Spring 5-18-2018

A Close Look at Audit Standards and Best Practices How to Validate the Existence of an Asset

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by

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A capstone submitted in partial fulfillment of the

requirements for the degree Master of Science in Economic Crime and Forensics

LaSalle University

Philadelphia, PA

January 2018

Executive Summary

A comparative analysis will be conducted seeking to identify how to obtain sufficient evidence to determine the existence of an asset within an organization during an independent audit. The external auditor is often regarded as the "gatekeeper" of the financial markets which has a fiduciary duty to its clients. (Choy, Fields, & King, 2008) Accounting firms are required by operation of law to act in an ethical manner and have a social responsibility to protect the interest of the public. However, there exists an ongoing issue in the performance of audits by larger firms. In a recent study conducted by the Public Company Accounting Oversight Board, members found that 1 in 3 audits contain deficiencies that should not have been signed off by the firm.[1] (Chasan, 2015) This capstone will research the current standards and practices related to determining the asset existence within an organization. The capstone will look at current cases involving problems and suggest strategies for validating the existence of an asset by an organization.

Keywords: audit engagement, best practices, existence and occurrence, external auditor, auditor liability, management assertions, internal controls, financial statements, negligent misrepresentation, fraud, gatekeeper

[1] Significant audit performance deficiencies are defined by Public Company Accounting Oversight Board as deficiencies that result in the audit firm lacking sufficient evidence to support its audit opinion. The Public Company Accounting Oversight Board inspectors conduct annual inspections to evaluate the overall effectiveness of the firm's quality control policies and procedures. Annual inspections assist in determining whether deficiencies are present in public company audits including weaknesses in the firm's business practices.

A Close Look at Audit Standards and Best Practices

How to Validate the Existence of an Asset

The layperson may wonder what is so important about investing in debt and equity securities. Do we need an independent third party to provide auditing, attestation, and assurance services? If so, is there any value in validating management's financial statement assertions over the existence of an asset? What is the economic impact of having financial statements accredited by an accounting firm? There are several reasons why an external audit is necessary. Audited financial statements are essential to the vitality of the capital markets "supplying over $8 trillion in corporate debt and trillions more in mortgage funding" (Elliot, 2015). Investors are more inclined to engage in business transactions through the allocation of capital resources where such decisions are reliant on the entities overall financial health and performance. According to Podziemska and Losi, (2017), "the securities market industry alone raised $2.2 trillion of corporate capital for U.S. businesses in 2014". Further evidence signifying the positive effects of investment activities are directly linked to the global economy. The driving engine behind business investment opportunities is made possible through public and private placement offerings of securities that contribute to capital formation to stimulate economic growth. Such activities play a role in the production of new lines of businesses and decisions to increase production of products or services that lead to job creation. Moreover, Adena Friedman, CEO of Nasdaq, recently described the dramatic effects of when fewer companies go public and how that can affect the U.S. economies future growth. Friedman outlined a plan to jump-start job and wealth creation. (Belvedere, 2017)

However, the downfall from negligent or fraudulent audits are costly to investors and have caused severe economic harm to the global economy. For instance, the economic fallout from

Bernie Madoff's elaborate Ponzi-scheme had a catastrophic effect on the lives of many investors who lost an estimated $17.5 Billion USD. Several peer-reviewed studies, articles, and publications written over the last ten years (Cheng & Epstein, 2012; Burke, 2011: Pearson, 2011; Beasley et al., 2001; Davis & Moravy, 2013) have discussed common areas susceptible to audit failures. Some experts have suggested that the cause of audit failures is linked to mental fatigue, which explains why so many of the results of auditor failure are due to poor judgment. (Tackett, Wolf, & Carpool, 2004) Human error is by no means the only reason for audit failure. As some violations of law have been so reprehensible one cannot stop to think of Arthur Anderson and their recklessness in issuing unqualified opinions during their audit of the Enron Corporation.

The collection of sufficient appropriate evidential matter by far is the most critical component of the external audit. During an audit engagement of a publicly traded company, much of the "independent auditor's work in forming his or her opinion consists of obtaining and evaluating evidential matter concerning the assertions made by management regarding the financial statements" (AU § 326.02, 2010). For instance, the validity of management's assertions regarding account balances, classes of transactions, and the overall presentation and disclosure of events is contingent on the performance of audit procedures which are designed to gather evidential matter and is used to form the basis of one's own opinion about the financial statements. The rules and standards developed by the Public Company Accounting Oversight Board (PCAOB) and American Institute of Certified Pubic Accountants mandate the planning and performance of audit procedures to gather evidential matter. As a matter of fact, the AICPA expresses the importance of "evidential matter" that is defined as "the underlying accounting data and all corroborating information available to the auditor" (AU §326.14, 2010).

In Vanasco, Skousen, and Jensen (2001), the article discussed the significance of gathering sufficient competent evidential matter. By emphasizing "the ultimate purpose of the audit is the gathering of evidence that supports the auditor's expression of an opinion…which has been defined by philosophers, jurists, astronomers, mathematicians, medical professionals, and scientists". Although this is true, much of the success of the capital markets since the 1920's has been largely influenced by the role of the independent auditor, but some of the most well-recognized audit firms have become the subject of extensive research and public scrutiny. And these issues have been over the quality and reliability of financial audits in both the public and the private sectors. Because of the ongoing issues raised by the PCAOB and the Securities and Exchange Commission, there is a need to take a closer look at the audit standards and specifically those related and used to determine the existence of an asset within an organization.[2] However, the case may be let us not get confused about the proper use of the Generally Accepted Audit Standards. They are not a step-by-step process used solely to confirm line items found on a financial statement. An important concept discussed in each of the fraud cases that resulted in audit failure was largely influenced by the independent auditor's inability to make an appropriate assessment as to whether or not internal controls were active and working effectively. Therefore, any audit procedures used to test for the existence of an asset within an entity could not be confirmed.

Considering the number of audit deficiencies present in the three fraud cases it can be concluded that because the auditors did not clarify in its audit what steps were taken to prove the

[2] Management makes assertions (claims) either implicit or explicit regarding assets, liabilities, and equity interest reported on the financial statements about account balances that existed during period end. For additional guidance on this subject matter refer to AS No. 15. See https://pcaobus.org/Standards/Auditing/pages/auditing_standard_15.aspx

"underlying objective facts" were "free from dispute" one can suggest that they did not apply the concept of materiality appropriately when planning and performing audit procedures.

More importantly, the independent auditor is required to communicate with management and the audit committee in writing about all significant deficiencies and material weaknesses identified during the audit. (AU § 325.4, 2007) As equally important is adherence to Generally Accepted Accounting Principles (GAAP) as they are intertwined with auditing law, and any departure from GAAP is a violation of Generally Accepted Audit Standards. In 2015, the PCAOB during an annual inspection discovered "firms did not take into account relevant audit evidence that appeared to contradict management assertions made in the financial statements" (PCAOB, 2015). In a similar case study, the SEC issued sanctions against individual auditors mainly because they failed to gather sufficient competent evidence to support a clean financial audit. (Beasley, Carcello, Hermanson, & Neal, 2013) Further research on this subject matter opens a new wave of discussion and opportunities to identify the causes of audit deficiencies.

The fraud case decisions involving PricewaterhouseCoopers (PwC), Ernst &Young (E&Y), and Deloitte & Touché (Deloitte) resulted in costly litigation ranging from $20 million up to $5 billion for professional misconduct and negligent misrepresentation. The adverse effects of fraud on society undeniably calls for more emphasis on effective training methods, clarification or simplification of the audit standards, and further discussions about accounting and auditing best practices. The rationale for such corrective measures is rooted in case law "as an accountant who knows of, or recklessly disregards, fraud can be liable for aiding and abetting it" (Rudolph v. Arthur Anderson, 1986).

The results of the comparative analysis will share insight into the proper application of GAAS. The targeted audience will undoubtedly have a better understanding of how financial audits are affected given that the three court decisions resulted in a similar outcome where each accounting firm failed to validate the existence of assets reported on the company's financial statements. Each accounting firm claimed to have performed its audit work in accordance with applicable professional standards. However, the rulings in each court case showed that the audit opinions provided by the firms lacked "sufficient appropriate evidence to support management's assertion over the financial statements including internal controls over financial reporting and information" (AS No. 15.02, 2010). A five-step accounting and auditing research process has been incorporated into the comparative analysis to assist in formulating ideas and solving problems associated with a deficient audit. (Weirich et al., 2012) The main components of the accounting and audit process include (1) identifying audit failure, (2) verifying audit procedures used to collect evidence, (3) evaluating the results, (4) providing a solution-focused approach, and (5) communicating the results of our findings.

