Sherb and Co. LLP: a triple play of misconduct

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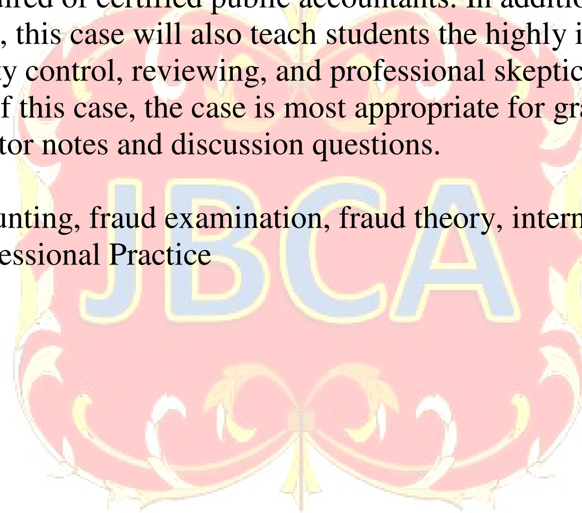
ABSTRACT

This case is an all-time tale of "auditing gone wrong." This actual SEC case is a real-world example of the severe consequences of failing to act with due professional care and proper professional conduct required of certified public accountants. In addition to learning the importance of both ideals, this case will also teach students the highly important concepts of proper supervision, quality control, reviewing, and professional skepticism. Due the international dimension of this case, the case is most appropriate for graduate accounting students. Includes instructor notes and discussion questions.

Keywords: forensic accounting, fraud examination, fraud theory, internal control, ethics, IMA Statement of Ethical Professional Practice



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CASE DESCRIPTION

This case is an all-time tale of "auditing gone wrong." This actual SEC case is a real-world example of the severe consequences of failing to act with due professional care and proper professional conduct required of certified public accountants. In addition to learning the importance of both ideals, this case also teaches students the important concepts of proper supervision, quality control, reviewing, and professional skepticism. Due to the international dimension of this case, the case is most appropriate for graduate accounting students. The case includes instructor notes and discussion questions.

CASE SYNOPSIS

The purpose of a financial statement audit by independent accountants is to provide an opinion on the fairness of the financial statements and an opinion on the effectiveness of internal control so that the users of those statements can make important decisions that will not be affected later on because of material misstatements, whether resulting from error or fraud. Accordingly, every organization's goal is to receive an unqualified opinion, meaning that the auditor has no reservations regarding the assertions made by management which are inherent in the financial statements. In addition, if the auditor is providing integrated audit services, the findings become that much more important as the auditor is also extensively evaluating and communicating the effectiveness of the organization's internal controls, as they "exist as a way to mitigate and manage risk and are necessary for good long-term decision-making" (Gramling, Johnstone, and Rittenberg, 2012, p. 206).

Indeed, expressing the wrong opinion on a client's financial statements is an auditor's worst nightmare. For Sherb & Co. LLP (abbreviated to "Sherb LLP"), a public accounting firm based in the state of New York that had been registered with the Public Company Accounting Oversight Board (PCAOB) since 2003, this nightmare became a reality. Due to improper professional conduct and failure to follow appropriate auditing procedures, the CPA firm was responsible for the failed audits of three Chinese companies during the fiscal years ended 2007-2011.

From the beginning, the Sherb LLP auditors dug themselves into a hole from which there was no way out. As a result, on November 6, 2013, they were fined and charged by the Securities and Exchange Commission for their failed audits and improper professional conduct. The end result: all the individuals involved will no longer be able to practice as CPAs.

