



The Securities and Exchange Commission (Commission) instituted this proceeding on September 30, 1993, pursuant to Rule 2(e)(1) of the Commission's Rules of Practice (17 CFR 201.2). I conducted prehearing conferences in November 1993 and in February 1994. In March 1994, I concluded seven days of hearing. The record included testimony from nine witnesses and approximately 140 exhibits - forty some from the Commission's Office of the Chief Accountant (OCA) and approximately one hundred from Respondents.

The case is hotly contested. The OCA filed Proposed Findings of Fact and Conclusions of Law and a Post-Trial Brief, 63 and 44 pages, respectively, on May 20, 1994. Respondents filed Proposed Findings of Fact and Conclusions of Law, a Post-Trial Brief, and a Response to the Proposed Findings of Fact and Conclusions of Law of OCA, 60, 68, and 134 pages, respectively, on June 24 and 25, 1994. The OCA filed a Reply to Respondents' Post-Trial Submissions and a Counter Statement to Respondents' Proposed Findings of Fact and Conclusions of Law, 41 and 92 pages, respectively, on July 25, 1994. There are several pending motions.

## MOTIONS

### 1. Respondents' Motion to Dismiss the Proceeding, 1/

I deny the motion because the prevailing case law is that 28 U.S.C. § 2462 does not apply to administrative proceedings such as this one where the Commission's purpose is remedial. Howard F. Rubin, Exchange Act Release No.

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1/ Respondents' Motion dated April 12, 1994 was accompanied by a Brief in Support, the OCA filed in opposition on May 27, 1994, and Respondents filed a Reply Brief in Support on July 1, 1994.

35179 (December 30, 1994). Second, as is explained later in this decision, a violation of Rule 2(e) does not require a finding that a respondent acted with scienter, and finally, Respondents' argument that the allegations at issue do not constitute a sufficient threat to the Commission's processes to warrant imposition of any sanction requires a review of the evidence and will be considered in the public interest section of this decision.

2. OCA's Motion to Strike Respondents' Counter-Designations of Investigative Testimony 2/

I deny OCA's motion. Since I allowed OCA to introduce major portions of the investigative record in evidence, I see no reason to strike what Respondents' want in the record just because it is a statement by an attorney on behalf of Mr. Dentinger, and Mr. Dentinger's statements on other points are relevant to the issues. Pages 238 and 239 involve missing manual checks, a subject of a great deal of testimony. Pages 368 and 369, involve what amount the auditors considered to be a material error. Pages 406-13 relate to Respondents' claim that others at ILC in addition to Mr. Montoya provided them with false information. All of these subjects are relevant to the issues.

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2/ OCA filed a Motion to Strike on May 23, 1994, Respondents filed in opposition on May 26, 1994, and OCA filed a Reply to Respondents' Opposition on May 27, 1994.

3. OCA's Motion to Admit OCA Exhibit 41 3/

OCA Exhibit 41 is a summary exhibit based on materials in evidence. It compares information about the first 200 checks from a check log (Exhibit 27 at 5142), with information from bank statements (Exhibits 10 and 10A), and a general ledger (Exhibits 7A and 7B). OCA has provided with its motion, a document which states the page number of the exhibit which is the source of the information on Exhibit 41. I considered the admissibility of Exhibit 41 at the hearing but held off ruling based on Respondents' claims that the exhibit contained erroneous information. (Tr. 1085-95, 1106, 1615-17)

I grant the motion and allow Exhibit 41 in evidence. Respondents no longer claim that the exhibit is misleading. I reject their claims that it should be disallowed because one of the underlying exhibits is not a workpaper from the audit, that a summary is not necessary to the record, and that OCA's motive in offering the exhibit is speculative. None of these reasons are persuasive.

ISSUE

Arthur Young & Company (Arthur Young) issued an audit report which included an unqualified auditor's opinion on the financial statements for fiscal 1986 for ILC Technology (ILC). 4/ ILC's fiscal year ends on September 30 so

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3/ The motion was filed on July 26, 1994, Respondents filed in opposition on August 3, 1994, and OCA filed a Reply to Respondents' Opposition on August 5, 1994.

4/ Arthur Young & Co. merged with Ernst and Ernst in 1989 to form the firm of Ernst & Young. (Tr. 1345)

that the audit period at issue was from October 1, 1985 through September 30, 1986. The report, issued December 10, 1986, stated that the examination had been conducted in accordance with generally accepted auditing standards (GAAS) 5/ and that the financial statements presented ILC's financial position in accordance with generally accepted accounting principles (GAAP). On January 13, 1987, ILC included this clean or unqualified report in its annual report on Form 10-K with the Commission. (Exhibit 2)

Less than six weeks later, on February 26, 1987, Raymond Montoya, ILC's Vice President Finance, was arrested and charged with grand theft and embezzlement. As a result of Mr. Montoya's embezzlement, ILC reported an aggregate \$4.366 million as the net before-tax decrease in income resulting "from restatement for the correction of fictitious inventory and fixed assets and accounting irregularities" in its report for the quarter ended March 31, 1987 on Form 10-Q filed on or about July 6, 1987. (Exhibit 4, 6) This amount included estimated embezzlement losses of \$2.8 million. (Exhibit 4, 5) 6/

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5/ The American Institute of Certified Public Accountants (AICPA) adopted ten GAAS which are categorized into General Standards, Field Work Standards, and Reporting Standards. The AICPA has issued Statements on Auditing Standards (SAS) which amplify and interpret the GAAS. The term GAAS includes the ten GAAS and the forty nine SAS which were in effect in this time period. SAS 1 requires that an audit report state whether the financial statements are presented in accordance with GAAP.

6/ From the exhibit it appears that the aggregate number encompasses fiscal 1985, 1986, and the first half of fiscal 1987. Work done after the embezzlement revealed approximately \$4.3 million in unauthorized cash disbursements of which \$2.8 million were directly identified with Mr. Montoya who wrote manual checks that were posted to a fixed asset or inventory account at UDT. (Tr. 134-35, 508-09)

On or about August 11, 1987, ILC filed to amend its 1986 annual report, Amendment No. 1 on Form 8, by restating its financial condition to reflect embezzlement losses of \$600,000 and \$1.6 million in fiscal years 1985 and 1986, respectively. (Exhibit 6, 17) 7/

The issue is whether or not the Respondents engaged in improper professional conduct in connection with a 1986 audit of ILC. As pertinent to this proceeding, Rule 2(e)(1)(ii) provides 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 unethical or improper professional conduct.

### FINDINGS OF FACT

My findings and conclusions are based on the record and my observations of the witnesses' demeanor. I applied preponderance of the evidence as the applicable standard of proof.

#### Respondents

Angelo Danna (Mr. Danna), a certified public accountant licensed in California, joined Arthur Young in 1970, the same year he graduated from Santa Clara University with a degree in accounting. He became a partner at Arthur Young in 1982 and began working on the ILC account in 1983. ILC was one of the 15 or so public companies that Mr. Danna counted as clients. Mr. Danna

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7/ Respondents acknowledge that ILC's financial statements included in its 10-K filing did not present fairly ILC's consolidated financial position. (Tr. 1222)

was the Arthur Young engagement partner on ILC's audits in 1984, 1985, and 1986. As such, he had overall responsibility for planning, supervising, and reviewing the work performed in connection with the audit to assure compliance with all professional standards, and that there was an appropriate basis for the opinion that would be rendered in connection with the financial statements.

