ADMINISTRATIVE PROCEEDING
FILE NO. 3-6579

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

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| In the Matter of |
| ERNST & WHINNEY |
| and |
| MICHAEL L. FERRANTE, C.P.A. |

# INITIAL DECISION

Washington, D.C.
June 28, 1990

Jerome K. Soffer
Administrative Law Judge

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APPPEARANCES: Susan Ferris Wyderko, Benjamin Greenspoon, Thomas G. Goodbody and Michael S. Smith, of the Office of General Counsel, representing the Commission's Office of the Chief Accountant.

Proskauer, Rose, Goetz & Mendelsohn (by David I. Goldblatt, Ronald S. Rauchberg, Edward F. Westfield and David M. Lederkramer), counsel for respondents.

BEFORE: Jerome K. Soffer, Administrative Law Judge

## INTRODUCTION

On October 15, 1985, the Commission issued an Order for Private Proceedings ("Order") pursuant to Rule 2(e)(1)(ii) of the Commission's Rules of Practice (17 C.F.R. §201(e)(1)(ii) naming as respondents Ernst & Whinney ("E&W"), Michael J. Ferrante, C.P.A., ("Ferrante") and Michael S. Hope, C.P.A., ("Hope" or "the engagement partner").

The Order is based upon allegations of the Commission's Office of the Chief Accountant ("OCA") that respondents had engaged in "unethical or improper professional conduct" arising out of audits performed by E&W of the 1980 and 1981 financial statements of United States Surgical Corporation ("Surgical") resulting in the issuance of unqualified audit reports on statements which were incorrect for significantly over-stating income. OCA charges that E&W's examinations were not made in accordance with generally accepted auditing standards ("GAAS"), as certified by E&W, and challenges its further certification that the financial statements were prepared by Surgical in conformity with generally accepted accounting principals ("GAAP").

Based on these allegations, as detailed more fully in the Order, the Commission directed that this private proceeding be instituted to determine whether the specific allegations of the Order were true and, if so, what sanctions, if any, should, be

imposed as a result thereof. [1/]

Evidentiary hearings were commenced on August 18, 1986 continuing until March 3, 1987 during which there were some 50 hearing days producing 8,375 pages of testimony, and hundreds of exhibits and work papers. Following the close of the hearing, the respective parties simultaneously served and filed their respective proposed findings of fact and conclusions of law together with supporting briefs. The OCA offer 2,899 proposed findings of fact and those of respondents totalled approximately 1,773, to which each of the parties filed respective replies. In addition, respondents filed 585 supplemental proposed findings and conclusions to which OCA was permitted to reply. It should also be noted that by order dated August 11, 1987, the Commission directed that certain additional material on the part of respondents be admitted into the record.

The findings and conclusions herein are based upon the evidence as determined from the record and from observing the demeanor of the witnesses. The preponderance of the evidence is the standard of proof that has been applied. [2/]

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1/ Prior to any hearing in this matter, Hope had submitted an offer of settlement which the Commission accepted and issued its Opinion and Order on August 6, 1986, in which the Commission made detailed findings of fact and conclusions of law which the respondent neither admitted nor denied while consenting to the issuance of the Opinion and Order. Accounting and Auditing Enforcement Release No. 109A; Securities Act of 1933 Release No. 6655A). The opinion specifically stated that the findings are not binding on any other party than Hope.

2/ See Steadman v. SEC, 450 U.S. 91 (1981).

The Parties

E&W, an international accounting firm, is one of the eight largest public accounting firms in the world. It maintains 122 offices in the United States, having approximately 1,150 partners and employing a professional staff of 13,000 individuals. It is the auditor for more than 1,400 corporations whose financial statements are filed with this Commission.

During the relevant period herein E&W had a national office in Cleveland, Ohio, eight regional offices, and numerous practice offices through which all direct client services, including the assignment of engagement personnel, are performed. As a member of the SEC Practice Section of the American Institute of Certified Public Accountants ("AICPA"), E&W undergoes an independent peer review every three years by another major accounting firm as to its audit practice quality control procedures. E&W conducts its own internal peer review programs under which one-third of its practice offices are visited by a quality control team each year.

Ferrante has been the managing partner of the E&W practice office in White Plains, New York. He has a bachelor's and master's degree in business administration from Iona College where he majored in accounting and financial management. He is a certified public account licensed to practice in the State of New York.

Ferrante has been employed at E&W (and its predecessors) since 1968. He became a partner on October 1, 1980, moving to

his present position in the White Plains office in April 1981. He has been a member of a number of professional organizations, including AICPA and served as president of the Westchester Chapter of the National Association of Accounting. Ferrante has taught auditing and advanced accounting course at various colleges.

He was first assigned to the Surgical engagement in 1977 and participated in each of the Surgical audits from that time on through December 1983. 3/ He was the audit partner on the 1980 and 1981 audits involved in this proceeding.

Surgical is a publicly held New York operation organized in 1975 as the successor by merger to another corporation. Its executive offices are in Norwalk, Connecticut. Surgical is primarily engaged in designing, developing, manufacturing, and marketing a proprietary line of surgical products which are either manufactured by Surgical directly or by other companies on a sub-contractual basis. These products include surgical stapling and other wound-closing instruments as a substitute for conventional suturing with needle and thread. Its stapling instruments consist of reusable models as well as disposable models that are discarded after a single use.

Between 1969 and 1981, Surgical experienced dramatic growth. In 1969, total assets were $1,272,790 and sales were

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3/ Hope, the other individual respondent, was the engagement partner on specifically the 1980 and 1981 audits of Surgical by E&W, having been a partner on the Surgical engagement since 1974.

$573,615. By 1981, its total assets had grown to $207,339,000 and annual sales amounted to $111,800.000. Operations which resulted in a loss of $932,000 in 1969 showed a reported profit of $12,904,000 by 1981.[4/]

Another company involved in these proceedings is the Barden Corporation ("Barden"), a publicly held Connecticut corporation engaged in the engineering, design, manufacture and sale of precision ball bearings, surgical assemblies and high-precision dies. Its principal executive offices are in Danbury, Connecticut. Lacey Manufacturing Company ("Lacey") is a division of Barden located in Bridgeport, Connecticut, and, as pertinent hereto, has manufactured, among other things, surgical staplings and components and high precision dies for Surgical since 1971.[5/]

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4/ On February 27, 1984, the Commission instituted a civil injunction action against Surgical and certain of its officers alleging violations of the anti-fraud, reporting, accounting and proxy provisions of the Federal Securities Laws. The defendants, without admitting or denying the allegations contained in the Commission's complaint, consented to the entry of final judgments permanently enjoining them from violation of various provisions of the federal securities laws. The judgment also ordered Surgical to restate its financial statements contained in its annual reports on Form K for each of the years ending December 31, 1979, 1980, 1981, and 1982. SEC v. United States Surgical Corporation, Civil Action #84-0589 (D.C.D.C. February 27, 1984, SEC Litigation Release #10293).

5/ On June 26, 1984, the Commission instituted a civil injunction action against Barden and Robert P. More alleging that they aided and abetted Surgical in its violations of the securities laws set forth in footnote 4. The defendants, without admitting or denying the allegations in the complaint, consented to the entry of final judgments of injunction. SEC v. the Barden Corporation and Robert P. More, Civil Action #84-1948 (D.C.D.C. June 26,1984, SEC Litigation Release #10433).

At all times relevant to these proceedings, E&W was the independent auditor of Surgical and as such issued unqualified audit reports on Surgical's financial statement for that company's fiscal years ended December 31, 1980 and 1981. Each of these reports was incorporated in a Form 10-K filed with the Commission on or about February 3, 1981 and March 17, 1982, respectively.

E&W was also the auditor of Barden and issued audit reports on Barden's financial statements for each of that company's fiscal years ended September 30, 1980, 1981, and 1982. Each of those reports was incorporated in a Form 10K filed with the Commission.

## Background

In 1980 and 1981, Surgical experienced for the first time sharply increased competition for its products. Although Surgical's stapling devices were protected by patents, in 1980 the company began to face serious competition from other companies trying to enter this market, which Surgical had long dominated. In addition, a former dealer of its products in Australia, Alan Blackman, began to manufacture and market identical versions of Surgical's staplers in Australia, a country where Surgical held no patents, and in several other countries. Moreover, several of Surgical's most fundamental patents were to expire in the next several years.

In order to counter these pressures, Surgical undertook to develop, manufacture and market entire new lines of surgical

stapling products. Thus, whereas before 1980 Surgical had introduced an average of only 1 or 2 new products annually, it introduced 10 new products in 1980 and 14 new products in 1981. Additionally, Surgical also began a legal campaign to contain Blackman. It spent more than $5 million in legal fees and related expenses litigating against Blackman and his companies all over the world.

The Order charges that Surgical, faced with the additional expenses stated above, adopted a number of "fraudulent and manipulative" accounting changes intended to show the continuance at about the same levels of pre-tax income, resulting in an overstatement of pre-tax income by about 18 percent in 1980 and 67.8 percent in 1981. These reported earnings approximated in excess of $12 million each year.

The basis of these allegations against respondents by OCA in connection with the audits of Surgical's 1980 and 1981 financial statements is that they repeatedly ignored or failed to perceive material facts involving Surgical, a so-called "aggressive" company in a state of transition, failed to plan their audit procedures to test proper assertions, relied unduly on client representations, and failed to resolve material conflicts in the audit evidence, all of which resulted in the issuance by respondents of incorrect audit reports, i.e., that the 1980 and 1981 audits were performed in accordance with GAAS and that Surgical's financial statements were fairly represented in

accordance with GAAP.[6/]

Respondents, on the other hand, contend that the audits involved were conducted by experienced staff personnel exercising their sound and considered professional judgment with full knowledge and awareness of the business activities and practices of Surgical, and that where in some areas accounting decisions were made and auditing procedures were performed whose appropriateness might be debatable, such conduct did not amount to "unethical or improper professional conduct". Respondents further argue that Rule 2(e)(i)(ii) by its terms does not permit the disciplining of accountants absent a showing of willful misconduct and that mere negligent conduct offers no basis for imposing the sanctions called for in Rule 2(e).[7/]

## Audit Planning

The financial statements of a company are prepared by its managers and constitute assertions made by management that the statements are truthful presentations of the company's financial

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6/ On January 15, 1981, E&W issued an unqualified audit report on Surgical's financial statements for the fiscal year ending December 31, 1980; and on March 17, 1982 issued an unqualified audit report for the fiscal year ended on December 31, 1981.

7/ Rule 2(e)(1) provides, in pertinent part, (subparagraph ii) that 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 to have engaged in "improper professional conduct."

condition and the results of its financial operation. The purpose of an audit is to make an examination that will, in accordance with GAAS, put the auditor in a position to express an opinion as to whether the financial statements are presented fairly and in conformity with GAAP, applied on a consistent basis. (SAS 1, AU 350.1).[8/]

Most of the auditor's work during an audit consists of obtaining and evaluating evidential matter concerning the assertions in the financial statements. The relationship between clients and accountants during the audit process is one of healthy skepticism. GAAS requires the auditor at the outset to plan an overall strategy for testing management's assertions by considering, among other things, the company's business, its accounting policies and procedures, and the company's own internal controls over the accounting data. Since audits are fluid processes, transactions and events may occur during the course of the audit that cause the auditors to plan and perform additional audit procedures.

By the time of the 1980 and 1981 Surgical audits, Ferrante and Hope, the engagement partner, had had extensive contact with Surgical's financial management and operating personnel. They went into the audit engagements with a full staff of experienced auditors, extensive knowledge of Surgical, and collective audit

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8/ "SAS" refers to Statements on Auditing Standards promulgated by the Auditing Standards Board of AICPA.

experience of 28 years, nine of which had been devoted in part to audits of Surgical.

As part of their planning, and before doing the actual audit steps, the auditors must determine the risk of material errors in particular accounts or transactions and plan appropriate audit steps in light of that determination. In addition, the auditors must evaluate the company's internal controls in order to establish a basis for reliance thereon in determining the nature, extent and timing of audit tests to be applied. 9/

If a conclusion has been reached that the system can be a source of reliance, the auditors then determine, by performing compliance tests, whether the system is being followed. Compliance tests are an important prerequisite of audit reliance on a client's internal controls. Analytic review, a comparison of balances from one year to the next, is a type of substantive test.

The concept of materiality plays a significant role in planning the audit and assessing audit risk. Auditors generally consider amounts that are less that 5 percent of pre-tax income to be immaterial, and anything more than 10 percent of pre-tax income to be clearly material. Auditors must plan the audit to detect errors in the financial statements that individually or

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9/ The internal controls are the policies and procedures that are established by management to provide reasonable assurance that the accounting system will generate information that is adequate for preparing financial statements in accordance with GAAP.

in the aggregate are material to the financial statements. They must consider materiality of errors in individual accounts as well as in the aggregate of all the accounts.

In starting out on the 1980 and 1981 Surgical audits, the respective E&W audit teams consisted of the engagement partner (Hope), the audit partner (Ferrante) and other members of the respective engagement staffs. In addition, every E&W engagement has an "independent review partner" who reviews selected audit documents at the conclusion of the field work and whose concurrence with the auditors' conclusion that sufficient procedures had been planned and performed to support the auditors' report is required before that report can be issued. During the audits in question herein, William Hufferd was the independent review partner assigned to them by E&W. Robert Hammond also performed a second review of the audit papers.

The 1980 and 1981 Surgical audits were planned in accordance with the E&W audit approach based upon "specific risk analysis" ("SRA") designed to evaluate the risk of material error for related groups of accounts.

E&W approaches an audit in three phases: initial planning, program development and program execution. The objective of initial planning is to update the auditor's knowledge with respect to all facets of the company's internal and external operating environment that may bear upon audit risk. Thus, for the 1980 audit, the auditors reviewed Surgical's 1979 10-K and Annual Report to shareholders and the 10-K's filed by

competitors, re-reading Surgical's quarterly reports (Form 10-Q) for the first three quarters of 1980; and performing an overall analytical review of major financial statement amounts to determine whether they raised questions to be addressed by appropriate audit procedures.

During the program development phase of the 1980 audit (as well as the 1981 audit) the auditors performed detailed analytical reviews, evaluated the company's internal control systems; considered the likelihood of error in related groups of accounts and developed a preliminary audit approach. 10/

As a result of the auditors' evaluation of the foregoing factors, they expressed their conclusion as to risk by selecting one of three broad descriptions: "high", "moderate", or "low". After risk was assessed for each specific control objective, testing procedures were formulated as set forth in the preliminary audit approach section of the SRA workpapers which were then incorporated into the audit program. E&W contends that the audit approach used in the planning of the 1980 and 1981 audits was "thorough, comprehensive and in complete compliance with professional standards" (post hearing brief, page 18).

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10/ In contrast to the overall analytical review, which focuses on major financial statement amounts, the detailed analytical review is an examination of financial information at the account level. Internal controls are the procedures and systems by which a company processes and records financial information; audit planning is designed to assure that errors in the company's accounts will be detected and prevented.

On the other hand, it is the contention of the OCA that in planning for and executing the audits for the 1980 and, more significantly for the 1981 Surgical financial statements, the E&W auditors failed to consider a number of accounting changes which were put into effect by Surgical solely for the purpose of increasing reported income (assertedly a violation of GAAP) in anticipation of lower income resulting from efforts to meet increased domestic competition by developing additional product lines, and by instituting protective litigation against the Australian competition. OCA further alleges that E&W failed to plan appropriate procedures, failed to obtain sufficient competent evidential matter, and failed to recognize and deal appropriately with accounting issues that arose during the audits. In sum, OCA charges E&W with lack of due care in execution of the audits, particularly in the face of the new aggressive accounting stance taken by Surgical's management.

**The Specific Audit Failures Alleged**

The Order for Proceedings herein alleges various GAAP and GAAS violations in E&W's audits of Surgical's financial statements for 1980 and 1981 with respect to the following matters:

(1) The recognition of revenue on sales of product to salespeople.

(2) The allocation of overhead cost to inventories (1980 audit only).

(3) The capitalization of costs incurred in the "tooling qualification process".

(4) The manner of recording "Leased and Loaned" instruments (1980 audit only).

(5) The capitalization of legal fees as patent costs (1981 audit only).

(6) Changes in accounting estimates, particularly with respect to the estimated useful lives of patents, molds and dies, and recognition of a 10% salvage value on certain fixed assets (1981 audit only).

