Regulators Seek to Penalize Auditors Who Missed Fraud

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For many auditors, the news would have set off alarm bells. California Micro Devices Corp., a highflying chip maker, disclosed that it was writing off half of its accounts receivable, mostly because of product returns. Its stock plunged 40% after the announcement on Aug. 4, 1994, and shareholders filed suit alleging financial shenanigans.

Nonetheless, a team from Coopers & Lybrand, which was auditing Cal Micro at the time, gave the chip maker's books a clean bill of health the following month.

Within weeks, it became clear they had missed an audacious accounting fraud. An internal Cal Micro investigation uncovered "preposterous" revenue numbers "almost immediately," says Wade Meyercord, who was then an outside director and now is Cal Micro's chairman. One-third of the company's $45 million of fiscal 1994 revenue was spurious.

Undetected by auditors, according to Mr. Meyercord and testimony in a criminal trial of Cal Micro's former chairman and former treasurer, were a dozen or more accounting tricks that various employees, at various levels of management, had deployed to keep the stock buoyant. They included one particularly bold one: booking bogus sales to fake companies for products that didn't exist.

Bar Is Sought

Now, it's the auditors who need a clean bill of health. In a rare move that is sending shivers through the accounting world, the Securities and Exchange Commission is seeking to bar the two main Coopers auditors on this job from signing off on public-company audits. The "engagement partner," Michael J. Marrie, and the "engagement manager," Brian L. Berry, "conducted the audit in a vacuum, recklessly ignoring unmistakable red flags," the SEC says in its order instituting administrative proceedings against the auditors. An SEC administrative-law judge is set to begin a hearing on the allegations in late February.
The auditors maintain they followed the rules and did their jobs properly. Their lawyer, Michael F. Perlis, points to 15 boxes of audit "work papers" that he says cover the bases. He notes that Cal Micro managers falsified and destroyed certain documents. He says his clients declined an SEC offer to settle; instead, he has asked a federal court in Phoenix to block the SEC from proceeding with what he calls an abuse of power.

The case, coming on the heels of accounting blowups at Cendant Corp., Sunbeam Corp. and Waste Management Inc., provides a lesson for investors in how porous the auditing system is. "Auditors aren't doing what shareholders think they're doing," says Stuart Schube, a Cal Micro director.

A CFO's Resume

The roots of Cal Micro's accounting problems ran deep. In the late 1980s, with a thin-film product that reduced interference in a variety of electronic products, the Milpitas, Calif., company sported a glittering roster of technology customers. But its auditor at the time, Price Waterhouse LLP, told it in 1989 that it had "material internal control weaknesses." Besides proposing a quarterly-earnings restatement, Price Waterhouse advised the board to upgrade its finance team and replace its chief financial officer, Steven J. Henke.

Cal Micro took the CFO title away from Mr. Henke but gave him three others, including treasurer. Price Waterhouse and Cal Micro then parted ways. (Much later, Mr. Henke testified at his criminal trial that he hadn't majored in accounting, as his resume said, but instead took only one college accounting course, and got a D in it.)

Walking in the door in 1990, the auditors from Coopers & Lybrand inherited more problems. Chan Desaigoudar, then Cal Micro's chairman and 45.7% owner, sat on the board's audit committee, a panel that ideally is staffed by outside directors. And Cal Micro had no revenue-recognition policy -- that is, no guideline dictating at which point in a transaction it could be treated as a sale.

Who Said What?

A dispute exists over whether the Coopers auditors approved practices that led to some prematurely booked revenue. At the 1998 criminal trial of Mr. Desaigoudar and Mr. Henke, Ronald Romito, who was Cal Micro's chief accountant, testified that he asked the auditors if the company could book revenue on products sold but shipped after the close of the fourth quarter in June 1990 -- a practice almost universally considered improper. "And they said yes," Mr. Romito testified at the trial in San Francisco federal court.

"That is false -- the auditors gave no such assurance," says their attorney, Mr. Perlis. He adds that a 1994 company memo and testimony from a former manager show the auditors told Cal Micro not to book revenue for products shipped after a quarter's end. Coopers & Lybrand, now part of PricewaterhouseCoopers, declines to comment on the Cal Micro case.

In 1996 Mr. Romito settled SEC allegations of false bookkeeping and insider trading without admitting or denying them; Messrs. Desaigoudar
and Henke were convicted of securities fraud, insider trading and making false statements to the SEC; they are appealing.

Cal Micro managers faced aggressive revenue goals, and by late 1993 were relying on ever-easier definitions of a "sale." Besides the outright faking of product shipments, trial testimony showed that managers began booking revenue for products shipped before customers even wanted them; they often didn't reverse sales when customers returned goods; and they paid distributors "handling fees" to accept products that sometimes had unlimited rights of return, then booked the products as sales.

To keep track of it all, clerks compiled memos titled "delayed shipment," which became a euphemism for fake sales. Soon, even low-level workers were "joking about" the fraud, a former Cal Micro administrator, Karen Pujol, testified at the criminal trial.

By midsummer 1994, with as much as 70% of quarterly revenue in the fake category, some managers began fretting that the game was out of control. Their alarm prompted the August write-off equal to half of accounts receivable.

The annual audit was in progress. But instead of veterans, Coopers & Lybrand had deployed mostly junior staffers, one of whom had just six months' experience. They were "so fresh out of college and so inexperienced," recalls Mary Bridges, Cal Micro's former credit accountant.