Mark Dentinger (Mr. Dentinger), a certified public accountant licensed in California, graduated from St. Mary's College in California, and joined Arthur Young in 1981. Mr. Dentinger was Arthur Young's top field person in ILC's 1985 audit. In 1986 he participated in Arthur Young's quarterly consultations with ILC, and was the manager who did most of the review on the 1986 expense review described later. (Tr. 1354-56, 1203-04, 1390-91) Mr. Dentinger served as one of two audit managers on ILC's 1986 audit. As such, Mr. Dentinger was responsible for planning the audit, supervising, and reviewing work of the field auditors on a day-to-day basis. (Tr. 719-20)

### ILC Technology

ILC, located in northern California at Sunnyvale, designs, develops, manufactures, and markets high performance light sources and light sensor products used in the electro-optics industry principally in industrial, military, medical, and aerospace applications. The company began in 1967 and went public in 1983. In 1986, ILC had total assets of about \$21 million and total revenues of about \$27 million. (Exhibit 6, 11) Until 1986, it had operated at a profit each year since 1970.

In 1986 ILC operated two divisions. One of these, UDT in southern California at Hawthorne accounted for about half of ILC's revenues. 8/ The embezzlement occurred at UDT. ILC hired Mr. Montoya as UDT controller in 1984. He falsely represented that he was a citizen and a certified public accountant who had worked for Arthur Young. In October 1985, Mr. Montoya was elected acting ILC Treasurer, Secretary, and Chief Financial Officer pending a search for a new CFO. (Tr. 148) Mr. Montoya became ILC Vice President Finance in early 1986, and ILC designated him as the auditors' primary contact at the company for the 1986 audit. (Tr. 98, 111)

#### 1986 Audit - Background

ILC had been an Arthur Young client since the early 1970s. (Tr. 138) Arthur Young's San Jose office performed most audits of the many high tech firms, like ILC, located in the Silicon Valley. All the auditors who worked on the ILC 1986 audit were based at Arthur Young's San Jose office. Year-end field work for the audit began in mid-November and was completed on December 10, 1986 when the auditors issued their report on the financials.

In addition to the audit, Mr. Danna and Mr. Dentinger worked on quarterly reviews and two additional accounting engagements for ILC in 1986.

**Accounting Engagement Number One - Third Quarter Review** Following its customary practice, the spring meeting of ILC's Audit Committee dealt with the

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8/ The other division was the Sensor Technology Division which ILC acquired on April 1, 1986. (Exhibit 1, 6)



annual audit. On May 21, 1986, ILC's Audit Committee held its annual pre-audit meeting with Mr. Danna and Mr. Miller representing Arthur Young. The committee was quite upset that the auditors had not warned the committee to expect a very material inventory write-off in the third quarter. (Tr. 346-47, 1229-30; Exhibit 28, 8445) ILC's Form 10-Q for the quarter ended June 30, 1986, filed August 15, 1986, reported a net loss for the period which "includes the effect of a special expense charge of \$1,450,000, before taxes, relating primarily to the Company's Aerospace inventories and receivables due to the wind down of the Aerospace business of the company." (Exhibit 1, 6)

At the May 21, 1986 meeting, Mr. Danna as head of the engagement team told the Board either that ILC was not bothering to reconcile the cash accounts (bank statements) or that the auditors were not able to reconcile them, and that Arthur Young would expand the procedural review of the 1986 audit to determine whether or not systems were in place that allowed reliance on the accounting. (Tr. 341-47) 9/

The Audit Committee retained Arthur Young to conduct a review to help it understand the source of the inventory write-off problem. (Tr. 338-40) ILC's Audit committee expressed concern that the auditors were "not on top of their numbers." (Tr. 347-48) It told Mr. Danna and Mr. Miller that it desired less

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9/ The Chairman of the Audit Committee was not clear how to interpret his notes of the meeting on May 21, 1986, which read, "They did audit cash account/could not reconcile." (Exhibit 36)

aggressive accounting, 10/ that it did not want any more surprises from the figures, and that the auditors had to make sure that the Board received accurate audited information. (Tr. 346-50)

**Accounting Engagement Number Two - Expense Review** On October 27, 1986, Mr. Montoya shocked Mr. Danna by alleging that Deepak Chopra, President and CEO of ILC, was using company funds for his personal use and was attempting to inflate inventory values at UDT to cover a \$2 million short fall between book values and priced out physical inventories at UDT and ILC. (Tr. 1137-38) Mr. Danna contacted senior people at Arthur Young, and Mr. Danna and senior Arthur Young people met with ILC's management and Audit Committee on October 29. At that meeting and on a phone call on October 31, ILC's Board and/or Audit Committee met with Mr. Danna and others from Arthur Young concerning two audit issues - inventory valuation, which the third quarter adjustment did not appear to have fully addressed, and Mr. Montoya's allegations of unauthorized disbursements and expenditures and inflated inventory values. (Tr. 368)

Mr. Chopra did not deny Mr. Montoya's claim that he had spent approximately \$8,000 in unauthorized expenditures. (Tr. 374) Mr. Chopra informed the audit committee who informed the auditors that he believed some costs were inappropriately recorded in fixed assets. (Tr. 372)

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10/ The Audit Committee wanted the auditors to be very conservative in valuing assets. (Tr. 347)

Mr. Montoya's charges against Mr. Chopra and Mr. Chopra's charge that Mr. Montoya had improperly capitalized expenses prompted ILC to retain Arthur Young to conduct a special expense review using agreed upon procedures while the 1986 audit was in progress. The principal members of the expense review team were auditors working on the audit. Mr. Danna was engagement partner and Mr. Dentinger was manager of the expense review. Work was completed in about two weeks, and the initial budget was \$20,000 to \$25,000. (Tr. 112, 1391) The expense review covered the period from approximately June through October 1986, the period when Mr. Chopra served as ILC President and CEO. (Tr. 568) The parties did not write down the terms of the expense review, and Arthur Young and ILC disagree over its terms. There is agreement that the auditors were to:

- (1) examine the expense reports, cash disbursements, unusual disbursements, nonroutine vendors, credit card statements, and payroll records of Mr. Chopra, Mr. Montoya, and Mr. Sorenson 11/,
- (2) "dig into inventory valuation and come up with correct year end valuation" (Tr. 368, 372), and
- (3) examine the fixed asset account.

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11/ Mr. Montoya only leveled accusations against Mr. Chopra, however, the Board and the Audit Committee broadened the scope of the inquiry to include Mr. Sorenson, President, Chair, and Chief Executive Officer from 1970 until he retired in June 1986, and Mr. Montoya.

The persuasive evidence is that the Board also directed the auditors to conduct "a comprehensive check review" which was to include manual and computer generated checks. (Tr. 377, 379, 382) The Audit Committee conveyed to Mr. Danna and others at Arthur Young its concerns about inventory valuation, adequacy of the reserve for obsolescence in inventory, proper level of inventory carrying costs, work in progress inventory levels, and whether there was some systematic problem of unauthorized expenditures or peculations. (Tr. 368-69)

Arthur Young's expense review did not find any material irregularities. However, ILC's Board lost confidence in Mr. Chopra and relieved him of his responsibilities at ILC in mid-November 1986. (Tr. 310) He returned to UDT as President.

The relationship of these special engagements and the audit has been a disputed issue. Contrary to Respondents' claims, the evidence is that Respondents relied in the audit on work they performed in the special expense review, and that they did gain information during these reviews which should have put them on their guard in the audit. 12/ (Tr. 1260-61; Respondents' Post Trial Brief, 4) Mr.

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12/ Respondents seem to argue that they can ignore the special expense review because it did not result in findings of a material nature. I disagree. Respondents knew after they signed off on the audit planning document but before they completed the field work, about accusations of improper conduct by top management at ILC and they had information from the work they performed in the special expense review. This information and experience should have caused them to exercise a high level of care and critical judgment in the conduct of the audit. Instead they seem to have had the opposite reaction, i.e., a lower degree of care and critical analysis were required in the audit because they had not found material wrongdoing by Mr. Chopra in the special expense review and Mr. Chopra would not be involved in the audit.

