, he served as the Chief Executive Officer of Sky plc from 2003 to 2007, and as the Chairman and Chief Executive Officer of STAR Group Limited, a subsidiary of 21CF, from 2000 to 2003. Mr. Murdoch also formerly served on the boards of News Corporation from 2013 to July 2020, of 21CF from 2017 to 2019, of Sky plc from 2016 to 2018, of GlaxoSmithKline plc from 2009 to 2012 and of Sotheby's from 2010 to 2012. We believe that Mr. Murdoch possesses specific attributes that qualify him to serve as a member of the Board, including his lengthy executive and board experience across numerous companies, ***extensive knowledge of international markets and strategies and experience with the adoption of new technologies***.

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a. Shareholders would normally not know what qualifications are important for their external auditors. If the CEO or CFO had these responsibilities, the auditor would be more likely to bend to their wishes rather than take the hard stances that may be required for fair financial reporting. Part of the purpose of designating the audit committee to oversee the audit is to have an advocate for the stockholders of the company.

b. Factors to consider in evaluating the external auditor's independence include:
- The nature and extent of nonaudit services provided to the client.
- The policies and procedures the external auditor's firm has to ensure independence.
- The lengths of time individuals have been in charge of the audit.
- Any pending or completed investigations by the SEC or PCAOB of the firm.

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c. This part of the problem will vary based on the company that each student selected. This is a good problem to assign if you feel that your students are unfamiliar with locating basic public company filings using the SEC online data system.

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This exercise illustrates that the issue of corporate governance is a global issue. The insights the students will obtain will depend, in part, on the countries selected for research.

Data-Analytics Simulations

2-36

Data Pattern Scenario #1.

Which letter above best describes the type or location of potential fraud (a–f)? e

Important patterns in the data that cause you concern:

- $100,000 is a round number, whereas the other numbers are not.

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- The name of the vendor and the Vendor ID are slightly different than the other vendor (which the City of Chicago has used in prior years) (i.e., Car Wash Partners Inc. and Car Wash Partners Co.).
- The addresses are different.
- The vendor has a PO box as an address.

Data Pattern Scenario #2.

Which letter(s) above best describes the type or location of potential fraud (a–f)? a, f

Important patterns in the data that cause you concern:

- GreenTree Tech sales have only been recorded by Ted Thompson; normally, Receivables Department personnel would be recording these entries.
- It is odd that none of these three sales have resulted in a delivery, indicating that they are potentially fictitious sales.
- The Timestamp is outside normal business hours.
- The Datestamp is near the end of the month in each case, indicating that Ted might be trying to achieve his sales goals by recording fictitious entries.

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- The sales values are for round dollar amounts, whereas typical sales entries are not round numbers.

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