(7) The tooling confirmation Problems - other Vendors (1981 audit).

(8) The Lacey-Barden Premium Billings Issue (1981 audit only).

(1) Sales to Salespersons

Prior to 1980, Surgical marketed virtually all of its products via its "Auto-Suture Division", almost entirely through a network of independent dealers who purchased product from Surgical and then resold it to doctors and hospitals. Between 1975 and 1981, Surgical gradually changed over from the dealer marketing system to one relying exclusively on employee salespersons, so that by the end of 1981 all of the independent dealers had been replaced.

Employee-salespersons (as did the dealers before them) call upon hospitals and doctors to whom they demonstrate Surgical's products, which consist of sterile (or "clinical") and

non-sterile (or "non-clinical") merchandise. Newly hired sales people are shipped an initial inventory of demonstration ("demo") product, and later of new products as they are introduced. The salespersons are charged for the initial supply, receiving a discount of 20 percent on the sterile items, and at actual cost for non-sterile items.

Surgical's salespersons use the non-sterile product to demonstrate on artificial styrofoam "organs" how the stapling products work. They then encourage surgeons to use the sterile version of the stapling instruments during actual surgery (or "scrubs") in which the sales people participate.

When a surgeon has used a sterile Surgical product from a salesperson's inventory in a scrub, Surgical bills the surgeon (or hospital) for that product, replaces it in the salesperson's inventory without charge and gives the salesperson a commission on the sale.[11/] All orders for merchandise would be filled directly by Surgical and billed to the hospital or physician making the purchase, and an appropriate commission credited to the salesperson.

During the relevant period herein Surgical salespeople paid for their supply of demos through deductions from their commission checks (except during the first 17 weeks of employment for a new employee). In sum, unlike the dealers, salespeople did not

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11/ Non-sterile demos would be replaced in the salespersons' inventory without charge to anyone since their cost was relatively minor.

maintain an inventory to fill customers orders; they maintained a supply of product primarily for demonstration purposes but also to be available to meet emergency needs for an individual item and which was kept at a level pre-determined by Surgical and maintained through replacement. 12/

During 1980 and 1981, the written contracts of employment between Surgical and its salespersons provided that upon termination of employment, "the company shall. . . repurchase from the employee, who shall resell to the company, all products of the company then in the employee's possession or control and which are then currently in production and in usable and saleable condition". In addition to this contractual obligation, it was also Surgical's practice and policy to buy back demo product in the possession of terminated sales persons. Thus, Surgical's "Sales Force Termination Procedures" manual, although stating that the company was under no obligation to buy back all of the products in the possession of these individuals, goes on to say: "However, it is intended that all good, current saleable products be repurchased" and that all demo materials issued at inception should be returned. Thus, in typical letters addressed to terminated salespersons, (See Exhibits 164 and 165), Surgical advises that: "according to our records, you have in

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12/ Thus, in 1980, having decided on its own that the sales persons did not carry enough inventory, Surgical shipped each of them an additional $4,500 worth of sterile demo product.

your possession demonstration materials valued at [an amount] and loan products valued at [an amount], both of which constitute the property of United States Surgical Corporation". (Underlining added). The salespersons are then "requested and required" either to pay for or to return "the company's property".[13/]

Surgical reported these "sales" as current income at the time the merchandise was shipped to the salespeople, later entering offsets for the amount of product repurchased, even though the product was to be paid for over a period of time out of commissions earned.[14/]

This accounting method of recognizing revenues on the sale of goods where the right of return exists not only by contract but by policy, is not in accord with GAAP as expressed in "Statement of Position (S.O.P.) 75-1, issued by the AICPA. Basically, it states that where there is a right of return, either by policy or in practice, transactions should not be recognized currently as sales unless certain conditions are met.

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13/ In an inter-office memo on August 5, 1980 explaining to its salespersons and dealers the company's policy with respect to inventory purchased by them for scrubbing and emergency servicing, Surgical asserted: "In all cases, sales by our salespeople are sales by U.S. Surgical. This is so regardless of whether delivery comes from U.S. Surgical or from the salesperson's inventory".

14/ Footnote A to Surgical's 1980 and 1981 Forms 10-K contains the following representation: "Revenues are recognized when products are sold directly by the Company to ultimate consumers or to authorized dealers . . . ", even though Surgical no longer employed independent dealers.

It is clear that these conditions were not met under the practices of Surgical. 15/

Respondents in their Post-Hearing Reply Memorandum (at page 88) do not dispute that, given the totality of circumstances surrounding Surgical's sales of its product to its salespeople, Surgical should not have recognized profit on a portion of those sales. The same conclusion is warranted as to all of Surgical's sales to its salespeople.

In 1973, the question of whether it was appropriate for Surgical to recognize revenue at the time it shipped products to its then independent dealers (it had no sales employees) was the subject of discussions among Surgical, its auditors Ernst and Ernst (E&W's predecessor) and the Commission's Division of Corporation Finance. It was then concluded, with the approval of the Commission's staff, that the dealers maintained sufficient independence so that sales to them could be recognized for revenue purposes as sales to ultimate purchasers.

From 1973 through 1981, Surgical continued to record as revenues sales to dealers, and, as they were replaced by employee-salespersons, to them also. Although by the end of 1980, all but two of the dealers had been replaced by employee-salespersons, the 1980 work papers show no evidence that E&W

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15/ Thus, S.O.P. 75-1 permits the recording of sales and to account for returns as they are received but only where future returns and losses are expected to be clearly insignificant. No such expectation has been demonstrated.

considered the issue herein. In the 1981 audit, by which time all dealers had been replaced, E&W did recognize and consider the question to the extent that Stephen Dowd, the audit supervisor, discussed the matter with Howard Rosenkrantz, Surgical's comptroller, and reported (the "Dowd Memorandum") that Rosenkrantz assured him that Surgical was not required to buy back unused stock when the salesmen left the company, although it had the option to do so. Apparently, E&W was satisfied with this client representation since it does not appear that the auditors gave any further consideration to the effect under GAAP upon revenue recognition of Surgical's actual practice and policy of allowing the salespersons a right of return.

The question remains as to the "materiality" of these sales. In 1980, Surgical recognized revenues on sales by its salespeople of $2,900,000, which, after allowances for repurchases and write-offs, amounted to $2,233,000. By applying an E&W auditor's calculation, made during the 1981 audit it is estimated that the approximate gross profit on sales to salespeople was 50 percent, and the net profits on these sales totaled $1,115,000, or approximately 9.2 percent of Surgical's reported total 1980 pre-tax net income of $12,260,000. On the same basis, Surgical recorded in 1981 net sales to its salespeople of $1,450,000, 50 percent of which ($725,000) amounted to 5.6 percent of Surgical's reported 1981 pre-tax

income of $12,904,000.[16/]

It is recognized that the 50 percent profit formula arrived at in 1980 is imprecise at best. Respondents contend that reliance upon other ratios would show a lesser level of materiality. Thus, in 1980 total net sales of product to sales people ($2,900,000) amounted to only 2.5 percent of Surgical's total sales ($86,214,000). In 1981, the sales to salespeople of $1,450,000 was only 1.2 percent of total sales ($111,800,000).

As noted heretofore and as repeated by respondents in their post hearing memorandum of law (at page 111) they do not dispute that, except for the issue of materiality, the surrounding circumstances would have warranted "a professional judgment favoring non-recognition of a portion of the gross profit . . ."

The various ratios shown above, no matter which we accept, in no place exceed the 10 percent level where materiality has to be imposed, in many instances are below the 5% level where materiality has to be considered, and in a few instances lie between the 5 percent and 10 percent levels where the auditors were called upon to exercise judgment as to materiality.

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16/ Respondents argue that the payments made by salespersons for demo product, as deducted from their commissions, should be taken into account in calculating the effect of materiality. If this were done, the resultant ratios of sales to salespeople would even be less than shown (7.3 percent in 1980 and 4 percent in 1981). This argument is not persuasive. Whether or not revenue is recognized where there is a right of return does not depend upon whether there has been part or full payment.

Given the fact that since 1973 Surgical had been consistently recognizing revenues on sales to their dealers and later to their salespeople who replaced them, the auditors belief that Surgical's revenue recognition policies in general had received staff approval in 1973, and the reliance upon the client's representation as found in the "Dowd Memorandum" obtained in connection with the 1981 auditors' interest in this subject, it might be concluded that the failure of respondents to take additional steps to the ones already pursued to discover the improper treatment of these sales under GAAP in Surgical's financial statements, would not warrant a finding that respondents violated their professional obligations under GAAS. However, in view of all the later findings herein, and the serious question of client integrity found hereinafter, immateriality is no longer an issue and the failure of the auditors in taking further audit steps with respect to Surgical's misstating its sales to salespersons become quite material in deciding the ultimate issues herein.

(2) <u>The Allocation of Overhead Costs to Inventories (1980 Audit)</u>

From 1976 through 1979, Surgical applied overhead costs to its inventory of both manufactured and purchased finished goods and of work in process, by product line, primarily on the basis of direct labor hours incurred in manufacturing the products. The method used was a common one for allocating overhead to

inventory for manufacturing companies. However, it did not allocate any overhead cost to Surgical's raw materials inventory during this period.[17/] The unallocated overhead was applied to the cost of goods sold.

During the 1979 audit, E&W reviewed Surgical's overhead allocations between its inventory and its goods sold during the year. Thus, in this process it follows that when too much overhead is allocated to cost of sales and not enough to inventory, the latter would be understated on the balance sheet and the cost of sales would be overstated on the income statements resulting in pre-tax income being understated. However, in the year following, when the understated inventory is sold, cost of sales will be correspondingly understated and pre-tax income overstated.[18/] Hence, the ultimate consequence of an improper overhead allocation is a misstatement of inventory on the balance sheet and a misstatement in one direction of pre-tax income in the year the error is made, but in the opposite

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17/ Surgical's "raw materials" generally consisted of parts and components manufactured under Surgical's supervision by outside vendors with tooling owned by Surgical and used to assemble Surgical's products. The term "raw materials" does not carry the usual connotation of materials that are in a "raw state" in the sense that they have not undergone any of the manufacturing steps required to turn them into the end product.

18/ The converse is also true. If in the first year too much overhead is charged to inventory then cost of sales will be understated and pre-tax income overstated. The following year would understate pre-tax income.

direction in the following year, resulting in an eventual balancing out of the discrepancies.

During the 1979 audit, E&W had reviewed Surgical's overhead allocation of $1,258,292 to its inventory of finished goods and work in process and concluded that it appeared to be "fairly stated in a manner consistent with prior years". In October 1980, Surgical initially calculated its overhead allocated to inventory using the same method as in 1979 which was reviewed by E&W and who concluded that the "overhead application of $6,867,054 appears reasonable, is fairly stated and determined in a manner consistent of that with the prior year".

After the physical inventory was done, the auditors became aware that during the last two months of 1980, as a result of a year-end "sales push", Surgical's raw materials inventories had increased and its finished goods inventory had decreased thereby causing significant distortions. Consequently, Surgical and the auditors jointly decided to allocate overhead for the first time to the raw materials inventory as well as to finished goods and work in process. Thus, unlike in 1979 when overhead associated with raw materials inventory was charged to cost of sales, the change for the 1980 audit increased the amount of overhead costs allocated to inventory with the ultimate effect of overstating pre-tax income for 1980.

Based on its physical inventory on October 31, 1980, under the 1979 method, there was an initial allocation of $6,867,054 of overhead to inventory. Under the revised method for 1980, the

allocation to raw materials increased overhead applied to inventory, according to Surgical's calculations, to $8,207,000, for a difference of $1,339,946.

The ultimate result, then, was that pre-tax profits would also increase by $1,339,946. However, according to OCA's calculations, overhead applicable to Surgical's inventory using the same overhead allocation method as used in 1979 amounted to $6,275,000 whereas under the revised 1980 method of allocating overhead to raw materials the overhead allocations increased to $8,592,000 for a difference of approximately $2,300,000. Based upon the record herein, it is found that the OCA's calculations as shown in Exhibit 333 to be more accurate.

The OCA asserts that the allocation for the first time of overhead costs to raw materials costs resulted in a "change in accounting principle" under Accounting Principles Board Opinion Number 20 ("APB-20"), which requires that where such a change occurs, the nature and justification for the change and its effect on income should be disclosed in the financial statements for the period in which it is made. Specifically, the disclosure should state why the newly adopted accounting principal is preferable to the former one.

The 1980 financial statements of Surgical (Form 10-K) do not disclose this change in accounting principle. Moreover, the 1980 audit work papers do not show that this matter was discussed in the light of APB-20 by the auditors.

Respondents assert that the allocation of overhead to inventory was not the change contemplated by APB-20, and, even if it were, the matter was not material. They also contend that the question was in fact considered by the auditors who merely made a "judgment call" as to whether it was required to be justified or disclosed.

APB-20 (Paragraph 7) states that "a change in accounting principle results from adoption of a generally accepted accounting principle different from the one used previously for reporting purposes," and that the "term accounting principle includes not only accounting principles and practices but also the methods of applying them".

In Paragraph 8 of the opinion, it is pointed out that a characteristic of such a change is that it concerns a choice from among two or more generally accepted accounting principles.

> "However, neither (a) initial adoption of an accounting principle in recognition of events or transactions occurring for the first time or that previously were immaterial in their effect nor (b) adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring is a change in accounting principle."

It is clear from the circumstances herein that the decision to allocate overhead to raw materials inventory for the first time constituted "a change in accounting principle" as contemplated under APB-20, and should have been disclosed in the accounting statements. The change from the prior method (since 1977) of allocating inventory overhead only to finished goods and work in process, which at first was approved by the auditors for

1980, but then changed to include raw materials following the sales push during the last two months of that year, created what to the auditors and to Surgical seemed a "distortion" in the inventory account as a result of which net profits would have been reported proportionately lower.

Both methods of allocating inventory were in accordance with GAAP. Since under APB-20, (Paragraph 7) the term "accounting principle" includes not only such principles and practice but also the methods of applying them, the change in allocation during 1980 would be an appropriate change as contemplated by APB-20, unless the situation falls within either of the two exceptions set forth in paragraph 8 of APB-20.

Respondents assert that the manner of allocating overhead to inventory in the years prior to 1980 was immaterial in its effect, and did not become material until the 1980 audit, so that the overhead allocation to raw materials became an "initial adoption" of an accounting principle under para. 8(a) of APB-20. They additionally argue that the adoption of the manner of computing overhead to inventory in 1980 was necessitated by certain events allegedly "different in substance from those previously occurring", as set forth in Para. 8(b) of APB-20, to wit: the large increase in the inventory account both for finished goods and for raw materials. Thus, respondents argue that the change in allocation of overhead was within the exceptions cited in Paragraph 8. This contention is not persuasive.

It is clear that the auditors were aware that Surgical had been increasing its in-house manufacturing capabilities for several years and that raw material inventory, as a consequence, had been increasing steadily into 1980. In other words, there were no transactions or events that were clearly different in substance in 1980 than in the prior years; only the amounts had increased. As seen, Surgical initially calculated the overhead applicable to inventory in 1980 using the same allocation as in 1979. It was only as a result of the year end "sales push" that the change was initiated. But, a year end sales push was nothing unusual. Hence, there was nothing that occurred necessitating the modification or change in the previous accounting principle.

With respect to respondents' argument that the 1979 overhead allocation was not material and hence, that the 1980 practice constituted an initial adoption of an accounting principle, there is nothing to indicate that the auditors made a test of materiality for the 1979 figures during the 1980 audit. In fact, calculating the effect in 1979 of applying the "new" 1980 overhead allocation method would have applied additional overhead to inventory in the amount of $677,159, or 8.6 percent of Surgical's reported pre-tax income for 1979, resulting in an effect that would have been more than marginally material. Hence, it is concluded that Surgical's increased in-house manufacturing capacity and the consequent increase in manufacturing overhead costs, do not fall within the exceptions of para. 8.