Danna states that the auditors did not rely on work done in the special expense review in their audit of the three accounts at issue - cash, fixed assets, and inventories. But he also admits that they might have done so in the area of errors and irregularities (Tr. 1263), and that "above and beyond the cash transaction testing that was done during the special expense review, it's true that we did not do any more cash transaction testing in the audit." (Tr. 1264-65) Also, he believed the auditors' review of the third quarter inventory write-off (Accounting Engagement No. One - Third Quarter Review) probably dropped the risk level for the inventory account. (Tr. 1120-21)

The workpapers from the special expense review are marked as the last volume of the 21 volumes of audit workpapers. (Exhibit 27) Mr. Danna's explanation that the workpapers from the special expense review and the quarterly review are with the audit materials by coincidence is suspect considering the other evidence which indicates that the auditors relied in the audit on the work they performed in the special expense review. (Tr. 1261-62)

### FINDINGS OF LAW

The Order Instituting Proceedings alleges that the Respondents violated GAAS with respect to the annual audit of ILC's consolidated financial statements for fiscal 1986 because they failed to (1) adequately plan and supervise the audit, (2) obtain sufficient competent evidence, (3) detect errors and irregularities, and (4) exercise due professional care.

Specifically the OCA alleges that Respondents did not conduct an audit in accordance with GAAS because:

1. they failed to adequately plan the audit with respect to the cash and fixed assets accounts; they failed to adequately plan or perform audit procedures to search for errors or irregularities with respect to the cash account; they failed to properly investigate potential errors or irregularities in the fixed assets account; and they failed to adequately plan the audit of the inventory account to search for errors or irregularities (First Standard of Field Work, SAS 1, SAS 16, SAS 22);
2. they failed to supervise the audit of the cash and fixed assets accounts, and Mr. Danna failed to supervise Mr. Dentinger with respect to the inventory account (SAS 1, SAS 22);
3. they failed to acquire sufficient competent audit evidence concerning cash disbursements, fixed assets, and inventory (First Standard of Field Work, SAS 1, SAS 31), and
4. they failed to exercise due professional care. (Third General Standard, SAS 1) (OCA's Post-trial Brief)

One of the lead cases in this area is David J. Checkosky, 50 S.E.C. 1180 (1992); Checkosky v. SEC, 23 F.3d 452 (D.C. Cir. 1994). In remanding the case to the Commission for more adequate explanation, Judge Silberman wrote for the reviewing court in Checkosky:

The Commission has variously indicated that different levels of mental culpability are needed to make out a 2(e)(1)(ii) violation by professionals (lawyers or auditors): simple negligence as the Commission privately held in Schulzetenberg; gross negligence

implied by the "so deficient" language of Haskins & Sells; recklessness hinted by the Commission in its opinion below; or willfulness or bad faith suggested by Logan and Carter. I think the Commission must chose its standard and forthrightly apply it to this case. (23 F.3d at 462)

I have applied a negligence standard, i. e., the failure to use such care as a reasonably prudent and careful person would use under similar circumstances; the doing of some act which a person of ordinary prudence would not have done under similar circumstances or failure to do what a person of ordinary prudence would have done under similar circumstances. (Black's Law Dictionary, 5th ed. (1979)). 13/ Auditors are persons who based on education, experience, and professional licenses hold themselves out as capable of performing a specialized service at a level which meets GAAS and GAAP.

Every profession must set high standards for the quality of its work because people who rely on that work are usually unable to judge its quality for themselves ... Auditing standards, in the broadest sense, are guidelines for performing professionally responsible audits... They set the minimum level of quality that auditors are expected, by their clients and the public, to achieve. (Montgomery's Accounting, 10th edition, College Version, 53)

When auditors fail to meet these minimum standards established by their peers they are negligent. Thousands of publicly held companies are required to file financial statements with the Commission under a regulatory process that has proven to be effective. For the process to work, the filings must conform to a

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13/ I consider that the terms negligence, simple negligence, and ordinary negligence have the same meaning. Gross negligence is very great negligence or the want of even slight care. It is a degree of negligence greater than that which constitutes ordinary negligence but is not equivalent to a wanton or willful wrong. American Law of Torts, §10.5.

clearly defined and generally accepted level of competence. That standard is the level of accepted professionalism which the accounting and auditing professions have set for themselves in the GAAS and GAAP. To do less is negligent because it does not fulfill the performance level required of a reasonably prudent and careful auditor. 14/

### 1. Planning and Procedures

Mr. Danna and Mr. Dentinger violated GAAS because they did not adequately plan the 1986 audit for the cash, fixed assets, and inventory accounts. Respondents failed to consider materially changed conditions that existed in 1986 which should have caused the auditors to apply a higher risk assessment than Respondents applied, and they did not modify the plan to search for errors and irregularities when events at ILC made it increasingly likely that they existed.

The first of the three GAAS Standards of Field Work specifies that the audit work is to be adequately planned. (Exhibit 46, AU §150.02) 15/ SAS 22

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14/ See Touche Ross & Co. v. SEC, 609 F.2d 570, 582 (2d Cir. 1979) holding that Rule 2(e) provides the Commission with the means to ensure that those professionals, on whom the Commission relies heavily in the performance of its statutory duties, perform their tasks diligently and with a reasonable degree of competence. The Commission requires the filing of audited financial statements in order to obviate the fear of loss from reliance on inaccurate information, thereby encouraging public investment in the nation's industries. United States v. Arthur Young & Co., 465 U.S. 805, 819 n.15 (1984)

### 15/ Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.

(continued...)



provides further guidance on the required standards for planning in accordance with GAAS. (Exhibit 46, AU §311.03 and .05) 16/

15/(...continued)

2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

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

16/ .03 Audit planning involves developing an overall strategy for the expected conduct and scope of the examination. The nature, extent, and timing of planning vary with the size and complexity of the entity, experience with the entity, and knowledge of the entity's business. In planning the examination, the auditor should consider, among other matters:

a. Matters relating to the entity's business and the industry in which it operates. (see paragraph .07)

b. The entity's accounting policies and procedures.

c. The methods used by the entity to process significant accounting information (see paragraph .09), including the use of service organizations, such as outside service centers.

d. Anticipated reliance on internal accounting controls. (See section 320.51 through .55.)

e. Preliminary judgment about materiality levels for audit purposes.

f. Financial statement items likely to require adjustment.

g. Conditions that may require extension or modification of audit tests, such as the possibility of material errors or irregularities or the existence of related party transactions.

h. The nature of reports expected to be rendered (for example, a report on consolidated or consolidating financial statements, reports on financial statements filed with the SEC, or special reports such as those on compliance with contractual provisions).

.05 In planning his [her] examination, the auditor should consider the nature, extent, and timing of work to be performed and should prepare a written audit program (or a set of written audit programs). An audit program aids in instructing assistants in the work to be done. It should set forth in reasonable detail the audit procedures that the auditor believes are necessary to accomplish  
(continued...)

A key element in planning is making an audit risk assessment for each account - the risk that the auditors would not detect a material error or irregularity in the financial statements - and planning for errors and irregularities. (Tr. 728, 1364-65) <sup>17/</sup> Arthur Young classified risk into three basic levels: low, moderate, or maximum; the level of risk assessment dictates the procedures to be performed. (Tr. 705, 1642) SAS 16 requires the auditor to plan the examination to search for errors (unintentional mistakes), or irregularities (intentional distortions) that would have a material effect on the financial statements. (Exhibit 46, AU §327.05) Ordinarily this search is accomplished by the performance of procedures that the auditor judges are appropriate in the circumstances to form an opinion on the financial statements.

The ILC audit had two planning documents: the audit engagement plan and the audit approach plan. The audit engagement plan is a sixteen page document, dated September 30, 1986, most of which describes ILC in general terms. Under Audit Scope it states that the auditors "will be alert to the possibility that errors, irregularities, and illegal acts exist." (Exhibit 203, 2350-65) Mr. Danna signed this document as Audit Partner and Mr. Dentinger signed as Audit Manager.

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16/(...continued)

the objectives of the examination. The form of the audit program and the extent of its detail will vary. In developing the program, the auditor should be guided by the results of his [her] planning considerations and procedures. As the examination progresses, changed conditions may make it necessary to modify planned audit procedures.

