CBI Holding Company, Inc.

During the 1980s, CBI Holding Company, Inc., a New York-based firm, served as the parent company for several wholly owned subsidiaries, principal among them Common Brothers, Inc. CBI's subsidiaries marketed an extensive line of pharmaceutical products. The subsidiaries purchased these products from drug manufacturers, warehoused them in storage facilities, and then resold them to retail pharmacies, hospitals, long-term care facilities, and related entities. CBI's principal market area stretched from the northeastern United States into the upper Midwest.

In 1991, Robert Castello, CBI's president and chairman of the board, sold a 48 percent ownership interest in his company to Trust Company of the West (TCW), a diversified investment firm. The purchase agreement between the two parties gave TCW the right to appoint two members of CBI's board; Castello retained the right to appoint the three remaining board members. The purchase agreement also identified several so-called "control-triggering events." If any one of these events occurred, TCW would have the right to take control of CBI. Examples of control-triggering events included CBI's failure to maintain certain financial ratios at a specified level and unauthorized loans to Castello and other CBI executives.

Castello engaged Ernst & Young (E&Y) as CBI's independent audit firm several months before he closed the TCW deal. During this same time frame, Castello was named "Entrepreneur of the Year" in an annual nationwide promotion cosponsored by E&Y. From 1990 through 1993, E&Y issued unqualified opinions on CBI's annual financial statements.

Accounting Gimmicks

Castello instructed several of his subordinates to misrepresent CBI's reported operating results and financial condition for the fiscal years ended April 30, 1992, and 1993. *
Those misrepresentations allowed Castello to receive large, year-end bonuses to which he was not entitled. CBI actively concealed the fraudulent activities from TCW's management, from TCW's appointees to CBI's board, and from the company's E&Y auditors because Castello realized that the scheme, if discovered, would qualify as a control-triggering event under the terms of the 1991 purchase agreement with TCW. Several years later in a lawsuit prompted by Castello's fraud, TCW executives testified that they would have immediately seized control of CBI if they had become aware of that scheme.

Understating CBI's year-end accounts payable was one of the methods Castello and his confederates used to distort CBI's 1992 and 1993 financial statements. At any point in time, CBI had large outstanding payables to its suppliers, which included major pharmaceutical manufacturers such as Burroughs-Wellcome, Schering, and FoxMeyer. At the end of fiscal 1992 and fiscal 1993, CBI understated payables due to its large vendors by millions of dollars. Judge Burton Lifland, the federal magistrate who presided over the lawsuit stemming from Castello's fraudulent scheme, ruled that the intentional understatements of

CBI's year-end payables were very material to the company's 1992 and 1993 financial statements.

E&Y's 1992 and 1993 CBI Audits

In both 1992 and 1993, E&Y identified the CBI audit as a "close monitoring engagement." The accounting firm's audit manual defined a close monitoring engagement as "one in which the company being audited presents significant risk to E&Y … there is a significant chance that E&Y will suffer damage to its reputation, monetarily, or both." * E&Y's workpapers for the 1992 and 1993 audits also documented several "red flags" suggesting that the engagements posed a higher-than-normal audit risk.

Control risk factors identified for the CBI audits by E&Y included the dominance of the company by Robert Castello, * the absence of an internal audit function, the lack of proper segregation of duties within the company's accounting department, and aggressive positions taken by management personnel regarding key accounting estimates. These apparent control risks caused E&Y to describe CBI's control environment as "ineffective." Other risk factors identified in the CBI audit workpapers included the possible occurrence of a control-triggering event, an "undue" emphasis by top management on achieving periodic earnings goals, and the fact that Castello's annual bonus was tied directly to CBI's reported earnings.

For both the 1992 and 1993 CBI audits, the E&Y engagement team prepared a document entitled "Audit Approach Plan Update and Approval Form." This document described the general strategy E&Y planned to follow in completing those audits. In 1992 and 1993, this document identified accounts payable as a "high risk" audit area. The audit program for the 1992 audit included two key audit procedures for accounts payable:

a. Perform a search for unrecorded liabilities at April 30, 1992, through the end of fieldwork.

b. Obtain copies of the April 30, 1992, vendor statements for CBI's five largest vendors, and examine reconciliations to the accounts payable balances for such vendors as shown on the books of CBI.

The 1993 audit program included these same items, although that program required audit procedure "b" to be applied to CBI's 10 largest vendors.