In any event, E&W did not consider this issue in the light of APB-20 during the 1979 audit nor during the 1980 audit. Consequently, the auditors failed to discern that an accounting issue existed in connection with Surgical's change in method of application of overhead to inventory. This failure to recognize and deal appropriately with an important accounting concept was a violation of GAAS. Even if the issues had been considered, the auditors could not have relied on the exclusions contained in APB-20 to justify the failure to require Surgical to disclose the change in accounting principles or to qualify the audit report. 19/

(3) Capitalization of Costs Incurred in the "Tooling Qualification Process". 20/

In acquiring new or modified molds and dies used in the manufacture of its product parts, Surgical incurred costs consisting of amounts paid to vendors for construction of the tooling and "secondary" costs incurred in the process of qualifying the tooling, including test parts used and discarded, attributable engineering labor and costs of transportation of parts and tooling. Prior to 1981, all of these costs were either expensed or charged to inventory.

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19/ Had Surgical disclosed its change in accounting principle, the auditors would have been required by GAAS to qualify their audit report as to consistency. (SAS 1, AU 420.06).

20/ The tooling qualification process was to ensure that a mold or die was producing parts which, when assembled with the other parts of a particular product, functioned at an acceptable level of reliability.

During the fourth quarter of 1980, Surgical began to capitalize these costs into its molds and dies account. Concededly, this accounting change raised issues as to whether those costs should properly be capitalized; based upon representations made by Surgical, the auditors concluded that they were. The change was not disclosed in Surgical's 1980 10-K report.

In 1981, Surgical continued and expanded upon its described molds and dies capitalization policy to the extent of over $5.7 million in materials, labor and transportation costs.

(3a) Parts Capitalization

During the first eight months of 1981, Surgical capitalized as molds and dies approximately $1.4 million in the cost of component parts and assemblies which were identified as being capitalizable. According to the auditor's work papers, Surgical told E&W that it had identified these costs as capitalizable by collecting invoices for specific parts associated with prototype products or new products not yet being manufactured. Surgical asserted that all test parts were destroyed after testing by engineers or quality control workers and not put into inventory.

In September 1981, Surgical abandoned the specific invoice identification method and instead capitalized the cost of an estimated 10,000 parts produced from each new or modification mold or die (the so-called "10,000 parts" policy). Through application of this policy in the last quarter of 1981 Surgical capitalized an additional $1,165,000 into the molds and dies

account.[21/] As a result, Surgical was able to capitalize during all of 1981 approximately $2.5 million worth of parts, which previously would have been expensed or placed in inventory.

There were two critical assertions Surgical's management made to the auditors concerning its decision to capitalize parts: first, that the change from a method of accumulating costs based on actual invoices to one based upon an estimated 10,000 parts per tooling acquisition or modification was justified, because the former method supposedly had not captured a significant amount of properly capitalizable costs; and, second, that the parts capitalized throughout the year under both methods were scrapped by the engineers in the tool qualification process and hence did not wind up in inventory.

Before accepting these assertions, the auditors were required to determine whether they were reasonable, correct, and based on the facts. In other words, audit steps should have been taken to determine why the specific invoice identification method had not accurately identified the properly capitalizable parts costs, and why the 10,000 parts policy based purely on an estimate, was a reasonable substitute. However, the auditors failed to perform audit tests to determine how the old method had failed, whether it could be revised, or whether a different method of calculating capitalizable parts costs using existing

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21/ As compared to almost the same amount through all of the previous three quarters of 1981 when the specific invoice identification method was used.

accounting records could have been implemented, rather than relying on Surgical management's bare representations in this regard.[22/] The auditors should have been alerted by the arbitrary and uncorroborated selection of 10,000 as the number of parts expended for each new or revised tool, by the very roundness of the amount selected - 10,000 - and by the failure of Surgical to give any apparent consideration to the wide variations in parts cost.[23/]

It was not sufficient under the circumstances for respondents merely to rely upon Surgical's representations to them that the parts capitalized were produced exclusively for the use of "Engineering" and "Quality Control" personnel in determining the qualification and readiness of the molds and dies for production, and thus that all the parts capitalized had been consumed and thrown out. They should have tested these assertions beyond a mere reliance on management's written and oral representations. Yet, the auditors neither planned nor

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22/ Under GAAP, if a company changes from one method of applying an accounting principal to another, the company must justify the use of the new method on the basis that it is preferable (APB 20 ¶16). In fact, the auditors drafted a footnote for inclusion in Surgical's financial statements disclosing the change in estimate and its effect. (This disclosure was included in Surgical's 1981 financial statements in note A.)

23/ Surgical was capitalizing parts costing as little as $.0735 to as much as $6.25 each. It would seem that Surgical's 10,000 parts policy and its application should have been weighted by the cost of the parts.

performed audit steps to test them. Had the auditors sought to investigate the issue there were a number of ways in which Surgical's policy could have been tested, using among other things, Surgical's own internal accounting records. 24/

It is concluded that the auditors failed to plan or perform adequate audit procedures to test the critical assertions made by Surgical's management concerning the parts capitalization policy in violation of GAAS. Reliance upon Surgical's management representations is not sufficient to answer the assertions that the change in capitalization policy was necessary and that the parts were actually consumed in the tooling operations.

(3b) Engineering Labor

During its field work on the 1981 audit, respondents discovered that Surgical for the first time had capitalized all of the labor costs of its "Manufacturing Engineering" personnel, allegedly as part of the cost of its molds and dies. Thus, in 1981, Surgical capitalized approximately $1.2 million in engineering labor into its molds and dies account, most of which constituted the salaries and related expenses of its

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24/ Thus, the auditors could have attempted to obtain evidence supporting the estimate by asking any non-management engineer who tested and expended the part how many parts on average he tested and threw out. Another possible audit test would have been to probe more thoroughly the origin of the 10,000 parts estimate (it actually was an undocumented estimate by Surgical's management that an average of 10,000 parts were scrapped each time a tool was modified or purchased). Another source would have been Surgical's scrap records.

manufacturing engineers. In prior years, these costs had been charged to manufacturing overhead.

Surgical represented to the auditors in a written memorandum, that, due to the new products the company was introducing in 1981, there were significant increases in engineering labor costs, prompting Surgical to begin capitalizing the labor into the molds and dies account.

A critical assertion concerning Surgical's capitalization policy was that 100% of the manufacturing engineers' time was capitalizable. In order for all of the salaries of manufacturing engineers to be properly capitalizable, under GAAP, the engineers had to work exclusively on molds and dies and not on non-capitalizable activities such as administrative work, production planning, or the assembly of product.

As part of the 1980 audit, the auditors had become aware that all of the manufacturing engineering labor had been treated as part of manufacturing overhead because the engineers spent a considerable amount of time for production planning of labor steps, assembly techniques, etc. However, for the year 1981, Surgical represented to its auditors that <u>all</u> of the time of the manufacturing engineers was being capitalized as molds and dies and hence, apparently, that no time was spent performing the same activities with which they were involved in 1980. However, there is nothing in this record or in the audit work papers to indicate

that the auditors considered this apparent contradiction.[25/]

In sum, the auditors in violation of GAAS, failed to obtain sufficient competent audit evidence that Surgical's manufacturing engineering labor was capitalizable as molds and dies in 1981.

(3c) Capitalized Freight

During 1981, Surgical capitalized about $786,000 in freight costs paid to one carrier, Atlantic Interstate Messenger Service ("AIM"), representing that these expenditures were part of the costs of qualifying its molds and dies.

To test this client representation, E&W obtained a sample from Surgical of 33 invoices for parts purportedly used in testing tools during February 1981, along with freight invoices from AIM corresponding to the delivery of the parts involved. The auditors accepted the assertion by Surgical that the transportation of parts relating to molds and dies construction was performed almost exclusively by AIM in messenger service. In order to project the total amount of freight that could be properly capitalized, the auditors calculated the ratio of freight cost to parts costs in these 33 shipments and applied that percentage to the total amount of parts capitalized during

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25/ To test Surgical's capitalization of engineering labor, E&W reviewed the time cards of six engineers. While the cards showed the number of hours worked by project, they did not indicate what kind of work the engineers had done. Nevertheless, based on this testing, E&W concluded that Surgical's representation that the engineers spent all of their time working on molds and dies was reasonable.

1981. This calculation resulted in a projection of only $299,000 in capitalizable freight costs as compared with Surgical's estimates that these costs amounted to $786,000.

The auditors then inquired of Surgical concerning this discrepancy and was told that AIM not only transported parts, but tooling as well, and that the trucking costs would be substantially higher due to the increased size and weight of the tooling compared to parts thereof. Based upon this client representation, the auditors concluded that their projected freight costs of $299,000 would at least double. The auditors then increased the projected freight amount to an even $500,000.[26/] This audit work was reviewed and approved by Ferrante who concluded that in all material respects the client's accounting was not unreasonable.

There still remained the difference between Surgical's capitalization of $786,000 in freight costs, and the $500,000 amount estimated by the auditors, or some $286,000. However, the auditors concluded that the difference involved was not material particularly since any freight costs that were not capitalized would have been included in the overhead pool and that since 87 percent of the pool was capitalized in inventory (to be expensed the following year when the goods were sold) they concluded that

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26/ Expedited messenger service frequently involves hiring the exclusive use of a vehicle irrespective of the size or weight of the load. Thus, the doubling of the freight costs based upon an estimate has hardly been justified.

only 13 percent of the overstatement may have had an impact on Surgical's 1981 profit and loss.

Except for the questions of materiality with respect to the amount that the freight costs had been overstated, it is clear that the auditors failed to perform appropriate audit steps to determine whether the parts invoices supplied by Surgical and their transportation costs were, in fact, capitalizable tooling expenses under GAAP. 27/ They further failed to obtain sufficient evidential matter to corroborate Surgical's representation that AIM transported tooling as well as parts. While the overstatement of the freight charges may not have been material standing alone, the auditors were required to consider them not only individually, but also aggregated with the other questionable amounts for parts and labor capitalized for "tooling qualification."

The fact that Surgical capitalized an amount for transportation far greater than the auditors' projection of only $299,000 (or at most $500,000) in an account where $786,000 was capitalized should have increased the auditors' level of

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27/ Normally, freight charges are expensed as they occur. However, it is recognized that special circumstances may arise where special handling and expedited delivery may be required, for which the shipper will pay premium rates beyond regular freight charges for normal delivery. Such express service between Surgical and its vendors to expedite the tooling process may well have been provided by AIM at premium rates, and, perhaps to that extent constitute a cost of tooling qualification.

skepticism with respect to the entire tooling capitalization policy.

Similarly, the separate amounts involved for expended parts and engineering labor might be deemed not material. However, taking together all the elements capitalized by Surgical under the tooling qualification process, the total amount, some $5.7 million, comes very close to unqualified materiality. This, plus the fact that previously expensed items were, along with other costs, being capitalized at about the same time should have alerted the auditors to the need for conducting appropriate audit steps as indicated above to test the validity of Surgical's assertions. Reliance upon management's oral and written representations was not sufficient to comply with the requirements of GAAS.

(4) <u>The Manner of Recording "Leased and Loaned" Instruments (1980 Audit Only)</u>

Many of Surgical's products, such as reusable stainless steel stapling instruments and electronic instruments, were not held for sale in the ordinary course of business, but were either leased or loaned to customers. As at December 31, 1980, Surgical's leased and loaned assets had a recorded cost of 3.65 million dollars.

Under GAAS, a critical client assertion by Surgical with respect to the leased and loaned account was that the leased and loaned assets physically existed and were valued correctly under GAAP. In this connection it should be noted that E&W Audit and Planning Memoranda (APMs) for each of the years 1979 through 1982

identified the leased and loaned account as "high risk", indicating that this account had a possibility of potentially significant error.[28/] However, during the program development phase of the 1980 audit, the auditors claim to have assessed the likelihood of material error in Surgical's leased and loaned accounts as being of low, rather than high, risk, assertedly based upon: (1) Surgical's experience in prior years; (2) the computerization in 1980 of Surgical's leased and loaned records from a manual method; (3) improvements in the procedures by which Surgical monitored the location and status of leased and loaned items; (4) the asserted absence of significant risk that additions made in 1980 (which accounted for more than 45% of the year-end balance in the account) would disappear or be impaired by year end; and (5) the relative insignificance of the leased and loaned account to the financial statements as a whole.

Respondents suggest that the inclusion in 1980 of the leased and loaned account as being of "high risk" was probably a result of inadvertent repetition of language from prior years' APMs. This suggestion is not substantiated.

The first important client assertion that the auditors were faced with in this account was the physical existence of these assets, consisting of thousands of individually low-cost items, mostly loaned, and less frequently, leased. They thus resembled inventory, rather than fixed assets as they were treated in

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28/ Under E&W's own interpretation of GAAS, an account designated "high risk" required more audit attention than those of "low risk".

Surgical's books. Their physical nature would indicate that there would be considerable risk that units would be lost, damaged or destroyed as opposed to other fixed assets such as immovable property, plant and equipment and on-site machinery. The recorded value of these assets, 3.65 million dollars, representing 30 per cent of Surgical's pre-tax 1980 income, would would appear to be material to the financial statements. 29/ Nevertheless, during the course of the audit, respondents abandoned the original "high risk" assessment of the leased and loaned assets for the reasons stated above, and assessed the likelihood of material error as being low, as shown in the specific risk analysis (SRA) of the adequacy of Surgical's leased and loaned reserve.

Because there were so many individual units scattered in the hands of third parties, the only feasible audit procedure to test existence of the assets was some kind of audit sampling. Thus, in every year from 1979 through 1982, the auditors tested the existence of instruments in the leased and loaned account by

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29/ Respondents, on the other hand, contend that the net book value of the leased and loaned account represented only a small fraction of the total net book value of Surgical's fixed assets- $50,643,000 at the end of 1980 or about 6% of the total and a still smaller fraction of Surgical's total assets of $119,103,000 at years' end (or 3%). Finally, respondents assert that revenues derived from the leasing and loan of the instruments amounted to but 1.5% of Surgical's net sales in 1980. These amounts are at least borderline material, and under the circumstances of the use made of these assets and the revenues derived directly and indirectly from their existence they are deemed to be material.

sending confirmation letters requesting the recipients to affirmatively confirm that they were in possession of specified instruments.

E&W's own work papers noted in 1980 that, following the guidance of SAS 1, Section 320B.22 and 24, a representative sample size for drawing a conclusion about a population should number at least 25 confirmations in order to provide a basis for relying upon the results. In each of the years 1979, 1981, and 1982, but not in 1980, the auditors had selected 25 instruments in which to request confirmation of existence. In 1980, however, they requested confirmations for only eight instruments. Two of the eight confirmation letters were never returned and the auditors performed no follow-up procedures on them, as GAAS required. (See SAS 39 ¶25). Two other letters were returned stating that the recipients were unable to confirm the existence of the units. One of these two was subsequently located, but the auditors were unable to resolve whether the second unit existed. Thus, of the eight confirmation letters sent out, the auditors received what amounted to three exceptions.

GAAS requires auditors to extrapolate the results of errors discovered during an audit test to the population as a whole. Although the eight individual instruments that E&W selected for confirmation may have individually cost very little, they presumably were assumed to be representative of Surgical's entire population of leased and loaned instruments. Consequently, having originally assessed the account as being of high risk, and

the confirmation procedures having produced a failure to account for approximately 37 1/2 percent of the units, it must be concluded that respondents did not plan or perform audit procedures adequate to determine whether the leased and loaned assets existed in the amounts recorded, and that the results of the confirmation procedures did not provide sufficient competent evidential matter to form a reasonable basis for an opinion that Surgical's leased and loaned accounts were fairly stated.

Respondents contention that the 1980 APM high risk evaluation was a mistake which was re-evaluated on a reasonable basis as being low is not persuasive, since at least from the planning stage, the account bore a high-risk designation and the audit steps should have proceeded accordingly.

Respondents assert that Surgical's internal controls were sufficient and adequate to determine the existence of the assets, especially following the replacement of the manual system of record-keeping by the computerization of the account. Other than the fact of the conversion, it has not been shown that reliability of the information put into the computer was established, nor that the risk of error in recording additions to, deletions from, and transfers between outside customers was sufficiently accounted for.

E&W further contends that the auditors performed sufficient procedures to assess the reasonableness of the account balances in the leased and loaned accounts in the 1980 audit. These included the performance of procedures to determine whether any

leased and loaned items had become obsolete; by testing the reasonableness of the amount of depreciation recorded; by reconciling the leased and loaned register with the leased and loaned general ledger control accounts; by considering an analytical review that compared the amount of revenues generated by the leased and loaned items in 1980 with that in 1979; and by the sending of the confirmation request as outlined heretofore. However, other than for the 8 confirmation letters, there is insufficient proof in the workpapers as to whether the other procedures were, in fact, carried out.