CASE BODY

Introduction: The Auditors and Clients at Hand

Sherb LLP's failed audits from 2007-2011 were of three China-based clients. Specifically, these were of China One Sky Medical (CKSI) for the year ended 2007; China Education Alliance (also known as "CEU") for the year ended 2010; and Wowjoint Holdings for years ended August 31, 2008 and August 31, 2009, December 31, 2009 (after a change in the ending of the fiscal year), and December 31, 2010 and December 31, 2011 (Securities and Exchange Commission, 2013, p. 3). The principal individuals behind these three botched audits are as follows:

- Steven J. Sherb, CPA - Managing partner and only equity partner of Sherb & Co., LLP, who was therefore the principal figure of the firm. He served as the concurring partner (reviewer) of both the CKSI and Wowjoint Holdings audits.
- Christopher A. Valleu, CPA - Served as the engagement partner for the audit of CKSI's and Wowjoint Holdings' financial statements; quality review partner of the CEU audit.
- Mark Mycio, CPA – Served as the engagement partner for the audits of CEU and Wowjoint Holdings. In addition, he served the distinguished position of Chair of Financial Accounting Standards of the New York State Society of Certified Public Accountants.
- Steven N. Epstein, CPA – As the senior audit manager for the firm, he served as the manager for the financial statement audits of CEU and Wowjoint Holdings. In addition, he performed key services in connection with the audit of CEU's 2010 year-end financial statements.

Welcome to the Chinese Market

Sherb & Co. unfortunately chose to audit U.S. based stock exchange clients whose headquarters were in China at a very inconvenient and complex time. As Joe McDonald (2012) states, the Chinese market continued to emerge and grow throughout the global recession in 2008, and as such, many investors looked towards the Chinese market for potentially rewarding investments (para. 23). However, over the past few years, the SEC has placed a high level of scrutiny on audits of Chinese companies traded or listed in the U.S. due to allegations of accounting fraud and irregularities (para. 9). Many companies under scrutiny became listed in the U.S. through "reverse mergers", in which "investors of the private company acquire a majority of the shares of the public shell company, which is then merged with the purchasing entity," according to Marv Dumon (2009) (para. 2). Dumon also states how these "relatively simple shell companies can be registered with the SEC on the front end (prior to the deal), making the registration process relatively straightforward and less expensive." This could be a disadvantage for management if they are not ready to go public and comply with SEC regulations (para. 2, 11). Of the three companies audited by Sherb, LLP, CSKI was (and still is) considered a reverse merger.

Due to this level of scrutiny in recent years, many investors have been pulling out of Chinese companies listed in the U.S. for fear of what will come next. In addition, as the years went on, fewer and fewer of these China-listed companies went public in the U.S. To put it into perspective, forty-one Chinese-companies went public in 2010, only twelve in 2011, and three in 2012, according to Aubin and Oran (2013) (para. 8). As time wore on, the SEC became so stringent about transparency that by July 2013, the Chinese government gave in to the agency's pressure to exchange (Gayathri, 2013, paragraph 1). The situation became complex as auditors faced challenges with this protocol due to the strong level of secrecy that exists within the Chinese government overall (para. 2). Making matters even worse, on June 20, 2013, a Chinese company known as China MediaExpress was charged by the SEC for "fraudulently misleading investors about its financial condition by touting cash balances that were millions of dollars higher than actual amounts," according to the press release (SEC, 2013a).

The CSKI 2007 Audit – The Onset of the Storm

China One Sky Medical is a company headquartered in Harbin, Heilongjiang Province, China and incorporated in Nevada, according to the investigation (SEC, 2013b, para. 8). It traded on the NASDAQ Global Market under the ticker symbol "CSKI" from September 14, 2008 to February 15, 2012; however, it now trades on the OTC (Over The Counter) market in which no exchange floor is actually present (para. 8). As part of the pharmaceutical industry, it is "engaged in the development, manufacture, marketing and sale of over-the-counter, nutritional supplements and over-the-counter plant and herb-based pharmaceutical and medicinal products" (Reuters, 2013, para. 1). As of December 31, 2010, it sold 120 products, which were all classified into the categories of "Ointments, Patches, Sprays, Drops, Suppositories, Diagnostic Kits and others," (Reuters, 2013, para. 2).

Sherb & Company exhibited a complete disregard for due diligence, professionalism, adequate supervision, and the crucial stage of planning. Generally accepted auditing standards (GAAS) define the planning stage as "developing an overall audit strategy for the expected conduct, organization, and staffing of the audit. Obtaining an understanding of the entity and its environment, including its internal control, is an essential part of planning and performing an audit in accordance with generally accepted auditing standards," (AU 311.02, 311.09, 311.10). Effective planning is needed in order to determine how much, and what type of, evidence will need to be gathered and to determine the amount of necessary testing.