In the first case study, *FutureSelect Portfolio Management, Inc. vs. Ernst & Young, LLP.*, the plaintiffs FutureSelect, a privately held investment firm representing a group of investors filed a lawsuit against Ernst & Young, LLP. (E&Y) accusing the "Big Four" audit firm of negligent misrepresentation over its financial audit of the Rye Funds. In 1997, Ron Ward, managing partner for FutureSelect, entered into a partnership agreement with Tremont Partners to invest in the Rye Funds, which they believed had tens of millions of dollars in assets held under management. FutureSelect was influenced by the fact that they were investing their monies with Bernard L. Madoff Investments Securities (BMIS). And because of his reputation, they accepted the terms of the partnership agreement which made for a great investment opportunity.

However, they were unaware that the auditors had made false statements, omitted material facts, and claimed the external audit of the Rye Funds for years 2000 to 2003 was conducted in accordance with Generally Accepted Audit Standards (GAAS). Even more alarming is the fact that E&Y did not review the books and records of BMIS to verify the investment trades with assets held in the Rye Funds. FutureSelect believed the auditor's report to be true and relied on the certified opinion of E&Y while continuing to make investment decisions. FutureSelect lost $195 million dollars because the auditors failed to perform essential auditing tasks needed to confirm the existence of assets found on the company's financial statements.

The case involving FutureSelect and E&Y presents an opportunity to evaluate and identify why a material misstatement occurred during the audit of Tremont Partners and looked at issues regarding management's representations related to the Rye Funds. As part of the partnership agreement, the investor's contributions in the Rye Funds would be held as cash or invested in cash equivalents for short-term investments in securities. One of the line items found on the balance sheet called investments in U.S. Treasury bills had a balance of $831 million dollars. E&Y should have planned and performed substantive procedures found under AU § 332 to address assertions about derivatives and securities. Unfortunately, confirmations were never sent to a third party to determine if the trades ever occurred. By sending only confirmations directly to BMIS to confirm the existence of assets found on the financial statements the evidence could not be relied upon because such measures are inconsistent with AU § 332. If E&Y complied with GAAS, the auditors would have discovered that BMIS was never involved in a legitimate business transaction. One of the most compelling arguments made in the case is related to the annual reports which disclosed investments in U.S. Treasury bills. An experienced auditor who is independent and used sound professional judgment would have realized a red flag upon further review. According to Stephen Thomas, the plaintiffs' attorney, confirmations were sent directly to BMIS and were almost the only source used to determine the existence of U.S. Treasury bills.

The basis for rendering an opinion about the validity of an account balance used for investment activity was inadequate meaning that the evidential matter obtained was not only insufficient but unreliable. A third-party confirmation would have been needed to attest to the validity of the investor's cash held at Fidelity Spartan U.S. Treasury money market account. Mr. Thomas said, "Ernst & Young's job was to audit the Broad Market Funds, but there was nothing there" (FutureSelect v. Tremont Group, 2013). The money did not just disappear. Bernie Madoff made everyone believe in something that was not real.

A more compelling argument as to why there is a need to take a closer look on how to validate the existence of an asset during the course of a financial audit is raised in the second case study. During a public administrative hearing in 2007, the SEC imposed remedial sanctions against Robert M. Harbrecht, CPA and Brian R. Spires, CPA in connection with their audit of National Century Financial Enterprise. Deloitte & Touché LLP's is widely known and is one of the most respected accounting firms in the United States, more importantly, they are held in high regard and often referred to as the gatekeeper of the financial markets. Unfortunately, the auditors failed to identify conflicts of interest that existed within National Century Financial Enterprise. A total of eight non-permitted loans were made in the amount of $1.3 billion to healthcare providers from 1999 - 2002. Ironically, the health care providers who received the loan proceeds were either wholly or partially owned by National Century Financial Enterprise (NCFE) executives.

Like the first case, the auditors for Deloitte failed to capture sufficient appropriate audit evidence to corroborate management's assertions over the existence of assets described as eligible patient healthcare accounts receivables. They relied heavily on management representations regarding the effectiveness of internal controls without documenting in their working papers what specific procedures were performed to validate the existence of purchased patient-specific healthcare receivables. The supporting documentation to prove that accounting balances throughout a given period were basically non-existent. (SEC v. Harbrecht & Spires, 2007) NCFE was required to purchase eligible healthcare receivables but instead were found to have advanced additional funds to healthcare providers that exceeded their value and even provided funding on future receivables. As a result of their repeated violations of GAAS and professional misconduct, the auditors failed to uncover a fraud involving seven former executives of NCFE who were charged with conspiracy, securities fraud, wire fraud, mail fraud, and money laundering.

Audit failures are not uncommon in the mortgage lending industry and have been linked to deregulation in the financial industry. This led to the mortgage crisis resulting in a number of unprecedented bank failures. In fact, the collapse of New Century Financial in 2007 ushered in a series of failures, forcing banks around the world to write down or take losses on nearly $250 billion in mortgage-linked securities. (Bajaj & Creswell, 2008) Two years later Taylor, Bean & Whitaker Corporation (Taylor Bean), a mortgage lending wholesaler, was raided by the Federal Bureau of Investigations (FBI) and the Treasury Department’s Troubled Asset Relief Program for their involvement in a seven-year multi-billion-dollar fraud scheme.

The connection between violations of GAAS and audit failure is discussed further in the third case study examining the outcome in the *Taylor Bean & Whitaker Plan Trust vs. PricewaterhouseCoopers, LLP* decision. On October 22, 2013, the plaintiffs in the Taylor Bean case filed a lawsuit accusing the Big Four audit firm of negligent misrepresentation for their involvement in the audit of Colonial Bank. For seven years, PwC certified over $4.6 billion in fake assets. PwC failed to conduct a physical inspection of the mortgage documents that were located at the Colonial Bank in Orlando, FL to verify if they were real or fake. The auditors did not mark anything on their working papers, instead of obtaining evidential matter to test the balance of a major account PwC decided to "obtain a written confirmation from Taylor Bean for the entire $1.5 billion balance. Colonial entered into business transactions with institutional investors referred to as an Assignment of Trade (AOT). This type of transaction held a pool of residential mortgages classified as mortgage-back-securities that were under contract to be purchased on a specific date. In other words, Colonial's financial statements reported an AOT on its balance sheet as securities purchased under agreements to resell and were said to contain high-quality assets. In theory these were preapproved for sale and scheduled to be purchased by an institutional investor in less than 30- 60 days, but PwC never investigated why Colonial Bank held on to stale loans. An even more startling discovery is that PwC never examined the actual final written contract. By failing to examine the contract, the fraud more than doubled between 2006 and 2007 (Taylor Bean v. PwC, 2016). Not only was this a problem but other issues were discovered involving the incorrect application of accounting principles causing Colonial's financial statements to be overstated. PwC's sales accounting treatment for various participation credit facilities[3] violated US GAAP. To illustrate, the inappropriate accounting treatment used by PwC first you would have to understand the nature of the transaction involving Taylor Bean and Colonial. They both entered into what is called a loan participation agreement. The loan purchase agreement was a lending facility, (referred to as COLB facilities) which gave Colonial the right to purchase a 99% interest in residential mortgages. Colonial's mortgage warehouse lending division reported the COLB facilities as mortgages held for sale on its financial statements. In reality the terms of the agreement required such transactions to be treated as an extension of

[3] A facility is a formal financial assistance program offered by a lending institution to help accompany that requires operating capital.

credit. In fact, Colonial was really providing short-term financing to Taylor Bean to assist the company with the closing of loans. Given these facts about the two types of credit facilities and PwC's sales accounting treatment not only inflated Colonial's financial statements, so that a favorable opinion given by PwC that allowed Taylor Bean to receive additional financing. This received little scrutiny from regulators for loans that had been rejected by institutional investors because the tracking system used by Colonial could not differentiate pools of loans assigned under an AOT agreement. The face of uncontrollable greed was left unchecked leaving a gaping hole in the Colonial's balance sheet. What is more troubling was the conduct of PwC. The conduct is described as being so reprehensible that its inaction and failure to follow GAAS caused tremendous harm to Colonial Bank which was the 26th largest bank in the United States until its demise in 2011. Sadly, 346 offices would close after it filed for Chapter 11 bankruptcy. As for Taylor Bean, they too suffered a similar faith as 2,000 employees lost their jobs crippling the economy in Ocala, FL. Like Colonial Bank they also suffered the same faith. Taylor Bean's presence in the finance and mortgage industry would come to an end. Taylor Bean was once considered to be one of the largest warehouse mortgage lenders in the U.S. before it filed for bankruptcy in 2009. In light of this tragic episode, their misfortunes would change in just seven years. On August 26, 2016, the bankruptcy trustee for Taylor Bean won a $5.5 billion-dollar settlement, which is one of the largest summary judgments against an accounting firm in U.S. history.[4] The unintended consequences of failing to provide persuasive evidence to support the

