

ADMINISTRATIVE PROCEEDING
FILE NO. 3-6776

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of)	
)	
DAVID J. CHECKOSKY)	INITIAL DECISION
NORMAN A. ALDRICH)	
)	

Washington, D.C.
September 5, 1989

Brenda P. Murray
Administrative Law Judge

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APPEARANCES: John E. Birkenheier and Susan Ferris Wyderko of the Office of General Counsel, appearing for the Office of the Chief Accountant, Securities and Exchange Commission.

Geoffrey F. Aronow, Robert Chakrin, Andrew T. Karron, Peter M. Kreindler, Walter G. Ricciardi for Respondents.

BEFORE: Brenda P. Murray, Administrative Law Judge

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I. Introduction

Coopers & Lybrand, auditor for Savin Corporation (Savin) during the period in question, issued unqualified opinions on Savin's fiscal year 1981 through 1983 financial statements representing that auditors had examined those financial statements in compliance with Generally Accepted Auditing Standards (GAAS) and that in their opinion these financial statements were fairly presented in conformity with Generally Accepted Accounting Principles (GAAP). Savin's fiscal year ran from May 1 to April 30. Coopers & Lybrand's audits of Savin for fiscal 1984 and calendar 1984 (eight months ended December 31, 1984) were unqualified and stated that based on an audit that conformed with GAAS, it was the auditor's opinion that the financial statements were stated consistent with GAAP subject to the recovery of the deferred start-up costs. These opinions were included in Savin's Form 10-K reports which it filed with this Commission.

Respondents, David J. Checkosky and Norman A. Aldrich, were the senior people assigned to the Savin audits. The five audits in question generated some 750 to 1000 wove paper binders. One hundred and thirty binders dealt with the issue of deferred start-up costs. Work on the audits occurred throughout the year and concluded in June or July. In addition to the year end audits, Coopers & Lybrand did interim reviews of Savin's quarterly

financial statements. Respondents signed the completed audits for Coopers & Lybrand indicating that they were personally satisfied that the audits complied with GAAS and GAAP.

The Securities and Exchange Commission (Commission) initiated this private proceeding on November 12, 1987 pursuant to claims by the Commission's Office of the Chief Accountant (OCA) that the Commission should deny respondents, the privilege of appearing before it because they engaged in improper professional conduct as participants in audits of Savin in 1981 through 1984. Rule 2(e) authorizes such Commission action where there is a finding of improper professional conduct after notice and opportunity for hearing (Rules of Practice, 17 CFR 201.2(e)(1)(ii)).

The Commission's order initiating the proceeding alleges that respondents engaged in improper professional conduct in the following respects:

1. Did not obtain sufficient competent evidential matter as required by GAAS to afford a reasonable basis for concluding that Savin's financial statements were fairly presented in accord with GAAP.
2. Did not develop audit plans adequate to determine whether Savin's financial statements were fairly presented in accord with GAAP as required by GAAS.
3. Did not exercise due care as required by GAAS in examining Savin's financial statements and in preparing their reports on these standards.

4. Did not qualify their audit opinions because of Savin's improper deferral of material amounts of research and development costs as required by GAAS.
5. Falsely represented that their audit examination was in accord with GAAS.

The reference to GAAS is commonly meant to apply to ten generally accepted auditing standards adopted by the Auditing Standards Board and the American Institute of Certified Public Accountants (AICPA). The standards are interpreted by the Statement on Auditing Standards (SAS): These materials appear in an AICPA publication codified by AU number. As pertinent to this case the GAAS provide:

General Standards

- * * *
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
 3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
- * * *
3. Sufficient competent evidential matter is to be obtained through inspections, observations, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with GAAP.

* * *

Thirteen witnesses testified during the 30 days of hearing. The evidentiary record consists of a 3,778-page transcript and approximately 350 exhibits. Both sides filed briefs and proposed findings of fact.

I grant respondents' motion and take judicial notice of the dictionary definitions and Savin Form 10-K amendments attached as Appendix A and B, respectively, to Respondents' Request for Judicial Notice dated December 7, 1988.

II. Facts

Savin had been a client of Coopers & Lybrand since the mid-1960's. Respondent Checkosky, a Coopers & Lybrand partner since 1975, served as engagement partner or partner in charge on the Savin audits beginning with the first quarter of the fiscal 1981 audit through the calendar 1984 audit. Respondent Aldrich was the audit manager on the fiscal year audits in those years and, after he became a Coopers & Lybrand partner on October 1, 1984, he served as concurring or second partner on the calendar 1984 audit.

Savin began marketing photocopiers in 1959. In 1975 Savin became the exclusive distributor and marketer in

the United States and Canada of photocopier machines produced by Ricoh Company, Ltd. (RicoH). In the late 1970's, Savin did approximately \$450 million worth of business annually and placed 400,000 to 500,000 copiers against competitors such as IBM, Xerox and Eastman Kodak. Savin established itself as a profitable business servicing customers who wanted acceptable copies from a convenient, relatively inexpensive, reliable machine while its higher cost competitors produced Rembrandts. Unlike its competitors, the Ricoh machines used a liquid, rather than dry, toner technology.

In anticipation of Ricoh's decision not to renew its exclusive marketing agreement which expired on September 30, 1983, Savin in the late 1970s decided to undertake efforts to manufacture a new line of liquid-toner copiers of its own design. To this end it entered a research contract in 1977 with Mr. Benzion Landa of Indigo Ltd., a company located in Israel, to produce a low cost photocopy machine of simple (elegant) mechanical design for the high end of the market (Tr. 1977, 2535, 2584). As part of this strategy, in 1979 Savin purchased Magnetic Laboratories, Inc. (MLI), a manufacturer of computer parts with three or four production facilities located in the Binghamton, New York area. These facilities became Savin's Engineering and Manufacturing Division (E&M). Savin also began constructing a new

building in which to assemble its new copier from parts manufactured in the old MLI facilities. In April 1979 Savin hired a project manager for the E&M and he began a massive recruiting effort to hire engineers. The number of employees at E&M went from two in April 1979 to 400 or 500 when the first project manager left in late November 1982 (Tr. 15, 73). In early 1980 certain Savin employees visited Mr. Landa in Israel and saw the "Landa model" copier or Indigo machine he was building for Savin. What they saw was not a working model, i.e., it did not make copies but, according to one viewer, it involved sophisticated design concepts. This model and its design drawings were delivered to E&M in the spring of 1980 and E&M began working to satisfy the product specifications Savin had established for its new copiers. According to a memorandum written by the project manager on January 22, 1980, "In about two weeks Indigo, will bring their model, plus 3-4 lead design people to Savin E&M to work with Savin E&M people in translating the design intent of the drawings now being made into models at Savin E&M." (Exhibit B) In March 1980 the project manager authorized purchases of parts to build machines to begin testing, i.e., B Builds or Block Builds (Tr. 20-21, 35). By the end of 1980, E&M began tooling (provision of machinery in preparation for production) and purchasing parts for a 20 Build. The B-1 or B builds of the Diamond and Ruby

copiers were used to validate design and to test to see how closely the machines operated to their functional specifications (Tr. 157-58).

In 1980 through 1982, the new copier was referred to as Project X and consisted of the following designations (Tr. 23, 298, 479):

- Diamond - base model
- Ruby - base model with reduction capacity.
- Sally - base model with document handler/sorter.
- Rhino - top of the line machine consists of base model with recirculating document handler, two sided copying and stapler

The product specifications for the Diamond and Ruby machines dated January 12, 1981 called for 60 copies per minute on 8.5x11 paper, an automatic document feeder, and a maximum of 64 and 66 failures per million copies for the Diamond and Ruby, respectively (Exhibit 166, pp. 3, 19). The specs note that (Id.):

4.0 Reliability

4.1 Goals

To a very large degree the success of the Savin machines is due to the high level of reliability consistently demonstrated in the field. A major goal of the Ruby and Diamond machines

is to maintain this level of reliability.

Throughout this period Mr. Landa continued working in Israel on toner and laser development for the new Savin copier. Savin expensed Mr. Landa's efforts as research and development costs. E&M employees worked to have the machines satisfy their specifications and to get them ready for commercial production (Tr. 51-61, 158, 163-67, 225-26, 298-301, 1330). In its quarterly report for the three months ended July 31, 1980, Savin reported that its development plans were on schedule and it expected to introduce its newly manufactured copiers in early calendar 1982 (Exhibit 17).