A further important assertion that Surgical made in this account was that the leased and loaned assets were valued correctly under GAAP.

One type of leased and loaned asset was the TPR "Quick Check", an electronic instrument that quickly recorded a patient's temperature, pulse and respiration. The TPR monitors were listed individually on the leased and loaned register, and were identified by serial number, purchase date, instrument type, date of last rework, unit cost of acquisition, salvage value, depreciable costs, accumulated depreciation and net value to date.

These instruments had listed purchase dates of 1977, 1978 and 1979. The purchase price of these instruments as shown on the register ranged from $490 to $795 respectively with an average per unit acquisition cost of $707. The aggregate

acquisition cost of the TPR units in 1979, also shown on the December 31, 1979 register, was $1,300,000.

At some point during 1980, Surgical removed from its leased and loaned register almost half the TPR units that had been listed on the December 31, 1979 register. At the same time, Surgical inflated the recorded cost of the TPR units by almost quadrupling the purchase prices of the remaining units.

Surgical's December 31, 1979 leased and loaned register, listed 1,846 TPR instruments with purchase dates of 1977, 1978, and 1979. By the removal during 1980 by Surgical from its leased and loaned register of almost half of the TPR instruments which had been listed at December 31, 1979, Surgical's October 31, 1980 leased and loaned register contains but 880 TPR instruments with an alleged purchase price of every TPR unit at exactly $2,695.76 each. Thus, the aggregate acquisition cost of the TPR units at October 31, 1980 is shown to be $2,272,000, an increase of approximately $1 million from the December 31, 1979 total. By the end of 1980, 30 additional TPR instruments were shown to have been purchased at a unit cost of $600 each.

The listed net book value of Surgical's leased and loaned assets increased from approximately $1.9 million at December 31, 1979 to approximately $3.65 million one year later. As seen, the TPR valuation was increased by over $1 million during this period thereby accounting for most of the increase. The elimination of half of the TPR units from the account by Surgical, and the inflation of the costs of the remaining units during the year by

almost 400 percent was not disclosed to respondents by Surgical. The auditors did not obtain sufficient competent evidence to determine the reasonableness of Surgical's assertion that the TPR assets had increased by $1 million, as would be required under GAAS.

Under all of the circumstances, it is concluded that respondents violated GAAS by not planning and performing audit tests to gather sufficient evidence concerning the existence and valuation of the leased and loaned instruments, and Surgical's assertion that the TPR assets had with no apparent justification increased in value by $1 million. Those steps that were taken, particularly the use of only 8 confirmation letters, were woefully inadequate both in sample size and in the proportionately large number of exceptions reported. Thus, there was a wholly insufficient statistical basis for concluding that the account was fairly stated under GAAP.

(5) The Capitalization of Legal Fees As Patent Costs (1981 Audit)

Alan R. Blackman was Surgical's former Australian distributor who, beginning in 1979, embarked upon a program of manufacturing and marketing stapling products that were copies of and in competition with Surgical's products, first in Australia and, in 1980, in the United States and other parts of the world.[30/] Surgical responded to Blackman's conduct by commencing litigation in 1980 against Blackman in a number of jurisdictions

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30/ As used herein, "Blackman" refers collectively to Blackman and several corporations and or other entities under his control.

throughout the world. By 1981 there were nine law suits pending between Blackman and Surgical. Only three of them directly involved patents held by Surgical (specifically, in the U.S. District Court for the District of Connecticut, one in Canada and the third in France, based upon patents held by Surgical in those countries and similar to those held in the United States). The remaining six actions embraced two in Australian courts, seeking injunctive and monetary relief, based upon violations of the Australian Trade Practices Act including related fraudulent, misleading and deceptive conduct. The other Australian suit, in the Equity Division, alleged fraud, conspiracy and breach of fiduciary duty, and sought, among other things, an assignment to Surgical by impressing a trust of the business assets of Blackman including good will, as well as injunctions, an accounting and damages.

The remaining legal actions included one in the courts of England based upon the alleged fraudulent conduct by Blackman in the sale of Surgical's products and seeking injunctive relief and damages; an action in the United States District Court for the Southern District of Texas alleging claims of unfair competition in violation of state and federal law and for infringement of Surgical's registered and common law trade marks; another in New York state courts alleging claims of conspiracy to defraud, unfair competition, trade mark infringement and misappropriation of trade secrets; and, finally, an action instituted by Blackman against Surgical in the United States District Court for the

Southern District of New York charging that Surgical monopolized the market for surgical stapling products in violation of the Sherman and Clayton Acts.

As of January 1982, two of the nine actions between Surgical and Blackman had been effectively withdrawn (the New York state and Texas actions). Two more were inactive (the action pending in the Southern District of New York and one of the Australian actions) in deference to and pending the outcome of other actions.

Of the five active litigations as of December 31, 1981, the British action was in its earliest stages having been pending less than one month, three contain specific allegations of patent infringement, and the fifth being the Australian action to establish a constructive trust on all the businesses of Blackman which was ready for trial. It was the feeling of Surgical that success in this last action would afford it complete relief and render all of the other actions moot by virtually driving Blackman out of business.

In its 1981 financial statements, Surgical capitalized as patents all legal fees and related costs amounting to $5.8 million incurred in connection with the Blackman litigation, including over $2 million incurred in connection with the suits in Australia. Under GAAP, only those costs incurred in successfully establishing or defending the validity of a patent are properly capitalizable as patents. The theory behind this rule is that these expenditures are directly related to the

asset, the patent, and will make that asset more valuable. On the other hand, GAAP holds that legal fees incurred in defending a company's business in general are not properly capitalizable but should be expensed, as are all legal fees.[31/]

The OCA contends that the cost of Surgical's Australian action against Blackman should not have been capitalized in the patent account because Surgical, not holding any Australian patents, did not assert patent infringement in its causes of action. Surgical's management represented to respondents that all of the legal fees and related expenses incurred in connection with litigation against Blackman were capitalizable as patents because they considered all of the lawsuits to be, in substance, one litigation, the primary thrust of which was the defense of the company's patents. Respondents, without further investigation and relying solely upon management's representations concurred in that conclusion.

It is clear that the Australian law suit to impress a trust, which Surgical asserts is the lynchpin of its strategy to stifle

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31/ None of the parties to this proceeding have brought forth any governing pronouncements by authoritative bodies such as the FASB or the Accounting Principles Board, but did reveal relevant commentary in two text books; Sullivan J., et al., Montgomery's Auditing (10th Ed. 1985) and Wixon Kell & Bedford, Accountants' Handbook (5th Ed. 1970). These sources affirm that the legal costs in connection with filing for and obtaining a patent as well as defending the validity of the patent when challenged in the courts or in the successful prosecution of original infringement suits are all capitalizable. On the other hand, however, Accountants' Handbook, states that under income tax regulations, the cost of defending the patent is an expense in the year that it is incurred.

the competition from Blackman, does not rely upon the existence of patents for its successful prosecution. In essence, the Australian equity action alleges Blackman's fraud, breach of fiduciary duty, breach of contract, and, alternatively, as part of a conspiracy to set up a business in Australia in competition with Surgical. The proof of these allegations does not rely upon whether or not Surgical had patents outstanding in other countries. Rather, the legal fees incurred in connection with this lawsuit were in defense of the company's business, not its patents (some of which were due to expire shortly anyway).

The actions taken by Blackman in Australia in no way constituted an attack upon the patents held by Surgical. They did constitute a threat to the business that Surgical was doing in Australia and other countries where Blackman established competing facilities. The outcome of the Australian equity action would have had no effect upon the validity of the patents in the United States or elsewhere. Hence, all legal expenses in connection with that action should not have been capitalized under GAAP but rather expensed as any other legal fees would be.

To put it another way, even if Surgical lost its law suits in Australia, its patents elsewhere would have continued to be valid and enforceable. Conversely, success in the Australian action would in no way have constituted an affirmation of the validity of the patents.

Respondents' claim that the nine law suits heretofore described were all bundled together as part of one global

strategy to wear down Blackman and force him out of business may be true, but the strategy was not for protection of patents but rather the protection of Surgical's business. Looking to the substance of the lawsuits as a whole rather than the form in which they were presented in the various jurisdictions makes it clear that they were not patent related. They were primarily designed to drive out Blackman as a business competitor.

In the light of the large ($5.8 million) amount of legal fees that Surgical capitalized during 1981, respondents had an obligation under GAAS to plan its audit procedures to test management's assertions that the legal fees were incurred to establish or defend Surgical's patents, rather than simply to rely upon these representations.

Respondents allege that they read various opinions by lawyers who were engaged by Surgical to prosecute these law suits. However, one looks in vain for any reference therein to the keystone Australian action as being involved with a defense or establishment of patent rights.

Under all of the circumstances, it is concluded that respondents' failure to design audit procedures to test the critical assertions by Surgical constituted a violation GAAS. The arguments of respondents that under GAAS it was reasonable for them to have accepted without question management's assertions as merely being an instance of using professional judgment in an ambiguous situation is rejected as having no justification under the circumstances where the lawsuits on

their face had no bearing upon the validity or value of Surgical's patents.

(6) Changes in Accounting Estimates and Recognition of Salvage Value (1981 Audit).

In 1981, Surgical adopted changes in accounting estimates that had the effect of increasing reported pre-tax income by $1,280,000, as follows:

(a) Change in the estimated useful life of patents from 5 to 10 years - $476,000.

(b) Changing the estimated useful life of new additions to molds and dies from 7 to 10 years- $270,000.

(c) Recognizing an estimated salvage value of 10% on certain fixed assets to which no salvage value had previously been applied - $402,000.

(d) A change in estimate involving salesforce development in France- $138,000.[32/]

The OCA contends that respondents violated GAAS by performing insufficient audit procedures to test the reasonableness of these changes. OCA further asserts that there is an accounting presumption that entities will not change their accounting estimates unless justified by new events or new or better information, and argues that it is the duty of the auditors to review the company's evidence supporting the changes and satisfy themselves that management had a reasonable and sound

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32/ This change in estimate was neither discussed nor commented upon during the hearing, nor in the post-hearing briefs filed by the parties. Hence, it is concluded that no further discussion thereof is required.

basis for making them. This interpretation of APB-20 would seem to create a presumption against changes in estimates and place a burden upon a company to overcome that presumption by appropriate evidence.

While it is true that APB-20 recognizes a presumption against changes in accounting principles (Paragraphs 7 through 9), there is no such presumption against changing in accounting estimates (Paragraphs 10 and 11). APB-20, paragraph 10, states that changes in estimates used in accounting "are necessary consequences of periodic presentations of financial statements," and that "accounting estimates change as new events occur, as more experience is required, or as additional information is obtained".

To accept the client's justification for a change in accounting estimate, the auditor need only conclude that it is reasonable and supported by the evidence. The client is not required to show that the change is for the better or is an improvement.

OCA contends that three considerations should have caused the auditors to increase their level of skepticism with respect to these changes, namely, (1) that Surgical did not volunteer to its auditors the fact that it had made the changes in estimates; (2) that three of the four changes were all made in the fourth quarter of 1981; and (3) Surgical's fourth quarter earnings had fallen dramatically, (and hence presumably exerting pressure upon the company to seek off-setting increases in profits

elsewhere). These factors are said to have presented an unambiguous picture of a company manipulating its accounting to inflate its income, particularly since Surgical had also, during the fourth quarter, adopted a policy of capitalizing other expenses such as, as seen above, tooling qualification costs. As a result, it is argued that the auditors should have examined carefully their decision to accept each change in estimate, and that there was some duty imposed upon management to justify the changes by showing to the auditors that they were better than the estimates being replaced. However, APB-20 does not place such a burden.

In coming to the conclusion concerning these disputed items, the auditors relied upon their knowledge of the client's business and upon the representations made to them by management. There is nothing unusual or suspicious about a company's adopting changes in estimates without first consulting with its auditors. Moreover, it is logical for a company to adopt changes in estimates in the fourth quarter of a fiscal year when it is in preparation of its annual financial statements. The fact that the changes in estimates had the effect of increasing reported income is not significant, in most cases, since estimates, when they are initially adopted, tend to be conservative due to the lack of experience on which to base them. The auditors were aware that in 1981, Surgical had adopted five other changes in asset or liability reserves that had the effect of <u>decreasing</u> pre-tax income by a total of $900,000.

Surgical's business was undergoing profound changes in 1981. The amount of its tangible assets had increased more than three-fold over what they were in 1979. In 1980 and 1981, Surgical introduced some 20 new products as compared with prior years when it had introduced, at most, two. It sold off a division and product line. Its fixed assets accounts had increased by approximately $51 million and its patents account by $5.8 million.

In light of the changes in Surgical's business and the material additions to its asset accounts, it was not unreasonable to expect that management would reassess and, if appropriate, revise accounting estimates that pertain to those accounts. Since some of Surgical's revised estimates relating to asset reliability reserves had the effect of decreasing income by a substantial amount, as shown above, the fact that the proposed estimates had the effect of increasing net income would not, by itself, be cause for raising the level of skepticism on the part of the auditors. 33/

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33/ When Surgical did propose accounting conventions or changes in estimates that were inconsistent with GAAP or were not reasonable in light of the evidence, the auditors did not permit Surgical to adopt such changes which had to do with attempts to capitalize rent, refinements in the method of calculating average interest rates, changes in estimated useful life of leasehold improvements, and over-capitalization of interest expenses on construction of a facility. Surgical's pre-tax income would have been $528,000 higher but for the auditor's refusal to concur in Surgical's adoption of these changes.

Estimates by nature are imprecise projections as to future events. In order to evaluate a change in estimate, auditors must look to the past to determine where the changed estimate is reasonable in light of experience, and into the future to determine whether there is a legitimate reason to believe that what was true in the past will no longer hold true in the future.

(a) Patent Lives

Prior experience showed that product manufactured by Surgical under patent had economic lives of some 15 years or more. The patents had a legal life of 17 years. Hence, it would appear that a change in estimated patent life from 5 to 10 years was conservative.

Additionally, another firm, Delmed, Inc., paid Surgical nearly $2 million for a fully amortized (for 5 years) patent which indicated that they had a useful life beyond their 5-year accounting life. Moreover, a research report by Sanford C. Bernstein & Co., concluded that Surgical would remain the market leader in its field for a substantial period into the future despite the fact that several strong competitors were about to enter into the manufacture and distribution of similar products.

(b) Molds and Dies

It would appear from the record that the change in the estimated useful lives of molds and dies was reasonable. The molds and dies had an economic life of at least ten years and they physically lasted approximately that period. This

estimation was also supported by tests made by respondents of Schedule V of Surgical's Forms 10-K during each audit for the duration of the Surgical engagement. 34/

(c) Salvage Values

Salvage value is the estimate of the amount recoverable upon disposition of an asset at the end of its useful life. The recognition of a salvage value decreases the depreciable cost of an asset and increases income. It would appear that the assets to which the salvage value was applied did, in fact, have a recoverable value at the conclusion of their usual lives, of which the auditors were aware, and that many companies employ a 10 percent salvage value as a matter of convention.

It is agreed by OCA and counsel for respondents that Surgical violated GAAP by applying the 10 percent salvage value retroactively. GAAP requires that such a change in estimate be applied prospectively only.

The effect of applying the salvage value retroactively was to increase 1981 reported pre-tax income by $260,000. Since this amount was approximately 2 percent of pre-tax income, it becomes an immaterial amount to which GAAP would ordinarily not apply. However, it could be taken into consideration in determining whether respondents were guilty of improper professional conduct

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34/ Schedule V sets forth, among other things, the dollar value at historical costs, of molds and dies retired each year. The auditors knew from their tests of Schedule V that the rate of retirement of Surgical's molds and dies supported the 10-year estimated useful life.

in not recognizing a campaign by Surgical's management to unduly inflate its net profits, and whether respondents, in carrying out their auditing functions under GAAS, should not have noted and called attention to this allegedly violative conduct.

Under the circumstances herein, the change in estimates and the imposition of the salvage charge were not sufficient in and of themselves to increase the level of skepticism with which respondents should have conducted the audit.