[4] Taylor, Bean & Whitaker Corporation filed a Chapter 11 petition of the Bankruptcy Code on August 24, 2009. The United States Bankruptcy Court Middle District of Florida appointed Neil F. Luria as the Trustee for the Taylor, Bean & Whitaker Plan Trust who sued PricewaterhouseCoopers, LLP for negligent misrepresentation. Section 552 of the Restatement (Second) of Torts holds accountants liable to third parties for supplying false information for the guidance of others in their business transactions. The auditors of PwC owed a duty of care to those persons who relied on their financial audits. Taylor Bean Whitaker's business relationship with Colonial Bank's mortgage warehouse lending division was contingent on the audited financial statements of PricewaterhouseCoopers.

existence of an asset have led to several private lawsuits and enforcement proceedings involving the SEC. Economic crimes are constantly evolving, beyond the reach of our most entrusted government watchdogs and gatekeepers. There is a need to show how accounting firms fail in their process and what steps should be taken to support compliance with GAAS while focusing on strategies and best practices to confirm the existence of an asset.

Comparative Analysis

During an audit engagement, the independent auditor's goal is to "plan and perform audit procedures necessary to comply with professional standards in order to obtain reasonable assurance regarding the financial statements presented by management are free of material misstatement, whether caused by error or fraud." Upon completion of the financial audit, if the auditor is satisfied with their findings, he or she issues an unqualified opinion conveying to the public that management's representations about the "companies financial statements are fairly presented in conformity with GAAP" (AU §110.02, 1972).

The PCAOB regulates the audits of publicly traded companies monitoring the performance of audit firms to ensure compliance with professional standards. For example, the guidance discussed in this section are comprised of general standards, standards of fieldwork, and reporting requirements consisting of ten standards that provide a measure of audit quality and objectives which have been adopted by the AICPA. (AU §150.02, 2001) In this case study professional standards applicable to the audit of FutureSelect are found under AU section 332 which outline how to plan and perform audit procedures for auditing derivative instruments, hedging activities, and investments in securities for the following assertions:

a. Existence and occurrence

b. Completeness

c. Rights and Obligations

d. Valuation and allocation

e. Presentation and disclosure

The collection of audit evidence is accomplished through the performance of risk assessment procedures, a test of controls, or substantive procedures to assist the auditor in evaluating the assertions made by management regarding the company's accounting policies and procedures, financial records, and financial statements. The basis for his or her opinion is contingent on the reliability of the audit evidence. How the evidence was obtained and from whom the evidence was obtained determines the quality of the information. Furthermore, the relevancy of the audit evidence obtained depends on its relationship to the assertion or control being tested. In order to support the basis for an unqualified opinion, the auditor seeks corroborating evidence to determine if the assertions made by management are complete, truthful, and accurate. The auditor may choose to find the right kind of mix and matching of auditing procedures to address specific questions about assertions that are related to a series of transactions which may have occurred during a given period. The goal is to find the right mix set of audit procedures to verify if management's assertions about the existence of assets are in fact related to financial activity found in the financial statements. To illustrate how this is accomplished the following audit procedures will assist in collecting evidence by obtaining (1) written confirmations, (2) making observations, performing a physical inspection, and (3) vouching for transactions contained in the financial statements back to the original source document.

Based on controversial issues found in the *FutureSelect Portfolio Management v. Ernst & Young* case; the external auditor was required to confirm if management's assertions about assets reported on the statement of financial condition actually existed and if the transactions and events related to those assets occurred for the period under audit. Another key component of the external audit is the assessment of information that discloses the rights and obligations that a company may have regarding assets held within the company that are associated with business transactions that are relevant to their audit objectives. The steps taken provide the basis for reaching a conclusion as to whether or not management presented financial information fairly as required by US GAAP.

This next section of the audit discusses the importance of understanding who is the user organization and whether the company elected to use a service organization. Why is it important to make this distinction? Well in order to obtain persuasive evidence that the controls over the authorization, recording, custody, and segregation of duties for those transactions are operating effectively he or she must obtain evidential matter and document their findings in the working papers. In this case study, the user organization is Tremont Holding Group which was responsible for the day-to-day activities of the Rye Funds. The service organization according to the expert witness Dr. Dan M. Guy who testified in the case was identified as Bernie Madoff. The provision for a service organization found under AU § 332 (2001) states the following:

> "Service organizations may initiate securities transactions for an entity and hold and service the securities. In determining the level of detection risk for substantive tests, the auditor should consider whether there is a segregation of duties and other controls for the services provided."

As a result of their lapse in professional judgment, E&Y failed to provide sufficient evidence about the effectiveness of internal control over personnel and their responsibilities within the organization and whether any regulations were violated by Bernie Madoff. The auditors made no distinction between the Rye Funds and BMIS in their working papers. The provision for a service organization states,

> "If one service organization initiates transactions as an investment adviser and also holds and services the securities, all of the information available to the auditor is based on the service organization's information. The auditor may be unable to sufficiently limit audit risk without obtaining evidential matter about the operating effectiveness of one or more of the service organization's controls" [pg. 1925].

In addition to this issue, there were other matters of importance in the *FutureSelect Portfolio Management v. Ernst & Young* professional negligence case. The jury found that the auditors did not do their job correctly because "the initiation to determine what to buy and sell when to buy and sell, execution, servicing, safeguarding, and safekeeping" were the sole responsibility of Bernie Madoff. (FutureSelect v. Tremont Holding, 2014) Mr. Madoff violated the Investment Adviser Act of 1940 which states that all advisers with custody of clients assets should be held with a qualified custodian who is independent and has no direct contact with the entities employees. Even more alarming is the fact that Madoff kept all the accounting records and had custody of the assets. It is impossible to determine the existence of any trades made or whether the monies were used for investment purposes that resulted in gains and losses from the sale of stock without having proper checks and balances.

Therefore, the evidential matter found in E&Y working papers that were used to determine if Bernie Madoff's internal controls were operating effectively could not be relied upon. For the simple fact E&Y "failed to gain an understanding of the client's internal controls and for this reason, affected their ability to provide reasonable assurance as to whether or not the assets were real or fake. (FutureSelect v. Tremont Holding, 2014) If the reported assets held under management within the Rye Funds existed within a given period, the auditor would be required to conduct a physical inspection of the limited partnership agreements made between FutureSelect and Tremont Partners. A third-party confirmation requesting information about investment activity from the banking institution or brokerage firm would provide evidence to support the initial investments made between the clients of FutureSelect and the managing partner of the Rye Funds including any subsequent investing activity that should have occurred during a particular time period. This information would have been in the possession of BMIS which should have prompted the auditor to collect such evidence to be able to substantiate the business activities. A third-party confirmation sent to a fund manager assists in determining the value of the investors shares in the Rye Funds. To determine if the investment activity found on the statements sent to each investor was real another confirmation would be sent to the brokerage firm who had custody of the bank accounts held by BMIS. This provides evidence about cash deposits and withdrawals that were made for a given period. In other words, the auditor would be satisfied when the audit evidence about an account balance can be substantiated with financial records about the securities to assist in reconciling the client's investments. The comparison of such financial information should be independent of the investment adviser who authorizes the purchase or sale of the investments. AU§ 332. 21 provides further guidance on issuing inquiries to counterparties to assist in validating settled and unsettled transactions to satisfy management's assertions about a class of transactions that took place during a specified period. Consequently, with Madoff acting as an investment adviser and as the custodian of the funds' assets, it should have raised a red flag. A confirmation sent from E&Y to BMIS to gather evidence about a class of transactions, trade tickets, or monthly statements sent to the clients would have more than likely failed to prevent, detect and correct a misstatement. Although the examples given raised serious concerns, further evaluation of evidential matter would have been needed to prove the financial statements were falsified by Bernie Madoff. Therefore, to comply with this section Tremont Partners would have needed to establish “independent departments that provide investment advisory services and the holding and servicing of securities, then reconciling the information about the securities that is provided by each department” (AU § 332.20, 2001). The auditors were required to test the account balance for the existence of assets vouching backward from the recorded journal entries to the source document to have been certain they had captured sufficient evidence that is consistent with GAAS.