17/ AU §312 requires the assessment of audit risk to determine the nature, timing, and extent of auditing procedures in planning and performing any audit.

The audit approach plan is a more detailed document. (Tr. 1133; Exhibit 203, 2366-458) In September, Mr. Danna and Mr. Dentinger approved the audit approach plan (AAP) dated September 30, 1986 which assigned a low risk assessment for the cash and fixed assets accounts and a moderate risk assessment for the inventory account. (Exhibit 203, 2367) 18/ There is no evidence that Mr. Danna held any meetings to plan the 1986 audit, however, he did not consider it necessary to document all the audit steps performed, such as planning sessions. Mr. Danna characterized his informal conversations with the assigned auditors when he happened to meet them at the San Jose office as meetings that were part of the planning process. (Tr. 1126-27)

Planning goes on throughout the audit and auditors have a continuing responsibility to evaluate new information to determine whether it is necessary to modify the audit plan. (Tr. 711) An auditor is required to consider conditions that may require extension or modification of audit tests, such as the possibility of material errors or irregularities, and as the examination progresses changed conditions may make it necessary to modify planned audit procedures. Respondents did not modify their initial risk assessments in the three accounts at

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18/ The Division's expert, Mr. Tersigni, opined that Respondents should have assessed the risk in the cash account at the maximum level originally and they should have raised their low risk assessments in the fixed assets account and their moderate risk assessment in the inventory account to the maximum level after October 29, 1986. (Tr. 727, 748, 750, 995) Respondents' expert, Mr. Avondet, agreed with Respondents' risk assessments. (Tr. 1642)

issue - cash, fixed assets and inventory. The auditors completed the field work on December 10, 1986. (Tr. 1300) 19/

The following conditions required implementation of greater planning, a higher than low risk assessment in the cash and fixed assets accounts, and the use of more intensive, critical auditing procedures in the cash and fixed assets accounts in the 1986 audit than had occurred in previous audits:

(1) In its management letter on the 1985 audit, Arthur Young disclosed no material weakness but under the designation "conditions requiring attention" it noted that "improperly or untimely prepared reconciliations greatly increase the risk of misstatement or misappropriation of cash." (Exhibit 12, 103)

(2) Prior to 1986, ILC had had no significant inventory write-offs. (Tr. 417) In May 1986, ILC's Audit Committee expressed displeasure to Mr. Danna in unequivocal terms that the auditors had not warned them of the materially large third quarter inventory write-off. The Committee indicated to Mr. Danna that they wanted the auditors to use less aggressive accounting, they wanted no more surprises, and they wanted Arthur Young to make sure that the audit was comprehensive and thorough. (Tr. 347-58)

(3) In the summer of 1986, Mr. Sorenson who had been ILC's Chair, President, and CEO for sixteen years retired.

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19/ This is the date of Arthur Young's report on the audit. Technically field work continues until the auditors sign off on the financials. (Tr. 330)

(4) In October 1986, Mr. Montoya, the Vice President Finance, shocked Mr. Danna and others by accusing Mr. Chopra, the President and CEO, of unauthorized expenditures and directing the use of inflated inventory values.

(5) In October 1986, Mr. Chopra claimed that ILC faced a fixed asset exposure of about a quarter million dollars and questioned whether the CIP account was being used as a "dumping ground". (Exhibit 29) 20/

(6) In late October 1986, the chair of the Audit Committee exhorted the auditors to roll up their sleeves and work hard, and scrub the audit totally. Notes of the committee Chair taken at the Audit Committee meeting on October 29, 1986 state "AY [Arthur Young] told to scrub the audit totally. Mgmt. will cooperate in every regard." (emphasis in original) (Exhibit 37, 4) Mr. Miller's notes of the October 29 audit committee meeting show that the auditors were told to "scrub down audit." (Exhibit 29) Mr. Miller was the other audit manager.

(7) In November 1986, the Board relieved Mr. Chopra of his responsibilities even though Arthur Young's special review did not verify Mr. Montoya's claims. According to Mr. Baumgartner, an ILC founder who retired in the spring of 1985 as ILC's Executive Vice President and Chief Financial Officer, the Board lost confidence in Mr. Chopra because he could not explain why ILC's operating losses occurred. Mr. Baumgartner returned as ILC Chair and CEO in November 1986. (Tr. 51-62)

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20/ I am unaware that CIP is defined in the record.

(8) 1986 would be the first year since 1970 that ILC would not show an operating profit.

(9) In discussing the fourth quarter book-to-physical adjustment for inventory, a document from the audit workpapers marked "ILC Top Notes September 30, 1986" states:

4) All of the above factors [lower than expected profit margins, misreported yields by manufacturing department, and erroneous physical counts] and others were occurring in part due to the large turnover in the accounting departments during the year. This occurred at all levels from CFO/VP-finance down to the clerk level. (Exhibit 19, 2249)

ILC had one CFO, and ILC and UDT each had controllers. After Mr. Baumgartner retired as ILC's CFO, there was confusion in the CFO position beginning in the fall of 1985. A Mr. Laramen held the position briefly, Mr. Montoya held it on an acting basis, and a Mr. Chernoff occupied it for a while. (Tr. 148-49) Mr. Montoya assumed the CFO position on a permanent basis on January 8, 1986. (Tr. 149) ILC's Board minutes for December 10, 1986 show that the Board elected Mr. Baumgartner ILC's CFO and Secretary until such time as Mr. Montoya shall obtain the security clearance required by the Industrial Services Division of the Department of Defense at which time the Board intended to elect Mr. Montoya to that office. (Exhibit 287; Tr. 299-03) 21/ The Board

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21/ ILC's government contracts required a security clearance for its CFO. ILC's Board was told Mr. Montoya did not have a security clearance and needed to obtain it. (Tr. 429-35) ILC's Board did not know before the embezzlement was discovered that Mr. Montoya did not qualify for a security clearance because he was not a citizen. (Tr. 261) Mr. Baumgartner learned this fact in December 1986. (Tr. 230)

minutes were provided to the auditors during the audit. (Tr. 295) The audit workpapers indicate that the auditors reviewed these minutes. (Exhibit 18, 2161)

Mr. Ron Fredianelli, who had been ILC Controller for about five years left in November 1985 and returned to the position in August 1986. (Tr. 453) The auditors considered Mr. Fredianelli's return a plus but he had not been present for ten months of the audit period. Finally, it would appear that there was a change in the controller position at UDT when Mr. Montoya moved up to CFO at UDT.

(10) In early December 1986, Arthur Young, pursuant to its internal policies, classified the audit as a close monitoring engagement based on "the

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21/(...continued)

In late October or early November 1986 when he knew he was going to return as ILC Chair and CEO, Mr. Baumgartner, without telling anyone and using his own funds, ordered a private investigation of Mr. Montoya and Mr. Chopra, the Block Report. (Tr. 261, 248-49, 305) The written Block Report was not available until after Mr. Montoya was arrested. (Exhibit 427; Tr. 255-60, 310-11)

When he returned as ILC Chair and CEO on November 18, 1986, Mr. Baumgartner learned that in August 1986 ILC's attorney had received an investigator's report about Mr. Montoya, the Barnes Report. (Tr. 244; Exhibit 290) Mr. Baumgartner does not recall ILC's Board on which he served ever receiving the report. (Tr. 250) Mr. Baumgartner read the report in December 1986 or January 1987. (Tr. 244-45, 250) It disclosed that Mr. and Mrs. Montoya, who appeared to be wealthy, had filed personal bankruptcy in 1979, that Mr. Montoya was the defendant in several law suits, and that Mrs. Montoya had pled guilty to a felony. (Tr.254-55)

Neither Mr. Baumgartner nor ILC informed the auditors about these investigations.

material weakness in the system of internal accounting control and the substantial loss for the company for 1986". (Exhibit 19, 2220) 22/

I reject Respondents' contention that their activities in connection with the 1986 audit are being held to a higher standard based on hindsight applied to them after discovery of Mr. Montoya's embezzlement. The issue is whether they violated GAAS based on the information they had available at the time of the audit. The answer is yes. It appears that the audit plan for 1986 used the same procedures as prior years, and there is nothing to indicate that the audit plan approved in September was evaluated and/or modified despite these ten conditions and other indicators - for example, the failure to obtain an official check register for UDT's manual checks and the large number of UDT manual checks shown as

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22/ According to Arthur Young's manual, the designation "close monitoring engagement" indicated the possibility of significant audit risk and required the following additional procedures which it performed:

a determination that the staff and management assigned to the ILC engagement was appropriate,

a colleague partner was assigned to the engagement, however, he did not independently review the financial statements or workpapers, Mr. Danna reviewed all significant working papers in material financial statement areas and sensitive areas;

Mr. Dentinger or Mr. Miller reviewed all workpapers;

Mr. Danna and other high level Arthur Young personnel determined that there was no need for an independent review of prior years work papers.