Engagement partners Valleau and Epstein did not undertake to obtain an understanding of the nature of CSKI's business. The partners were unaware that the company was technically classified as a reverse merger and was already under scrutiny by the SEC at the time. According to the SEC press release on Sherb LLP, the only work undertaken by Valleau and Epstein involved "partially filling out a few forms with generic checklists" (SEC, 2013a, para. 19). Such limited procedures severely affect the outcome of the audit as the partners completely overlooked a well-established deceptive fraud. Essentially, during fiscal year 2007, CSKI reported to the SEC that it had entered an agreement with a Malaysian distributor who would distribute exported sales of 'slim' patches to Malaysia by two sales agents, known as customers "A" and "B", to whom the goods were originally sold by CSKI. Through this agreement, CSKI purported that its sales revenue from the slim patches increased from $1.2 million in 2006 to $12.3 million in 2007, with sales accounting for 25% of CSKI's total revenue during 2007 (SEC 2013, para. 13-14).

In actuality, the purported sales revenue from the slim patches determined it to be entirely fraudulent upon an SEC investigation completed in September 2012. The investigation revealed that CSKI never actually entered into a distribution agreement with the Malaysian distributor, nor did customers "A" and "B" actually exist (SEC, 2013a, para. 2, 5). This alarming information could have been discovered had the Sherb LLP auditors performed an audit in accordance with generally accepted auditing standards (GAAS). According to the investigation, because Valleau and Epstein never actually examined the supposed agreement, they were unaware that there was no mention of any such customers (SEC, 2013a or b, para. 19). No action was taken by Sherb LLP to consider what the risk of material misstatement would be due to fraud. As a result, no plan was set in place to identify where fraud could be potentially concealed (SEC 2013a para. 21).

In addition to granting an unqualified opinion for the 2007 audit based on $12.2 million of fraudulent sales, numerous other problems existed. One of these major problems was that there was no supervision of the Hong Kong auditors who were contracted to perform the actual field work, which included testing of CSKI's sales revenue. As GAAS dictates, substantive testing requires that the auditor have "adequate technical training and proficiency to perform the audit" (AU 210.01). Therefore, it was Sherb LLP's intent to send out a senior auditor who was fluent in Chinese to discuss with the contract auditors their background to determine if they were qualified to perform the audit. However, no documentation exists that this ever occurred, and as a result, the contract auditors' workpapers contained many errors and were also incomplete. Still, Valleau and Epstein signed off on them despite knowing full-well of the overwhelming errors (p. 7).

Due to this lack of supervision, the contract auditors also made several other major mistakes that were undoubtedly 'red flags' with regards to the integrity of CSKI's management. The first major red flag was during the testing of the sales invoices to identify whether Value-Added-Tax (VAT) was properly assessed. Chinese law dictates that a VAT must be assessed on all imported sales and refunded on all exported sales made. However, upon testing, it was soon realized that VAT sales invoices were never prepared for the sales made to customers "A" and B." After inquiring of CSKI management as to why the customers never received any VAT assessments, the contract auditors were told that it was because these customers never requested any sales invoices. In actuality, A and B would have been entitled to $2 million worth of VAT refunds, which contradicts the statement that they would have no desire to request a sales invoice. Both Valleau and Epstein accepted this explanation despite this obvious red flag (para. 28-29).

The other major red flag dealt with the procedures the contract auditors applied towards CSKI's documenting the delivery of the goods and its bank statements. The contract auditors neglected to realize that the documents supporting the delivery of the goods gave no shipping address or the name of the customer and they also failed to determine whether the deposits shown on the bank statements were actually related to those sales made to customers A and B. As an example, some of the sales were recorded 20 days prior to the date of the actual purchase. Despite these clear signs of utilizing the fake customers for fraudulent revenue, both partners signed off on the related workpapers (para. 30-31)

As for Steven Sherb, serving as the concurring partner (in charge of reviewing the workpapers), he did not exercise due diligence in the audit. He never conducted in full-depth review of the workpapers. He merely signed off on a couple of checklists. He never retained the workpapers relating to the planning and assessment of risk of material misstatement. He, or anyone else in the firm, never communicated with CSKI's predecessor auditor before or after accepting the company as a client. All of these circumstances culminated in Sherb, LLP rendering an unsupported unqualified opinion (pgs. 9-10).