In the fall of 1980, Savin informed Mr. Checkosky that it had successfully developed a new copier and it would begin deferring all costs attributable to projects that had passed into manufacturing start-up (Tr. 1939-40). Mr. Checkosky informed Savin this was acceptable accounting subject to his knowing more. Mr. Checkosky reread Statement of Financial Accounting Standards No. 2 - Accounting for Research and Development Costs (FAS 2) promulgated in late October 1974 by the Financial Accounting Standards Board (FASB), a body responsible for establishing standards that govern the presentation of financial statements that conform to GAAP, and Montgomery's Auditing with respect to deferred charges and start-up costs and concluded that Savin could defer

the product related costs at issue provided that Savin had tangible evidence that research and development had ended. In January 1981, Mr. Checkosky visited E&M and saw a working machine. Using his wrist watch, he timed it making 60 copies per minute. He found the copies to be of good quality and he talked to someone, a kind of senior engineer, who told him that the machine was in production because "they were drawing the final manufacturing blueprints for the parts and tooling" (Tr. 1962). Mr. Checkosky suggested to Savin that it adopt a written policy of cost deferral which described a start-up period after research and development during which costs would be deferred rather than expensed (Tr. 1938-45, 2257-58, 2299-301, 2337-41, Exhibit 65). Mr. Checkosky suggested to Savin that a benchmark indicating the end of research and development, which FAS 2 directs be expensed, would occur when the company had a working machine that it was going to produce (Tr. 1942). To assist Savin draft the policy, Mr. Checkosky requested information from Coopers & Lybrand's research unit on other companies which deferred start-up costs relating to new facilities (Exhibit 31).

Savin began deferring costs of a base machine in November 1980 when it claimed to have a working model of the Project X machine (Tr. 2443). Some audit work papers (Exhibit 30, p. 9 and Exhibit 57, p. 57) state that Ruby

passed into the start-up mode on November 1, 1980. Another work paper says Ruby/Diamond entered start-up in August/September 1981 (Exhibit 37, p. 71). Savin began deferring costs of the Diamond and Ruby machines as if they entered start-up on May 1, 1981 but later changed that date to August 1, 1981 (Tr. 1574-75, 2042, 2440-42). Savin adjusted its financials to reflect an August 1, 1981 start-up date. The audit work papers show that Savin considered the cut-off between research and development and start-up to be when engineering released drawings to manufacturing (Tr. 3625, Exhibit BR pp. 111-12).

Savin began deferring start-up costs in its financial statements for fiscal 1981 and continued to do so through the financial statements for the eight months ending December 31, 1984. By deferring rather than expensing, Savin kept these costs from increasing the net operating loss it experienced in each of the financial reports at issue. Instead these costs were included as assets on Savin's balance sheet and increased owners' equity.

In fiscal 1981 Mr. Checkosky did not consider the \$3.9 million of deferred start-up costs significant enough for separate line item disclosure so the amount is included in Other Assets. The notes to the 1981 financial statements state "Start-up costs associated with major projects are deferred and amortized, generally over a

period of three years." (Exhibit 154, p. 24). However, most of the deferred costs in 1981 were not related to building the new manufacturing facility but were related to the new product (Tr. 1621). For example, in fiscal 1981 Savin deferred some \$1.8 million of costs associated with the 20 Build as start-up costs.

Savin collected costs in various categories by codes. For labor costs the codes included the basic machine/Project X and Ruby, Diamond, Sally, and Rhino. Savin did not collect information by activity. Selected line items in millions of dollars from Savin's annual reports on Form 10-K are as follows: (Exhibit 198):

	<u>4/30/81</u>	<u>4/30/82</u>	<u>4/30/83</u>	<u>4/30/84</u>	<u>12/31/84</u>
Net Loss	2.2	32.2	21.1	58.8	13.8
Total Assets	413.2	406.9	379.5	350.9	362.5
Stockholders' Equity	100.4	103.1	116.1	85.9	72.2
Research and Development Expense	18.8	11.8	11.8	8.3	3.6
Deferred "Start-up" Costs (Annual Additions)	3.9	18.3	20.4	14.2	11.0
Deferred "Start-up" Costs (Cumulative)	3.9	22.2	42.7	56.9	67.9

Savin's fiscal year 1981 Annual Report to Shareholders announced that it would introduce the new

copiers by the spring of 1982. Beginning in the summer of 1981, Savin began retrofitting Ricoh copiers with a new Landa toner. The manufacturing side of Savin E&M manufactured Landa kits which included the new Landa toner and peripherals. Savin called these items current products. Some people from manufacturing also worked with the engineering group which was doing conceptual drawings, designing and redesigning, and building and testing engineering models and prototypes.

On October 29, 1981 one outside reviewer observed ("Red Flag" Review of Savin's Engineering Program, Manufacturing Planning and Installed Plant and Equipment, Arthur D. Little, Exhibit N, pp. 1,7):

Savin . . . has committed major resources in the total program to design and manufacture its own copiers and peripherals. These copiers will be equipped with a patentable new wet toner process (Landa) which has certain marketable advantages over conventional liquid toning. . . . Savin has made major capital expenditures in facilities and equipment by acquiring Magnetic Laboratories, Inc. (MLI) a copier components producer and in the construction of a modern 320,000 sq. ft. assembly plant. Approximately two years of engineering design and manufacturing planning has gone into the program. Most of the key management and engineering staff have been hired and are actively working on site.

* * *

We believe the X series LTT copier is a sound design and Savin will be able to demonstrate that it is a reliable and manufacturable product.

The A.D. Little study was done in anticipation of the purchase by Canadian Development Corporation (CDC) of 57 percent of Savin's outstanding shares in March 1982 (Joint Stipulation of Fact, ¶7).

On June 18, 1982 Savin management announced that it moved the projected date for introducing the new copier to the United States market back to January 1983 (Exhibit 48 at 47). By the summer of 1982 E&M had built 15 to 20 copiers which incorporated the new Landa toner. In July 1982 Savin showed its Project X copiers at the National Office Machine Dealers Association (NOMDA) in Kansas City. After the show E&M employees continued to work on the machines to improve their reliability so they would meet the product specifications. In the summer of 1982 the machines performance was too poor to keep meaningful data (Tr. 51-52). The Project X machines had not met their reliability specifications by the end of November 1982 (Tr. 28, 473-74, 521-22,). In the fall of 1982 Mr. Landa took charge of E&M to try to get the new Project X copiers to market, but he was unsuccessful. Savin's Board of Directors minutes on September 21, 1982 indicate an introduction date of April 1983, and five areas of needed work before production of the machine (Exhibit 73 at 214):

1. Toner/fuser
2. Radiant heat

3. Production toner availability
4. Finalization
5. Reliability of machine

In late 1982, Savin stopped work on its Project X copiers and E&M terminated 275 employees in January 1983. Savin's explanation is that it missed the market window of opportunity because other companies had already begun to market machines with similar features to the Project X machines (Tr. 2548). According to respondents, Savin then began an effort to redesign or to reconfigure the Rhino model, the Project X machine with the most features (Tr. 2193, Exhibit 80). Some people who were working at Savin at the time believe that E&M under Mr. Landa started over to design a new machine in late 1982 or in early 1983 (Tr. 242-44, 305-07, 416, 468, and 475-80). A work paper dated 12/31/82 shows the Rhino project as discontinued while in the research and development phase (Exhibit 65, p. 92).

In an undated position paper contained in the work papers for the 1983 audit, Savin's Director of Accounting explained (Exhibit 60, p. 69-70):

Initial manufacture of the DIAMOND model began in March 1982 and field introduction occurred in the summer of 1982 at a meeting of the National Organization of Machine Dealers Association (NOMDA) in Kansas City. By late 1982, thirty-five units had been manufactured and inventory to produce an additional 400 units (Diamond and Ruby) had been ordered. Full scale production was scheduled to begin on December 1982.

* * * *

. . . it was decided in December 1982 that additional features (e.g., flexible upgrades conducive to field installation) would offer long range competitive positioning. The design and technology of the Rhino model was retained and retitled "8000 series"

* * * *

Production of 8000 series machines began in fiscal year 1981. . . . Although refinements and improvements have been made to the features of the basic Rhino model, it continues to represent the original, existing product line. Furthermore, current production timing for the Rhino model does not differ substantially from the timing included in the original product line plan. Management has therefore concluded that the product line is in a start-up phase since no events have occurred from which could be concluded that commercial production and marketing of the product line will not be successful.

To meet existing competition, the 8000 series or Pegasus was to have a variety of functions as standard equipment such as a minimum speed of 70 copies per minute, reduction and enlargement capability, and four input paper trays. Various options would be available such as two-sided copying and the ability to use different colored ink. The performance specifications for the Pegasus used the Rhino specs for format and boiler plate but the description of the performance and subsystems were unique to Pegasus (Tr. 389-91). Coopers & Lybrand, Matters for Attention of Partner - Summary Statement (MAP), which respondents signed on February 28,

1983 stated under the title Deferred Start-Up (Exhibit 136, p. 7):

The 8000 series is currently being re-evaluated and is in a redesign stage. Significant changes to the product may require future adjustment to deferred start-up costs. We will continue to monitor the status of the 8000 series and will address the issue of recoverability with management upon completion of the product re-evaluation.

On April 21, 1983 McKinsey & Company submitted a report to Savin, Developing an Integrated Business Strategy/Top Management Agenda for Capitalizing On Opportunity with 8000. The report discusses the high performance criteria the 8000 should meet and the schedule for its development and introduction in the period April 1983 through July 1984. Two of the report's key assumptions were that Savin bring to market a highly reliable machine by about July 1984.

The work papers for the 1983 audit identify the 8000, Ruby, Diamond, Sally, and Landa 8000 as being in the start-up phase and Rhino as being in research and development (Exhibit 65, p. 92). In fiscal 1983, Savin wrote off \$5,776,271 which it had deferred as start-up costs (Exhibit 64, p. 6). This amount includes \$2 million for Ruby, Diamond, and Rhino tooling.