Running Joke

She says that in a visit prior to the audit, one of them asked a bookkeeping question so elementary that she and a cost accountant had a "running joke" in which they'd say to each other, like in a Bugs Bunny cartoon, "What's wevenue?" Mr. Perlis, the auditors' attorney, says the Coopers staffers had enough expertise to handle the audit.

From the perspective of the SEC and several auditing experts, the work should have started with a thorough review of the $8.3 million write-off; the agency maintains that the write-off is barely mentioned in the auditors' work papers. But Mr. Perlis responds: "There's nothing in generally accepted auditing or accounting principles that requires an audit of a write-off."

Though many investors don't realize it, auditors don't scrutinize every number in financial statements during annual audits; that would be too costly, the industry says. Instead, like other auditors, those reviewing Cal Micro tested certain samples of company transactions to make sure the overall numbers were accurate.

But the SEC says the auditors did the bare minimum in certain areas. For example, the agency says they reviewed paperwork for 10 product sales that took place in June, the last month of the fiscal year. They missed documents that managers -- correctly guessing that the auditors would look only at June paperwork -- had back-dated to May. Mr. Perlis says the review met auditing standards.

Warning Signs
The auditors did increase the number of so-called confirmation letters sent to customers with outstanding bills; the letters covered 91% of the accounts receivable. But, according to the SEC, the auditors ignored warning signs flickering from some of the responses. Of the 37 replies to the auditors' 54 letters, the SEC says, one-third raised serious issues with Cal Micro's bookkeeping.

For example, the SEC says letters from several companies indicated that Cal Micro had booked revenue on unshipped products, which the companies said they didn't receive until after the end of the fiscal year. Another noted "some amount still in negotiation for return of parts." One company said Cal Micro had set up a consignment arrangement, and thus the company wasn't obligated to pay until the products were resold, the SEC says.

Coopers auditors told Cal Micro to reverse several hundred thousand dollars connected with the parts return and consignment matters. But they didn't investigate further to see whether any other such revenue irregularities existed, the SEC says and a review of work papers shows.

"The auditors did what they needed to do to satisfy themselves with respect to those receivables," says Mr. Perlis. He also says they relied on a letter from company officials -- a boilerplate feature of audits -- saying the numbers were correct.

**Product Returns**

The SEC also takes issue with the auditors' conclusion, in a so-called audit strategy memorandum, that Cal Micro's vulnerability to a large volume of product returns was "below maximum." The regulators point to the write-off, two-thirds of which the company blamed on product returns. They also note that Coopers used old product-return data that included a period when Apple Computer was the company's biggest customer, though less-tested foreign distributors had supplanted Apple. Mr. Perlis responds that "the work papers clearly document management representations as to when product returns occurred," and that the auditors appropriately tested the assertions.

Among the other warning signs missed by the auditors were hints from Ms. Bridges, the former Cal Micro credit accountant, according to her trial testimony. Ms. Bridges says in an interview that she "gave clues to a junior audit staffer" by pointing him in the direction of a certain May 1994 document detailing millions of dollars of revenue reversals. In a statement, Mr. Perlis dismisses Ms. Bridges' assertions as "hardly evidence" that the auditors were "given any information that should have raised a 'red flag.'"

Mr. Perlis also disputes Ms. Bridges's credibility, saying "she lied to the auditors." He points to an SEC deposition in which she acknowledges destroying documents and preparing others she knew to be false, which she said she did at the behest of management. In an interview, Ms. Bridges denies making any false statements to the auditors. "I rarely met with them and I didn't give them any false documents," she says.

**Internal Probe**

After the auditors signed off on the audit in late September, the truth quickly unfolded. Motivated by the shareholder lawsuits, Scott R. Hover-Smoot, then a Cal Micro staff attorney and now general corporate counsel, started an internal probe of the company's accounting
practices. Working with an outside lawyer, he immediately saw that reported fiscal 1994 cash flow lagged far behind its billings. "That told us it was possible customers had been receiving product they didn't want or that these were consignment sales which should not have been booked as revenue," Mr. Hover-Smoot says.

Mr. Meyercord, the current Cal Micro chairman, adds: "I was just amazed that the auditors had not found something in the course of their audit."

Mr. Hover-Smoot's probe prompted the board to hire Ernst & Young to re-audit the books, and in early 1995, Cal Micro restated its fiscal 1994 results. Instead of 62 cents a share in profit, it had a loss of $1.88 a share. In August 1995, Mr. Berry left Coopers, ending a 12-year career there. Mr. Marrie quit the next month, ending his 25-year Coopers career. Mr. Marrie, 51 years old, now is an administrative manager of a Phoenix law firm, Snell & Wilmer LLP; Mr. Berry, 38, is a controller for Pentegra Dental Group in Phoenix.

Can the SEC win a case against the auditors? Their attorney says the agency is trying to hold them, retroactively, to a stricter auditor-conduct standard than existed at the time of the fateful Cal Micro audit. Only in 1998 did the SEC update the standard to define exactly what reckless conduct is, after a federal appeals judge criticized the agency's auditor-conduct rule as obscure. And only over the past few years have auditors been required under industry rules to do more to detect fraud.

The SEC responds that reckless auditor conduct has been punishable under the law for at least 20 years. And, says Douglas Carmichael, author of auditing textbooks and a professor at Baruch College, auditing rules have always required auditors to "keep their eyes open."

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