Another Failures – The 2010 CEU Audit

One would think that a failed audit in the past would mean that the firm would immediately correct its past mistakes as soon as possible in order to prevent 'botched' audits in the future. For Sherb LLP, the picture only became more and more dismal with the audit of China Education Alliance's (known as CEU) financial statements for the 2010 year-ending, in which an unqualified report was included with CEU's 10-k released on April 15, 2011.

China Education Alliance is a "leading educational service company offering high-quality online education materials and on-site training and tutoring to families, provincial education officials, administrators, schools and teachers in China," (China Education Alliance, 2013). It is a North Carolina based-corporation with headquarters in Harbin, China and was listed on the NYSE from January 27, 2010 to December 28, 2011; however, it now trades on the OTC market (SEC, 2013, para. 42).

Mark Mycio of Sherb, LLP served as the lead engagement partner for CEU's audit. His audit was doomed from the start when he decided that it would be suitable to photocopy a risk assessment form completed for a prior-year audit of CEU. In doing so, he allegedly "changed several dates, crossed out the name of the prior engagement partner, and inserted his own name," (para. 51). No risk assessment interviews were conducted with CEU management and, even though a summary was included among the workpapers, it only contained Mycio's initials.

During 2010, CEU reported that a majority of its operations were completed through cash and that many of its cash deposits were located at various banks. During 2010, CEU also came under fire from public allegations that the company's operations were fraudulent. The investment advising firm Kerrisdale Capital made claims that the CEU was a hoax; the website did not function; the physical location was merely an empty building; and most importantly, the financial statements were fraudulent ("China Education Alliance", 2010, p. 1). These allegations alone would necessitate Mycio and his engagement team would have to associate a high audit risk with CEU, especially in the audit of cash.

Sherb LLP's attempts to gather evidence in support of the cash account proved to be futile. In March of 2011, a staff auditor sent to Harbin, China was unable to gather the bank statements from the banks despite being told that they could be printed for a small fee. In the following month, Sherb LLP's partner Epstein decided to take matters into his own hand when he tried to gather the bank statements by personally meeting with CEU's management. At the first bank, he was handed bank statements by a CEU employee who purported that they were real even though Mycio never actually saw any bank official procure them. At the second bank he visited, a purported bank teller handed him bank statements but never actually provided her name. A bank official also visited him but would neither give her business card nor would she authenticate the bank statements (para. 53-55).

Sherb, LLP auditors also had difficulty in gathering evidence supporting CEU's training centers (where the revenue was generated) and the company's overall fixed assets. Contrary to normal audit practice, CEU management chose which training centers the staff auditors could visit in order to examine the student records. Upon the staff auditors' visit, the CEU manager would not allow them to examine the records by asserting that they had to be kept confidential. In addition, a staff auditor reported that the managers "hastily exited from that training center with the Sherb LLP staff auditors" which led the auditor to conclude the possibility of the center never being associated with CEU. Despite these strange encounters, Mycio still thought nothing of it. Epstein also made a visit to the centers as well, but again CEU dictated which centers he would visit. Epstein did not perform any substantive testing during his visit (para. 56). Upon these visits, one of the staff auditors reported that one of the CEU managers tried to bribe him to directly influence the 2010 audit. Mycio never followed-up on the attempted bribery.

As for CEU's fixed assets, management reported that they increased by 51% from year-end 2009 to year-end 2010. With such a significant increase, one would expect significant testing

to prove the validity behind this assertion. However, Mycio never performed any physical inspection or analytical procedures (para. 57).

Similar to the complete disregard seen with the CSKI audit, the CEU audit workpapers were never retained and an unqualified opinion was given despite the numerous irregularities and problems.

Valleau, who was the CEU engagement partner for the 2008 CEU audit, now served as the partner in charge of the quality review for this current CEU engagement. According to PCAOB No. 7, paragraph 8, "the person who served as the engagement partner during either of the two audits preceding the audit subject to the engagement quality review may not be the engagement quality reviewer." Sherb LLP did not correct this impropriety. Valleau did not investigate the bribery charge; the fraud assessment workpapers only contained his signature while all other areas were incomplete or merely copied from the prior year's workpapers. (para. 65, 68-69).