Arthur D. Little, Inc. submitted a review of the 8000 Series to Savin on February 23, 1984 (Exhibit 205, pp. 20, 22). The author of the review noted that production was scheduled to start in late 1984 and that he/she:

- did not see an operational 8000
- did not see a completed 8000
- did not see copies claimed to have been produced by the 8000
- did see the skeleton of an 8000 prototype, prior to the assembly of most of the components.
- manufacturing prototypes scheduled to start in July 1984

Savin showed the Pegasus machine to dealers at the NOMDA show in July 1984. In June 1984 McKinsey & Company did an update study titled "Assessment of the Status of the 8000 Program." The update notes that "no working model incorporating all of the planned modifications to the earlier generation of machines (i.e., Diamond/Ruby) has yet been built." (Exhibit 129, p. 4). Respondents had this report before they issued their opinion on the fiscal 1984 audit (Tr. 2141-42).

Savin never sold or leased any Project X or Pegasus/8000 Series copiers. It discontinued efforts to manufacture its own copiers in December 1985.

The Commission filed a civil action against Savin in November 1985 with respect to these matters. Savin consented to the entry of an injunction on the same date. In connection with the injunction, Savin restated the financial statements contained in its annual reports (Form 10-K) for all the periods in question (Compare

Order for Private Proceeding, November 12, 1987, p. 6 and Savin's Answer, p. 7).

III. Argument

The OCA maintains that the public interest demands that the Commission deny respondents the privilege of appearing and practicing before it for five years because they violated Rule 2(e) of the Commission's Rules of Practice by approving five sets of financial statements despite having affirmative evidence that these statements departed from GAAP. According to the OCA, the departure occurred because Savin improperly reported material amounts of product development costs as assets. The OCA agrees that there can be start-up costs associated with the opening of a new plant or facility (Tr. 767-70, 954-55).

The OCA lists respondents' improper professional conduct in the five Savin audits as follows:

1. Gave unqualified opinions even though Savin improperly deferred material amounts of research and development costs which it should have expensed under GAAP.
2. Failed to obtain sufficient competent evidential matter to form an opinion as to whether the deferrals of start-up costs were appropriate.
3. Failed to adequately plan the audits so as to obtain evidence whether Savin's financial

statements were presented in accordance with GAAP.

4. Failed to observe due professional care to assure that the auditors performed adequate audit procedures to obtain the evidence needed (sufficient competent evidential matter) to support the audit opinions.

Mr. Paul J. Glasgow, a mechanical engineering expert, and Dr. Nam P. Suh, an expert mechanical engineer with considerable experience in starting new companies, testified for respondents that research and development in engineering consists only of new technology, i.e., that flash of inspiration that results in ideas that are new to mankind. In their view, during this period Savin E&M was engaged in the nitty gritty work of manufacturing copiers even though Savin never sold or rented any of these copier models. These experts contend that Savin manufactured copiers when it made models and proceeded with various product builds. They believe that the OCA is wrong to define manufacturing as meaning commercial manufacture. They contend that during all the audit periods in question Savin was in an early phase of commercial production.

Dr. Sidney Davidson, Arthur Young Distinguished Service Professor of Accounting, University of California, Mr. Robert Berliner, National Audit Partner,

Spicer & Oppenheim, and Mr. Larry J. Parsons, partner, Ernst & Whinney, testified that Savin's policy for reporting research and development costs conformed to GAAP, and that respondents' actions conformed to GAAS and were within accepted professional standards. Mr. Dennis Beresford, at the time National Director of Accounting Standards at Ernst and Whinney, testified in support of respondents' position.

IV. Findings of Fact and of Law

A. Was Savin's Deferral of Start-up Costs Appropriate Under GAAP?

The first issue is whether Savin in its financial statements for fiscal years 1981 through 1984 and for calendar year 1984 properly deferred as start-up costs the product costs incurred in connection with work at its E&M division.

An auditor has an affirmative responsibility under GAAS to satisfy himself that a client's accounting policies are applied in accordance with GAAP. I find that respondents were wrong to give unqualified opinions to Savin's financial statements in fiscal years 1981 through 1984 and eight months of calendar 1984 because the evidence is persuasive that GAAP required Savin to expense these product costs. Contrary to respondents' claims, the language of FAS 2 is clear and unambiguous. FAS 2 paragraphs 8, 9 and 10 specify (Exhibit 144):

8.
 - a. Research is planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service (hereinafter "product") or a new process or technique (hereinafter "process") or in bringing about a significant improvement to an existing product or process.
 - b. Development is the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use. It includes the conceptual formulation, design, and testing of product alternatives, construction of prototypes, and operation of pilot plants. It does not include routine or periodic alterations to existing products, production lines, manufacturing processes, and other on-going operations even though those alterations may represent improvements and it does not include market research or market testing activities.
9. The following are examples of activities that typically would be included in research and development in accordance with paragraph 8 (unless conducted for others under a contractual arrangement -- see paragraph 2):
 - a. Laboratory research aimed at discovery of new knowledge.
 - b. Searching for applications of new research findings or other knowledge.
 - c. Conceptual formulation and design of possible product or process alternatives.
 - d. Testing in search for or evaluation of product or process alternatives.

- e. Modification of the formulation or design of a product or process.
 - f. Design, construction, and testing of pre-production prototypes and models.
 - g. Design of tools, jigs, molds, and dies involving new technology.
 - h. Design, construction, and operation of a pilot plant that is not of a scale economically feasible to the enterprise for commercial production.
 - i. Engineering activity required to advance the design of a product to the point that it meets specific functional and economic requirements and is ready for manufacture.
10. The following are examples of activities that typically would be excluded from research and development in accordance with paragraph 8:
- a. Engineering follow-through in an early phase of commercial production.
 - b. Quality control during commercial production including routine testing of products.
 - c. Trouble-shooting in connection with breakdowns during commercial production.
 - d. Routine, on-going efforts to redefine, enrich, or otherwise improve upon the qualities of an existing product.
 - e. Adaption of an existing capability to a particular requirement or customer's need as part of a continuing commercial activity.
 - f. Seasonal or other periodic design changes to existing products.
 - g. Routine design of tools, jigs, molds, and dies.

- h. Activity, including design and construction engineering, related to the construction, relocation, rearrangement, or start-up of facilities or equipment other than (1) pilot plants (see paragraph 9(h)) and (2) facilities or equipment whose sole use is for a particular research and development project (See paragraph 11(a)).
- i. Legal work in connection with patent applications or litigation, and the sale or licensing of patents.

The work done by the engineers and others at E&M working on the new proposed Savin copier was either research, i.e., a "planned search or critical investigation, aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product" or development, i.e., "the translation of research findings or other knowledge into a plan or design for a new product." I reject respondents' explanation that research and development were finished and the copiers were in a start-up phase of manufacturing wherein product costs are deferrable. Respondents are wrong that the term research as it is used in FAS 2 is limited to activities which produce something new to the mind of man (new technology) for several reasons. The first reason is that the FAS 2 definition of research does not use the words new technology and the language of the standard does not convey this requirement. Mr. Checkosky gave no reason why he interprets Paragraph 9 of FAS 2 which states that the design, construction, and

testing of preproduction prototypes and models are examples of typical research and development activities as covering only prototypes that use a "new technology" (Tr. 2189-99). Second, both respondents acknowledged that in reaching their decision that Savin's product start-up costs were deferrable they did not read materials which describe the National Science Foundation (NSF) definition of research and development which includes applied research defined as the discovery of new scientific knowledge. The fact that the NSF definition was the starting point for the FASB's deliberations which resulted in FAS 2 is therefore irrelevant to assessing the reasonableness of respondents' actions. Moreover, FAS 2 makes clear that the NSF definition did not carry over to what was adopted as FAS 2. Also the audit work papers do not discuss the meaning of the term new technology, do not contain any evidence that the auditors tested whether Savin's copiers used new technology, and do not contain any evidence that respondents investigated how Savin used the term manufacturing (Tr. 1709-10, 3719). Third, the definition of research as requiring new technology is a technical, scientific definition. Respondents did not dispute the position of Dr. Sprouse, the FASB member assigned to the project that FAS 2 was written for use by non-engineers such as preparers (managers and accountants) and users of

financial statements (bankers and financial analysts) (Tr. 754). The drafters of FAS 2 did not intend that a peculiar technical expertise would be required in order to understand it (Tr. 755, 825, 885-86, 1043-44, 1075, 1336-37). Finally, in 1981 when Messrs. Checkosky and Aldrich signed off on the Savin fiscal 1981 audit, FAS 2 had been in effect for over six years. In this time frame its meaning was not the subject of controversy or debate within the accounting profession, and there is no precedent in accounting literature or practice for the definition that respondents put forward here.