(7) The Tooling Confirmations Problems - Other Vendors (1981 Audit)

In its 1981 financial statements, Surgical reported owning molds and dies costing about $32 million, or about 15 percent of its total assets, most of which were physically in the possession of outside vendors who used them to make parts for Surgical. One critical assertion that GAAS required E&W to test was that these molds and dies physically existed. Accordingly, E&W selected nine vendors, each of which according to Surgical's books held over $1 million of Surgical's molds and dies, and sent them confirmation letters itemizing by tool number the molds and dies which Surgical's records showed the vendors had in their possession. The letters requested the recipients to confirm the holding of the listed items. The net book value of the tooling at the nine locations was $12,100,000.

Only six of the nine confirmation letters were returned, four of which contained exceptions. These six provided the auditors with a sample that consisted of 479 individual tools and dies representing 43 percent of all tooling at outside locations.

These returned confirmations contained about 127 exceptions, some 56 of which were followed up by the audit staff and disclosed evidence of either the tools' actual or probable existence or that the error in the vendor's records arose from some aberration in the vendor's response procedures. There was no follow-up on the remaining 71 exceptions, the book value of which was almost one million dollars.

Moreover, respondents did not follow up or perform additional audit procedures on the three tooling confirmations that were not returned. The book value of the tools and dies involved amounted to over $3 million. Nevertheless, respondents aver that although E&W's audit procedures did not confirm the existence of approximately $4 million of molds and dies listed on Surgical's financial statements, the matter did not involve any material error requiring further audit procedures. They further contend that since there are no contemporaneous professional standards that unambiguously require the auditors to do so, no finding of unethical or unprofessional conduct would be appropriate. They see no difference between confirmations that were not returned and those that were deemed exceptions on the confirms that were returned.

Respondents seek support for their position in SAS-1, Appendix A- "Relationship of Statistical Sampling to Generally Accepted Auditing Standards", AU Sec. 320 A. and SAS 31, "Evidential Matter" Sec. AU 326, that the competence of evidential matter is solely a matter of auditing judgment, and

hence the follow-up check of more than half of the reported exceptions and none of the non-returned confirms was an adequate check of evidential matter.

SAS-39, AU-350, was issued in June of 1981 effective for periods on or after June 25, 1982. Under this standard, unresolved exceptions to confirmation procedures must be treated as "errors" for the purpose of analyzing the results of the confirmation procedures, and that errors discovered by auditors must be projected or extrapolated over the entire population of items being tested. Further, an auditor should attempt to determine the cause of an error before dismissing it as immaterial or expanding his audit procedures. Respondents argue that the provisions of SAS-39 were not effective at the time it was doing the 1981 Surgical audit. However, as testified to by OCA's experts and lacking in the testimony of respondents expert, the requirements of SAS-39 were merely a codification of and a reflection of what was the overwhelming view of most auditing firms in 1980 and 1981, and required E&W to follow-up on the three non-responses as well as the exceptions recorded in the other six. 35/

Respondents isolated for testing the nine vendors that

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35/ Although the tooling confirmations issue is alleged in the Order for Proceedings, in the Order sanctioning Hope and in the OCA's pre-trial memorandum, respondents failed to seek any findings of fact or conclusions of law with respect thereto or in their initial supporting brief, but rather waited until its reply to OCA's proposed findings, etc., to even discuss the questions involved and then proceeded to do so at length.

held material amounts of Surgical' tooling. Under E&W's own internal guidance, this selection was a test of "key items" that were individually material. Thus, the auditors were required to validate or confirm each vendor's confirmation and to follow them up in some manner, especially the three that were not returned. This failure constituted a violation of GAAS, and, in view of the amount of the total book values of the molds and dies listed in the confirmations, a material one. 36/

One of the vendors that did not return its confirmation letter was Precision Metal Products (or "PMP"). Surgical's records showed approximately $1,120,000 of molds and dies in PMP's possession. In fact, the actual acquisition cost of Surgical's molds and dies resident at PMP at that time was much lower at approximately $250,000 to $350,000. PMP did not return the confirmation letter because it could not confirm that most of the tooling listed on the attachment existed. Accordingly, the failure of respondents to perform follow-up procedures on the confirmations that were not returned by Surgical's vendors, on the "tools" that Lacey confirmed were "staple units. Not

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36/ Two exceptions that were not followed up or resolved were in the confirmation letter sent to Lacey, specifically tool numbers 39324 and 39343. Lacey indicated for both of these "tools" that they were not "on hand" and noted with respect to both that "information shows this item to be staple unit. Not tooling." This explanation by Lacey that the items were not tools but were staple units raised questions concerning the validity of the accounting records. The failure to follow up or resolve these two exceptions, which had a total acquisition cost of about $390,000, violated GAAS.

tooling", and on all the exceptions contained in the confirmations that were returned constituted a failure to exercise due care as required by GAAS. 37/

(8) The Lacey-Barden Premium Billing Issue (1981 audit).

As noted heretofore, Barden, through its Lacey manufacturing division, was a major supplier to Surgical of parts for its stapling instruments. The tooling necessary to produce these

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37/ The failure to perform appropriate follow-up procedures, particularly with respect to the confirmation requested of PMP but never returned, presented some apparent parallels to the Lacey/Barden premium billings issues hereinafter discussed at length.

By early 1981, Surgical experienced a substantial build up of component parts embracing those that had not yet as been inspected, or were obsolete, defective, or unsuitable for use. Surgical decided to return the backlog raw materials to the vendors that made them and to debit their respective accounts for the parts so returned. When the vendors objected since they did not create the problem, Surgical undertook to accommodate these vendors by increasing tooling purchase orders or creating fictitious tooling purchase orders in amounts equal to the product returns to compensate them for the unjustified product returns and did so in the case of at least four of its vendors (including PMP and Tenax). Surgical thus capitalized as molds and dies the full amount of the inflated or fictitious purchase orders and invoices in the amount of approximately $2.7 million (of which Tenax's share amounted to $1.4 million and PMP's share to $400,000). Typically, in PMP's case, Surgical did not actually return any parts to PMP but rather informed PMP that a tooling purchase order would be inflated above the original amount and then upon PMP's invoice, would send PMP a check in the appropriate amount.

These procedures were discovered by Hope and respondent Ferrante who were looking to find other instances similar to those involving the Lacey premium billing question, but it was agreed to put the matter on hold pending the outcome of the Lacey investigation. After that was completed, however, there was no follow-up even though important questions of client integrity were raised thereby.

parts was also built by Lacey to Surgical's design and specifications.

On or about January 27, 1982, E&W completed its field work on the audit of Surgical's 1981 financial statements. On February 3, 1982 E&W authorized Surgical to issue a press release disclosing its sales and earnings figures for the calendar year 1981, specifically that its earning rose from $.89 per share in 1980 to $1.13 in 1981. 38/

Coincidentally, E&W was the independent auditor for both Barden and Surgical during these periods.

During the same week that Surgical's earnings were released, Paul Yamont, Senior Vice President and Treasurer of Barden, called William Burke, the E&W partner in charge of the Barden audit, and advised him that in excess of $300,000 in Lacey billings to Surgical appeared to have been improperly recorded by Barden during the first quarter of Barden's fiscal year, and more importantly, that Surgical may have paid Lacey over $1 million for production work, with the purchase orders and invoices mislabeled as being for "tooling modifications". Since Surgical capitalized its tooling payments and expensed its product costs as "cost of sales" this presented the question as to whether

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38/ Surgical's executive officers could earn bonuses arranging from 15 percent to 75 percent of their base salaries if the earnings per share growth ranged from 15 percent to 30 percent over the previous year, which provided an incentive to these officials to keep earnings per share at a higher level.

Surgical might have deliberately misstated its molds and dies account and thus its pre-tax earnings, by a material amount.

Yamont told Burke that Barden's accounting department was not aware of any costs underlining the invoices, and Yamont suggested that the work described on the invoices might not have been performed. He further suggested that the facts might indicated a "kickback" scheme involving individuals at Barden or Lacey, and someone at Surgical.

Burke visited Barden twice during that week to discuss the issue with Yamont and two other members of the Barden accounting department, Thomas Loughman and Russell Moore, who were united in their analysis that the premium charge billings were for product and not for tooling.

Recognizing that the information Burke received from Yamont warranted his consulting with Norman Strauss, E&W's regional director of accounting and auditing, on February 10, 1982, Burke and Strauss met and discussed the fact that the amount of billings of about $300,000 recorded in the wrong period was immaterial to Barden's fiscal 1981 financial statements, but was material to the first quarter of 1982 for Barden. It was agreed that Burke should recommend to Barden that it disclose this item in its quarterly financial statements.

Burke also discussed with Strauss the fact that the billings to Surgical for alleged tooling modification was not supported by any records of tooling costs and that if this were

so, Surgical would be improperly capitalizing as tooling amounts expended for parts.

That same day Strauss informed Bruce Dixon, E&W's managing partner for the New York region, that Yamont had reported finding tooling invoices to Surgical with no associated costs, suggesting that the descriptions on the invoices might be incorrect.

After receiving this information from Burke, Strauss ascertained that Surgical's financial statements for the year ending December 31, 1981 were scheduled to be issued shortly. Consequently, Dixon advised Hope not to release the accountants report on Surgical's 1981 Form 10-K unless and until the questions relating to those billings were resolved. Hope then informed Surgical that for reasons he was not in a position to disclose, the accountants' report could not be issued at that time. 39/

On February 11, 1982, Dixon and Strauss discussed Burke's information with Robert Neary, E&W's national director of accounting and auditing was well as with E&W's in-house lawyers. This order not to sign off on the Surgical audit came at a time when it was expected that E&W would do so. 40/

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39/ This inability to tell Surgical why its report was delayed was because it would have been ethically bound not to disclose Barden's confidential information to Surgical.

40/ In fact, the very day that Dixon told Hope not to sign the Surgical financial statements, Rosenkrantz, Surgical's comptroller, came to Hope's office to pick up what he expected to be the signed 10-K.

Several days prior, on February 8, 1982, Barden's board of directors asked E&W, Barden's corporate accounting department and Barden's outside counsel to investigate the Lacey billings to Surgical. During the period February 12 to 15, Burke and Robert Kempenich, the manager of the Barden engagement, reviewed and analyzed documents provided by Barden's accounting department and visited Lacy to interview Robert More, Lacey's general manager.

Burke and Kempenich were told by More that beginning in 1980, Lacey (Barden's manufacturing division) had been billing Surgical base prices for certain products, particularly for DTA and TA(P), plus "premium charges" intended to compensate Lacey for manufacturing steps that were being performed manually. 41/

More told the auditors that tooling costs involving the modification program had not been significant. Nevertheless, in early 1981 Lacey began invoicing Surgical for "the design and modification of tooling", with the amounts of the invoices calculated in the same manner as were the premium charges for the production of the same parts.

By February 15, Burke and Kempenich had concluded that invoices in the amount of approximately $1,050,000 that were described as being for "tool modification" work at Surgical's direction were in fact for production work on parts. They also

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41/ The base price for the product represented the cost at which Surgical thought Lacey would ultimately be able to produce the product once cost-saving equipment or manufacturing changes enumerated in the agreement came on line. Lacey and Surgical agreed to reduce the premium charges as the manual operations were discontinued.

concluded that some of the premium charge billings amounting to $300,000 had been issued in the wrong accounting period. The auditors recorded their conclusions in a memorandum and on February 18, 1982, Burke reported them at a meeting of the Barden board of directors. (Yamont, although not a director, was present at the meeting).[42/]

At that meeting, Irving Berelson, chairman of Barden's executive committee stated that Barden's outside counsel (in which firm he was also a senior partner) reported that their own investigation corroborated E&W's auditors' findings.

Once the auditors has learned about the Barden information, the crucial issue became whether Surgical was improperly recording the premium billing payments as capital items, rather than expensing them as purchases of product (which, in turn, inflated the net profits). This raised a fundamental question of the integrity of Surgical's management, and that the integrity issue might affect other items in Surgical's financial statements as well.

Lacey calculated and Surgical paid monthly premium charges for the product in accordance with this agreement from November 1980 through January 1982. Only in the first two months did the billing descriptions describe the work as "premium charges" and these payments were not capitalized. Beginning with the premium

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42/ Burke also told the board that the fact that Robert More had exclusive knowledge and control with respect to Lacey's relations with its customers, including Surgical, was a control weakness.

charge amounts Lacey assessed for products produced in January 1981, the Surgical purchase orders and the billing descriptions began calling the work "tooling modifications" and the costs then were being capitalized by Surgical. A similar pricing arrangement was negotiated with respect to manufacturing new products, the DTA and TA(P) cartridges.

At this point, E&W and its staff were not only faced with the problem of client confidentiality but also one of client integrity. The information that Yamont disclosed to the Barden auditors raised the distinct possibility that Surgical had concealed material information from them and that this, in turn, had profound implications for the entire Surgical audit. If the representations of Surgical's highest management could not be trusted, GAAS would at least require its auditors to revisit the audit field work and might also require them to resign from the audit itself. (SAS 16, AU 327, deals with errors and irregularities in financial statements and sets forth GAAS requirements for auditors when a client's integrity is questioned). SAS 16 also directs auditors who "remain uncertain" whether the financial statements are materially misstated to consider resigning from the engagement.

The client confidentiality problem affecting E&W lay in the fact that the firm and its counsel believed they could not use information learned from the Barden audit to resolve their problem with Surgical's financial statements unless and until

Barden gave E&W permission to do so.[43/] Thus, although the auditors knew the issue was whether Barden had made products for Surgical and billed them as capitalizable tooling, because of the perceived client confidentiality problem, they could not tell Surgical the reason E&W would not sign off on its Form 10-K.

At the same time Surgical was pressing very forcefully for a prompt signing off without change on its financial reports since its purported net profits for 1981 had already been reported in the media. Having learned of possible client fraud from its audit of Barden, E&W had to straighten out that matter before it could sign off on Surgical by either reviewing the "premium billing" and other instances of Surgical's capitalizing expense items or withdrawing from the engagement. However, E&W could not ethically justify either action with respect to the Surgical audit since both would have been based upon information learned from the Barden audit. Moreover, either course would have been time consuming. If E&W did not resolve the matter promptly, Surgical threatened to bring action for any delay in issuing its financial reports which, if nothing else, would have caused the disclosure of E&W's ethics situation arising from its representation of two audit clients and possible misusing of information with respect to both of them. In fact, E&W's concern

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43/ Barden was reluctant to give such consent since it did not want to disclose business secrets to Surgical, its most important customer.

was so great it brought in its highest officials including Robert Neary its national director of accounting and auditing, and Joseph Keller, its national co-chairman to help resolve the dilemma.

It is quite clear that Surgical, Barden's principal customer, because of its economic clout over Barden and to some extent over E&W, 44/ and the threat of public disclosure of E&W's ethical posture, was in a strong position to insist upon prompt disposition of the matter. Hence, the only satisfactory solution would have been one involving the obtaining of Barden's consent and resolving the accounting issue arising from the premium billings in a way allowing E&W to sign off on the audit without delay, including delay resulting from protracted inquiry into Surgical's accounting methods, or, should E&W have withdrawn from the engagement, from an audit by another auditor.

On February 22, 1982, E&W personnel Dixon, Burke and Hope met at Berelsen's law offices with Berelsen, Yamont and two other attorneys for Barden in an unsuccessful effort to persuade Barden to let E&W use information obtained by its Barden auditors in its audit of Surgical. (Prior thereto it was thought that Yamont had met with Hirsch, Surgical's president, to tell him the full story as Yamont understood it).

On February 23, 1982, Dixon and Hope for E&W met with Hirsch, (President) Rozenkrantz (Comptroller) and Korthoff (Vice-

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44/ Surgical was one of the top five revenue producing clients in E&W's White Plains Office.

President of operations) of Surgical at which meeting Dixon told them that Barden had refused to permit information developed in connection with audit work to be used in the Surgical audit. Hope further informed the group that E&W would not sign off on Surgical's financial statements until the matter was resolved. At this point Hirsch became angry and verbally abusive of the auditors, causing Dixon to walk out of the meeting.

Hirsch retrieved Dixon from the lobby of the building, and apologized to him for his conduct, and the meeting resumed.