In 2005, Tremont Partners reported in its financial statements that the Rye Funds had $2.5 billion in assets held under management. If the transactions and events reported by BMIS were associated with the account balances, an independent third-party confirmation would have captured trade activity for all of Bernie Madoff’s advisory accounts that were overseen by the Depository Trust Company (DTC) to determine if they had actually cleared. This example would have provided corroborating evidence that would lead to a conclusion that the events actually took place and the ending balances on the balance sheet existed.[5] The third-party confirmations did not exist for settled and unsettled transactions which would have allowed the auditor to assess the relationship between the reported events and information recorded from external sources. The auditor would have reconciled the statements to the DTC records to test for the existence of assets found in the account balance. Unfortunately, the records held by DTC showed that Bernie Madoff only had $18 million in equity compared to the financial statements amount

[5] The Deposit Trust Company (DTC) is as clearing agency registered with the SEC. This company was established to provide security custody and book-entry transfer services for securities transactions in the U.S. market involving equities, corporate and municipal debt, money market instruments, American depositary receipts, and exchange-traded funds.

of $2.5 billion and would have uncovered a Bernie Madoff's Ponzi Scheme. (Morrissey, 2009) Another red flag was discovered the pricing data obtained from Yahoo Finance. It showed listed prices for the day (Open, Low, High, and Close), but at times did not coincide with the monthly statements produced by BMIS. If E&Y had contacted Fidelity Spartan U.S. Treasury Money Market Fund to validate the existence of cash in the clients' accounts they would have discovered that the "Fidelity Brokerage Services, LLC did not even offer investment opportunities in any such money market fund from 2005 forward" (Madoff v. Securities LLC, 2010). The validity of the information found on the Statement of Financial Condition is only reliable if the audit engagement team can find evidence to support the existence of assets was obtained from a knowledgeable source that is independent of the company. Another crucial factor to consider would be if management implemented effective controls within the company. Or if the evidence was obtained directly by the auditor and is an original document. (AS 15.08, 2010) Unfortunately, Ernst & Young should not have continued with the audit from the beginning. If it had performed several risk assessment procedures during the first phase of the audit opinion process, they would have uncovered Bernie Madoff's Ponzi scheme.

The second case involving National Century Financial Enterprise shares similarities to *FutureSelect Portfolio Management, Inc. vs. Ernst & Young* decision addressing issues of audit failure due to non-compliance with GAAS. The ramifications of this Ponzi scheme left investors with billions in losses and forced companies into bankruptcy. The results of the comparative analysis look to address issues associated with the lack of audit quality, departures from audit standards, and violations of law that expose accounting firms to liability claims. An evaluation of professional standards used to determine the existence of assets in the healthcare industry provides an opportunity to address limitations that lead to poor audit quality and non-compliance with professional standards. The auditors conducted limited substantive procedures in reaching a conclusion about the existence of assets found on the company's financial statements and made improper assumptions about several critical audit areas. For example, information found in the company's accounting information system (AS 400) regarding eligible patient healthcare receivables were either ignored or not factored into the reconciliation of key general ledger accounts. There was simply not enough evidence to corroborate management's assertions over the entities financial statements. The commission found that the auditor's overreliance on confirmations provided by management did not meet the requirements under GAAS. By mid-1999 more than 50% of the accounts receivable balance on its books was comprised of non-permitted advances made to related parties. Of which either had no value or were non-existent. (SEC v. Poulsen et al., 2003)

An independent auditor satisfies an important aspect of the external audit when there is evidence that suggests that they followed authoritative guidance found under AU 326. Section AU 326 (2001), specifies how to "obtain sufficient competent evidential matter…which is accomplished through the implementation of audit procedures that include inspection, observation, inquiries, and confirmations that affords a reasonable basis for rendering an opinion regarding the financial statements under audit." In this case study, the most important evidence is embedded in the terms and conditions outlined in the master indenture, class of transactions, and account balances. As equally important is the accounting processes and audit procedures implemented to maintain integrity and accuracy within an organization.

Substantive Tests

A more precise audit objective would have been to request a third-party confirmation from all healthcare providers that would have provided valuable information related to the eligible receivables. For instance, NCFE made payments to the healthcare providers in exchange for eligible receivables that gave them ownership rights to the collateral and were required to pay bondholders. NCFE subsidiaries paid upfront 80% of the total value of the receivable, and the other 17% was placed in the reserve account. Given the fact that a substantive test of transactions and balances is a key evidence-gathering audit procedure. If written confirmations were directed to the healthcare providers, and JP Morgan this documentary evidence would have made for an important finding and addressed whether or not an account balance could be substantiated. The request for information about the total value of each receivable purchased compared to the note proceeds that were deposited into NCFE's purchase accounts and any subsequent transactions that were made to the healthcare provider, would have provided the evidence. A physical inspection of accounting records and other documentary evidence made available to the auditor would have shown advances made by NCFE to the healthcare providers. One of the significant issues, in this case, was NCFE made advances to healthcare providers that were more than the amounts reported on the receivables. A review of the accounts receivable aging reports compared to the cash receipt payments received from third-party payers including Medicare and Medicaid would have given an indication whether the receivables were being repaid on time and were not stale. An inspection of the underlying agreement (master indenture) which set lending limits for each healthcare provider was not followed by NCFE. During the enforcement proceeding, the respondents were found to have had prior knowledge of many of the related parties' transactions, which violated the master indenture agreement. For example, Lance K. Poulsen, CEO of NCFE, approved numerous non-permitted advances which were in essence unsecured loans to six health care providers owned and controlled by Mr. Poulsen through his stakes in NCFE and other entities. An observation (walkthrough) of the accounting processes and procedures performed by personnel assists an auditor in determining whether or not events have taken place in a prior period has occurred. The effectiveness of a walkthrough is furthered enhanced with multiple surprise visits to evaluate if recorded advances made by NPF VII and NPF IX to healthcare providers match the original documents furnished by each healthcare provider. Even if there was collusion between the healthcare provider and NCFE subsidiaries the auditor could have conducted inquiries with Bank One, Credit Suisse, JP Morgan regarding the issuance of note proceeds to NCFE and compared that information to the provisions in the master indenture which had set lending limits for each provider. According to the evidence obtained in the case, the auditors were found to have ignored that most of the transactions were made between six healthcare providers who NCFE executives held an interest, which violated the terms of the master indenture.

Analytical Procedures

The validation of account balances while considered a substantive test also encompasses a review of a related set of financial data which is achieved by comparing prior year account balances to current year balances. The concerns over the financial statements of NCFE when Deloitte assumed the duties of the independent auditor should have raised a red flag. For instance, the Healthcare Receivables in 1993 were $124,369,982 compared to the totals in 1999 which ballooned to $1,887,302,000. A sign of trouble within an organization is the increase in accounts receivable but a lack of sales growth. This is an indication that the company may not be collecting payments in the time specified within the master indenture. Further review of the company’s financial statement line items and their relationship to accounts receivable turnover ratio would have revealed that NCFE affiliates had issued stale receivables to investors of which had no value. Consequently, corporate greed was the ultimate factor in the demise of NCFE as executives falsified audit documents that many stakeholders relied upon including Deloitte & Touché.

The third comparative analysis discusses the problems associated with the financial audit performed by PwC and the proper application of GAAS that are used to determine the existence of an asset within an organization. The results of the comparative analysis are meant to provide a basis for developing new strategies to enhance the quality of information used as audit evidence to validate the existence of mortgage warehouse assets found on Colonial Bank's financial statements for the period under audit. PwC performed an integrated audit of Colonial BancGroup, Inc.'s consolidated financial statements from 2004 - 2008. The audit report transmitted to the SEC claimed PwC had conducted an "examination meant to capture evidence to support the amounts and disclosures in the financial statements… including assessing the accounting principles used and significant estimates made by management" (AU §508,1989). In addition to the review of the financial statements, PwC was said to have conducted a test and evaluated the design and operating effectiveness of internal controls. The court concluded PwC's certification of Colonial Bank's financial statements was legally insufficient and had violated its public watchdog function because the audit report was false and misleading and was not performed in accordance with GAAS.