The preponderance of the evidence is that the meaning of FAS 2 is settled in the profession to be as represented by the OCA accounting experts, Dr. Norton Bedford, Professor of Accounting at the University of Illinois, Dr. Robert Sprouse, FASB member 1973-85 and now Distinguished Accounting Research Professor at San Diego State University, and Mr. Ernest Ten Eyck, National Accounting Partner, Laventhol & Horvath. According to that definition, research and development covers activities surrounding the development of a new product before it goes into commercial manufacture. There is no intermediate stage between research and development and the start of commercial manufacturing (Tr. 781-82, 861-63, 1357). The reason for this interpretation is that FAS 2 was written to deal with the fact that there is a

high degree of uncertainty that a company will ever benefit from its research and development activities. One study cited in the background to FAS 2 found less than 2 percent of new product ideas and less than 15 percent of product development projects were commercially successful (Tr. 758, Exhibit 144 at 14). The purpose of FAS 2 was to give users of financial statements notice of a company's research and development expenditures to avoid situations such as this one where corporations accumulate large amounts of costs that are not identified with saleable assets and then have to write off those amounts when the project proved unsuccessful (Tr. 757-61, 957-58, 1376). Respondents' creation of a start-up phase or early commercial manufacturing phase where costs are deferred destroys FAS 2's ability to convey the very information which was its purpose. I find the testimony of Dr. Bedford and Dr. Sprouse persuasive. Unlike respondents' accounting and auditing experts, who also possess outstanding professional qualifications, they did not assume when making their professional judgment that Savin had begun manufacturing when it incurred the costs at issue. Dr. Bedford, active for over 35 years in accounting academia, did not know of any company other than Savin that had deferred start-up costs related to production of a new product at a new plant since the issuance of FAS 2 (Tr. 1450). Dr. Sprouse conducted a

computer search of the 10K reports of 3,500 companies over a six year period (1981 - portion of 1987) and found that only in Savin's situation were the deferred start-up costs clearly relating to product development (Tr. 838, 1157-58, 1202-03). None of the 25-30 manufacturing companies that Mr. Ten Eyck audited early in his career, before FAS 2 was issued, had a policy of deferring start-up costs (Tr. 1752).

The testimony of Mr. Anthony J. Mottola, a practice fellow with the FASB in 1974 and 1975, and Dr. Robert T. Sprouse, the FASB member primarily responsible for the effort which resulted in FAS 2, could be viewed as contradictory. Mr. Mottola recalls 75 to 100 inquiries about FAS 2 including six to twelve inquiries about what constitutes research and development under the terms of FAS 2 ¶9 during the year and a half he was at the FASB (Tr. 3114-16, 3124). Dr. Sprouse, on the other hand, testified that during the years he served on the FASB, 1973-85, inquiries about FAS 2 were virtually non-existent except for the three areas where the Board issued interpretations -- computer software, research and development acquired through business combinations, and research and development by companies in their development stage. Dr. Sprouse would be expected to know about FAS 2 inquiries because his technical advisor was the Board's project manager for FAS 2 and the staff

member responsible for answering public inquiries. Also, under Board procedures, telephone inquiries were noted on a memorandum form and Dr. Sprouse was on the distribution list to receive these memoranda. He does not recall any that dealt with Statement 2 subsequent to the issuance of the three interpretations made shortly after the Board issued FAS 2 (Tr. 756-57, 1301).

I accept Dr. Sprouse's representation. I reject Mr. Mottola's representations because they are internally inconsistent. Mr. Mottola testified that the Board issued an interpretation on accounting for computer software development costs after six or so inquiries (Tr. 3117), and an interpretation on accounting for research and development by companies in their development stage after a couple of inquiries (Tr. 3118). Based on this testimony it is reasonable to expect that the FASB would have issued an interpretation about the meaning of the terms research and development as used in FAS 2 if Mr. Mottola is correct that it received six to twelve inquiries in 1974-75 on this subject. In fact the three interpretations issued shortly after the FASB issued FAS 2 are the only interpretations the Board has issued in the 14 years the standard has been in effect. The FASB has never issued an interpretation of the terms research and development as used in FAS 2.

I find that Dr. Davidson's views do not provide a basis for respondents' actions because (1) respondents did not have them available when they decided that Savin's product costs were deferrable, and (2) the record does not support Dr. Davidson's positions that FAS 2 is ambiguous, that the FAS-2 definition of research and development requires new technology, that FAS 2 provides for an intermediate step called the start-up of manufacturing which occurs between research and development and "the period of normal productive capacity", and that from 1981 through 1984 Savin thought it was manufacturing its new copiers because it had a 20 Build and showed the machine at the NOMDA show in 1982 (Tr. 3358, 3364, 3417). Dr. Davidson is a critic of FAS-2. This accounting standard does not use the accounting method for treating research and development costs he advocated when FAS 2 was being drafted (Tr. 3425).

I find that Mr. Berliner's views do not provide a basis for respondents' actions because (1) respondents did not have them available when they decided that Savin's product costs were deferrable, (2) his substantial doubts about respondents' efforts as shown in the work papers were resolved by conversations with respondents off the record, (3) he agrees that the costs of testing pre-production prototypes and models and

engineering activities necessary to meet product specifications should be expensed, and this is what several of OCA fact witnesses testified they did as employees at Savin E&M, and (4) the record does not support his position that Savin was in an early stage of the manufacturing process (Tr. 3583, 3588).

Mr. Parsons' views do not provide a basis for respondents' actions because (1) respondents did not have them available when they decided that Savin's product costs were deferrable, and (2) the record does not support Mr. Parsons' position that Savin was in the start-up phase of commercial production and FAS 2 allows product costs incurred at that stage to be deferred. Mr. Beresford's views do not provide a basis for respondents' actions because respondents did not have them available when they decided Savin's product costs were deferrable, and the record does not support Mr. Beresford's position that product start-up costs can be deferred (Exhibit BR, p. 56).

Based on the preceding discussion, I find that FAS 2 and therefore GAAP required that Savin E&M expense as research and development the product costs associated with its efforts to make a copier in fiscal years 1981 through 1984 and calendar 1984, and that respondents were wrong to sign unqualified audit opinions where Savin did not do so.

B. Were the Amounts Deferred Material?

After deciding that Savin should have expensed as research and development its E&M product costs, the next consideration is whether or not the amounts involved were material. A fact is material if there is a substantial likelihood that a reasonable investor would consider it important. Respondents contend that the amounts were not material in fiscal 1981.

I find that Savin's financial statements were materially misstated in each audit. Savin's total deferred start-up costs for each of the audits in question is set out in the Facts section of this decision. The evidence is that the following amounts (in millions) which Savin included in deferred start-up costs should have been expensed as research and development costs because they included such costs as labor and materials for testing pre-production models and prototypes, premiums paid for parts, interest costs or some other cost associated with research and development activities for the Project X copiers or the 8000 series also known as the Pegasus copiers. The total amount of deferred start-up costs is shown in column 2, the amount the OCA challenges through the testimony of Dr. Sprouse is in column 3 and the cumulative total of the contested amounts is in column 4, (Tr. 933-55, 1508).

	(1)	(2)	(3)	(4)
	<u>Year</u>	<u>Deferred</u>	<u>Contested Amount</u>	<u>Contested Cumulative Total</u>
FY	1981	\$ 3.9	\$ 1.8	\$ 1.8
FY	1982	18.3	8.8	10.6
FY	1983	20.4	9.1	19.7
FY	1984	14.2	11.7	31.4
Calendar	1984	11.0	5.6	37.0

The error was material in fiscal 1981 because the amount which Savin should have expensed would have increased Savin's net loss from \$2.2 million to \$4.0 million, an increase of 82 percent. The error in fiscal 1982 was material because the amount which Savin should have expensed would have increased Savin's net loss from \$32.2 million to \$41.0 million, an increase of 27 percent. This increase is especially significant since only one-fourth of Savin's total assets of over \$400 million represented shareholders' equity, and the amount of deferred start-up costs inflated this figure. The error in fiscal 1983 was material because the amount which Savin should have expensed would have increased Savin's net loss from \$21.1 million to \$30.2 million, an increase of 43 percent. In addition shareholders' equity increased by the amount of the deferral and by fiscal 1983 deferred start-up costs accounted for 17 percent of Savin's shareholders' equity. Overstating

shareholders' equity was material where Savin's debt to equity ratio was 69 percent debt, 31 percent equity. The error was material in fiscal 1984 because the amount which Savin should have expensed would have increased Savin's net loss from \$58.8 million to \$70.5 million (20 percent), and including this amount in deferred start-up costs overstated shareholders' equity of \$85.9 million by a cumulative total of \$31.4 million by fiscal 1984. The error was material in calendar 1984 because the amount which Savin should have expensed would have increased its net loss for the period from \$13.8 million to \$19.4 million, an increase of 41 percent. In addition, by December 31, 1984 the cumulative total of erroneously included start-up costs totalled \$37 million, over half of Savin's reported shareholders' equity for the period and this inflation of shareholders' equity distorts the debt-equity ratio.

I reject respondents' argument that Dr. Sprouse's opinion that the contested amounts are material is worthless because Dr. Sprouse did not consider the tax consequences of Savin's failure to expense these amounts. The figures are valid as pre-tax amounts. Calculating the tax effect would be a complicated calculation requiring knowledge of Savin's finances that is beyond the information available to the witness.

- C. Did Respondents Violate GAAS in Fiscal 1981 by not Exercising Due Professional Care and not Obtaining Sufficient Competent Evidential Matter When Savin Deferred for the First Time Costs for Products in "Manufacturing Start-Up"?