During the 1992 audit, the E&Y auditors discovered numerous disbursements made by CBI in the first few weeks of fiscal 1993 that were potential unrecorded liabilities as of April 30, 1992. The bulk of these disbursements included payments to the company's vendors that had been labeled as "advances" in the company's accounting records. CBI personnel provided the following explanation for these advances when questioned by the auditors: "When CBI is at its credit limit with a large vendor, the vendor may hold an order until they receive an 'advance.' CBI then applies the advance to the existing A/P balance."

In truth, the so-called advances, which totaled nearly $2 million, were simply payments CBI made to its vendors for inventory purchases consummated on, or prior to, April 30, 1992. Castello and his confederates had chosen not to record these transactions—their purpose

being to strengthen key financial ratios of CBI at the end of fiscal 1992 and otherwise embellish the company's apparent financial condition. The conspirators developed the advances ruse because they feared that E&Y would discover the material understatements of accounts payable at year-end.

Subsequent court testimony revealed that after reviewing internal documents supporting the advances explanation—documents that had been prepared to deceive E&Y—the E&Y auditors readily accepted that explanation and chose not to treat the items as unrecorded liabilities. This decision prompted severe criticism of the audit firm by Judge Lifland.

The federal judge pointed out that the auditors had failed to rigorously investigate the alleged advances and consider the veracity of the client's explanation for them. For example, the auditors did not investigate the "credit limit" feature of that explanation. The E&Y auditors neglected to determine the credit limit that the given vendors had established for CBI or whether CBI had "maxed out" that credit limit in each case as maintained by client personnel. Nor did the auditors attempt to analyze the given vendors' payable accounts or contact those vendors directly to determine if the alleged advances applied to specific invoice amounts, particularly invoice amounts for purchases made on or before April 30, 1992. Instead, the auditors simply chose to record in their workpapers the client's feeble explanation for the advances, an explanation that failed to address or resolve a critical issue. "The advance explanation recorded in E&Y's workpapers, even if it were true, did not tell the E&Y auditor the essential fact as to whether the merchandise being paid for by the advance had been received before or after April 30, 1992."

Because of the lack of any substantive investigation of the advances, the E&Y auditors failed to determine "whether a liability should have been recorded for each such payment as of fiscal year-end, and whether, in fact, a liability was recorded for such payment as of fiscal year-end." This finding caused Judge Lifland to conclude that E&Y had not properly completed the search for unrecorded liabilities. The judge reached a similar conclusion regarding the second major audit procedure for accounts payable included in the 1992 audit program for CBI.

The 1992 audit program required the E&Y auditors to obtain the year-end statements sent to CBI by the company's five largest vendors and to reconcile the balances in each of those statements to the corresponding balances reported in CBI's accounting records. E&Y obtained year-end statements mailed to CBI by five of the company's several hundred vendors and completed the reconciliation audit procedure. However, the vendors involved in this audit test were not the company's five largest suppliers. In fact, E&Y never identified CBI's five largest vendors during the 1992 audit. The federal judge scolded E&Y for this oversight and maintained that the "minimal" amount of testing applied by E&Y to the small sample of year-end vendor statements was "not adequate."

The audit procedures that E&Y applied to CBI's year-end accounts payable for fiscal 1993 suffered from the same flaws evident during the firm's 1992 audit. Similar to the previous year, CBI's management attempted to conceal unrecorded liabilities at year-end by labeling subsequent payments of those amounts as "advances" to the given vendors. Once more, Judge Lifland noted that the "gullible" auditors readily accepted the explanation for these advances that was relayed to them by CBI personnel. As a result, the auditors failed to

require CBI to prepare appropriate adjusting entries for approximately $7.5 million of year-end payables that the client's management team had intentionally ignored.

The 1993 audit program mandated that E&Y obtain the year-end statements for CBI's 10 largest vendors and reconcile the balances in those statements to the corresponding accounts payable balances in CBI's accounting records. Again, E&Y failed to identify CBI's largest vendors and simply applied the reconciliation procedure to a sample of 10 CBI vendors. *

One of CBI's 10 largest vendors was Burroughs-Wellcome. If the E&Y auditors had reconciled the balance due Burroughs-Wellcome in its year-end statement with the corresponding account payable balance in CBI's accounting records, the auditors would have discovered that a $1 million "advance" payment made to that vendor in May 1993 was actually for an inventory purchase two weeks prior to April 30, 1993. This discovery would have clearly established that the $1 million amount was an unrecorded liability at year-end.