Fraud Risk Factors

Taylor Bean began to experience financial difficulty in 2002 as mounting operating expenses resulted in overdrafts in its main bank account with Colonial Bank. The demand to meet its operating expenses grew exponentially as they were unable to make service payments to Federal Home Loan Mortgage Corporation (FMCC) and Government National Mortgage Association (GNMA) including issues with payroll expenses and other financial obligations. The risk of losing its right as a servicer for not making pass-through payments to FMCC and GNMA is one of the fraud risk factors that influenced Lee Farkas, Chairman of Taylor Bean and several co-conspirators who worked under him including representatives at Colonial Bank to devise a fraudulent scheme referred to as kiting. Colonial Bank made periodic transfers from one account to another to hide Taylor Bean's overdrafts. By December 2003, the rolling overdraft grew to $120 million dollars and became unmanageable which led Taylor Bean to devise a new fraudulent scheme where it began selling residential mortgages to Colonial Mortgage Warehouse Lending Division. In a related complaint against Colonial Bank, they began to falsify loan documents to obtain financing by recycling loans that were either double pledged or considered impaired every 30 -90 days to make it appear that they were sold to investors. If PwC had scrutinized and reviewed the accounting data and the underlying mortgage contracts they would have discovered the collateral securing the loan pools sold in the secondary market were non-existent.

Assignment of Trade Facility

The fraudulent scheme perpetrated against Colonial Bank continued to evolve as the residential mortgage loans purchased under the COLB facilities were moved into a different account and were classified on its financial statements as securities purchased under agreement to resale. The AOT Lending Facility provided an avenue to disguise the mounting mortgages that were unpaid, defective, or fraudulent. The main difference between the COLB and the AOT lending facility was volume. Under the COLB Facility, Colonial Bank purchased individual loans. While on the other hand financing under the AOT lending facility involved the purchase of pools of loans. Taylor Bean entered into agreements with issuers of mortgage-backed securities to sell pools of mortgages that included Colonial Bank buying a 99 percent interest in exchange for cash. The pool of mortgages was sold to third parties in the secondary market within 30-60 days upon closing. One of the critical factors that allowed for the fraud to continue is that once the loans from the COLB account moved into an AOT account, the individual loans were no longer tracked therefore they could literally hide fake mortgages without anyone ever noticing. If PwC had reviewed the bank records related to the AOT transactions they would have discovered that they never took place because Mr. Farkas and co-conspirators "created fabricated documents and transactions to give the false appearance that the third-party resales were taking place. By not auditing the COLB and AOT account balances to determine if the underlying mortgages were sold to Colonial and if the subsequent sale of mortgage-backed securities actually existed and were in compliance with the terms of the agreements resulted in violating professional auditing standards found under AU § 230, AU § 316, and AU § 326. (FDIC v. PwC, 2013)

Audit Quality

It became apparent that the issues discussed in this research paper related to audit failure involving three of the largest accounting firms drew a striking similarity; all of the financial audits contained many contradictions that resulted in violations of professional standards found under AU § 332.[6] More importantly, financial statement assertions unchecked for accuracy, "regarding the recognition, measurement, presentation, and disclosure of the various elements of the financial statements", exposes an auditor to liability as issues of this nature increase the risk of material misstatement due to error or fraud. (AS 15, 2010) After evaluating the nature of each lawsuit against PwC, Deloitte, and E&Y it was evident that the audit deficiencies associated with

[6] AU § 332 discloses requirements on planning and performing audit procedures for derivative instruments, hedging activities, and investment in securities to assist in determining if the assertions made by management about the financial statements are in fact a faithful representation of the company's financial condition at the end of a period.

the external audit were the result of not properly vetting assets found within a company. In short, the audit procedures used to obtain audit evidence to confirm assertions about the existence,[7]occurrence,[8]and rights and obligations [9] for line items found on their client's balance sheet were grossly overstated. The factors that contributed to a decline in audit quality is linked to the audit firms exclusion of audit procedures intended to evaluate the assertions made by management regarding significant accounts and disclosures found in the financial statements. The consequences for excluding a test of internal controls for major account balances not only is a gross error as stated earlier it has a material effect on a company's financial statements. Moreover, a failure to evaluate internal controls impairs the ability to accurately make an assessment of management's procedures used to safeguard assets and the production of accurate and reliable financial statements. These factors described in this section contributed to numerus violations of professional standards found under AU § 322.07 (1991); which required the auditor to capture "evidence relating to the design and effectiveness of controls as it relates to the entity's internal processes used to initiate, record, process, and report financial data consistent with the assertions embodied in the financial statements."

Conclusion

As indicated earlier, one of the primary objectives of the PCAOB is to conduct annual inspections of registered public accounting firms to determine if independent auditors comply with laws, regulations, and professional standards during their audit engagement of U.S. companies. The assessments conducted by the PCAOB revealed significant audit deficiencies by

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[7] Managements representations about the existence of assets, liabilities, and equity are referred to as account balance assertions and are primarily related to balance sheet accounts.

[8] Business related activities that have occurred are associated with transaction-level assertions made by management that claim that they have actually taken place and are found on the income statement.

[9] The rights and obligations assertions are related to the overall presentation of information found on the financial statements and whether the entity holds and controls the rights to that asset.

many firms. A representative of the board mentioned in a recent staff inspection brief that "accounting firms need to consider additional or different steps to improve and sustain audit quality" (PCAOB, 2017). The annual inspections conducted by the PCAOB is a classic blueprint proving a relationship between audit performance deficiencies and violations of GAAS found in accounting scandals. The presence of audit deficiencies was also cited in a report administered by the SEC spanning a 13-year period that evaluated allegations of fraudulent financial reporting by publicly traded companies. The SEC reported 87 cases involving enforcement action against an independent auditor for not providing sufficient evidence to support the existence of assets within an entity during an audit engagement of a publicly traded company. (Beasley et al., 2013) The oral testimony of Stephen W. Thomas, private attorney, and Dr. Dan M. Guy, litigation consultant in GAAS, in the *Taylor, Bean & Whitaker Plan Trust v. PricewaterhouseCoopers, LLP.* case was so profound in articulating negligent and fraudulent audits of an accounting firm that led to the implementation of a comparative analysis that reflects on the limitations of the audit profession. Although this may be true, the purpose of this research paper was to understand these issues of audit quality and the lack of reliability of a financial audit performed by an independent auditor. By analyzing the outcomes in the jury's decisions offered an in-depth understanding of the laws and regulations associated with the review of financial statements.

The financial audits of Deloitte, PwC, and Ernst & Young were deficient in many areas, and much of the work performed had contradicted GAAP and GAAS. The adverse effects of a defective audit in the three case studies resulted in civil litigation against two accounting firms and one SEC enforcement proceeding against two CPA's. Shockingly in each of the three auditor liability cases showed a similar pattern in that they lacked any meaningful written communication to support an unqualified opinion. When looking back at the actions of the independent auditor’s certification of their client's financial statements and the claims they made as being an accurate depiction of the company’s financial health. Many in the audit profession may wonder in astonishment and disbelief about the events of each case. It is hard to fathom that the auditors signed their names and even said they took measures not to omit any information that would have misled others about the current financial condition of the companies under audit. Surprisingly the auditors even defended their position on such matters by certifying the company’s financial statements were presented fairly in conformity with GAAP and were free of any material misstatements. Despite the representations found in the auditors working papers[10]they were, in fact, a fabrication of the truth and in direct contrast to the guidance found under AS No. 15 that defines and describes what constitutes audit evidence.[11]

Given the points made it is without question that the audit deficiencies discovered in each case were directly linked to the misapplication of audit standards and accounting principles. These issues of non-compliance with auditing laws compounded the problem as it led to weaknesses in internal controls over financial reporting. A further investigation was conducted to determine the validity of account balances and transactions that were said to have corresponded with the reported assets found on the balance sheet but was later found to have either no value or did not exist. The reason for audit failure is a culmination of events related to the performance of audits. The evaluations made by the fraud expert in the civil cases viewed the work of the CPAs as audits that were grossly substandard. These conditions previously discussed in this

[10] Working papers contain audit programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents, and schedules or commentaries prepared or obtained by the auditor. Working papers also may be in the form of data stored on tapes, films, or other media.