In an effort to open up communication between Surgical and Barden without breaching Barden's confidentiality requirements, the E&W representatives had Surgical send a confirmation letter to Yamont, Barden's treasurer, on February 23, 1982, asking Barden to agree or disagree that the tooling invoices issued to Surgical from April 1981 through January 1982 (and attached to the letter) represented valid charges for services actually performed in the design, development and modification of Surgical's tooling. Because of Yamont's prior contentions that these invoices represented premium labor charges, they did not expect him to confirm, but offered him the opportunity to have denied the allegations in the letter. He did neither. Hence, the line of communication remained closed.

Previous statements by Berelson, chairman of Barden's executive committee, had made it clear that he did not want Barden involved in the Surgical audit. Hence, the auditors were probably not surprised that Berelson expressed displeasure at

receiving the confirmation request and that Yamont was also unhappy about it. Nevertheless, following a meeting between Hirsch and Rosenkrantz of Surgical, and Berelson and Yamont of Barden, Berelson abruptly changed his mind (apparently as the result of pressure by Hirsch) and agreed to allow the E&W Surgical team access to his company's records.

On March 3, 1982, E&W staff met with officers of Surgical to discuss the issue of the premium billings and the labeling of them as "tool modifications". Korthoff, Surgical's operations chief, submitted that since November 1980, Lacey and Surgical had agreed upon a standard, or base price for the manufacture by Lacey of certain of Surgical's new-generation stapling products and a "premium charge" representing additional manual work that Lacey had to do before tooling could be put in place. Korthoff stated that in April 1981, Surgical informed Lacey that it would no longer pay the agreed-to premium charges, but that it would instead pay for tooling modifications that would eliminate the need for future manual operations. 45/

The auditors asked Korthoff to reconcile this statement with the fact that the documentation showed no change in the premium-type billing after April. He explained that Robert More, Lacey's general manager, asked that the premium billing methodology be

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45/ Nevertheless, the descriptions on the billing for January, February and March read for "tooling modifications", instead of for "premium charges", which supposedly did not change until April. This raises the question of when the change in billing took place, if at all.

continued for the convenience of Lacey's accounting system. Korthoff said that because the tooling modifications were taking place at the same time that the tools were turning out product, and since Surgical's engineers were at Lacey on a daily basis monitoring the program, he was confident that Surgical was being billed fairly for the tooling work being performed.

The auditors noted that the final monthly premium billings for January, February and March, 1981 (plus an estimated $70,000 for April added up to exactly $400,000.00. Although these invoices were labeled for premium charges, Korthoff told the auditors that the amount resulted from was a negotiated settlement to end the tooling modification program rather than for work done under the premium billing arrangement.

The E&W auditors present were not persuaded by Korthoff's explanations. His statements flew in the face of the substantial amount of audit evidence assembled by Burke and Kempenich leading to the conclusion that the billings had been mislabeled. This, then, raised the very serious question of client integrity, i.e., as to whether Surgical management's representations were truthful.

Concerned with the fact that Surgical may have been trying to improperly capitalize payments to other vendors as tooling, just as with Lacey, the auditors reviewed Surgical's purchase orders (POs) to other vendors who were manufacturing both tooling and product for Surgical, including purchase order requisitions ("PORs") and capital expenditure request ("CERs").

The review revealed eight Surgical purchase orders to two of its vendors, "Tenax" and "PMP", where the purchase order price exceeded substantially but in exact round numbers the prices detailed in the accompanying POR and CER. The sum of these differences amounted to a very round and exact $90,000.00. Moreover, one of the PORs appeared to have been purposely altered from $25,000 to $50,000. The auditors also found one $340,000 purchase order to PMP that bore a strong resemblance to the Lacey "cost reduction" program of premium charges in which the PO described a "cost reduction program".

As a follow-up to these other vendor issues, Ferrante and Hope discussed the matter with Korthoff and Rosenkrantz. Korthoff told Ferrante that he was personally responsible for changing one of the Tenax purchase orders from $25,000 to $50,000 as a premium for expedited delivery. This despite the fact that Surgical had already agreed to pay an expedited delivery charge of $5,631 for the same product. Korthoff was unable to explain the above discrepancies. The two auditors agreed to put these "other vendors" issues on hold, pending the outcome of the Lacey investigation. However, Hope and Ferrante never performed these additional audit steps, nor never mentioned the matters again to Surgical. 46/

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46/ See footnote 37, supra, at page 60, describing other attempts by Surgical to capitalize instead of expensing costs related to obsolete production parts through the use of fictitious billing.

On March 5, 1982, a meeting was held in E&W's White Plains office at which representatives of Surgical (Korthoff, Rosenkrantz and Surgical's general counsel), of Barden (More and an attorney), and of E&W (Hope, Burke and Strauss) attended. 47/

At the meeting, Korthoff gave the same explanation he gave to Hope and Ferrante two days earlier as to the way the premium billings were set up. More was generally silent and by his silence, seemed to confirm Korthoff's story. As pointed out heretofore, just three weeks earlier More had explained in great detail to Burke and Kempenich that the billings were for manual labor operations incurred in production and that the billings were mislabeled "tooling modifications" at Surgical's direction. The auditors stated that in view of More's prior story they were surprised at his acquiescence to Korthoff's version at the meeting, and that they had expected the clients, Surgical and Barden, to disagree concerning the nature of the work underlying the billings. It is quite apparent, however, that More was outgunned and standing alone face the principal customer of his employer without the support of those in his accounting department who had an understanding similar to his earlier one. The auditors were apparently satisfied, since More's turnabout in his story eliminated one of the chief problems preventing them from signing off on the audit. Under the circumstances, the

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47/ No one from Barden's accounting department including Yamont was invited to the meeting, even though these accountants had raised the problem in the first instance.

Still somewhat skeptical of the explanations given by Korthoff, the E&W auditors, Hope and Dixon, on March 8, 1982 met with Jay Huffard, chairman of Surgical's audit committee, accompanied by Surgical's general counsel. The auditors told Huffard that they found three inconsistencies with the position of Surgical (Korthoff) that the premium billings were actually for tooling, mainly, (1) More's initial version had characterized tooling costs as relatively insignificant; (2) Lacey's internal financial records did not evidence a substantial tooling effort; and (3) the documentation showed that billings even after April, 1981, continued to be based on product shipped and premium labor charges despite Korthoff's allegations that this practice ceased on April 1. They also told Huffard that they had discovered additional problems with Surgical's purchases of tooling from other vendors.

Although chairman of Surgical's audit committee and presumed to be independent, Huffard expressed his opinion that Surgical did not have a problem, accused the auditors of "over-reacting", and attempted to pressure them into signing Surgical's 10-K. 48/

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48/ At this point it can be observed that when the premium charge issue was raised, E&W responded appropriately. It instructed the engagement partner not to sign Surgical's audit report, assembled a consultative team including regional and national office partners, investigated relevant documentation, interviewed appropriate personnel, documented the result of its investigation with detailed memoranda and workpapers, and confronted Surgical.

Yet, as will be seen, the audit inquiry ultimately resulted in a failure by E&W adequately to address and resolve the important client integrity issues presented.

Having acceded to Korthoff's story as to how the premium labor billings became tooling billing, particularly in view of the significant evidence the other way, there remained a further step with respect thereto before respondents felt they could sign off on Surgical's Form 10-K. Specifically, this was the question raised by Yamont and others on Barden's accounting staff that Barden's books did not reflect any expenditures for tooling modifications by Barden on behalf of Surgical.

On March 10, 1982, Hope and Burke, the respective engagement partners, met with More, Korthoff and Lee Stremba (an attorney from Berelson's firm), first at the Lacey plant and later at Barden. While examining the books of Lacey and Barden they found an account called "Surgical production" for labor costs involved in tooling work done by Barden's tool makers for Surgical.

The tool and die makers ordinarily charged their time to two types of direct labor accounts: (1) Where Lacey had a separate purchase order for a particular tool or modification and thus planned to bill the customer separately for tooling, Lacey would open a job order and charge time to a job-order account called "Product Group Six". (2) Toolmakers also modified tools when there was no specific purchase order for tooling, in which case the toolmakers charged their time to the account known as "Product Group Eight".

More told the auditors that Lacey toolmakers never worked on production. The auditors inferred from this that all toolmaker time under the so-called "tooling program" which was supposedly

paid for through the premium billings must have been charged to Group Eight, because of the absence of special job orders (Group Six). The auditors further inferred that since More was now telling them that the Lacey toolmakers never worked on production, all of the time charged in Group Eight had to be for tooling only and not for production. 49/

At the request of the auditors, Loughman, of Barden's accounting section, pulled from the Barden records all toolmaker time under Group Eight amounting to $217,000 and the auditors concluded therefrom that this represented the Surgical tooling charges which Yamont and Loughman previously were unable to find in Barden's books.

However, the record is clear that the Barden tool and die makers did, in fact, perform substantial duties that were solely for production and hence not capitalizable, such as repairs, maintenance, sharpening and aligning of tools and dies and that these costs should be charged to production. Thus, in order for the auditors to be able to reasonably conclude that substantially all of the time charged to Group Eight was properly capitalizable or whether any part thereof should be charged to production, it would have been appropriate for them to find out just what jobs were performed by the toolmakers and what percent of their time, if any, was in production work. Rather than to ask this simple

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49/ Burke asked More how he reconciled his prior statements to Kempenich and Burke that there was an insignificant effort for tooling modification in 1981 with his contrary statements at this meeting and More replied that he had not yet thought the matter through at the earlier time.

question of the toolmakers themselves, or of the Barden accountants, or to physically visit and watch the toolmakers at work, or to see even one tool that had been modified, the auditors chose to rely upon contradictory management assertions that toolmakers do not work on production, which in turn became the basis for their assigning the entire $217,000 of toolmakers services performed for Surgical in 1981 to modification and production of tools and dies.

It became important to accept this figure without any diminution since it permitted the auditors through some rough calculations by Hope to conclude that the sum of $1,050,000 was the correct amount to be capitalized as tooling modification, thereby removing one of the obstacles critical to E&W's signing off on Surgical's 1981 financial statements.

Hope's calculations started with the sum of $217,000 as representing direct labor costs. He added to this a charge for overhead of, $325,000, computed by using a general overhead rate of 150 percent shown in Lacey's financial statements as applicable to all production. Hope then added an estimated $117,000 for engineering labor which he computed from a ratio which Product Group Eight toolmaker costs bore to total toolmaker costs. Finally, by subtracting the total of these costs from $1,050,000, Hope obtained an estimated gross profit on the billing of $391,000, or 37% of the total billings, which he

considered to be "not inappropriate". 50/

However, in actuality Barden had varying overhead rates for different departments, and in 1981, tool room rate was 90%, not 150% as utilized by Hope. Moreover, this 90% rate included overhead for engineering labor, rather than as a separate additional charge in Hope's calculations. This must have been known to the E&W auditors doing the Barden audit.

It is obvious that Hope's calculations would have resulted in significantly different results if he had taken the trouble to seek out the correct tool room overhead rate and its embracing of engineering labor overhead, both of which could have been readily ascertained by inquiry which apparently the auditors did not do.

On March 11, 1982, the E&W "working group" convened in Dixon's office to consider Hope's results. Present in person or by telephone from the lowest to the highest in the E&W audit echelon were Hope, Burke, Strauss, Dixon, Neary, lawyers from

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50/ To summarize Hope's calculations:

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|---|---|
| Tool and die labor charged to Surgical production orders during calendar 1981 | $ 217,000 |
| Lacey overhead rate (exclusive of engineering labor) of 150% x $217,000 | 325,000 |
| Lacey engineering labor allocated to Surgical product support in the same proportion as tool and die labor ($284,000 x 41.2%) | 117,000 |
| | 659,000 |
| Indicated gross profit (37.2%) | 391,000 |
| Total billings | $1,050,000 |

E&W's general counsel's office, two attorneys from E&W's outside law firm, and Joseph Keller, then E&W's co-chairman. All of them agreed that the facts developed by Hope supported his conclusion that the toolmaker labor costs accumulated in the Group Eight production account at Lacey reasonably supported the payment to Barden and the capitalization by Surgical of $1,050,000. However, in the interest of extra caution they concluded that E&W should obtain from Korthoff on behalf of Surgical a written version of his story, and from Barden a confirmation that the invoices for premium billings were actually for tooling work performed.

As noted heretofore, a confirmation letter had been sent to Yamont on February 23 asking both More and Yamont to sign the confirm, which they both declined to do. In conformity with the request of the E&W working group, a second confirmation was prepared similar in form and content to the first, except that it only asked for an affirmative confirmation that the "premium billing" was actually for tooling.

Some time between March 10 and 16, Burke and Dixon asked Yamont to sign the second confirm as Barden's "chief financial officer". It was important that Yamont sign because of his known disagreement that there was tooling involved in the billing. Yamont refused to sign in that capacity since that was not his title, nor in any capacity, since he had no personal knowledge of the transactions.[51/] The Barden auditors knew of Yamont's position all along and that he never had changed it.

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51/ At all times, Yamont was Barden's senior vice-president and treasurer.

On March 16, 1982 Burke met with Berelson and a lawyer for Barden and related the result of E&W's second investigation, i.e., that the premium charge of $1,050,000 really was for tooling modification. Berelson then authorized More to sign the confirmation as a representative of Lacey. The next day, Berelson in a separate letter attested to More's authority to sign the confirm. 52/

The auditors now had in hand what they felt was sufficient evidentiary matter to justify signing off on the Form 10-K which they did promptly. On one day, March 17, 1982, they received Korthoff's written explanations, a letter signed by Surgical's general counsel attesting to Korthoff's authority to sign his memorandum, More's signed confirmation, Berelson's attesting letter, 53/ and a detailed report from Hope in which he set

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52/ Normally, it is unusual in seeking confirmations involved with an audit to require more than the signature of an officer attesting to the contents of the confirmation letter. Here, however, the auditors were insisting upon two signatures, one of which was to be Berelson's. However, Berelson refused to confirm directly the contents of the letter but agreed to and did, in a separate writing, merely confirm that More was a vice-president of Barden and as such authorized to sign the confirmation. Berelson's attestation letter was totally superfluous and added nothing except window-dressing. It is clear that Berelson, an experienced and careful attorney, was distancing himself and keeping his name off the confirm while satisfying E&W's desires for a second signature. His excuse that he would not have allowed More to sign the confirmation if he though it were untrue is rather weak.

53/ It should be noted that both attestations were made in a single, joint letter.

forth his calculations that $1,050,000 of premium labor billing could have reflected tooling costs only. Also on the same day, Hope signed off E&W's unqualified audit report on Surgical's 1981 financial statements and they were filed with the Commission.

Since the auditors were satisfied concerning the Lacey/ Barden matter, they decided not to pursue any further the other evidence suggesting that Surgical was padding its tooling billing with several of its vendors. Thus, the auditors performed no further work on the $340,000 PMP purchase order for a "cost reduction program" nor on the eight purchase orders from other vendors that exceeded the amounts on the purchase order requisitions by rounded-off amounts. They also were willing not to pursue further the PO/POR discrepancies on the grounds that although explanations with respect thereto were incomplete, the amounts were deemed immaterial. Concededly, immateriality does not justify an auditor to ignore an issue of client integrity, an issue which is very much involved herein.

Hence, at the conclusion of the March investigation, the E&W auditors had lost their proper audit skepticism (i.e., concerning the matter set forth in footnote 37, ante), ignored and disregarded comprehensive documentation that was inconsistent with Surgical's story, ignored the earlier audit conclusions, relied upon unwarranted and untested assumptions, and disregarded the clear objections of the Barden accounting department.

Subsequent to the filing of Surgical's financial report for 1981, there were other events by which E&W was made aware that the Barden accountants continued in their belief that the premium billings of $1,050,000 were for production and not for tooling.[54/] Thus, on March 26, 1982, Richard Larsen, E&W's tax partner for both Surgical and Barden, visited Barden and was told by the accounting staff of their belief.[55/]

Again, in the E&W Audit Management Letter dated June 14, 1982 to Barden resulting from the 1981 audit, E&W expressed concern over the fact that a senior member of Barden management was allowed sole authority and responsibility for business transactions with a major customer (Surgical) and who entered into "unusual billing arrangements" with that customer during the first quarter of fiscal 1982. Despite respondents' protestations to the contrary, the language of the letter and the context in which it is stated make it clear that E&W was referring to Robert More as the Barden official, and that the "unusual billing arrangements" referred to the to the manner in which More had entered into the premium billing arrangements with

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54/ Respondents claim that during their investigation of this matter none of the Barden accountants ever made known this assertion to them. The record speaks otherwise, especially with respect to E&W's Barden auditors.