E&Y Held Responsible for CBI's Bankruptcy

In March 1994, E&Y withdrew its opinions on CBI's 1992 and 1993 financial statements after learning of the material distortions in those statements that were due to Castello's fraudulent scheme. Almost immediately, CBI began encountering difficulty obtaining trade credit from its principal vendors. A few months later in August 1994, the company filed for bankruptcy. In early 2000, Judge Lifland presided over a 17-day trial in federal bankruptcy court to determine whether E&Y would be held responsible for the large losses that CBI's collapse inflicted on TCW and CBI's former creditors. Near the conclusion of that trial, Judge Lifland ruled that E&Y's conduct during the 1992 and 1993 CBI audits was the "proximate cause" of those losses.

> *The demise of CBI was a foreseeable consequence of E&Y's failure to conduct its audits in fiscal 1992 and 1993 in accordance with GAAS, which was the cause of its failure to detect the unrecorded liabilities, which in turn foreseeably caused it to withdraw its opinions in March 1994. As direct and reasonably foreseeable consequences thereof, CBI's vendors restricted the amount of credit available, CBI's inventory and sales declined, its revenues declined, its value as a going concern diminished, and ultimately it filed for bankruptcy and was liquidated.*

Judge Lifland characterized E&Y's conduct as either "reckless and/or grossly negligent" and identified several generally accepted auditing standards that the accounting firm violated while performing the 1992 and 1993 CBI audits. Although the bulk of the judge's opinion dealt with the audit procedures E&Y applied to CBI's accounts payable, his harshest criticism focused on the firm's alleged failure to retain its independence during the CBI engagements.

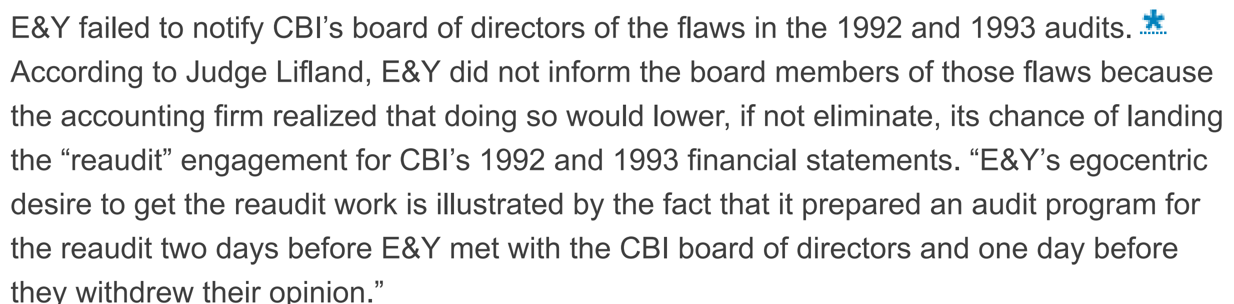
Several circumstances that arose during E&Y's tenure as CBI's audit firm called into question its independence. For example, Judge Lifland referred to an incident in 1993 when Robert Castello demanded that E&Y remove the audit manager assigned to the CBI engagement. Apparently, Castello found the audit manager's inquisitive and probing nature

disturbing. The CBI audit engagement partner "submissively acquiesced" to Castello's request and replaced the audit manager.

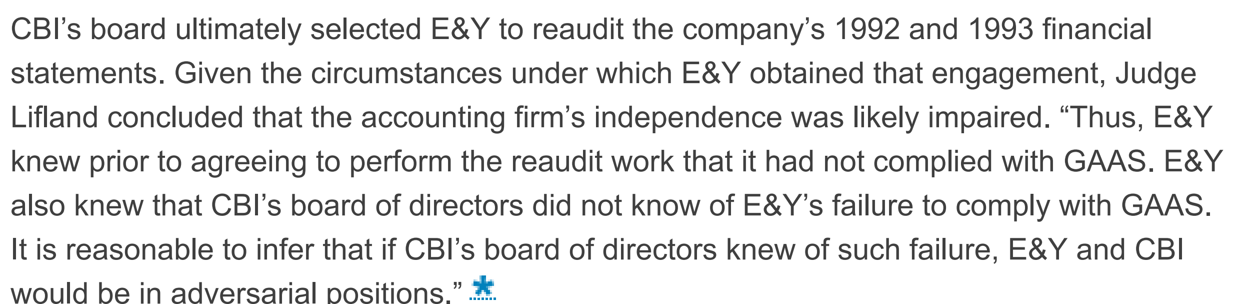
Shortly after the completion of the 1993 audit, Castello hired a new chief financial officer (CFO). This individual resigned eight days later. The CFO told members of the E&Y audit team he was resigning because of several million dollars of "grey accounting" he had discovered in CBI's accounting records. Judge Lifland chided E&Y for being slow to pursue this allegation. Nearly five months passed before the CBI audit engagement partner contacted the former CFO. By that point, E&Y had already discovered Castello's fraudulent scheme and withdrawn its 1992 and 1993 audit opinions.