GAAS, General Standards No. 3 and Standards of Field Work No. 3 state:

Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Sufficient competent evidential matter is to be obtained through inspections, observations, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Respondents' expert agrees that auditors must maintain an attitude of healthy skepticism (Tr. 3577):

. . . the auditor's role is to question, to challenge, to doubt that which he sees because he is exercising, in the Supreme Court case, U.S. Government versus Arthur Young, very often frequently quoted, the watchdog responsibility of the auditor, the public watchdog. And to fulfill that responsibility the auditor, has got to question what he is confronted with, and resolve it.

I find that respondents did not exercise due professional care and did not obtain sufficient competent evidential matter on which to base their audit opinion about Savin's financial statements in which it deferred product costs as start-up costs. The record indicates that respondents only examined the policy question of whether deferral was appropriate for the kinds of product costs Savin was incurring at E&M in 1980-81. After respondents decided that it was appropriate under FAS 2

for Savin to defer costs where the product was in manufacturing start-up their focus in later audits was to determine if amounts were (1) appropriately deferred (whether costs were in the correct category based on the policy statement adopted in 1980-81), (2) reasonably stated, and (3) recoverable. The last two features are irrelevant to determining treatment under FAS 2.

I find first that respondents did not exercise due care and did not gather sufficient competent evidential matters when they made the initial classification decision. Mr. Checkosky went about making the judgment on this significant question (Savin was not deferring any costs at the time) in a cursory, subjective, unprofessional manner. I make this finding based on his description of what he did, i.e., he agreed with Savin's position that it should be allowed to defer start-up costs associated with its new copiers subject to rereading FAS 2 and Montgomery's Auditing. On this important issue Mr. Checkosky should have tested management's representation which is what auditing is all about (Tr. 1598, 3578) by asking a series of questions about what the client was doing, checked out the answers he received by some objective and reliable method, used the considerable information resources at his disposal either within Coopers & Lybrand or at the FASB to research whether similar situations existed and the

accounting treatment given, and write or have written for him a memorandum laying out the facts and detailing the rationale supporting his position. He did none of these. On the basis of statements made by Savin's chief financial officer, a visit where he saw a machine make copies, and a rereading of FAS 2 and one monograph he made a decision which resulted in a deferral of \$3.9 million of costs in fiscal 1981. The work papers for the 1981 audit contain no documentation for the January 1981 visit to E&M when Mr. Checkosky saw a machine making copies. Mr. Checkosky made no record of what he saw. He did not examine whether the machine he observed satisfied the specifications which Savin believed were necessary before it would take the product to market even though FAS 2 ¶9 i cites "engineering activity required to advance the design of a product to the point that it meets specific functional and economic requirements and is ready for manufacture" as an example of an activity that would be included in research and development.

The SAS state that direct personal knowledge obtained through physical examination, observation and inspection is more persuasive than information obtained indirectly (AU §326.18, Exhibit CU). However, Mr. Checkosky's observation of the working machine did not give him personal knowledge that Savin was ready to begin manufacturing this particular model machine because it

was no more than a cursory viewing. He is not an engineer, he did not have a set of machine standards for comparison, he did not see any performance records, and he did not ask any probing questions. The SAS also specify that evidential matter obtained from independent sources outside an entity provides greater assurance of reliability than that secured solely within the entity (Id.). Respondents did not seek or direct the auditors to obtain corroborating evidence from sources outside Savin. They accepted, without checking independent sources, the information which Savin provided.

There is no evidence indicating that Mr. Checkosky engaged in serious deliberations on the subject with Mr. Aldrich or other members of the auditing team (Exhibit BR, p. 119). The inquiry he made to the Coopers & Lybrand Research Unit on January 26, 1981 does not indicate he sought and received support for his decision. This is because the inquiry asked was off the mark. The request was for information about companies deferring start-up costs relating to building a major manufacturing facility (Exhibit 31) but Savin wanted to defer start-up costs associated with a new product as well as a new facility. The evidence indicates that Mr. Checkosky was anxious to go along with what Savin wanted to do and that, instead of remaining independent in mental attitude, exercising due care, and gathering competent

evidence, he assisted Savin in accomplishing its objective of deferring the product costs of its E&M Division while it was attempting to produce inhouse a copier for the commercial market. Mr. Checkosky knew that FAS 2 is the governing standard and that it does not mention a start-up status. However, Mr. Checkosky suggested that Savin write up its policy on start-up costs and that it establish a benchmark between research and development and a new status called manufacturing start-up. The benchmark between research and development where costs would be expensed and manufacturing start-up costs where costs would be deferred would be the existence of a working model of the machine which Savin was going to produce. Respondents consulted with the person at Savin drafting the policy and they obtained and supplied written materials to Savin which they thought supported deferral of product costs. (Tr. 1945-46, 2299-301). In summary there is no evidence of any careful, measured consideration of both sides of the question by Mr. Checkosky, any testing by him of Savin's representations, or of any objective attempt by him to gather sufficient competent evidential materials so as to reach a conclusion on the merits.

Mr. Aldrich did not take issue with the conclusion of Mr. Checkosky that Savin's deferral of start-up costs associated with the new copier project was appropriate

(Tr. 2337-41). Mr. Aldrich made no independent inquiries and did not research the issue but instead worked with Savin to write up a policy authorizing Savin's desired deferral. (Tr. 2339-45). I find that Mr. Aldrich violated the required standard of exercising due professional care and the necessity to gather sufficient competent evidential matter to afford a reasonable basis for his unqualified audit opinions for the same reasons I set out with respect to Mr. Checkosky.

D. Did Respondents Violate GAAS by Not Exercising Due Care and not Obtaining Sufficient Competent Evidential Matter in Connection with Savin's 1981-84 Audits?

Respondents point to the amount of time and effort they put into these audits and the 130 volumes of work papers produced on the issue of deferred costs. No one contests these facts. The problem is the effort was off the mark. The record supports the description of respondents' auditing procedures given by OCA witness Mr. Ten Eyck (Tr. 1870-71):

As to the classification, in the years 1981 and 1982 and 1983, the principal procedures consisted of looking at the client's accounting system; testing whether the numbers mechanically flew through from summary schedules that the client had prepared; and in some cases, discussion with client personnel concerning certain of the classification matters.

And at 4/30/82, part of the procedures that were, part of the meeting that was held where Savin did what I would refer to as a "dog and pony show," a presentation on the

status of the project, might also arguably relate to classification in that year.

I believe they also verified the mathematical accuracy of certain of the schedules that had been prepared by Savin.

In 1984, both in the April 30 audit and the December 31 audit, there was also work done related to interviews of Savin personnel working at the E&N facility, although to a much greater extent, as I recall, was the December 31, 1984, than at 4/30/84.

I find that respondents violated the standard of due care and requirement of gathering sufficient competent evidence in each of the audits at issue. I make this finding because respondents (1) reached conclusions without sufficient supporting evidence, (2) overlooked, failed to take appropriate action, or chose to ignore many indications that Savin's project to manufacture its own copiers was in research and development as defined by the authoritative standard, FAS 2, and (3) failed to resolve the inconsistencies apparent on the face of the work papers about whether Savin was in compliance with its policy on deferral of product start-up costs. One example of respondents' failure is that the audit work papers do not contain copies of the product specifications or a request by respondents for copies of these documents for any of the machines Savin hoped to make and sell (Tr. 1592, 2177). Product specifications describe the desired features and performance of the item being made. By comparing test results to the product

specifications, you can judge how much work needs to be done to meet the desired objectives. Other examples follow:

In fiscal 1981 Savin reported a net operating loss for the first time in the period 1977-81 (Exhibit 154). The operating loss of \$2.2 million would have risen to \$6 million if Savin expensed the costs it deferred as product start-up costs (\$3.9 million). The audit engagement supervisor questioned in her planning memorandum whether "in light of Savin's current environment," items which have been capitalized should be expensed (Tr. 1969). Mr. Checkosky characterized this information as a red flag concerning Savin's deteriorating financial environment but the record does not show that he and Mr. Aldrich attempted to validate management representations or installed any measures in the audit program, i.e., the detailed steps that the audit teams would follow, which would yield evidence on the nature of the costs at issue. Mr. Aldrich believed 1981 was potentially the most significant audit year (Tr. 2351). However, as Mr. Ten Eyck noted, the work papers do not show that respondents' audit procedures directed a rigorous, objective examination. In fact respondents did not have an audit program in fiscal 1981. I conclude from the evidence that respondents ignored this warning for no reason.

On Mr. Checkosky's undocumented visit to E&M in January 1981, someone told him (he does not remember who and made no notes showing who he talked with) that "this machine was ready for production; in fact was in production" (Tr. 1962). The basis for that statement was that "they were drawing the final manufacturing blueprints for the parts and tooling for the machine" (Id.). He accepted this answer and concluded Savin was in manufacturing start-up meaning that Savin had decided to manufacture this product even though he knew the building in which Savin would assemble the new copier was under construction and was an empty shell three months before the end of fiscal 1981 (Tr. 1955-57, 1964).