55/ Larsen, who could have disputed or confirmed the testimony of the Barden accountants, was never called as a witness by either side.

Surgical for payment of additional labor charges.[56/] This meaning of the term "premium charges" had been quite clear to E&W in February 1982, as appears in the Burke and Kempenich memorandum following their examination of Barden's books.

In Hope's memorandum of March 17, 1982, which wrapped up all of the information E&W deemed necessary to sign off on Surgical's financials, he recognizes that the amount of $1,050,000 as charges for "tooling" had been arrived at on the same basis as amounts previously billed by Lacey as "premium prices" for production. Nothing was changed except the nomenclature. At the time, Hope had before him Korthoff's memorandum of March 12, 1982 referring to the practice of Lacey billing Surgical for "premium charges" the costs of the extra direct labor required to perform additional manned operations to the various component product parts.

Additional post-filing developments relate to Barden, as the holder of an industrial revenue bond issued by the Connecticut Developing Authority (CDA) covering its Lacey facility in Bridgeport, being required to periodically file with CDA schedules of its expenditures for capital items. Barden retained E&W to perform the required audit examination of these schedules. Prior to January 1983, the schedule of capital expenditures filed

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56/ In fact, the Barden Board of Directors had, at a meeting held February 18, 1982, ordered these practices to cease immediately, and that thereafter invoicing should reflect the true descriptions of the work performed and related charges therefore.

by Barden did not contain any of the items involved in the "premium billing" arrangement. However, E&W decided that because of the changes in nomenclature on the billing, they should be listed as capital expenditures.

So, on February 23, 1983, E&W filed with CDA an audit opinion and a new "Exhibit B" including the $1,050,000 in premium charge billings as a capital expense for tooling modifications. The schedule submitted, as prepared by the Barden accounting department, was under a heading reading as follows:

"THE BARDEN CORPORATION

SCHEDULE OF PREMIUM BILLING CHARGES

INCLUDED IN MANUFACTURING PRODUCTS COST

BILLED AT CUSTOMER REQUEST

AS MODIFICATION OF MOLDS, TOOLS AND DIES.

(Emphasis added).

The auditors would not interpret the wording of the caption by the Barden accountants as reflecting that Barden was taking a position that the "premium billings" were not for capitalizable tooling. The language of the heading and the surrounding circumstances demonstrate otherwise. In fact, the Barden auditors insisted upon including the language: "Billed at customer request . . ." because of their continuing belief that the billing charges related to production, not tooling expense.

In November 1983, Burke, after giving testimony in connection with the Commission's investigation of Surgical, got the impression that Loughman did not agree that the Lacey

billings to Surgical represented work done on Surgical's tooling. E&W, therefore, decided that Burke and Bruce Rosen should go to Barden to perform additional procedures. There they met with Lacey's engineering vice president, Robert Werner, who advised that while toolmakers spend more than half their time doing modification and design work, that the rest is spent doing non-capitalizable maintenance. He also advised that Lacey performed substantial tool and die modification and design work which was charged to Product Group Eight. At this point, it should have been clear to the auditors that not all of the labor costs in the sum of $217,000 were for tooling. Although the auditors never learned how much non-capitalizable toolmaking labor was included in this account, E&W decided not to pursue the question further because E&W resigned from the Surgical audit in December 1983 having become aware by this time of Surgical's deception relating to its arrangements in 1981 with certain vendors for the cost of defective parts to be billed to Surgical as tooling rather than expensed, as described hereinbefore in footnote 37, supra. Finally, on November 29, 1984, Barden terminated its engagement with E&W.

SAS 16, AU 327, ¶14 (1977) states that when an independent auditor's examination causes him to be believe that irregularities may exist, he should attempt to obtain sufficient evidential matter to determine whether, in fact, material errors or irregularities do exist and, if so, their effect.

The most serious of the audit failures found in this case, is the Lacey/Barden client integrity investigation. In the face of the apparent implications involved in the premium billing issue pointing to a conclusion that the two corporations and officials thereof were engaged in a scheme to permit Surgical to improperly capitalize product costs relating to the new items manufactured for Surgical by Lacey, the initial reaction by the auditors after investigation was that invoices in the amount of some $1,050,000, described therein as being for "tool modification" work at Surgical's direction, were in fact for production work on parts. It was even suspected that fraud or some "kickback" dealings may have been going on. By that time, respondents, recognizing the seriousness of the issue involved, proceeded with a further investigation to resolve these questions, as outlined heretofore.

Yet, some six weeks later there developed a complete change in E&W's conclusions made on February 15, 1982, based upon the Korthoff's representations as to the "premium billings," the change in More's assertion that there were only nominal costs for engineering and tooling associated with the premium billing program, and the discovery of an account "Surgical production", showing toolmaker labor costs of $217,000. The fact that More hand changed his statement and that Lacey's internal bookkeeping did not appear to reflect a significant Surgical tooling program were deemed unresolved questions by Hope in his wrap-up

memorandum of March 17, 1982 to the E&W working group. 57/

Under the circumstances, it should have been quite clear to the auditors that More's change in statement was made in the face of severe pressure by Surgical at the meeting of March 5, 1982, which surely called for a more searching investigation than was made herein. The assumption by the E&W auditors that the $217,000 toolmaker costs for Surgical reflected only tooling modification labor was unwarranted. The auditors should have clarified this fact either in the tool room itself with the toolmakers or in the record and documents of Barden. As it turned out in fact, almost half of the toolmakers' work was involved with production not toolmaking and had the $217,000 figure been proportionately amended, it would have shown that there was no basis for E&W's assumption that Surgical paid Barden in 1981 $1,050,000 for tooling modification. Moreover, Hope's calculations in arriving at this latter sum was also based on erroneous assumptions concerning overhead and engineering labor, the correctness of which was readily available rather than from guesswork.

## Discussion and Conclusions of Law

The authority of the Commission to discipline accountants and bar them from practice before the Commission under Rule 2(e)

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57/ The Hope memorandum also refers to two additional unresolved questions, namely: (1) that the documentation Hope had obtained was ambiguous and (2) that review of other tool and die vendor files had raised questions of "a lesser magnitude" that they were investigating. These questions continue to remain unresolved.

has been expressly upheld in the federal courts. See Davy v. S.E.C., 792 F.2d 1418, 1421 (9th Cir. 1986) citing Touche Ross v. S.E.C., 609 F.2d 570 (2nd Cir. 1979). As stated in Davy, "no court has since disagreed with Touche Ross".

The Second Circuit in Touche Ross, in sustaining the validity of the Rule as a necessary adjunct to the Commission's power to protect the integrity of its administrative procedures and the public in general, stated at page 581:

> " * * * 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."

Respondents contend that in order to make a finding under Rule 2(e) of "improper professional conduct" by accountants and the imposition of a sanction therefor, there must also be a showing of "wilful" misconduct. They argue that to discipline "merely negligent" conduct would not be "reasonably related" to preserving the integrity of the Commission's processes.

The provisions of Rule 2(e)(1), call for the imposition of sanctions in situations wherein the Commission finds inter alia that the respondents:

> "(i) not to possess the requisite qualifications to represent others, or
>
> "(ii) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct, or
>
> "(iii) to have wilfully violated * * * any provision of the Federal Securities Laws, or the rules and regulations thereunder."

The Order for Proceedings herein charges only violations of subparagraph (ii), specifically that respondents have "engaged in unethical or improper professional conduct".[58/]

Respondents, however, argue this way: that the charge of failure to comply with GAAS should be governed by the "wilfully violated" requirements of subparagraph (iii) of the Rule, since such failure amounts to a violation of the Commission's Regulation S-X (17 C.F.R. 210) which requires that all financial statements filed with the Commission be audited in accordance with GAAS; and that the Commission cannot proceed under subparagraph (ii) of Rule 2(e) thereby to avoid the "wilfully violated" requirements of subparagraph (iii).

This argument is specious. There is nothing in the administrative process that prevents the Commission from proceeding based upon violations of subparagraph (ii) even though the conduct of respondents might also come out to a violation of subparagraph (iii) or some other provision of law.

Respondents further urge that a reading of Rule 2(e) in its entirety demonstrates that its provisions contemplate sanctioning only wilful or deliberate wrongdoing, and that subparagraph (ii) is embraced within the "willfully violated" language of subparagraph (iii).

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58/ Notwithstanding the decisions in Touche Ross and Davy, Respondents question the validity of the entire Rule but reserve "until the issue can be presented to the Commission for reconsideration", their argument that the Commission's use of Rule 2(e) to administratively discipline accountants and other professionals exceeds the Commission's statutory power". See respondents' post-hearing memorandum, p.23 n.4.

This argument is likewise insupportable; the allegation of "improper professional conduct" can very well stand on its own as a basis for proceeding against respondents.

Respondents advance in support of their contentions the Commission's decision in Matter of William R. Carter, 47 S.E.C. 471 (1981) in which the Commission dismissed proceedings under Rule 2(e) against two lawyers because there had not been then adopted applicable standards of professional conduct, and because generally accepted standards of professional conduct did not then unambiguously cover the actions of the lawyers in that case.

Carter, however, is inapplicable to the instant situation. It involves the question of when an attorney must disclose to a corporate client evidence of corporate misconduct. The Commission specifically directed itself only "to the narrow range of lawyers engaged in a federal securities practice, to the specific factual context of an ongoing disclosure program of a corporate client, and to the limited question of when it is appropriate for a lawyer to make further efforts within the corporation to forestall continuing violative conduct." (at page 476 of 47 S.E.C.) The Commission specifically differentiated between lawyers and accountants noting that the latter "issue audit reports that speak directly to the investing public and publicly represent that the code of conduct embodied in the statements of auditing standards promulgated by the AICPA has been followed" (at page 478). Lawyers, on the other hand,

speak to their clients, not to the public, and are governed by generally recognized professional standards.

Finally, in Carter, the Commission expressly elected to analyze respondents' actions in the context of the "wilfully violated" provisions of subparagraph (iii) rather than under subparagraph (ii) of Rule 2(e)(1). Thus, the dicta quoted by respondents in their brief are unrelated to the situation which exists in this proceeding and do not give support to the respondents' contentions.

In the same vein, respondents contend that Rule 2(e) cannot be construed as to permit the imposition of sanctions on accountants' mere negligence arising from the good faith exercise of their professional judgment, that the language in subparagraph (ii) is vague, and that the Commission has never clearly articulated the meaning of the phrase "unethical or improper professional conduct" with reference to non-specific auditing and accounting standards. They urge that since the application of accounting and auditing standards to unique factual circumstances requires the subjective exercise of professional judgment, when this judgment is exercised in good faith, even erroneously, they cannot be the basis for an adverse finding under subparagraph (ii).

None of these arguments relates to the fact that the conduct of the auditors, whether through negligence, good faith, incompetence or ignorance, may subject accountants to the discipline of subparagraph (ii) in order to preserve thereby the

integrity of the Commission's processes.[59/]

These contentions by respondents are not persuasive and should be rejected. Accounting and auditing standards do exist in the pronouncements of AICPA, and in the setting out of auditing standards and accounting principles in the decisions of the Commission. As was stated in Carter:

> At the same time, however, we perceive no unfairness whatsoever in holding those professionals who practice before us to generally recognized norms of professional conduct, whether or not such norms had previously been explicitly adopted or endorsed by the Commission. To do so upsets no justifiable expectations, since the professional is already subject to those norms. (page 508 of 47 S.E.C.).

Under all of the circumstances hereinbefore described it is concluded that the unqualified signing of the 1980 and 1981 Surgical's financial statements by E&W constituted a violation of the GAAS requirements and improper professional conduct under the provisions of Rule 2(e)(1)(ii) with respect to the respondents herein. The auditors failed to plan appropriate procedures, failed to obtain sufficient competent evidential matter, failed to recognize and deal appropriately with accounting issues that arose during the audits, failed to exercise due care in the execution of the audits, failed to maintain the proper level of professional skepticism, and failed to resolve the serious question of client integrity before certifying the 1981 financial statements.

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59/ These factors, however, are to be considered in assessing the sanctions to be imposed.

The auditors unduly relied on the representation of Surgical's management with respect to matters of major significance in the audit. SAS 19 states that:

> "representations from management are part of the evidential matter the independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for his opinion on the financial statements".

Without being repetitious of what has been stated hereinbefore, it is concluded that the auditors did not perform the necessary audit procedures to confirm the representations of management.

Respondents assert as a defense that they have been the victims of Surgical and Barden managements' fraud and deception, particularly with respect to the premium billings arrangements. That they were deliberately deceived in clear. Such deception however, did not relieve them of their responsibility to perform audits in conformity with GAAS and it does not matter that the accountant had been intentionally deceived by the party being audited. See Matter of S.D. Leidesdorf & Company, 46 S.E.C. 776 (1977) and Matter of Ernst and Ernst, 46 S.E.C., 1234, 1272 (1978), although the fact that auditors are deliberately deceived by management may be viewed as a mitigating factor, particularly in assessing a sanction. But such deception does not relieve the auditors of their responsibility to perform audits in conformity with GAAS (see Ernst & Ernst, supra). In fact, had the auditors properly conducted such routine audit procedures as following up on confirmation exceptions, they might well have discovered

sooner Surgical's fraudulent practices regarding the vendor tooling purchase order scheme.

Responsibility of E&W

It has long been held that an accounting firm consisting of many partners shares responsibility and becomes answerable under Rule 2(e) for its audit failures merely by virtue of the fact that the firm's name was signed to the audit reports. In Ernst & Ernst, supra, at page 1271, the Commission stated:

> "* * * we note that we have consistently held that where, as here, a firm of public accountants permits a report or certificate to be executed in its name, it will be held responsible therefor."

The doctrine was reaffirmed in Matter of Touche Ross & Company, 45 S.E.C. 469, 477 (1974), which adverted to another relevant basis for firm responsibility namely, the involvement in this case of the "working group" made up of other partners and officials of E&W, as is customary and expected of a national accounting firm. 60/

The working group, consisting of E&W partners all the way up to the top level including the co-chairman, were participating in the outcome of the audit particularly as it related to the Lacey/Barden premium billings matter. E&W's entire audit review structure including the working group and the independent review

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60/ In view of the clear and unequivocal language set forth in Ernst & Ernst and in Touche Ross, there appears to be no need to discuss common law partnership principles relating to the liability of the partnership entity for acts committed by any of the partners acting within the scope of their express or implied authority.

partners failed to detect and correct the obvious failures in the field work summarized hereinbefore.

Respondents dispute responsibility on the part of the firm arising out of the actions of a "handful of partners", out of the many partners in the firm, who participated to some degree in the planning and performance of audit procedures and in the review of the conclusions reached and recommendations made by the Surgical engagement partner. In support of its position, respondents cite Touche Ross, supra, in note 21 at page 582 of 609 F.2d. However, in note 21, the Second Circuit clearly states that no such issue was raised in that proceeding.[61/]

Respondents assert that the Commission itself has since retreated from the position expressed in Ernst & Ernst, supra and now requires more than merely affixing the auditors' name as a basis for partnership responsibility. They point specifically to the decisions in Matter of Keating, Nuething and Klekamp, 47 S.E.C. 95 (1979) ("KNK"); and Matter of Lester Witte & Co., 47 S.E.C. 409 (1981). Neither opinion, however, is authority to alter the conclusion holding the firm of E&W responsible for the actions of its partners.

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61/ Specifically, the Second Circuit stated:

> "Nothing in the complaint, or the District Court proceedings, or the briefs and oral argument before us purports to raise the question of the extent to which the Commission has the power, in a disciplinary action, to hold Touche Ross and its 525 partners vicariously liable to the extent of permanent revocation of the right to practice for the acts of its erstwhile partners".

KNK was a small law firm consisting of 11 partners which filed various reports with the Commission on behalf of its principal client which accounted for some 50 to 80 percent of its billings. Almost every member of the firm was aware of one or more of the material transactions by the client as to which disclosure was deemed by the Commission to have been inadequate or misleading. The Commission found that because the firm's procedures did not have a system to assure that the information gained by its individual members was communicated to persons responsible for preparing the various reports to the Commission, his small law firm became responsible for its failure to carry out its professional responsibilities on behalf of virtually its sole client. This is clearly not the case herein.