According to Respondents' expert, Arthur Young considered whether the scope of the audit was appropriate and whether communications between Arthur Young and the ILC Board were sufficient. (Tr. 1650)



not used or void - that the risk of error in the 1986 audit with respect to the cash and fixed assets accounts was higher than it had been in prior years. (Tr. 762-63, 1009) 23/ Respondents' expert maintains that it was not necessary for Respondents to modify their audit plan and procedures because "their audit already was planned to search for errors and irregularities", and they did not waive any procedure that they would have done but for the fact that they did the special reviews. (Tr. 1634) The evidence does not support this conclusion. But in any event, I find that Respondents should have done more. Respondents violated GAAS by not ratcheting up their planning and audit procedures where circumstances indicated an increased possibility for errors or irregularities in the financials, and they did not do so.

As noted earlier, any reliance in the audit on work done in the special expense review was improper because the special engagements or reviews were separate and distinct occurrences from the audit. (See discussion on pages 11-12 and note 12) According to Mr. Danna, the review was conducted "as our professional standards contemplate that term, as opposed to an audit." (Tr. 1119)

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23/ According to Mr. Baumgartner, Mr. Dentinger told him at the conclusion of the special expense review that the auditors had accounted for all manual checks and Mr. Dentinger did not say the auditors did so by relying on Mr. Montoya. (Tr. 102)

Mr. Dentinger disagrees with Mr. Baumgartner's recollection. (Tr. 1595) He claims he told Mr. Baumgartner that the auditors had relied exclusively on Mr. Montoya "with respect to the Hawthorne [UDT] disbursement activity, and his representations on the completeness and accuracy of the check registers provided." (Tr. 1594-95)

In their pleadings, Respondents refer to the special expense review as a non-GAAS engagement, and "nonaudit engagements do not require that sufficient competent evidence be obtained to provide the relatively high level of assurance that an opinion based on an audit demands." (Montgomery's Accounting, 10th edition, College Version, 1075; Tr. 27-29; Respondents' Opposition to Admission of Exhibit 41, 1 n.1) In addition, the expense review was completed in only two weeks, an abbreviated period which limited the amount of analysis possible.

Cash account The objective of an audit planning strategy is to provide the auditors with the reasonable level of assurance that is required in an audit performed under GAAS for the purpose of forming an opinion on financial statements. (Montgomery's Accounting, 10th edition, College Version, 35) Mr. Danna's reasons do not justify assessing the risk of material errors and irregularities occurring in the cash account as low - the "routine, non-judgmental nature of the account, no significant issues noted in prior years, all accounts can be independently confirmed." (Exhibit 203, 2376) This generic rationale ignores the particular circumstances that existed at ILC in 1986.

Mr. Danna was wrong to discount the fact that ILC was not making timely bank reconciliations because he believed that many small to medium firms had this problem and it in and of itself was not a sufficient reason to raise the risk assessment. (Tr. 1155) ILC's untimely bank reconciliations were not the only event that signaled that the risk of error was greater than low, the minimum level. When Mr. Danna made this judgment, he knew that ILC faced its first operating

loss in sixteen years of operation, and that it had experienced a large turnover in the finance/accounting departments at both ILC and UDT. 24/

Moreover, as the engagement partner Mr. Danna was responsible for the management letter dated March 31, 1986, which Arthur Young sent to ILC at the conclusion of the 1985 audit. 25/ As I have noted, this management letter, which Mr. Dentinger drafted, found no material weakness but did cite as a condition that needed correction "Cash ... Improperly or untimely prepared reconciliations greatly increase the risk of misstatement or misappropriation of cash." (Exhibit 12) In the highly unusual circumstances that existed at ILC, the 1985 management letter was a strong reason for a higher risk assessment in planning the 1986 audit of cash.

Finally, it appears irreconcilable for Mr. Danna to think it was sufficiently important on May 21, 1986 to report to the Audit Committee that either ILC was not bothering to reconcile the cash accounts (bank statements) or that the auditors

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24/ Respondents acknowledge a turnover at ILC but not at UDT. However, UDT experienced significant turnover since Mr. Montoya, UDT's controller since 1984, became ILC's Chief Financial Officer in an acting capacity and then in January 1986 permanently. Presumably, someone filled his position at UDT. Mr. Chopra, UDT's President, left UDT in mid-1986 to become ILC's President and CEO, and then returned to UDT as President in November 1986.

25/ A management letter satisfies the requirement that auditors inform clients about material weaknesses in internal accounting control that come to their attention in the course of an audit. In practice, auditors often extend that communication to encompass weaknesses that do not meet the carefully defined materiality standard in the professional literature and weaknesses in internal administrative as well as internal accounting controls; suggestions for improving internal controls are also included. Montgomery's Auditing, 10th edition, College Version, at 25.

were not able to reconcile them, and in September to fix the risk of error or irregularity in the cash account as low. 26/

Respondents were wrong to assess the risk of cash as low in September, and they certainly were in error in not raising that risk in October when Mr. Montoya alleged that Mr. Chopra had used company funds for his personal use. (Exhibits 29, 37) I reject Mr. Danna's position that the allegations against Mr. Chopra should not have caused the auditors to raise the risk assessment and/or increase the testing in the cash account. (Tr. 1157-58) 27/ Arthur Young's manual notes that in many instances cash is over-audited, however, it also warns that "cash, due to its liquidity, is more vulnerable to misappropriation than most assets and thus, the potential for errors of audit importance is relatively great." (Exhibit 32, 323) ILC relieved Mr. Chopra of his position as head of the company because he could not explain why the company was losing money, this concern should have caused the auditors to exercise a heightened degree of care and concern.

I find that Mr. Danna and Mr. Dentinger violated GAAS because they failed to plan adequately or to perform audit procedures to search for errors or irregularities in the audit of the cash account. Respondents relied mainly on a

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26/ See note 9.