In February 1994, the audit engagement partner met with Castello to discuss several matters. E&Y's unpaid bill for prior services provided to CBI was the first of those matters, while the second issue discussed was E&Y's fee for the upcoming audit. The last topic on the agenda was the allegation by CBI's former CFO regarding the company's questionable accounting decisions. According to Judge Lifland, the audit partner "wanted to speak to [the former CFO] in order to ask him whether his leaving the post of chief financial officer and his allegations of 'grey accounting' had anything to do with the financial statements that E&Y had just certified; however, [the audit partner] obligingly allowed himself to be put off." In Judge Lifland's opinion, the E&Y audit partner was "more concerned about insuring E&Y's fees than he was about speaking to [the former CFO]."

The final matter Judge Lifland discussed in impugning E&Y's independence was the accounting firm's effort to retain CBI as an audit client after discovering that the 1992 and 1993 audits had been deficient. Judge Lifland charged that E&Y officials realized, when they withdrew the audit opinions on CBI's 1992 and 1993 financial statements, that the CBI audits had been flawed. In the days prior to withdrawing those opinions, two individuals, a former CBI accountant and CBI's controller at the time, informed E&Y that the "advances" discovered during the 1992 and 1993 audits had been for payment of unrecorded liabilities that existed at the end of CBI's 1992 and 1993 fiscal years. After investigating these admissions, E&Y determined that they were true. E&Y also determined that the CBI auditors "had failed to detect the unrecorded liabilities because they had failed to properly perform the search [for unrecorded liabilities]."



E&Y failed to notify CBI's board of directors of the flaws in the 1992 and 1993 audits. * According to Judge Lifland, E&Y did not inform the board members of those flaws because the accounting firm realized that doing so would lower, if not eliminate, its chance of landing the "reaudit" engagement for CBI's 1992 and 1993 financial statements. "E&Y's egocentric desire to get the reaudit work is illustrated by the fact that it prepared an audit program for the reaudit two days before E&Y met with the CBI board of directors and one day before they withdrew their opinion."



CBI's board ultimately selected E&Y to reaudit the company's 1992 and 1993 financial statements. Given the circumstances under which E&Y obtained that engagement, Judge Lifland concluded that the accounting firm's independence was likely impaired. "Thus, E&Y knew prior to agreeing to perform the reaudit work that it had not complied with GAAS. E&Y also knew that CBI's board of directors did not know of E&Y's failure to comply with GAAS. It is reasonable to infer that if CBI's board of directors knew of such failure, E&Y and CBI would be in adversarial positions." *

Questions

1. Most of Judge Lifland's criticism of E&Y focused on the firm's audit procedures for CBI's accounts payable. Generally, what is the primary audit objective for accounts payable? Do you believe that E&Y's two principal audit tests for CBI's accounts payable would have accomplished that objective if those tests had been properly applied? Why or why not?

2. Do you believe that the E&Y auditors should have used confirmations in auditing CBI's year-end accounts payable? Defend your answer. Briefly explain the differing audit objectives related to accounts receivable and accounts payable confirmation procedures and the key differences in how these procedures are applied.

3. In early 1994, E&Y officials discovered that the CBI auditors had failed to determine the true nature of the "advances" they had uncovered during the 1992 and 1993 audits. In your view, did E&Y have an obligation to inform CBI management of this oversight prior to seeking the "reaudit" engagement? More generally, does an auditor have a responsibility to inform client management of mistakes or oversights made on earlier audits?

4. Under what circumstances, if any, should an audit engagement partner acquiesce to a client's request to remove a member of the audit engagement team?

5. E&Y officials believed that the CBI audits were high-risk engagements. Under what general circumstances should an audit firm choose not to accept a high-risk engagement?