In Witte, the Commission stated that the fact that the accountant-partnership put its name on the report or certification filed with it "will be a factor in deciding whether to take action against the firm for the conduct of its partners and employees or for the deficiencies of the audit" (at page 422) (underlining added).

Witte goes on to say that at a minimum, the Commission expects each firm practicing before it to adopt, implement and maintain a thorough system of quality control policies and procedures to provide it with reasonable assurance that it is conforming with GAAP in its audit engagements; to insure that its auditors are supervised adequately; and to review periodically its entire auditing process to see that it functions effectively.

With respect to the Surgical audit and all its ramifications, it is concluded that E&W does not meet the tests laid down in Witte. Specifically, despite the audit review by Hufferd and Hammond, there was a failure to discover deficiencies that were readily apparent, such as the undisclosed change in accounting principles, the improper recognition of revenue on sales to salespeople, the inadequate planning and subsequent follow up of the leased and loaned confirmations, the absence of audit evidence supporting the reasonableness of the 10,000 parts policy, etc. The firm must share responsibility for these and other audit failures.

Most significantly was the appointment and activities of the consulting group which included not only the auditors involved in the Barden and Surgical audits and their supervisors but a broad section of supervisory and policy-making members in New York as well as in the Cleveland national office. There were lines of communication by which they and everyone involved was made aware of the facts. Thus, the action of this group in so readily reversing the original evaluation that indicated there was over a million dollars in premium billings for product improperly designated as tooling evidences a failure to meet minimum standards, even if the placing of the partnership name on the Surgical financial statements be considered a "factor" in determining the firm's responsibility.

Responsibility of Ferrante

Respondents argue that Ferrante as the audit partner had relatively little involvement with the issues raised in this proceeding, that he was merely one member of a full complement of experienced professionals, each of whom had specific responsibilities and duties commensurate with his or her experience, and that the team functioned as a whole with the primary responsibility being that of Hope as the engagement partner calling all the shots. It is asserted that Ferrante's role was subordinate to that of Hope with respect to each of the substantive issues.

Respondents contend that Ferrante's involvement with the all important Barden-Lacey issue was very limited and that it was Hope who was directing what should be done, including the decision to defer taking any further action with respect to the PMP and Tenax purchase orders. Finally, it was Hope who recommended to the working group that E&W should accept Surgical's accounting treatment of the premium billings.

A good summary of Ferrante's activities in connection with the audits herein involved is set forth in respondents' proposed findings of fact (Section III, findings 16-22), as follows:

> "16. When Ferrante was first assigned to the Surgical audit in 1977, he took a number of steps to learn about Surgical in order to serve knowledgeably as manager of the audit staff. These steps included discussing the company with the predecessor-manager on the engagement as well as the accountant who was junior to him; discussing the company, its products and personnel at length with Hope; discussing the company's tax position with the Ernst & Whinney tax specialists who had worked on the engagement; discussing with Ernst & Whinney

health care specialist Surgical's position in the industry and various health care reimbursement systems that might affect Surgical's revenues; reviewing the prior year's SEC report on Form 10-K; reviewing the prior year's workpapers; taking a number of tours to observe directly Surgical's physical plant, offices, and laboratories; and attending demonstrations of Surgical's products on foam rubber models of human organs as well as on live tissue in the laboratory. (Ferrante 6598-99).

* * *

20. As the partners on the 1980 and 1981 Surgical engagements, Hope and Ferrante brought to bear extensive knowledge of the company, its business, operations, and personnel, and the industry of which it was a part.

* * *

22. The collective audit experience of Hope and Ferrante, as well as their knowledge of the company's operations, its product and management, put them in a excellent position to supervise the planning and performance of the Surgical audits, to evaluate the evidence developed, and to form a professional opinion as to the fairness of presentation of Surgical's 1980 and 1981 financial statements."

Although Ferrante's participation in the Lacey-Barden matter was limited, it was not so with respect to the other auditing failures found herein. In respondents' proposed findings of fact (Section III, finding 14) they describe a meeting on February 2, 1982 at which Hope and Ferrante met with Hufferd and Hammond (the reviewing partners) in E&W's White Plains office "to discuss all significant auditing, accounting, and disclosure issues that had arisen during the 1981 audit, including the audit support for an accounting with respect to, the Blackman litigation costs, the capitalization of tooling qualification costs, and Surgical's 1981 changes in estimates. After reviewing the audit evidence and discussing it with Hope and Ferrante, Hufferd and Hammond concurred in the auditors' conclusions". (Underlining added).

It is clear from the foregoing that Ferrante was no mere innocent completely subject to the direction of his superiors, particularly Hope. Given his duties and activities in connection with the audits in 1980 and 1981 it is difficult to believe that he had no say or influence over the audit steps and decisions to be made, even in the Barden/Lacey matter. In both 1980 and 1981, he shared responsibility with Hope for the audit planning and the day-to-day conduct of the audits. As an audit partner, he bears some of the responsibility for the shortcomings of E&W in connection with these audits as well as for his own failure to observe the numerous "red flags" that appeared and to observe GAAS and GAAP in connection therewith. In these respects, he along with E&W are found to have engaged in improper professional conduct.

## Public Interest

It having been determined that respondents engaged in improper professional conduct within the meaning of Rule 2(e)(1)(ii) of the Commission's Rules of Practice, it becomes necessary to consider what disciplinary action is appropriate in the public interest.

It has been said that "assessing the nature of the remedial action that the public interest calls for under the concrete circumstances of a particular case is a serious and an onerous task. Many factors (some of them more easily felt than

articulated) are worthy of consideration". Matter of International Shareholders Services Corp., 46 S.E.C. 378, 386 (n. 19) (1976).

In imposing administrative sanctions, the Commission may take into account such factors as "the egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations". Steadman v. S.E.C., 603 F.2d 1126, 1140 (5th Cir. 1979), aff'd. on other grounds, 450 U.S. 91, (1981). This case also tells us that when the agency seeks to impose drastic disciplinary sanctions, such as a bar from practice, it has the burden of demonstrating that less drastic sanctions will not suffice to protect the public interest (P. 1129).

The Commission relies very heavily on the competence and integrity of the independent auditors who practice before it in order to fulfill its statutory responsibilities. This reliance is in recognition of the unique responsibility independent auditors have and their role in preserving the integrity of the securities markets. The independent auditor assumes a public responsibility transcending any employment relationship with the client, and breaches of professional responsibility jeopardize the achievement of the objectives of the securities laws and can

inflict great damage on public investors (U.S. v. Arthur Young & Co., 465 U.S. 805, 817-18 (1983) and Touche Ross, supra, at page 581 of 609 F.2d).

Ernst & Whinney

OCA seeks a sanction suspending the firm from accepting new SEC clients for a period of 180 days, asserting that this would meet the need for a sufficient deterrent to protect the Commission's processes from the future impact of improper professional conduct. OCA accuses E&W of "recidivist" tendencies, based upon the Commission having once before sanctioned its immediate predecessor for committing acts similar to those found to have been committed in this proceeding. (Matter of Ernst & Ernst, et al., supra.

In Ernst & Ernst, the Commission reversed the sanction in the initial decision of an administrative law judge recommending that the firm be barred from accepting new SEC clients subject to a lifting of that restriction after six months upon an appropriate showing. The Commission felt that "with respect to E&E as a firm, the record does not reflect an involvement sufficient to warrant a sanction greater than censure" (at page 1273 of 46 S.E.C.).

OCA cites in support of the recommended sanction similar ones in other Commission proceedings. Virtually all of these other proceedings embraced large or major accounting firms and, the sanctions imposed were based upon negotiated settlements, except in Ernst & Ernst. As for sanctions imposed in other

cases, the remedial action which is appropriate in the public interest depends on the facts and circumstances of each particular case and cannot be precisely determined by comparison with that taken in other proceedings. See Collins Securities Corp., 46 S.E.C. 20, 42 (1975). Moreover, in settlement cases, pragmatic considerations such as avoidance of time -and manpower -consuming adversary proceedings are taken into account. Matter of Williams, 48 S.E.C. 122, 124 (1985).

As respondents point out, to impose a severe sanction upon E&W of the kind recommended by OCA would affect many accountants in the numerous offices maintained by E&W none of whom has been involved in the derelictions found to exist in connection with the Surgical and the Barden audits. In fact, it is doubtful that the partners and the staff presently employed by E&W are, with some few exceptions, the same individuals who were so employed at the time of the 1980 and 1981 audits of Surgical. It is also true that although E&W's White Plains practice office was primarily responsible for the audits in question, E&W partners from other offices, including partners assigned to the New York regional office, also participated in and were consulted with respect to the principal aspects of the audits. On the other hand, in view of the fact that E&W had once before been censured after a full hearing for conduct which in many respects parallels that found herein (Ernst & Ernst, supra) would indicate that a sanction of somewhat greater severity than a censure is in order.

Moreover, by its published decisions in the Hope settlement

heretofore cited, and in the respective injunctive proceedings against Barden and Surgical, and certain of their officers (See footnotes 4 and 5, herein), the Commission has already made abundantly clear for guidance of the accounting profession the derelictions found to have occurred in connection with the 1980 and 1981 Surgical audits, the reasons for the improprieties and an outline for future guidance.

Under all of the circumstances it is concluded that an appropriate sanction against E&W herein would be limited to its practice offices within its New York region (including the White Plains office) as they existed on March 1, 1982, and with respect to these offices, that they be barred for a period of 45 days from engaging in new business involving Commission practice.

In recommending the foregoing sanction, it has not been overlooked that some of the mistakes in judgment committed by E&W were as a result of client deception. However, reliance upon management's representations or fraudulent conduct does not excuse the auditors from proceeding with the requirements of GAAS which, in many cases, might very well have uncovered fraud. Moreover, E&W's "judgment" calls on the accounting matters embraced in this proceeding served to assist Surgical's management in overstating profits to a material degree, for whatever purpose motivated management.

Michael L. Ferrante

OCA would assign much of the blame for E&W's failures during the 1980 and 1981 audits on Ferrante in his capacity as audit

manager. Specifically, reference is made to his failure to react to the "red flags" apparent in the changing audit environment, and by his inappropriate reliance on management representations. OCA thus recommends that Ferrante be permanently suspended from practicing or appearing before the Commission, with the further recommendation that after three years, he be allowed to apply to the Commission to resume practice before it.

OCA charges Ferrante, as audit partner, with primary responsibility for supervising and conducting the day-to-day audit operations and that he was the single most important person involved with the audit. Although as seen before Ferrante was guilty of improper professional conduct, in most instances he was subject to the authority of Hope as well as the control group set up by E&W to resolve the issues of client integrity. It does not appear that he had, or exercised, the authority to make policy decisions, or to direct the conduct of the audit. With respect to the single most important issue herein, that of the premium billing and related questions of client integrity, he concededly had very little part to play.

In participating in the planning and execution of the 1980 and 1981 audits, Ferrante was one member of a full complement of experienced professionals. Together, the team functioned as a whole under the ultimate authority of Hope and William Burke as the partners in charge of the respective Surgical and Barden engagements. In fact, it was Hope who was responsible for having E&W make a complete reversal of the initial (and correct)

understanding of the so-called "premium billings", by preparing recommendations in his March 17, 1982 memorandum based upon unverified and unsupported expenditures for supposedly Barden tool work. Despite this primary part played by Hope, he received only a censure in his settlement with the OCA and the Commission.

Even though it has been noted that sanctions imposed by way of settlement should usually not be precedential in determining the sanction to be imposed after a hearing on the merits in another matter, it would indeed be incongruous for the individual who was the leader at every step of the way to escape with a censure while the one who was subordinate at every step of the way be barred from practice before the Commission.[62/]

The OCA has failed to establish that the public interest requires the imposition of so severe a penalty or to justify why a lesser sanction would not do. (See Steadman, supra). While the record establishes that Ferrante did engage in improper professional practices, he did so as a subordinate of Hope and of every partner making up the working group. He has been an accountant with many years of professional experience having an unblemished record. Having observed his demeanor and examined his background, there is no reason to believe that he will not

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62/ True, the Commission relied upon Hope's representation that he had not practiced before the Commission as an independent public accountant since March 1983, and has no present intention to do so. However, there is nothing in the settlement offer to prevent him from changing his mind at any time and without further ado to resume such practice.

learn from the findings of the Commission in this matter or that he would commit similar offenses in the future.

Under all of the circumstances, it is concluded that the public interest will be satisfied by censuring respondent Ferrante.

## Miscellaneous Matters

At the conclusion of the evidentiary hearing herein, counsel for respondents moved for oral argument following the submission of post-hearing pleadings. I reserved decision on the motion. Thereafter, proposed findings of fact and conclusions of law together with initial supporting briefs were filed by each side simultaneously, followed by simultaneous filings of extensive reply briefs. Additionally, counsel for respondents, with permission, filed supplemental proposed findings and conclusions of law to which the counsel for OCA was permitted to reply.

As noted at the outset (page 2) herein, the post-hearing pleadings filed were very extensive, very thorough and very detailed. For example, OCA filed almost 3,000 proposed findings of fact and conclusions of law and those of respondents equalled almost the same number. Post-hearing memoranda filed on behalf of the OCA totalled some 370 pages; those on behalf of respondents about 580 pages.

It is felt that all of the issues have been thoroughly briefed, and that no useful purpose would be served by granting

oral argument, Accordingly, the motion for oral argument is denied.

As noted heretofore, four expert witnesses testified on behalf of OCA while respondents called but one. All of these experts are highly qualified individuals and among the leaders in their profession. In many if not most instances there was no conflict in their testimony, particularly with respect to GAAP and GAAS requirements.

Although no specific reference to the testimony of these experts is made in this decision, I have given careful consideration to their testimony and to the opinions expressed therein, and have incorporated my own judgment in the findings and conclusions herein. I do not deem it necessary to discuss such testimony at length. 63/

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63/ The experts for OCA included William R. Kinney who has had many years experience as a professor of accounting at various universities; Lee J. Seidler, a managing director of an investment banking firm, who also has had many years experience as a professor of auditing at New York University and had a number of years working for a major accounting firm; Robert Sack who, at the time of the hearing, was the chief accountant of the Division of Enforcement of this Commission and had worked for many years with a large accounting firm, rising from staff accountant to partner, including such auditing positions as Director of the Audit Department with a staff of about 100; and Kenneth W. Stringer, who also had many years experience with a major accounting firm. Robert L. May, the sole expert called by respondents, had many years of experience with an accounting firm where he held many responsible positions, including services as an engagement partner on audits for major American corporations. May also held many positions with the AICPA and was involved with the formulation of many of the Standards (SAS) which were binding on the profession with respect to the conduct of audits.

Each side in this proceeding has challenged the credibility of some of the witnesses for the other based upon such allegations as prior inconsistent statements within their own testimony in this proceeding or at other times, or with that of other witnesses, their motivations and biases. All such conflicts have been resolved in the findings set forth in this initial decision to the extent that such testimony has otherwise been supported by oral or documentary evidence in this record.

In their briefs and arguments, the parties have requested me to make findings of fact and have advanced arguments in support of their respective positions other than those heretofore set forth. All such arguments have been fully considered and I conclude that they are without merit, or that further discussion is unnecessary in view of the findings herein.

## ORDER

For the foregoing reasons and pursuant to Rule 2(e) of the Commission's Rules of Practice (17 C.F.R. §201.1(e)):

**IT IS ORDERED** that respondent **MICHAEL L. FERRANTE** be censured.

**IT IS FURTHER ORDERED** with respect to respondent **ERNST AND WHINNEY** that its practice offices within the jurisdiction of the New York region of E&W, including the White Plains practice office, maintained as of March 1, 1982, be barred from accepting or undertaking any new professional engagement which can be expected to result in filings, submissions or certifications with

the Commission for a period of 45 days from the effective date of this order. Nothing herein shall be construed to affect the right or obligation of E&W's New York Regional practice offices to continue to perform their normal functions and services for existing clients or engagements.

This order shall become effective in accordance with and subject to the provisions of Rule 17(f) of the Rules of Practice.

Pursuant to Rule 17(f), this initial decision shall become the final decision of the Commission as to each party who has not, within fifteen days after service of this initial decision upon him, filed a petition for review of this initial decision pursuant to Rule 17(b), unless the Commission, pursuant to Rule 17(c), determines on its own initiative to review this initial decision as to a party. 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.

Jerome K. Soffer
Administrative Law Judge

Washington, D.C.
June 28, 1990