27/ Respondents' Findings of Fact, No. 165 states, "Nor did the allegations against Chopra require AY [Arthur Young] to change its risk assessment. ... the Chopra allegations had been resolved and determined to be immaterial in the special expense review..."

year-end bank reconciliation to audit the cash account, i. e., confirming ILC's bank balances with third parties (banks) and reconciling those amounts with ILC's books. This so called classic approach was insufficient in view of the conditions that existed prior to and during the audit which called for additional procedures to deal with the increased likelihood of errors and irregularities. Of the conditions listed earlier, the specific suspicious indicia or red flags which should have caused the use of more than the standard auditing procedures in these two accounts were (1) the disarray among the top level of ILC's management including accusations of unauthorized disbursements, (2) that 1986 would be ILC's first operating loss, (3) a demand by the audit committee that the auditors scrub the audit, and (4) the Board's concerns, especially Mr. Baumgartner, a company founder who had returned as Chief Executive Officer in November 1986, about manual checks and his recommendation that the auditors undertake a procedure called a "proof of cash" or "long form" which traces funds from the bank statements to the company's books in some detail. (Tr. 91-92)

Mr. Baumgartner suggested that the auditors conduct a "proof of cash" or "long form" as part of the special review because of his concern about manual checks. Mr. Baumgartner contends that Mr. Danna told him it was not necessary because of the scope of the special review and that the auditors were reviewing all checks over \$100. (Tr. 95-96) Mr. Danna does not recall representing that the auditors would examine all checks over \$100. Mr. Danna determined that a "proof of cash" was not necessary because he relayed Mr. Baumgartner's

concerns that the auditors review manual checks to Mr. Dentinger and Mr. Sermone, one of the auditors. The Respondents decided that a proof of cash was not needed because "we had, in fact, been seeing manual checks, and Mr. Montoya represented that he was providing all the information regarding manual or otherwise -- manual checks, computerized checks." (Tr. 1147-49)

Despite their disclaimers, it appears that Respondents improperly relied on work they did outside the audit in making judgements as to what risk level to assess and what audit procedures to perform. Respondents violated GAAS by not accounting in the audit for the entire population of manual checks and testing a sample of the unusually large number of checks listed as void or unused due to printing problems. (Tr. 500-02, 1566-68) The workpapers for the special expense review show that in November 1986, Mr. Dentinger signed that he had done the workstep "verify completeness & numerical sequence of the register." He did so based only on conversations with Mr. Montoya. (Exhibit 27, 4996; Tr. 1565) Mr. Dentinger waived the agreed upon procedure as indicated on another expense review workpaper

due to the lack of control over manual checks, we understand that short of doing a comprehensive proof of cash to identify all disbursements flowing through the bank account during the period, there is no way to get comfort with respect to the integrity of the disbursement listing. We have waived performing such a proof for the following reasons

A) ... we feel the concerns that initially prompted the review have been identified.

B) Ray Montoya, CFO, has represented that the listings are complete. (Exhibit 27, 4999)

Mr. Danna signed off on both workpapers. (Tr. 1248)

It is compelling that in the audit of cash, the auditors knew or should have known from the special expense review that a significant number of manual checks were labeled as void or "printing problems." This knowledge required that they increase the audit risk and procedures with respect to errors and irregularities. This subject is also covered in the next section.

Respondents contend that they did not rely in the audit on anything they did in the expense review but that is not what the record shows. Work done in the expense review should not have been relied on in lieu of audit procedures because an expense review is not the same as an audit. Unlike an audit, an expense review has no requirement that the auditors obtain sufficient competent evidential matter to support their opinion. (Montgomery's Accounting, 10th edition, College Version, 1075; Tr. 969-70) Also, this expense review only performed audit procedures that the parties agreed upon, and it was limited in terms of time - slightly less than two weeks - and budget - initially set at \$20,000 to \$25,000. (Exhibit 254, 771; Tr. 112, 177, 1396) 28/ There was no written expense review report. (Tr. 1146) Mr. Baumgartner who reviewed the expense review findings and materials characterized Arthur Young's work paper techniques as "sad". (Tr. 193-94)

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28/ The special expense review began after the October 31, 1986 phone call between Mr. Danna and members of the Audit Committee. Mr. Danna gave an oral report to ILC on November 11. (Exhibit 254, 771; Tr. 185-86, 291-92)

Additional reasons Mr. Danna gave for classifying the risk of the cash account as low - that Mr. Montoya did not claim that Mr. Chopra was trying to hide the allegedly unauthorized disbursements, and that the year end balances were verified with outside sources (banks) - do not justify in these very peculiar circumstances assessing the risk of error in the cash account as low. Where there are startling charges of improper conduct by senior management, Respondents should not have awarded the lowest risk assessment to the cash account which was accessible to those managers. Another indicator that should have caused the auditors to assign a greater risk to the cash account was the fact that Mr. Baumgartner had expressed concerns to Mr. Danna about the lack of controls over manual checks. (Tr. 181) Mr. Dentinger was aware that problems existed with respect to access to manual checks at UDT and ILC. (Tr. 1505-06)

Fixed asset account I find that Respondents violated GAAS with respect to their audit planning and procedures for auditing the fixed asset account for material errors and irregularities. The low level risk assessment for this account was questionable in September in view of the fact that ILC suffered its first operating loss in 1986, Mr. Sorenson had resigned in July 1986 after sixteen years as President and CEO, and the top financial and accounting positions at ILC had been in a state of flux throughout the year. But certainly by October, GAAS required Respondents to raise their risk assessment above the minimum level because the fixed assets additions were so large, one senior executive charged another senior executive with improper conduct impacting this account, and ILC's



Audit Committee questioned whether this account had become a "dumping ground" in the auditors' presence. Specifically, at ILC's October 29, 1986, Audit Committee meeting, Mr. Chopra claimed that "Ray and Gerda" had gone to Puerto Rico and the expense was improperly charged to the fixed asset account. (Exhibit 37) Mr. Danna assumed that Ray was Raymond Montoya. Mr. Miller, co-manager on the 1986 audit, and Mr. Lane, Chair of the Audit Committee, recorded this information at a meeting that took place on October 29, 1986. The notes of both these individuals question whether the fixed asset account had become a dumping ground, i.e., if the allegation were true, would there be more wrong items in the account. (Tr. 373-74)

I reject Mr. Danna's defense that he acted reasonably because ILC's one million dollar increase in fixed assets was not unusual since ILC was upgrading sophisticated equipment at its wafer fabrication facility and that this amount was in line with prior years. (Tr. 1186) This explanation is not persuasive because Mr. Danna noted on a workpaper that ILC's fixed assets were high and he did not deny the Division's claim that the upgrading the manufacturing facility was completed in fiscal 1985. 29/ Mr. Danna does not recall the audit committee expressing concern about fixed assets being used to hide improprieties but the fact that two people noted this subject at the meeting he attended convince me that the concerns were expressed. (Tr. 1234-35) The auditor's purpose is to do those things that are necessary to provide a reasonable level of assurance for forming

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29/ His recollection is that upgrades continued through 1986. (Tr. 1236-37)

an opinion about the financials. The events described above raised the risk level in the fixed asset account above low and should have caused Respondents to plan additional procedures to search for errors and irregularities in this account. They did not do so and thus violated GAAS.

Inventory account I find that Respondents did not violate GAAS with respect to planning the audit of the inventory account to search for errors and irregularities. The auditors' task was to verify the inventory pricing prepared by the company. (Tr. 305) A moderate risk assessment throughout the audit was reasonable. 30/ Respondents placed the risk at this midpoint level because of the high degree of judgment involved in valuing inventory. They knew in September that another substantial write-down of inventory, which turned out to be approximately \$2.5 million for the fourth quarter, was required despite the \$1.4 million third quarter write down, but this did not raise suspicion in view of the nature of the industry and the reasonableness of ILC's explanation that it had systemic problems tracking inventory, book values were inflated because estimates of cost of goods sold were too low, production yield estimates were too high, and ILC accounting staff did not catch that UDT inventory was overvalued because of lack of experience.

I disagree with the Division's expert that Respondents should have raised the audit risk in the inventory account from moderate to the maximum level

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30/ According to Mr. Dentinger this resulted in expanded testing in the account. (Tr. 1365) Mr. Danna testified that the auditors did a lot more work in 1986 with respect to inventory - reserves for excess and obsolescence - that was not shown in the approach plan but is shown in the workpapers. (Tr. 1159)

because Mr. Montoya alleged that Mr. Chopra, the Chair and CEO, tried to have Mr. Montoya and Mr. Fredianelli, ILC's Controller, inflate the value of inventory to hide the difference between the physical inventory and book value. Respondents acted decisively on this information.