Mr. Checkosky believed deferral of product start-up costs was appropriate based on what he saw and heard on his visit to E&M and because Savin was purchasing inventory, tooling, and hiring manufacturing employees even though there was no manufacturing facility available and no assembly line (Tr. 2008-09). Some \$1.8 million of the \$3.9 million of E&M costs deferred in fiscal 1981 was related to the "20 Build" which Mr. Checkosky thought was to test the manufacturing process (Tr. 2002-03), but testing of this type was impossible at the time because the manufacturing facility was not ready. Mr. Aldrich also knew the manufacturing facility was not available but he wrote on the MAP for the fiscal

1981 audit that Savin's deferral of start-up costs incurred in connection with commencing manufacturing activities at E&M and marketing activities in Canada appears appropriate (Exhibit 6, p. 13).

Mr. Checkosky believed that it made a difference under FAS 2 when and for what purpose models were tested and that Savin would have to test prototypes before it could launch a new copier (Tr. 2210). However, the evidence does not show that Mr. Checkosky and the people he supervised examined closely and thoroughly the nature and purposes of the tests conducted at E&M. Mr. Checkosky believed a product left research and development when Savin made a commitment to manufacture this particular machine. However, respondents knew that Savin's Board of Directors had not authorized the manufacture of a particular machine. Mr. Checkosky believed that Savin would not sell a product that did not meet its high reliability standards (Tr. 2186-87). However, he knew that in fiscal 1981 the Project X machines did not meet Savin's product specifications.

Savin's policy statement requires that Savin's marketing personnel believe the product will satisfy the customers and that Savin engineering, manufacturing and quality believe there is a high probability of success with this product for a product to leave the research and development phase. Mr. Aldrich could not locate in the

1981 audit work papers any evidence that these elements were present in 1981 (Tr. 2676-77).

When respondents were preparing the fiscal 1982 audit in May or June 1982, they knew that even with deferring start-up costs of \$18.3 million Savin experienced a net loss for the second year, and that the loss in 1982 was much greater than in 1981 (\$32.2 million versus \$2.7 (Restated) million) (Exhibit 155). They also knew that Savin's new assembly facilities had not become operational in late calendar 1981 and that Savin had not introduced the Project X copiers in early calendar 1982 as expected. These facts should have caused auditors who had been told the year before by management that the product was in the manufacturing start-up phase to show some skepticism and to devise new procedures to corroborate Savin's representations that its activities were past research and development and that manufacturing had begun. These new facts and developments did not cause respondents to change, modify or tighten their procedures for conducting the Savin audit. Neither did the fact that respondents discovered that Savin had been deferring costs on the Ruby and Diamond models three months earlier than it should have (Tr. 2041-43), and that confusion existed about when Ruby/Diamond entered start-up (Tr. 1572-76). The auditors accepted the changed start-up date without testing whether the

representation was true (Id.) In fiscal 1982 like fiscal 1981, respondents relied very heavily on the representations of Savin's management that the activities were not research and development (Tr. 2049-60). Respondents did not corroborate any of Savin's representations with knowledgeable people outside Savin or with employees below the top level of Savin management. There are several areas where verification or corroboration of management's representations was appropriate. For example, Savin represented that the large number of machine failures that occurred during testing were no problem because a failure was anything less than a perfect copy and reliability would improve as a natural progression of the manufacturing process (Tr. 2055). Respondents accepted this explanation without any corroboration even though they knew that the reported machine failures in June 1982 were far in excess of the copier's specifications. A second example of where respondents should have had more supporting data than the unsubstantiated views of Savin management occurred on March 30, 1982 when respondents visited the E&M Division. Based on a view of a working Ruby machine Mr. Checkosky "felt comfortable that the Company was past the prototype stage and deferral (and continued deferral) was appropriate" (Exhibit 37, p. 8). Finally, respondents' own expert agrees that the footnotes to Savin's financial

statements in 1982 and throughout the 1981-84 period clearly indicate that Savin was not yet manufacturing the new product (Tr. 3588-89). All these signals that Savin's activities at E&M were research and development within the meaning of FAS 2 should have caused respondents to carefully examine and substantiate Savin's position that it was engaged in manufacturing start-up. There is no evidence in this record that in these circumstances respondents exercised due care in the performance of the examination and preparation of the report and gathered sufficient competent evidential matter to afford a reasonable basis for their unqualified audit opinion.

In fiscal 1983 several things occurred which should have raised large red flags when respondents were performing the 1983 audit in May and June 1983. First, even after deferring rather than expensing some \$20.4 million in start-up costs, Savin's 1983 financials showed a net loss of \$21.1 million (Exhibit 156). This was the third successive year of net operating losses. Second, Savin slipped the introduction date for its new copiers for the fourth time (early calendar 1981 to spring of 1982 to January 1983 to April 1983). Third, Mr. Landa came to E&M as Director of Engineering. Fourth, Savin decided not to introduce the Ruby and Diamond models and E&M laid off 275 employees. Fifth, the work

paper headed Interim/Final Matters for Attention of Partner dated January 31, 1983 and signed by respondents stated "The 8000 series is currently being re-evaluated and is in a redesign stage." (Exhibit 80). FAS 2 ¶9 e states that modification of the design of a product is an example of research and development. Sixth, the McKinsey report indicated that the 8000 series had still to be developed and tested before it could be introduced, and Savin's Board of Directors' minutes contained in the 1983 audit work papers describe serious technical problems, tests on engineering models, and prototype builds targeted for November 1983 (Exhibit 73). Seven, respondents knew that Savin did not have a working model of the 8000 Series or Pegasus, i.e., Mr. Checkosky's benchmark for the end of research and development. They accepted management's explanation that a working model was not necessary because Pegasus was the same basic Project X machine without any new technology (Tr. 2137-38, 2517-18). Respondents accepted Savin's representation that Pegasus was a reconfiguration (rearrangement of the same parts and components) of the Rhino model of the Project X series. Mr. Aldrich believed that Savin had a working model of the Rhino but the evidence is that it did not (Compare Tr. 2517, 2728 and 298-99, 393). Moreover, an audit work paper dated

12/31/82 states that Rhino was discontinued while in the research and development phase (Exhibit 65, p. 92).

There is no evidence that information in the audit work papers indicating that Savin did not have a copier in manufacturing start-up and that Savin's attempt to manufacture a new copier was in serious trouble caused respondents to test Savin's representations and to rethink their 1980-81 decision that it was appropriate to defer rather than expense these product costs. For example, the auditors' reaction to a one-page paper prepared by Savin justifying current deferral of the 8000 series dated 1/18/83 (Exhibit-65, p. 93) was a handwritten note which says:

Note: This w/p represents the client's justification for deferring costs for the 8000 series (which includes Diamond, Ruby, Sally, Rhino projects). C&L reviewed the client's reasoning for deferring costs for these projects. Based on this review and discussions with client, it appears that projects noted above meet the criteria for deferring start-up costs.

This note is insufficient because it gives no reasons why the client's reasoning is correct, does not describe what was done in the review, and does not corroborate Savin's

representations contained in the paper that Ruby/Diamond had passed testing on pre-production prototypes and models and engineering effort was aimed at re-engineering some of the basic model, and trouble-shooting problems which had arisen due to attempts at commercial production and field testing (Tr. 1599-1601). Also, the auditors missed a significant discrepancy in that one work paper dated 1/18/83 states that Sally was in research and development since it was in the initial design and testing stage, another dated 12-31-82 puts Sally in a start-up production phase, and another dated 4-30-82 says Sally is not in start-up (Compare Exhibit 65, pp. 93 and 92 and Exhibit 64, p. 24). Respondents also failed to investigate and resolve the inconsistencies raised by Savin's write-off of Rhino tooling costs and Savin's position that the Pegasus was a reconfigured Rhino model for which manufacturing start-up costs should be deferred (Tr. 1612). Still another unresolved discrepancy is the statement by Savin's then Vice President - Manufacturing and Engineering to Mr. Aldrich in June 1983 that design changes have not altered the basic machine represented by last year's prototype and Savin's Board minutes in January 1983 that called for building a prototype of the 8000 series in November 1983 (Compare Exhibit 60 p. 67 and Exhibit 73, p. 207). Also unresolved in the work papers are Savin's representations

in June 1983 that the E&M engineering staff were performing minor design changes to the Rhino/8000 and that the sorter for the 8000 series was unchanged and representations to the Executive Committee of the Board of Directors on April 18, 1983 that "sorters for 8000 series have significant design problems." (Exhibit 60 p. 67, 71 and Exhibit 73 p. 200).

In the face of all this information, respondents in fiscal 1983 relied on the same type of audit evidence that they relied on in prior years to issue an unqualified opinion, i.e., Savin's management representations that its activities were not research and development (Exhibit 60, pp. 66-68), visits to E&M, audit work by the Coopers & Lybrand staff, and Savin's representation letters (Tr. 2124). Also Mr. Aldrich wrote a memorandum on June 24, 1983 which erroneously states that Savin deferred \$6.8 million in fiscal 1981 in connection with establishing the production line and facilities (Exhibit 60, p. 28-36, Tr. 2508-09). The deferred amount was \$3.9 million and his position now is that these costs included product costs associated with the initial manufacturing builds (Id.)