Third Time's a Charm – Or Not

The final botched audits of Wowjoint Holdings, Inc. wrapped up the perfect storm of failures that entangled Sherb LLP so deeply. Similar to CSKI and CEU, Wowjoint is a U.S.-based company with an operating subsidiary in China; specifically, it is based in the Cayman Islands and its subsidiary in China is located in Beijing (para. 70). The subsidiary, known as Beijing Wowjoint, is "involved in customized heavy duty lifting and carrying machinery for heavy and bulky loads used in such large scale infrastructure projects as railway, highway, bridge construction and so on," ("Introduction", 2013, para. 1). According to the investigation, Wowjoint was traded on the NASDAQ exchange in 2010 under the listings of "BWOWF" and "BWOWU", but like CSKI and CEU, became delisted in 2011 and later listed OTC (para. 70).

Wowjoint audits were for the years-ending August 31, 2008 and 2009, the four-month transition at December 31, 2009 due to the change in fiscal year, and December 31, 2010 and 2011. Valleau was the engagement partner for the audits from 2008-2010. As with the other audits, he did not properly plan for the Wowjoint audits nor did he actually gain an understanding of the nature of the business. The majority of the audit-related work was assigned to Epstein, who not only reviewed the workpapers but also communicated with Wowjoint and its SEC counsel (para. 72). Epstein was unable to gain a full understanding of Wowjoint's use of the percentage-of-completion (POC) method dealing with the use of heavy machinery, which is needed to properly recognize revenue from the contracts overseeing construction-related work. Although a staff auditor assigned to the engagement had experience with the POC method, his expertise of the subject only dealt with Taiwan entities and not those of the U.S. (para. 73).

Due to the engagement team's failure to familiarize themselves with the POC method and understanding how each part of the formula needs to be assessed in order to determine proper revenue recognition, Valleau and Epstein were unable to determine whether the purported revenue from the contracts was correct or not. As a result, they could not reconcile the projected costs, which were based on the accrual method, and therefore could not calculate the true Cost of Goods Sold expense for Wowjoint. This failure to determine the true amounts and then accepting them as given led them to improperly render an unqualified opinion on the audits for August 31, 2008 and 2009. In addition, no adjustments were made to CEU's reported increase in net income from $3.9 million in 2008 to $9.8 million in 2009 (para. 77-78).

After August 31, 2009, Wowjoint changed its fiscal year so that the year-ending date would now be on December 31 after it issued an F-1 to the SEC. This meant that Sherb LLP would provide an audit for those four months leading up to December 31, 2009. Alarming and shocking news came to Epstein when he discovered that the company had somehow suffered a net loss of $6 million in a matter of only four months (or a net decrease of $15.8 million). Epstein soon realized that it was due to a very large adjusting journal entry that is known as a "topside" entry, in which the entry, as authorized by senior management, is manually entered into the books (para. 80). The entry was measured at RMB (the Chinese currency) at 43 million, which was material in nature and was done to record the "lost" COGS that were never recognized in prior years.

Upon inquiring with Wowjoint's controller – the culprit behind this large journal entry – it was explained that Wowjoint had been using the cash-basis accounting method the entire time, resulting in liabilities that were never accrued. This immediately explained why such a large topside entry during the transition to the new fiscal year-end was needed. However, U.S. GAAP dictates that only accrual-basis accounting may be used. Valleau and Epstein took no further action at all and seemingly passed on the amounts with another unqualified opinion for the transitional period (p. 19-20).

In addition to misstated revenue and income for these three audits, there were significant problems with the audit of accounts receivable. During all three audits, accounts receivable accounted for the majority of Wowjoint's current assets, with a large portion of them showing accounts that were delinquent for more than one year. A delinquency of this magnitude is undoubtedly risky since it shows that the company is failing to collect any payments on time.