Mr. Danna told ILC on October 29, that Arthur Young might not be able to complete the audit unless it resolved the issue of Mr. Chopra's credibility and unless ILC provided the auditors with an inventory list with values to be audited. ILC complied with the auditors' requests. Mr. Baumgartner, a company founder who had been Executive Vice President and CFO, provided the auditors with a list and pricing of physical inventory to be audited. Furthermore, ILC removed Mr. Chopra from work on the audit and Arthur Young conducted a special expense review which found that Mr. Chopra had made approximately \$20,000 in improper expenditures, an amount considered immaterial.

## 2. Supervision and Failure to Obtain Sufficient Competent Evidence

The GAAS Standards of Field Work require that assistants performing the audit be properly supervised and that the auditors obtain sufficient competent evidential matter to afford a reasonable basis for their opinion regarding the financial statements under examination. (Exhibit 46, AU §150.02; SAS 22 and 31)

Cash account Glaring discrepancies occurred in the expense review which indicated that material errors or irregularities may have existed. Respondents were not aware of these indicia because of their failure to adequately supervise

the audit. For example, in the special expense review and in the audit of the cash account, the field auditors did not obtain UDT's official check register for manual checks. They accepted a substitute document, a "check log", in the mistaken belief that it was UDT's official check register. (Tr. 499, 1247-48, 1501) 31/ The preponderance of the evidence is that while the "check log" looked like UDT's check register in that it contained columns of the same information but in different order, the auditors should have recognized that they did not receive an official document. 32/ A comparison of the "check log" (Exhibit 27) with UDT's official check register (Exhibit 8) showed the difference. It is difficult to understand how Respondents, experienced auditors who had worked on prior ILC's audits, missed this discrepancy.

Arthur Young was by far the largest firm in the area doing audits of high technology companies like ILC; Mr. Danna and Mr. Miller, the co-manager, were very experienced; and Mr. Dentinger was experienced. (Tr. 1121-22, 1637-

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31/ Mr. Montoya used manual checks to embezzle funds. He had this document prepared for the auditors. (Tr. 575, 581)

32/ ILC's controller considered it unusual that the auditors were provided the material in this form since the computer generates the expense check register. (Tr. 500) Exhibit 8 is UDT's Expense Check Register for October 1985 through September 1986 (Fiscal 1986). It contains both computerized and manual checks. Exhibit 27, pages 5142 through 5147, are parts of a document titled United Detector Technology Union Bank Check Log (1986). The checks are from June through September. The six pages with about 45 entries to a page contain the following number of void checks: five, six, fourteen, fifteen, eight, and two.

40) 33/ However, Mrs. Patricia Smith O'Malley, who reviewed UDT's checks during the special expense review and the audit, was not a certified public accountant when she did this work. She did not have the experience required although she had passed the CPA examination. Mrs. O'Malley was just completing her first year with Arthur Young. (Tr. 1438, 1484) 34/ She did not know there was any difference between the official check register and the check log. She mistakenly understood that the purpose of her work was to look only for personal expenses of Mr. Chopra because Respondents did not tell her that the expense review was to include Mr. Sorenson and Mr. Montoya. (Tr. 1468) She did not realize it was unusual for UDT to have so many manual checks in a four month period, and she did not verify that 418 manual checks, those numbered 7881 through 8069 and 8086 through 8299, were in fact "not used (printing problems)". (Tr. 523, 525, 1473) Neither ILC nor UDT ever had printing problems with manual checks. (Tr. 500) Since manual checks are handwritten, printing problems could only occur on computer generated checks. (Tr. 501-03) Mrs. O'Malley was unaware, because Respondents did not tell her, that Mr. Baumgartner was concerned that too many people had access to the safe where the manual checks were kept. (Tr. 1463-64, 1468) Her attitude was improperly

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33/ Mr. Miller, a manager with Mr. Dentinger, had been senior account manager on the 1984 and 1985 audits. Mr. Miller and Mr. Sermone worked on the special review in November 1986.

34/ The Audit Engagement Plan lists Mrs. O'Malley as Assistant - UDT. It shows Deborah Coad as Senior-UDT. (Exhibit 203, 2362)

uncritical because despite the large number of allegedly unused checks, she just assumed a check shown on the check log as void was not used because she had no reason to believe otherwise. (Tr. 1468)

Respondents did not question or adequately review the improper judgments of the field auditor so that these red flags were not considered and resolved in the audit. Mr. Dentinger failed to recognize that the auditors did not receive UDT's official check register for manual checks. (Tr. 1398-99) He did not make Mr. Danna aware of this fact, and Mr. Danna thought that the auditors had reviewed the official document. (Tr. 1247) 35/

Also in connection with the audit of the cash account, ILC used manual or handwritten checks on an exceptions basis, i.e., infrequently between the monthly or semi monthly computerized check runs for things like COD payments, travel advances, or expense reimbursements. (Tr. 71-72, 470-71) At regular intervals, a service bureau printed and sent to ILC computer generated checks based on information in its accounts payable account. In 1986, ILC issued 4,000 computer generated checks totaling \$5.1 million. In nine months of 1986, it issued 1,400 manual checks totaling \$2.7 million. (Tr. 72) The high number and quantity of manual checks was "unusual" and should have caused the auditors to recognized

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35/ UDT's check register is missing three months of listings. Mr. Dentinger assumed the check register was available during the audit, but does not recall checking that it was complete. (Tr. 1501)

that something could be amiss. They should have searched for an explanation but they did not do so. (Tr. 117-18, 470-71, 525, 746-47, 877-78) 36/

Mr. Danna was the key contact with ILC and he participated in all the conversations where these crucial issues were discussed. I reject Mr. Danna's position that he made sure Mr. Dentinger and Mr. Miller, the two co-managers, knew as much as he did about ILC and that they were responsible for informing the other auditors. The record does not support this delegation or his belief that the audit staff was adequately informed and supervised. Since Mr. Danna had no staff meetings and did not issue written directives, he presumably relayed information when he discussed the audit with various staff members when he met them at Arthur Young's San Jose offices where they were all headquartered. The evidence is that this means of communication was insufficient as the audit staff was woefully uninformed. For example, Mr. Dentinger denied that Mr. Danna told him that the Audit Committee on October 29 indicated it wanted a "scrubbed down" or very thorough audit and that it was concerned (based on Mr. Chopra's allegation) about the fixed asset account. (Tr. 1582) Mrs. O'Malley, the field auditor at UDT, was woefully uninformed. Neither Mr. Dentinger nor Mr. Danna knew that the field auditor never received the official check register for UDT's manual checks.

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36/ As a reason for the large number of manual checks, Respondents point to evidence that several vendors had put UDT on a COD-only basis at the beginning of 1986. However, this information is from the restatement workpapers which occurred after the audit, and there is no evidence that the auditors were aware of this fact and made judgments based on it.

Fixed assets account I reject Mr. Dentinger's claim that he had no supervisory responsibility for work on the fixed asset additions account at UDT. (Tr. 1319, 1419, and 1541) There is evidence that he did not have direct reviewing responsibility, however, the preponderance of the evidence is that he acted in some type of supervisory role on the audit of this account. 37/

The evidence that supports this conclusion is that Mr. Danna's initial testimony was that he considered Mr. Dentinger as principally responsible for the audit work performed at UDT. Later, Mr. Danna stated that Mr. Dentinger had responsibility for UDT, but he was busy so Mr. Miller, who was senior, reviewed the work in this account. (Tr. 1184-85) 38/ During the investigation Mr. Dentinger testified that he was the audit manager at UDT. At the hearing, Mr. Dentinger claimed that his earlier statement that he was the audit manager at UDT might have been an oversimplification. (Tr. 1489-90) His position now is that he reviewed about 60 percent of the accounts at UDT, about 40 percent of the accounts at ILC, all the accounts at Sensor Technology, and that at each location he reported to the other manager, Mr. Miller, who used Mr. Dentinger's "review of the workpapers to determine how much involvement he would have