Respondents failed to exercise due care and did not gather competent evidential matter to support their unqualified opinion because they did not resolve the conflicting information but conducted the audit in fiscal

1983 in the same manner as the two earlier audits even though the work papers raise questions about whether Savin's E&M had a copier ready for manufacture, that it was in compliance with Savin's policy on deferral of product start-up costs, and that activities at E&M were research and development within the meaning of FAS 2.

By the close of fiscal 1984, more large red warning flags were flying. Savin had not introduced a new copier and two years had passed since the date it originally predicted this would occur. Mr. Landa had left E&M but continued to work on the fuser and toner elements, and in January 1984 a new person came in to head manufacturing. On June 25, 1984 respondents attended a briefing on the status of the Pegasus project. The handouts for the meeting talk in the future tense about bringing suppliers on board during program start-up and give future dates for release of subsystem plans for a Bo build (Exhibit AQ, pp. 9, 19). Inconsistencies about toner costs of the Pegasus are apparent but unresolved in the work papers (Tr. 1642-44). In July 1984 Mr. Aldrich heard Savin's dealers express concern about Savin's ability to manufacture the new machine on a timely basis (Tr. 2644-45).

In spite of these developments, respondents did not reevaluate their position that deferral of start-up costs was appropriate, obtain audit evidence to

corroborate Savin's representations, or get an engineering opinion on the nature of this redesign from any objective source outside Savin. An example of respondents' almost total reliance on management's representations is obvious in a work paper dated January 26, 1984 headed "Savin E&M R&D costs 5/1/83-12/31/83" which concludes, "Based on discussions with management it appears all R&D costs are expensed currently -- none are capitalized." (Exhibit 96, p. 9). Another example of the way respondents viewed everything in a way that favored Savin's position is that they believed that the fact that a lot of different people in charge of E&M told them it was not engaged in research and development was a reason to think the information was accurate. Respondents did not interpret the musical chairs situation at the highest levels of E&M as a sign of difficulty in getting the new copier to market.

Mr. Aldrich prepared a memorandum dated July 20, 1984 which contains several factual errors, i.e., that the \$3.9 million deferred in fiscal 1981 were costs associated with establishing the production line and facilities and that Diamond was an upgraded model for the Ruby (Exhibit 90, pp. 4, 5). In fiscal 1981, \$1.8 million of the total start-up costs deferred was not related to plant and facilities but rather to the cost of the 20 Build of test machines, and Diamond not Ruby was

the basic machine model. Finally, Savin's Form 10-K for the period ended April 30, 1984 states "The Company is currently conducting reliability testing for a new line of high-volume liquid toner copier-duplicators, which it plans to manufacture and assemble in its own facilities." (Exhibit 157, p. 2). Respondents contend that this statement is consistent with their position that Savin had begun manufacturing its new copiers in fiscal 1981 (Tr. 2682).

I find respondents failed to exercise due care and failed to gather sufficient competent evidential matter to support the unqualified opinion they issued on Savin's 1984 fiscal year financial statements in view of the numerous ambiguities, discrepancies and indications in the work papers that Savin E&M was engaged in research and development not manufacturing.

When respondents audited Savin's financials for the eight months ending December 31, 1984, Savin had deferred a total of almost \$57 million in start-up costs incurred at E&M in connection with the new copier it had expected to market almost two years earlier. The highly touted manufacturing executive brought in as Vice-President Technical Operations left after seven months in July 1984. The audit work papers show that on July 24, 1984 engineering had not yet released a substantial number of drawings to manufacturing and release of these drawings

was a key benchmark marking the end of research and development under Savin's policy of product start-up costs (Tr. 1657-59). The fact that engineering drawings were not released by mid-1984 raises questions about Mr. Aldrich's statement in a 1983 memo that Pegasus involved only minor changes to the Rhino copier. The 1984 McKinsey & Company report talks about the introduction delay caused by the longer than expected time required to produce and test working prototypes, a signal that the product was not ready to manufacture. Finally, a summary of the audit work performed indicates that engineering at E&M was dedicated to improving the machine's reliability. This activity falls within the example of research and development set out in FAS 2, ¶9 i, i.e., engineering activity required to advance the design of a product to the point that it meets specific functional and economic requirements and is ready for manufacture.

These events should have caused even the most optimistic auditor to entertain serious second thoughts about Savin's representations that its E&M Division was in the start-up phase of manufacturing. Respondents however performed the same type of review and relied on the same sources of information as the basis for their audit opinion that they used in years past. Based on the representations of the new management team that E&M was not engaged in research and development, representation

letters from Savin that the information it provided was accurate, a visit to E&M, and staff work by the auditing team, respondents issued an unqualified opinion to financial statements that included \$11 million in deferred start-up costs incurred in the last eight months of calendar 1984. I find that respondents' conduct violated the GAAS standards that auditors exercise due care in the performance of the examination and preparation of their report and that they obtain sufficient competent evidential matter through inspections, observations, inquiries, and confirmations to afford a reasonable basis for their audit opinion.

Another basis for my finding that respondents violated the GAAS' requirements of due care and of gathering sufficient competent evidence is that respondents gave Savin an unqualified opinion even though Savin did not keep records which showed the type of activities worked on so as to permit the analysis called for in FAS 2. In fiscal 1981 and fiscal 1984 respondents knew that E&M had weak internal controls, i.e., methods of accumulating accurate financial information, and Mr. Checkosky admits to having a very general understanding of Savin's cost accumulation system (Tr. 2018). There is no evidence that respondents caused Savin to strengthen the cost accumulation system or put in place an audit program that took this weakness into account. The evidence is that

Savin had a number of cost accumulation systems but none of them produced the needed information.

In fiscal 1982 E&M began accumulating costs by project codes and Savin personnel established criteria for what was start-up activities under the codes (Tr. 2019). To determine if the costs should be deferred or expensed under FAS 2, it is necessary to know the activity which generated the costs (Tr. 1464-66). Even the expert relied on by respondents agreed that such an understanding was necessary (Tr. 1711). Savin's project codes did not reveal that information to auditors reviewing the data (Tr. 1366-70) and while it could have been gathered by a method other than the accounting system the information is not contained in the work papers.

In fiscal 1982 Mr. Checkosky believed that Coopers & Lybrand would need to determine that the activities that were ongoing at Savin E&M were deferrable (Tr. 2189). Even so respondents did not require for the purpose of an unqualified opinion that Savin keep records in a manner which would allow a check of what activities were performed so as to comply with FAS 2. The summary sheet of work done shows that the auditors relied on the client to identify start-up costs and did not examine or question what activities were included in that classification (Exhibit 37, p. 159-160).

E&M modified its method of keeping accounts on May 1, 1983 but the more detailed project codes did not describe what activities were being performed. In fiscal 1984 the work papers raise unanswered questions about the justification for Savin's deferral of 25 percent of toner development costs (Tr. 1638-44, Exhibit 96, p. 9,).

I find that for each of the audits at issue, respondents did not, and should have, required for purpose of an unqualified opinion that Savin keep records which allowed the type of analysis required by FAS 2.

E. Did Respondents Adequately Plan the Audits as Required by GAAS, Field Work Standard No. 1?

Respondents signed engagement plans for each of the audits at issue. A plan is a strategy for conducting the audit. All of the engagement plans identify the deferred cost area as one requiring particular sensitivity. The term adequate planning requires more than an audit plan. It also requires an audit program which usually is a detailed description of what procedures the members of the auditing team should perform to accomplish the objectives set out in the audit plan. The purpose of the audit program is to instruct assistants in the work that is to be done and to assist senior members of the audit team in reviewing the work that was done. SAS Paragraph 05 of Section 311-- Planning and Supervision provides that "In planning his examination, the auditor should consider the nature,

extent, and timing of work to be performed and should prepare a written audit program (or a set of written audit programs)." The same paragraph states that the program should set forth in reasonable detail the audit procedures that the auditor believes are necessary to accomplish the objectives of the examination.

Respondents did not prepare an audit program for fiscal 1981. Respondents contend that the work done write-ups which the auditors prepared as they performed the 1981 audits served the same purpose as an audit program and that the auditors received direction on the work to be done in this year through the planning process. The work papers do not contain an audit program for fiscal 1982 and in fiscal 1983, fiscal 1984, and calendar 1984 the auditors used a program prepared for the review of Savin dated 12-31-82 which is after the fiscal 1982 audit was completed.

I find that the preponderance of the evidence is that respondents violated the GAAS by failing to adequately plan the Savin audits. I reach this conclusion based on the following facts. Respondents admittedly did not have an audit program for the fiscal 1981 audit. This audit was extremely important as this was the year Savin E&M began deferring start-up costs and the first year Savin E&M implemented a new company policy on the treatment of product start-up costs. The auditors' work write-ups are

not a substitute for the missing program because they lack the essential element of direction. The write-ups are not an adequate substitute because they did not direct the less experienced auditors on how to perform the audit but occurred after the fact as a written record of the work the auditors did. The evidence does not support respondents' claim that they provided members of the auditing team with adequate direction as part of the planning process. I disagree with Mr. Berliner that no written program was required because it was the first year of deferred costs and respondents were developing a set of procedures as they went along (Tr. 3508) I find that respondents failed to adequately plan the 1981 audit, arguably the most critical of the audit years in question.