[11] Audit Standard No. 15 contains guidance on how to plan and perform audit procedures necessary to support an opinion regarding the financial statement assertions made by management. This section also mandates that audit evidence must be sufficient and appropriate to be able to support the expressed opinions found in the auditor’s report.

comparative analysis were the main reasons for not obtaining sufficient appropriate audit evidence. As the CPAs in each case failed to corroborate key information found on the balance sheet that would have supported the occurrence of events and the existence of purported assets. It is important to remember that the role of the gatekeeper is to validate the creditability of management's financial statement assertions over the use of accounting policies, internal controls, and business transactions.

The PCAOB makes a meaningful connection as to what constitutes persuasive evidence. For example, if an “experienced auditor who had no previous connection with the audit was to review the work he or she should be able to determine from the audit documentation that the evidence supports the auditor’s significant judgments and conclusions” (AS No. 3, 2004). Why is this so important? If an auditor is going to prove the existence of an asset, the audit evidence obtained must be sufficient and appropriate to corroborate management’s financial statement assertions. The opinions in each of the cases provided by the independent auditor were either a complete fabrication or distortion of the truth.

Based on the findings of the PCAOB, the SEC, and the analysis of each lawsuit there are enough reasons to suggest a proposal of a new methodology used to form an audit opinion. There is a need for drastic changes as they are deemed necessary to support the public watch function in obtaining a higher level of assurance as businesses become more complex over time. A practical solution to address audit failure would require the further integration of software technology in the audit process. The software audit tools would enhance the quality of the audit by challenging the validity of each line item found in the financial statements. The single most important issue relevant to this research paper is the level of assurance an auditor can provide regarding management’s representations about the existence and true value of its assets reported on the financial statements. Based on this assumption one can infer that audit failure is directly related to the independent auditor's inability to interpret information found in an underlying agreement within an organization. The factors behind this assumption are related to the increasing complexity of how business is run today and the lack of understanding in the level of risk a company may be exposed to that require an auditor to "design procedures that consider the inherent risk for an assertion about a derivative or security and its susceptibility to a material misstatement" (AU § 332, 2001). In 2016, the PCAOB staff inspection brief highlighted that the most frequently identified deficiencies were due to non-compliance with internal controls over financial reporting. The inspection staff also discovered issues related to a lack of knowledge in applying audit procedures to capture evidence which was also prevalent in the cases covered in this capstone paper. A suitable remedy is the simplification of the audit approach integrating a software program designed to identify financial and non-financial data including internal policies and procedures used within an entity. Industry-specific certifications should be completed before an auditor is allowed to work under experienced personnel within an accounting firm. Some have blamed schools for the issues about accountants lacking the correct skills who just do not have the resources to offer an expanded curriculum. (Newquist, 2015) Another proposal is to incorporate software solution programs to hold all the professional standards and accounting principles to aid in clarifying the nature of each assertion made by management that is embodied in the financial statements. The possibility of computer programing to seek, define and outline the relationship between each reported event or line item may sound far-fetched, but it would assist an auditor's in the decision-making process. The intentions of this enhancement would be to avoid common judgment biases that can affect accounting and auditing decisions.[12]

[12] Further discussions about five common judgment biases that can affect decisions made during an audit refer to https://www.journalofaccountancy.com/issues/2015/feb/auditing-judgmentbias.html

Furthermore, one can only wonder if full implementation of data analytics will reach its peak allowing auditors to sample 100% of a population. This idea of increasing the level of assurance is discussed in a recent publication by the Emerging Assurance Technologies Task Force as research experts believe that with computerized data and file interrogation audit software many tests can be performed and would facilitate the capturing of a greater sample size. (Byrnes, Criste, Stewart, and Vasarhelyi, 2014) The transformation of the audit profession is inevitable and for its survival in the 21st century seeing the endless possibilities will require industry leaders to embrace change and to develop those who have accounting skills to learn to code and work with new technologies are just the first steps at seeing such ideas become a reality.

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Appendices

Appendix A | FutureSelect Portfolio Management, Inc. vs. Ernst & Young
Appendix B | SEC Enforcement Proceeding - Deloitte & Touché CPA's
Appendix C | Taylor Bean & Whitaker Plan Trust vs. PricewaterhouseCoopers, LLP

Appendix A

FutureSelect Portfolio Management, Inc. vs. Ernst & Young, LLP.

Investment Advisory Industry

Negligence Misrepresentation Tort Claim

Legal Issue

On August 26, 2010, FutureSelect Portfolio Management, Inc., a privately held investment advisory firm, filed a civil lawsuit in Kings County Superior Court in Seattle, WA against Ernst & Young, LLP. ("E&Y")

The plaintiffs in the case FutureSelect alleged that the defendants E&Y were liable under Washington State Security Act RCW 21.20.010 and RCW 21.20.43 for "providing false and misleading information that was a substantial contributing factor in making investment decisions and maintaining their investments. E&Y prepared annual audited financial statements from 2000 - 2003 for its client Tremont Partners who operated, managed and controlled the Rye Select Broad Market Fund and the Rye Select Broad Market Prime Fund collectively known as the Rye Funds. During this period E&Y auditors issued several unqualified opinions claiming the financial statement assertions made by the managing partner of the Rye Funds were true and that during their audit they had taken reasonable steps in confirming the existence of assets totaling $4.2 billion.

Unfortunately, this was not the case, because the evidence obtained from E&Y working papers revealed BMIS had total control over all the investment activities made on behalf of the clients for FutureSelect. E&Y was required to obtain reasonable assurance that internal controls over financial reporting was operating efficiently but were found to have breached their fiduciary duty to its clients. According to Dr. Dan Guy, who said, "there was no indication that they did that in the audit work papers and, furthermore, they testified they had no knowledge of controls over Madoff" (FutureSelect v. Ernst & Young, 2014). This practice was contrary to the guidelines for auditing investments in securities which describes how a control risk assessment is satisfied when he or she "identifies controls over the authorization, recording, custody, and segregation of duties for derivative or securities transactions and to gather evidential matter about their effectiveness. (AU § 332, 2001) The guidance found under this section is meant to assist the auditor in evaluating the integrity of the information recorded that were related to each business transaction within the organization.

By ignoring potential control risk factors inevitably caused an increase in the likelihood of assets misappropriation within the organization. E&Y auditors even wrote in their working papers how Tremont Partners had effective controls in place and did not monitor the investment activity of Bernie Madoff. For example, Mr. Madoff operated his business as a register broker-dealer, but also acted as the custodian for the Partnership assets. One of the several functions of the audit formulation process requires an auditor to "plan and perform audit procedures that are necessary for obtaining sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion" (AS 15.04, 2010). The auditors had acted recklessly failing to confirm trades with the Depository Trust Company who is an independent third-party regulator that oversees the activities of investment advisors. Madoff claimed to have purchased and sold equity securities, options, and government securities, but no third-party confirmations were ever sent to DTC to verify the purported trades made on behalf of his clients even though they received monthly statements that reflected investment activity. Furthermore, the DTC showed that it had no record of BMIS or Mr. Madoff clearing a single purchase or sale of securities even though he reported to have an account with the DTC. (In Re Santander, 2009)

So, what if the auditors carefully examined the financial statements and verified that the assets managed by Bernie Madoff on behalf of his clients ever existed or did their due diligence in validating that the trades Madoff made actually occurred? Why did E&Y ignore the potential red flags and issued a clean audit if the entity lacked any meaningful segregation of duties to satisfy the requirements found under AU § 332? Since E&Y auditors were planning and performing an audit of the Rye Funds, they were required to obtain a sufficient understanding of internal controls that were implemented by Tremont Partners. The audit standards found under AS 15 requires the auditor to obtain sufficient appropriate audit evidence that involves planning and performing risk assessment procedures to assess whether the claims and assertions made about the recognition, measurement, and the disclosures found in the financial statements are presented fairly in conformity with the applicable financial reporting framework.[13] Both internal and external events may affect the entity's ability to initiate, authorize, record, process, and report financial data. Therefore, it is a critical audit function to "identify the controls placed in operation by the entity or a service organization and gathering evidential matter about the operating effectiveness of those controls" (AU § 332.18).