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37/ Mr. Miller testified that he believed he, not Mr. Dentinger, was the reviewer on the fixed asset additions at UDT. (Tr. 1318-19) Mrs. O'Malley remembered Mr. Miller as the reviewer, but she agreed that Mr. Danna, Mr. Dentinger, and Mr. Miller were her superiors, and she changed her earlier testimony in which she had identified Mr. Dentinger's handwriting on a workpaper. (Tr. 1439, 1449, 1457-59)

38/ Mr. Miller considered himself senior to Mr. Dentinger because he had more experience but their titles in the audit were identical. (Tr. 1317)



with the section." (Tr. 1491) Mr. Dentinger's new position would mean that he was not an audit manager but an assistant to Mr. Miller. Finally, I do not accept Mr. Dentinger's position that as an audit manager he can sign an audit workpaper "for" Mrs. O'Malley and not take on some responsibility for the contents of that document. (Tr. 1204, 1423, 1489-90; Exhibit 26, 4554) His explanation that he had nothing to do with the audit in the account but simply signed because she was not in the office that day is typical of the very casual, unprofessional manner in which the audit was conducted. (Exhibit 26, 4553-54; Tr. 1534-35) 39/

Auditors obtain evidence by inspecting assets or by inspecting documents or records. The auditor responsible for "vouching" UDT's fixed assets additions was the same auditor who did the field work on UDT's cash account. She had worked at UDT on the special expense review. Vouching refers to the process of checking

charges to a particular expense account by examining invoices, purchase orders, and receiving reports to ascertain that the charges are adequately supported. The auditor may look for documentation in the form of signatures or initials on a purchase invoice, indicating that the invoice has been compared, by appropriate client personnel, with the corresponding purchase order and receiving report... (Montgomery's Accounting, 10th edition, College Version, 189; Tr. 1689)

Mr. Danna violated GAAS with respect to supervision because he never informed this field auditor, or had anyone else inform her that ILC's Audit Committee was concerned that the fixed asset account might be a dumping ground

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39/ Mr. Dentinger testified he would have discussed signing the workpaper with Mrs. O'Malley. She has no recollection that he did so. (Tr. 1457, 1534)

for unauthorized disbursements, and that he had increased the scope of the fixed asset additions audit by lowering from \$10,000 to \$5,000 the value of the fixed assets to be audited in response to management's concerns. (Tr. 1448, 1463) 40/ This information was significant because it could very well have caused the auditor to have been more cautious and critical in her work.

In addition, even though it was Arthur Young's policy and general practice to obtain original invoices, Respondents did not question the auditor's wholesale acceptance of xerox copies of invoices without further inquiry. The auditor did not recall her supervisors, Mr. Danna, Mr. Dentinger, or Mr. Miller, ever discussing that she should require original copies when vouching. She accepted, without further inquiry, xerox copies for thirty percent of the value of the fixed asset additions she audited. (Tr. 828) Respondents did not realize she had done so even though the audit workpaper prepared by this field auditor, which Respondents reviewed noted that items were vouched to invoice copy and UDT purchase order. (Tr. 1449, 1452, 1535-37; Exhibit 210, 4553) According to this auditor, this notation does not mean that she did not have additional materials, however, she admitted that if she had further documentation she would have indicated that fact. (Tr. 1453)

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40/ Mr. Danna was at the October 29, 1986 Audit Committee meeting but did not recall that the Committee questioned whether the fixed asset account had become a dumping ground based on Mr. Chopra's charge that Mr. Montoya had improperly capitalized a Puerto Rico trip. Mr. Dentinger was not present at the meeting. I have found as a matter of fact that the committee expressed this concern.

Inventory The evidence does not support the Division's charge that Mr. Dentinger's work on the audit of the inventory account was improper and that Mr. Danna violated GAAS in supervising his performance. I disagree with the Division that Respondents were required to check inventory against the general ledger inventory account to determine the difference between the book and physical values. By all accounts reviewing the general ledger in any meaningful way is a very time consuming, labor intensive procedure that was not warranted in these circumstances. (Tr. 1677) ILC's inventory system, which was typical of a company its size, was imprecise. The auditors tested the assertions on why ILC book to physical inventory required adjustment made by Mr. Montoya, Mr. Baumgartner, Mr. Chopra, and Mr. Fredianelli, in ILC's letter to shareholders, and its filing with this Commission and found them reasonable. (Tr. 1680-81, 1684-85) Even if the auditors performed visual inspections, one measure advocated by the Division's expert, they would not have caught the discrepancies because Mr. Montoya had changed the dates on invoices for existing fixed assets.

In summary, Respondents had supervisory responsibility over the audit staff. They violated GAAS in that they failed to supervise adequately because they did not provide the audit staff with relevant information on problem areas, they did not give adequate instruction, and they did not provide a level of review necessary to catch and reverse errors of judgement by the field auditors. Specifically, Mr. Danna and Mr. Dentinger failed to supervise the audit of the cash and fixed asset additions account. This lack of audit supervision contributed

to Respondents' failure to obtain sufficient competent evidence to support their audit opinion as to the cash and fixed assets accounts in violation of GAAS.

### 3. Failure to Exercise Due Professional Care

The third general standard of auditing specifies that:

Due professional care is to be exercised in the performance of the examination and the preparation of the report. (Exhibit 46, AU § 150.02; SAS 1)

The exercise of due care requires critical review at every level in supervising work done and the judgment exercised by those conducting the examination. Respondents did not exercise due care in their conduct of the 1986 audit.

The overall picture from all the evidence is that the work was done casually, without attention to detail, and that despite the turbulence that existed at ILC because of changes in top management, the first operating loss in some sixteen years, and unsubstantiated charges of improper conduct, the auditors showed a total lack of professional skepticism in their conduct of the audit. This was a violation of GAAS, which along with other findings made in this decision, equate to a finding of lack of due professional care.

I have considered all the arguments advanced by the parties, including Respondents' position that ILC failed to share with the auditors information it had about Mr. Montoya. They are rejected to the extent they are inconsistent with this decision.

## PUBLIC INTEREST

Rule 2(e) of the Commission's Rules of Practice, 17 CFR 201.2(e), authorizes the Commission to deny, temporarily or permanently, the right to appear or practice before it in any way to persons who have engaged in improper professional conduct.

I reject the Division's position that a two year suspension is appropriate for Respondents because I believe it to be too harsh in this situation.

Mitigating factors are that there is no evidence that Respondents acted deliberately or willfully, both Respondents have no prior history of unprofessional conduct, and Respondents' unprofessional conduct occurred in connection with two accounts in a single audit. With respect to Mr. Dentinger, this was the first time he served as an audit manager, and he was not as aware as Mr. Danna was of all the information which made it obvious that the 1986 audit required a heightened degree of care and critical analysis. 41/

Finally, contrary to the OCA's claim, it is not conclusive that the audit would have uncovered the embezzlement if Respondents had fully complied with GAAS in the cash and fixed assets accounts. That is something that will never be known.

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41/ Mr. Dentinger was not present with Mr. Danna on (1) May 21, 1986, when ILC's Board and Audit Committee expressed annoyance and dissatisfaction with the auditors' performance, or (2) October 29, 1986 or October 31, 1986, when ILC's Board and Audit Committee told the auditors in unvarnished terms that they wanted a thorough audit.

It is necessary for the Commission to act to preserve professional standards for auditing in order to preserve the integrity of procedures established to provide accurate information to investors and stability to financial markets. In view of my findings that Respondents have committed unprofessional conduct, I find it appropriate in the public interest to deny Mr. Danna the privilege of appearing before the Commission for a period of one year, and to deny Mr. Dentinger the privilege of appearing before the Commission for a period of six months.


#### ORDER

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

Angelo P. Danna is denied the privilege of appearing or practicing before the Commission for a period of one year and Mark P. Dentinger is denied the privilege of appearing or practicing before the Commission for a period of six months.

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

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

  
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Brenda P. Murray  
Chief Administrative Law Judge

Washington, DC  
April 11, 1995