I will give respondents the benefit of the doubt and find that, in spite of the missing documentation, they did have an audit program in fiscal 1982. Since it is impossible to assess material that is not in evidence, I cannot make a determination on whether planning for this audit was or was not adequate.

The audit program for deferred costs dated December 31, 1982 which was used in fiscal 1983 and 1984 and in calendar 1984 directed the auditors to:

3. Review the client's projects/programs which are presently in a start-up phase and determine if the deferral is appropriate and that no other projects/programs should be considered to be in that phase.

This directive requires a review of Savin's decision to defer rather than to expense costs at E&M but fails to direct how this should be done, i.e., it does not tell the auditors what steps or procedures to use to accomplish this objective. As noted previously, the work papers show that the auditors' review did not examine the basic question of whether the activities performed at E&M came within the FAS 2 definition of research and development but examined whether Savin followed the policy for product start-up costs it established in 1980-81. The procedures used to accomplish the latter examination was to rely heavily on management's representations. The field auditors expended a great deal of time and effort testing Savin's figures. The result was a wealth of documentation. The problem was their work did not address the key issue.

As noted in the prior sections of this decision, respondents had notice or warnings which they overlooked or ignored of Savin's worsening financial condition and that Savin E&M was not in compliance with either FAS 2 or Savin's own policy statement. In spite of the warnings and inconsistencies contained in the work papers, respondents did not modify the audit program to adjust to changed conditions so that the assisting auditors would perform the work necessary to afford a reasonable basis for an audit opinion. The very general statement audit

program directive applicable to deferred costs which is quoted above remained unchanged for three consecutive audits. This audit program was inadequate in fiscal 1983 and more inadequate in fiscal and calendar 1984. I find that respondents in these years violated the GAAS standards requiring adequate audit planning.

Respondents raise in defense their many conversations with Savin personnel, meetings with the Board of Directors and the Audit Committee thereof, their on-site inspections, hands on management style, etc. These do not satisfy the requirement that they adequately plan the audits and thus give direction or instruction on what audit procedures they believed necessary to accomplish the objectives of the examination.

I reject respondents' claim that it was not necessary for step 3 of the audit program quoted above to be more detailed because the audit partner and the manager performed the primary work concerning classification of the deferred costs (Response to OCA Proposed FOF #507, 545). I do not know what respondents mean by primary work. Respondents agree that before an auditor can exercise judgement on a matter he or she must have evidence (Response to OCA Proposed FOF #568). The facts are that respondents did not gather competent evidential matter to support their opinions and that members of the auditing team did not gather it because respondents did

not adequately plan the audits so as to direct them to do so.

V. Sanctions

As pertinent here Rule 2(e) of the Commission's Rules of Practice (17 CFR 201.2) specifies that:

(1) The Commission may deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice of and opportunity for hearing in the matter ... (ii) ... to have engaged in unethical or improper professional conduct....

The purpose of Rule 2(e) is to protect the integrity of the Commission's processes established to achieve full and fair disclosures of material information. (Touche Ross & Co. v. S.E.C., 609 F.2d 570, 580-81 (2nd Cir. 1979)). Certification by accountants of financial statements which do not comport with GAAP impairs the reliability of the disclosure process. As the Second Circuit noted in Touche Ross (Id.):

By the very nature of its operations, the Commission with its small staff and limited resources, cannot possibly examine, with the degree of close scrutiny required for full disclosure, each of the many financial statements which are filed. Recognizing this, the Commission necessarily must rely heavily on both the accounting and legal professions to perform their tasks diligently and responsibly. Breaches of professional responsibility jeopardize the achievement of the objectives of the securities laws and can inflict great damage on public investors. As our Court observed in United States v. Benjamin, 328 F.2d 854 (2nd Cir.), cert denied, 377 U.S. 953 (1964). 'In our complex society the accountant's certificate and the lawyer's opinion can be instruments for

inflicting pecuniary loss more potent than the chisel or the crowbar.'

I reject respondents' position that scienter or bad faith conduct is required for the Commission to act under Rule 2(e) (ii). Haskins & Sells [1937-1982 Transfer Binder] Fed. Sec. L. Rep. - Accounting Series Releases (CCH) ¶72,092 at 62,197 (1952); Touche Ross & Co. v. S.E.C., supra at 579 and Davy v. S.E.C., 792 F.2d 1418, 1422 (9th Cir., 1986). I disagree that FAS 2 is ambiguous, and therefore find no basis for respondents' position that the Securities and Exchange Commission should be required to establish its interpretation of FAS 2 in a rulemaking proceeding before it can bring an action under Rule 2(e).

Violations by accountants of GAAP and GAAS constitute unethical and improper professional conduct. Respondents were responsible for the violations of the GAAP and GAAS set out in this decision. There has been no attempt to argue that Mr. Checkosky and Mr. Aldrich have varying levels of responsibility because of their different roles. I find them equally responsible for the violations. The audit partner on an engagement has the ultimate responsibility for the planning and conduct of the audit. The audit manager functions as the audit partner's right arm. He or she is responsible for audit planning, supervising field work, and reviewing and issuing the audit report (Tr. 2325-26). As concurring

partner on the 1984 calendar audit, Mr. Aldrich was more involved than a typical concurring partner because of his familiarity with the project. He participated in the planning, he signed the MAP, and he attended a meeting with Savin management in March 1985 to gather information before Coopers & Lybrand issued the audit opinion. In his role as second or concurring partner, Mr. Aldrich was responsible for providing additional assurance that the audited financial statements were in accord with GAAP and that the audit examination was in accord with GAAS.

I find the sanction recommended by the OCA to be appropriate here. Respondents' behavior showed little concern for the truthfulness of the five sets of financial statements on the issue of Savin's research and development costs incurred in connection with its efforts to manufacture a copier. I reach this conclusion because the evidence from Doctors Sprouse and Bedford is convincing that a substantial part of the costs Savin incurred in connection with activities at E&M in each of the audits should have been expensed under GAAP. I see no persuasive evidence that supports respondents' position that Savin's product start-up costs were deferrable. It is important to note that respondents did not seek any of the expert opinions expressed here on their behalf at the time they made the decisions in question. The experts who believe respondents' action to

be reasonable reached this conclusion, in part, based on off the record conversations where respondents answered questions about the work papers and the reasons for their actions (Tr. 3628, 3694, Exhibit BR p. 39). However, when respondents were under oath and were being cross-examined by OCA counsel at the hearing they often had very genral understandings or could not recall specifics about the subjects at issue. The description of respondents' actions set out in prior portions of this decision shows that they acted without due care and without obtaining adequate competent support for their position. Not previously noted is the fact that the individual who has served as senior technical advisor for Coopers & Lybrand since about 1979 testified that he was first consulted in connection with the opinion for the fiscal 1984 audit and was assured that the deferrals were appropriate.

Even assuming respondents correctly interpreted FAS 2 in Fiscal 1981, there is no persuasive evidence that Savin E&M was in manufacturing from the fall of 1980 until December 31, 1984. Respondents did not go back in later years and reconsider their decision that the costs at issue were deferrable in the face of a great deal of evidence that their earlier decision was wrong, and they did not apply the standard they believed was applicable,

Savin's product start-up cost policy, in a proper professional manner.

Respondents cite as a mitigating factor undefined hardships suffered since the Securities and Exchange Commission began investigating these matters in the fall of 1983 and since the Commission commenced this proceeding in November 1987. This contention merits little weight since Coopers & Lybrand supports respondents' position and has retained respondents in their professional capacities. Coopers & Lybrand named Mr. Aldrich a partner in the fall of 1984. The one mitigating circumstances in the record is that, except for these events, respondents have unblemished professional credentials. An explanatory but not mitigating factor is that these transgressions occurred in the first year Mr. Checkosky functioned as the engagement partner on the Savin audit account and when Mr. Aldrich was not yet a partner. Annual billings to Coopers & Lybrand from the Savin audit and interim reviews amounted to around \$340,000 (Exhibit 36, p. 94). For professional reasons, it was important to both men that the client be pleased with their efforts. Unfortunately, pleasing the client became their paramount consideration.

Respondents' unprofessional conduct was blatant, serious, and of long duration. Because of respondents'

conduct the public received five sets of audited financial information about Savin over a period of three and a half years which were materially incorrect and portrayed the company as a far more successful business enterprise than it was. In view of the characteristics of the behavior and the need to preserve the integrity of the Commission's procedures, a five-year suspension is appropriate.

VI. Order

Based on the findings and conclusions set out in this decision, I ORDER that:

David J. Checkosky and Norman A. Aldrich are denied the privilege of appearing or practicing before the Securities and Exchange Commission for a period of five years.

This order shall become effective in accordance with and subject to the provisions of Rule 17(f) of the Commission's Rules of Practice (17 CFR 201.17(f)). Pursuant to this Rule, this initial decision shall become the Commission's final decision as to each party who has not filed a petition for review pursuant to Rule 17(b) within fifteen days after service of the initial decision upon him, unless the Commission, pursuant to Rule 17(c), determines on its own initiative to review this initial decision. If a party timely files a

petition for review, or the Commission takes action to review as to a party, the initial decision shall not become final with respect to that party.


Brenda P. Murray
Administrative Law Judge

Washington, D.C.
September 5, 1989