On December 12, 2008, Mr. Madoff was arrested and would later confess that he never invested the money provided by Tremont Partners, but rather kept the money in a Chase Bank account in New York. E&Y had a duty to evaluate the nature of each business transaction that was pertinent to audit. If any of the transactions appeared to be fraudulent, they were responsible for investigating the evidence obtained which contradicted any of the representations made by management. (AU § 316, 2007) Unfortunately, the damage had been done, and the evidence was so overwhelming that the jury sided with the plaintiffs. As E&Y was held liable for negligent

[13] Examples of financial reporting frameworks are generally accepted accounting principles in the United States of America, International Financial Reporting Standards, and special purpose frameworks.

misrepresentation because the financial statements contained untrue statements and were found to have omitted material facts that were provided to the limited partner who relied on such information to continue making investments" (FutureSelect v. Ernst & Young, 2013). On November 13, 2015, a Washington State court jury found E&Y liable for losses FutureSelect sustained in connection with its audit over Bernie L Madoff's feeder fund awarding the plaintiffs $20 million plus interest. In retrospect, the legal proceedings provide an example of weaknesses in the quality of the audit as the audit engagement team failed to confirm the existence of $4.2 billion in assets. Tremont Partners had reported on its financial statement from 2000 - 2003 that were not a true depiction of the company's performance and asset holdings for that particular period.[14]

Background

In 1997, a representative of Tremont Partners visited Ron Ward, President of FutureSelect Portfolio Management Inc., in Redmond, WA to solicit investments in the Rye Select Broad Market Fund and the Rye Select Broad Market Prime Fund. Tremont provided Mr. Ward with audited financial statements certified by Goldstein Golub Kessler (GGK) who was the predecessor auditor for the Rye Funds from 1997 - 1999. Tremont representatives claimed to have monitored the activities of BMIS and even validated that Mr. Madoff had millions of dollars in assets. FutureSelect accepted the invitation to invest in the Rye Funds and would continue an ongoing business relationship with Tremont Partners who furnished Mr. Ward among other things a letter in 2001 that claimed Ernst & Young who replaced GGK as the external auditor that they had performed numerous procedures to confirm that the information

[14] In a published opinion filed in the Court of Appeals of the State of Washington the jury found that Ernst & Young had certified that the Broad Market Fund had $288 million in assets in 2000, $364 million in 2001, $400 million in 2002, and $450 million in 2003. The Prime Fund that Ernst & Young certified that it had $497 million in 2000, $667 million in 2001, $750 million in 2002, and ended with $831 million in 2003.

provided by BMIS was accurate. E&Y issued annually an unqualified audit opinion that claimed to provide "reasonable assurance to external users that the financial statements and accounting records of Tremont Partners were free of material statements and were represented fairly in accordance with generally accepted auditing standards" (FutureSelect v. Tremont Group, 2013) The plaintiffs, in this, case had invested approximately $195 million over the course of nine years, but what Madoff's clients did not know at the time is his "loyal employees fed price data for previous months from a computer indicating activity in the trading of stocks, options, and treasury bills. The operators of the computer terminals would generate a lengthy list of trades that signified a profit and would later mail documents containing fictitious trading tickets to his clients as supporting evidence" (Collins, 2009). On December 11, 2008, Bernie Madoff was arrested and would later confess his misdeeds that spanned over two decades. Mr. Madoff masterminded one of the most elaborate Ponzi Schemes that cost investors $50 billion. In his written confession Mr. Madoff told the judge that he had never invested his client's monies rather he took the money and placed in a Chase Manhattan Bank in New York. Ernst & Young had a fiduciary duty to its client to conduct its financial audits of the Rye Funds in accordance with "all applicable auditing and related professional practice standards of the PCAOB" (AS 1.01, 2004). The investors were unaware that their investments made with FutureSelect were funneled into the hands of Bernie L. Madoff. By not complying with professional standards led the jury to conclude that Ernst & Young actions was a material departure and negligently breached their fiduciary duty to its client.

Appendix B

Deloitte & Touché CPA's

Healthcare Industry

SEC Accounting and Auditing Enforcement Proceeding

Legal Issue

On September 09, 2007, the Securities and Exchange Commission held an administrative proceeding against Robert M. Harbrecht and Brian R. Spires for violating commission rule 102(e)(1)(iv)(B)(2).[15] The complaint is in connection with a previous civil complaint filed on February 11, 2003, in the United States District Court Southern District of Ohio, against accounting firm Deloitte & Touché, LLP (Deloitte) who was held liable for professional negligence. The two defendants in this parallel proceeding are meant to address the conduct of two licensed, certified public accountants who worked for Deloitte, Robert M. Harbrecht and Brian R. Spires, that audited the financial statements of National Century Financial Enterprise, Inc. (NCFE) for years 1999 through 2001.

The two CPA's signed off on an audit in the year 2000 certifying that the financial statements were prepared in accordance with generally accepted auditing standards. When in fact the audited financial statements "Deloitte had certified actually contained false financial data and omitted material facts about NCFE, its funding, accounting practices and its transactions with its common-control, related or affiliated entities." The two CPA's completed the audit engagement in May of 2001 and subsequently issued an unqualified opinion certifying that the "consolidated financial statements present fairly, in all material respects, the consolidated financial position of

[15] The Securities and Exchange Commission enforces rule 102(e)(1)(iv)(B)(2) if there is substantial evidence that suggests that a licensed to practice accountant has engaged in repeated instances of unreasonable conduct.

NCFE and its subsidiaries…and the results of its operations and cash flows…were in conformity with accounting principles generally accepted in the United States" (Parrett v. Poulsen et al., 2003).

The SEC discovered that the two defendants present at the enforcement hearing breached their fiduciary duty owed to its client. Bank One, J.P. Morgan Chase, and Credit Suisse entered into a series of business arrangements with National Premier Financing VI, Inc. (NPF XVI) and National Premier Financing XIX, Inc. (NPF XIX), and National Premier Financial Services (NPFS) referred to as the Health Care Receivables Securitization Program Notes Master Indenture (Master Indenture)[16]. The terms outlined in the master indenture included the following parties: NCFE special purpose NPF entities, program trustees, health care providers, and noteholders. Which contained contractual duties requiring NCFE subsidiaries to use the note proceeds made available from the funding program, to purchase eligible healthcare accounts receivables that were to be repaid by private insurers and public health care programs. Mr. Harbrecht who served as the engagement partner including Mr. Spires was found to have ignored numerous audit procedures that were required to substantiate the rendering of an unqualified opinion. Due to the circumstances surrounding several key executives within NCFE, the auditors should have identified red flags that were present within the organization at the time they were conducting their audit. NCFE subsidiaries issued non-permitted advances referred to as secured and non-secured loans to healthcare providers on future receivables and would subsequently add the "promissory notes as assets on its books in order to continue to receive funding from Credit

[16] The Healthcare Securitization Program (funding program) required that the purchased receivables be less than 180 days old and that NCFE at all times had to maintain "cash reserves and eligible receivables equal to at least 111% of the amount of notes outstanding." This provision within the agreement ensured that the bond investors were given reassurance that the likelihood of default was very low due to the fact that the company would only authorize the purchase of eligible patient-specific receivables.

Suisse through the issuance of new bonds that were classified as asset-backed securities" (Parrett v. Poulsen et.al, 2003). Mr. Spires reckless behavior during the audit of NCFE's financial statements resulted in a failure to obtain sufficient appropriate evidential matter needed to corroborate management's assertions over the existence of eligible purchased patient specific receivables. The unintended consequences from the "defendant's professional gross negligence and accounting malpractice" resulted in a failure to uncover a massive fraud perpetrated by NCFE executives who defrauded investors of $2.6 billion and forced 275 healthcare providers to file for bankruptcy. (USA v Poulsen, 2011) The methods used by Mr. Spires and Mr. Harbrecht were so unbecoming of a professional that its privileges as a public watchdog were revoked by the SEC prohibiting them from serving as a certified public accountant.

Background

National Century Financial Enterprise, Inc. was an Ohio based privately held healthcare financing company founded in 1990. NCFE and its subsidiaries provided financing, consulting services, merger and acquisition solutions to healthcare providers. From 1991 - 2003, NCFE issued $17 billions of dollars in asset-backed securities and secured $6 billion in note proceeds from the sale of the bonds with the assistance of Credit Suisse Securities, LLC. Credit Suisse purchased notes from NPF VI and NPF XI, provided funding, and was the securities underwriter for most of the private placement offerings selling asset-backed bonds in the secondary market to institutional investors. NCFE affiliates became one of the largest purchasers of healthcare receivables in the United States until its's financial collapse in November 2002 when the company filed for Chapter 11 bankruptcy.[17] The market for healthcare receivables at that time

[17] Credit Suisse served as the initial purchaser for many of National Century's note issuances and then sold the notes to institutional investors like the Noteholders. Credit Suisse also sold notes to some of the Noteholders in the secondary market.

was a new investment market strategy that some say was the riskiest on Wall Street because of the level of uncertainty in the repayment of unpaid healthcare bills.