Surprisingly, Epstein made the effort to inquire with management as to why these delinquencies had persisted for so long and was told that these Chinese government based entities were always slow in making payments. Again, he simply accepted this explanation and did not question management. As it turns out, the receivables were from a private entity that was a co-party contractor with Wowjoint and the payment structure presented by management was unlike any normal payment structure. There was no examination as to whether the accounts receivable was fairly stated. In addition, the staff auditors never provided any follow-up examination to these receivables in the following fiscal year and the workpapers related to testing of accounts receivable were left blank (p. 21-22).

Since most of the workpapers were written in Chinese, Epstein could not provide any sort of review. He decided to sign off on these workpapers as provided (para. 90, 93). As has been the pattern, the workpapers for these past three audits were also not retained.

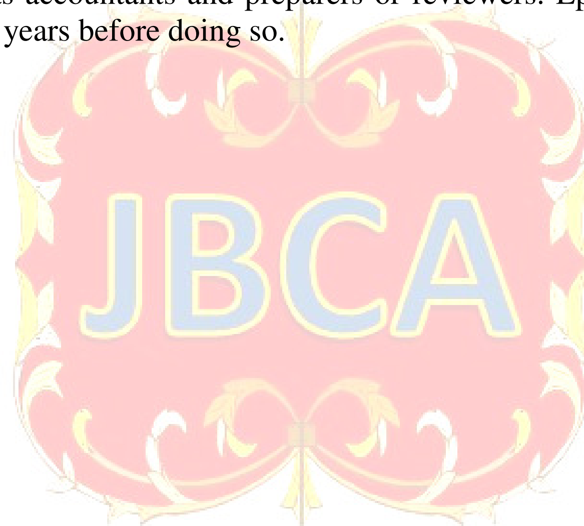
By the time the final audits of 2010 and 2011 had approached, due professional care was non-existent. Both audits were completely deficient to the point that they were undertaken recklessly. In the 2010 audit, Mycio was originally assigned as the engagement partner yet only spent one week at the Wowjoint location before immediately traveling back to the U.S. without considering who would supervise the staff auditors. According to the SEC investigation, the only work he performed was "audit planning and answer[ing] some technical question." The investigation also revealed that Valleau then took over at some point, yet he claims that this never happened other than providing support on a few workpapers (p. 24).

During the 2011 audit, Mycio returned as the engagement partner, yet similar to the prior year audits, he accepted the revenue computations as they were. He essentially allowed Wowjoint to use accelerated revenue recognition techniques whereby revenue was being recognized for projects that were not yet completed. The workpapers were never retained. In

addition, Sherb himself was assigned as the quality control reviewer and concurring review partner for both the 2010 and 2011 audits. However, no evidence was gathered that he actually reviewed prior year workpapers (other than completing a few general checklists). Sherb never realized that the initial client acceptance form clearly detailed that Wowjoint's financial reporting system had appeared to be "insufficient to provide evidence to support that transactions have occurred…" He rendered unqualified opinions for both the 2010 and 2011 audits (p. 25-27).

Epilogue

As a result of the lead partners' complete disregard for due professional care, supervision, quality control, and professional conduct overall, they received the same sentence from the SEC: they are no longer allowed to practice as Certified Public Accountants. In addition, the firm itself can no longer practice as a provider of public accounting services and will be required to pay a fine of $75,000. Sherb, Mycio, and Valleau must wait five years before reappearing before the commission to practice as accountants and preparers or reviewers. Epstein has been ordered to wait a maximum of three years before doing so.



INSTRUCTOR NOTES

Introduction

This case is an all-time tale of "auditing gone wrong." This case is a real-world example of the severe consequences of failing to act with due professional care and proper professional conduct required of certified public accountants. In addition to learning the importance of both ideals, this case will also teach students the highly important concepts of proper supervision, quality control, reviewing, and professional skepticism. Due the international dimension of this case, the case is most appropriate for graduate accounting students. The discussion questions and responses follow.

Discussion Questions and Suggested Solutions

1. **At the forefront of the many issues at hand with this case was complete lack of due professional care. Describe what this means and summarize the key areas as to how they so violated this area.**

In relation to the AICPA's Statements on Auditing Standards, the term due professional care is an overarching concept that is explored in great detail in AU 230. The third general auditing standard states that "the auditor must exercise due professional care in the performance of the audit and the preparation of the report," (para. 1) and expands upon this whereby it states that an auditor "should possess the degree of skill commonly possessed" by other auditors and should exercise it with "reasonable care and diligence"' (para. 5). More importantly, in the context of this case, it also states that "the auditor with final responsibility for the engagement should know, at a minimum, the relevant professional accounting and auditing standards and should be knowledgeable about the client" (para. 6).