Asset Backed Securities

The development of its healthcare financing business was made possible with the creation of NPFS, NPF XVI, and NPF XIX which were special purpose vehicles established to assist hospitals, physician groups, or other healthcare providers who experienced cash flow and financing difficulties. NPFS determined which healthcare receivables were eligible for purchase. NPF XVI and NPF XIX were both responsible for securitizing eligible healthcare receivables into bonds that were to be sold in the secondary market to institutional investors. The parent company NCFE derived most of its revenue from the funding program through private placement offerings. The note proceeds issued by Credit Suisse gave NPFS the necessary capital to buy receivables and provide loan options to healthcare providers who used the monies to meet its current operating expenses, payroll, and funding for business expansion. Mr. Spires, the acting manager, participated in the planning and the execution of the audit for National Century Financial Enterprises, Inc. from 1999 - 2001. While Mr. Harbrecht, engagement partner, was responsible for the completion of the audit including the certification of the financial statements. The auditors for Deloitte claimed to have reviewed NCFE financial statements and confirmed that NPFS purchased only eligible healthcare receivables and complied with the provisions set forth under the master indenture. The Health Care Receivables Securitization Program Notes Master Indenture required NCFE to purchase eligible receivables which were not to exceed 180 days and at all times had to maintain “cash reserves and eligible receivables equal to at least 111% of the amount of notes outstanding” (Capriotti & D'Aquila, 2011). This provision within the master indenture provided reassurance to the investors that minimized the likelihood of default because NPFS was required to conduct a proper screening of each healthcare provider before purchasing any eligible patient-specific receivables. The financing made available to healthcare providers was a part of sales and subservice agreement. Which allowed for companies like Amedisys to be given advances on anticipated future collections due to the fact the eligible receivables were paid by “highly rated third-party payers and government programs like Medicare and Medicaid for medical services that have been rendered and billed during the time of service” (USA v Poulsen, 2005).

Appendix C

Taylor Bean & Whitaker Plan Trust vs. PricewaterhouseCoopers, LLP.

Mortgage Banking

Professional Negligence

Legal Issue

On 10/29/2013, Taylor, Bean & Whitaker Plan Trust filed a complaint against PricewaterhouseCoopers (PwC) in the 11th Judicial Circuit in and for Miami-Dade County, Florida. The plaintiffs in the case (bankruptcy trustee) claimed that the certified public accountants breached its fiduciary duty owed to the Taylor, Bean & Whitaker Corporation (Taylor Bean) during the performance of its external audit of the Colonial BancGroup, Inc. (Colonial Bank) for years 2004 through 2008.

Colonial Bank's financial statements contained false and misleading information which Taylor Bean relied upon to make business decisions. For example, Taylor Bean "entered into various transactions, mortgage purchases and sales, commercial paper issuances and lending facilities, with Colonial and various other financial institutions" mainly because they relied on the certified financial audits of PwC. Taylor Bean entered into a mortgage loan purchase facility agreement with Colonial Bank which provided short-term secured financing to assist Taylor Bean and its customers with the closing of loans. Taylor Bean's business relationship with Colonial Bank was contingent on the audit opinion of PwC. Who claimed the financial statements of Colonial Bank were "free of material misstatement and had taken the appropriate action during its audit engagement in performing an examination of accounting records, gathered evidence to support the amounts and disclosures…including an assessment of the accounting principles." For example, PwC had certified in its audited financial statements the existence of

Colonial's assets, but the evidence obtained in the case against them revealed that the "residential mortgage loans did not exist, had been sold to others, or were worthless" (FDIC v. PwC, 2013).

PwC failure to follow professional standards found under AU Section 332 which provides guidance on performing substantive procedures to determine if management's representations regarding the existence of mortgage warehouse assets were true resulted in the certification of $4.6 billion in fake assets. "PwC's negligence and misrepresentations caused Taylor Bean not only to lose more than a billion dollars but also incurred billions of dollars in debt that could not be repaid." The evidence obtained in the case against PwC revealed that the audit engagement team violated numerous generally accepted audit procedures and accounting principles of the United States.

In a similar court proceeding the Federal Deposit Insurance Corporation found a total of 26 professional standards violations elaborating in further detail as to what actions were taken that constituted a case against PwC, which encompassed departures from general audit standards, audit procedures, and auditor reporting. Also, there were violations of SEC rules that governed auditor's independence and AICPA's rules regarding professional code of conduct. Instead of conducting a physical inspection of the residential mortgage documents that were in the possession of Colonial Bank to verify if they were real. They just marked on their working papers absolutely nothing. Instead of obtaining evidential matter to test the balance of a major account for existence found on the balance sheet. PwC auditors never requested nor examined the actual final written contract…by not examining the contract…the fraud more than doubled between 2006 and 2007. (Taylor Bean &Whitaker, 2016) The Taylor, Bean, & Whitaker Plan Corporation which started its business in Ocala, Florida in 1982 turned into one of the nation's largest wholesale mortgage financing companies and the 5th largest issuer in the United States before it filed for bankruptcy and finally ceased operations on August 05, 2009. Taylor Bean Whitaker Plan Trust and PwC reached an agreement settling their $5.5 billion-dollar lawsuit on August 30, 2016. The settlement agreement is one of the largest summary judgment against an accounting firm in recent U.S. history.

Background

The client under audit Colonial Bank, subsidiary of Colonial BancGroup, ran a mortgage warehouse lending division in Orlando, FL. Taylor Bean's business relationship with Colonial Bank began in 1999. Prior to the bankruptcy, Taylor Bean originated over 14,000 mortgage loans per month. Taylor Bean's primary operating activities included mortgage loan origination, underwriting, loan servicing, and issuing mortgage-backed securities in the secondary market to large institutional investors and financial institutions. Taylor Bean's core business objectives were to sell residential mortgages and issue mortgage-backed securities. Colonial Bank assisted Taylor Bean with short-term financing through various lending facilities to aid with the funding of residential mortgage loans. The time in between mortgage loan origination, closing, and the initiation of a contract to sell a pool of mortgages in the secondary market required significant funding. An important aspect in mortgage warehouse lending is the availability of financing through banks that provide liquidity for mortgage lenders to make loans to its customers. The lending facilities available to mortgage lenders generally begins at loan origination to the time it is sold in the secondary market. Therefore, to receive Colonial Bank's line of credit Taylor Bean was responsible for negotiating with takeout investors the sale of residential mortgage loans whether directly or through securitization.[18] The first form of financing available to Taylor Bean is referred to as the “COLB” Lending facility. The financing made by Colonial Bank’s warehouse lending division was contingent on take-out commitments made to third-party investors who had agreed to purchase the residential mortgage loans within 90 days. The line of credit issued to Taylor Bean became available upon entering a loan participation sale agreement with Colonial Bank who purchased a security interest in the individual residential mortgages loans originated by Taylor Bean. Colonial Bank’s mortgage warehouse line of credit is known as "wet funding" which is funding made available to Taylor Bean to pay for a mortgage the borrower used to purchase a property. Which generally occurs at closing but before the delivery and execution of the loan documents. The issuance of a participation certificate provided a written acknowledgment identifying the particular mortgage loans in which the buyer is purchasing a participation interest. The funds advanced to Taylor Bean were deposited into a Colonial master advance account and used to pay for the closing of the loans or purchase of loans from other banks. Upon the execution of a loan closing the promissory note and mortgage document were inspected and entered into Taylor Bean’s servicing system and later shipped to Colonial Bank’s Warehouse lending division. The pool of loans was verified as mortgages eligible for "dry funding" meaning additional financing was made available from the time they were eligible to be sold and the actual sale to the investors. The sale of residential mortgage loans to a government-sponsored enterprise or other financial institutions allowed Taylor Bean to pay down either the wet or dry funding balances. Colonial Bank’s financial statements described

[18] Investors in the secondary market, Ginnie Mae and Freddie Mac, entered into forwards sales commitments which are contracts to buy either a pool of mortgage loans or mortgage-backed securities. Taylor Bean mortgage servicing operation was responsible for the collection of monthly mortgage payments from the borrowers and was required to disburse payments to Colonial Bank in custodial funds clearing account.

COLB lending facility as loans held for sale, which include originated mortgage loans from Taylor Bean who acquired short-term participation in pools of mortgage loans.