All of the lead auditors never fully demonstrated due professional care throughout the audits of CSKI, CEU, and Wowjoint Holdings. In all three, each of the lead auditors never developed an adequate understanding of the client at hand in order to determine the exact degree of substantive testing necessary to lower the audit risk enough to prevent from issuing an inappropriate opinion. In addition, poor planning also meant that there was no identification as to which financial statement accounts would be at risk for material misstatements, whether due to error or fraud. The most prominent example was Valleau and Epstein's failure to adequately examine the distribution agreement and customers "A" and "B". If this had been done, they could have more readily detected the CSKI fraud. Another example was Epstein's failure to understand how the Percentage-Of-Completion (POC) method is applied to U.S. construction projects. If he had done so, he would have realized how grossly overstated CEU's revenue was during the course of the audit.

Due professional care requires professional skepticism at all times, which AU 230.07 defines as "an attitude that includes a questioning mind and a critical assessment of audit evidence." In the audit of all three companies, professional skepticism was not applied. In many situations involving the partners, be it communicating with management or examining audit evidence, they did not use their knowledge to fully question the validity of the information. The lack of effort to adhere to GAAS is what drove them to accept almost every piece of information handed over to them.

Due professional care within the planning phase also includes proper supervision. AU 311 provides the framework for planning and supervision, and in paragraph 28, it lists the following elements that constitute as what supervision entails: “instructing assistants, keeping informed of significant issues encountered, reviewing the work performed, and dealing with differences of opinion among firm personnel.” By following this standard during the audit of CSKI, both Valleau and Epstein should have thoroughly inspected the fieldwork by the contract auditors to prevent the numerous errors in the workpapers. In addition, since the partners involved never reviewed any workpapers, there was no way to be assured if the staff members actually were capable of performing the necessary audit procedures.

2. In the audit of CEU during 2010, a staff auditor encountered the situation of where he was reportedly bribed by a CEU manager in order to directly influence the outcome of it. How should auditors handle situations of illegal acts?

Indeed, while the bribe was not identified as actually creating any impact on the fairness of CEU’s financial statements, it was still unprofessional for Mycio to simply act as if it had never happened.

AU 317.02 defines illegal acts as the following: “...violations of laws or governmental regulations. Illegal acts by clients are acts attributable to the entity whose financial statements are under audit or acts by management or employees acting on behalf of the entity.” Then in paragraph seven it further adds the following: “If specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.”

Based on these facts, the bribe reported to Mycio should have been taken seriously since CEU management could have possibly gathered inside audit information in order to conceal other findings that Mycio would have discovered in an attempt to sway the financial statements to their desire. Although Mycio would still render an unqualified opinion based on his past actions, the point still lies in the fact that an act such as a bribe points to the sheer impact on the integrity of management. As CEU was already coming under fire for possible allegations of fraud, this reported illegal act should have forced Mycio into immediate action by seeking out CEU’s legal counsel, which could have led to an actual fraud that was ongoing (the seeking of a legal counsel is suggested in paragraph 10, part a).

As paragraph 17 states, Mycio should have learned the name of the manager from the staff auditor so that he could have sought assistance from other senior management after they were informed. If it came to light that senior management, as a whole, were also involved with the corruption detected by the staff auditor, then the last resort would have been for him to seek assistance from the governing body, i.e. the Board of Directors.

3. A major reason for the Wowjoint Holdings audit going drastically wrong was the inaccuracy of its large accounts receivable balances. Set forth the audit procedures for accounts receivable and explain the course of action that Epstein should have taken.

Since the accounts receivable balance constituted the majority of Wowjoint’s current assets, special attention was warranted and the audit procedures for accounts receivable needed to be

carefully followed. According to Gramling, Johnstone, and Rittenberg (2012), the following audit procedures should be performed for accounts receivable (p. 411):

- "Foot the individual accounts making up the total of accounts receivable"
- "Age the accounts"
- "Select individual items for further audit tests"
- "Print confirmations" (and therefore sending them out to selected customers)
- "Statistically evaluate the results"
- "Make a judgment on the need for an audit adjustment"

As these were most likely the steps that the staff auditors performed that led them to identify the largest accounts receivable balance, such as the private co-party affiliated with Wowjoints, the other step that Epstein so crucially missed was not seeking the use of confirmations. This would have been a much more productive measure for him to take since it was evident that management acted as if a delinquency for a year or more was not concerning. A positive confirmation would have been sent out to the private co-party as well as all other large delinquent accounts, since a positive confirmation request the recipients to "review the current balance or unpaid invoice(s) due to the client and return the letters directly to the auditor indicating whether or not they agree with the balance," (p. 546). This could have possibly led to the realization that some of the customers might have been less delinquent or more delinquent than Wowjoint reported. In general, confirmations represent a higher level of documentary evidence and provide appropriate safeguards against the possibility that management was lying to Epstein all along.

4. **During the audit of Wowjoint's revenue account, the percentage-of-completion method was used to determine the amount of revenue recognized from each contract. Identify and explain the procedures an auditor uses in the audit of accounting estimates. What should have Epstein took into factor if he actually planned for the audit?**

AU 342, Auditing Accounting Estimates, provides the detailed framework for auditors evaluation of revenue estimates derived through the percentage-of-completion method. AU 342 defines accounting estimates as "an approximation of a financial statement element, item, or account," which usually include one of the following (paragraph 1):

- "The measurement of some amounts or the valuation of some accounts is uncertain, pending the outcome of future events."
- "Relevant data concerning events that have already occurred cannot be accumulated on a timely, cost-effective basis."

Three key means to asserting the reasonableness of management estimates found in paragraph 10:

- "Review and test the process used by management to develop the estimate."
- "Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate."
- "Review subsequent events or transactions occurring prior to the date of the auditor's report."

Had Epstein and Valleau spent additional time to adequately understand the percentage-of-completion (POC) and then applied that knowledge with the steps given above on evaluating the reasonableness of the estimate, the realization that these contracts were not properly accounting for costs and revenues would have come to light much sooner. Since they only took the estimates provided by management at 'face-value', the behind-the-scenes work in developing the estimates were never fully understood. In addition, as paragraph 11 suggests, Epstein and Valleau could have utilized a specialist who has expertise in construction industry to advise them how revenue recognition should be handled. In this manner, the specialist could have explained the POC method to them as well as advising them on what the actual estimates should have been.

5. **One of the most important tasks a partner of a public accounting firm has is to establish an effective quality control system. Describe what constitutes a successful quality control program and identify what was missing in the Sherb & Co. LLP audits.**

QC 10, or A Firm's System of Quality Control¸ provides the overarching outline for what a firm must do in order to have an effective quality control system in place. According to paragraph 17, the following elements are needed to achieve appropriate quality control:

- "Leadership responsibilities for quality within the firm (tone at the top)"
- "Relevant ethical requirements"
- "Acceptance and continuance of client relationships and specific engagements"
- "Human resources"
- "Engagement performance"
- "Monitoring"

Thus, when examining this list, it becomes quite clear how much Sherb LLP was lacking for an effective quality control system; which, if properly instilled, the partners of the firm might have corrected the numerous control issues present. Leadership responsibilities were not clear; for instance, during the Wowjoint audit, Valleau was not informed that he was assigned to replace Mycio as the engagement partner. With the next category, ethical conduct was not taken seriously, with the most prominent example being that Mycio sought to take no action upon hearing the purported situation of bribery during the CEU audit. Procedures for the acceptance and continuation of client relationships were not in place as evidenced by the partners never communicated with the former auditors prior to the CSKI engagement. Human resources could have been much more effective at the firm if they hired auditors who were familiar with the Chinese environment and the language; especially since the workpapers were written entirely in Chinese. Finally, as for engagement performance, the audit firm did not follow GAAS since the workpapers were not properly reviewed and appropriate supervision was lacking. If the partners instilled a proper monitoring system, many of these botched audits could have been turned around with many of the misstatements being detected and corrected much sooner.

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