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June 9, 1987

Mr. Guy Wilson
Ernst & Whinney
515 South Flower
Los Angeles, California 90021

Dear Mr. Wilson,

I am an individual having certain confidential information regarding the financial condition of ZZZZ Best Co., Inc. I have read the prospectus and your Review Report dated October 3, 1986 and recognize you have not done an examination in accordance with generally accepted auditing standards, but that such audit will be forthcoming by you.

I wish to make you aware of the following material facts which require you to confirm or disaffirm:

1. The electric generators which appear on the balance sheet under Note 6 as being purchased for \$1,970,000 were purchased for scrap for less than \$100,000 thru intermediaries of ZZZZ Best and resold to ZZZZ Best at the inflated value. The sole purpose was to boost the assets on the balance sheet. These generators have never been used and have no utility to the company.
2. Note 5 of the balance sheet discusses joint ventures and two restoration contracts. These contracts are fictitious as are the bookkeeping entries to support their validity. Interstate Appraisal Service [sic] did not let such contracts although they confirm their existence. The same is true for the alleged \$7,000,000 Sacramento contract and the \$40–100 million contracts with Interstate.
3. Further, checks made and passed between ZZZZ Best, its joint venturers and some of its vendors are no more than transactions among conspirators to support the validity of these restoration contracts.
4. Earnings reported by ZZZZ Best are being reported as billings in excess of costs and estimated earnings on restoration contracts. These contracts do not exist nor do the earnings. This can be confirmed directly by contacting the alleged insurance carriers as well as physical inspections as to the existence and extent of the contracts.
5. Billings and earnings for 1985 and 1986 were fabricated by the company before being presented to other accountants for certification.

Confirmation of these allegations can be accomplished by a careful due diligence. Such due diligence on your behalf is imperative for your protection.

Very truly yours,

B. Cautious
(Signed)

EXHIBIT 4

ANONYMOUS
LETTER RECEIVED
BY ERNST &
WHINNEY
REGARDING ZZZZ
BEST

Collapse of ZZZZ Best

The *Los Angeles Times* article published in mid-May 1987 that disparaged Barry Minkow ultimately doomed the young entrepreneur and his company. Several years earlier, a homemaker had fallen victim to Minkow's credit card forgeries. Minkow had added a fraudulent charge to a credit charge slip the woman had used to make a payment on her account. Despite her persistence, Minkow avoided repaying the small

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amount. The woman never forgot the insult and tracked down, and kept a record of, individuals who had been similarly harmed by Minkow. At the urging of this woman, a reporter for the *Los Angeles Times* investigated her allegations. The woman's diary eventually became the basis for the *Los Angeles Times* article that, for the first time, cast doubt on the integrity of the "boy wonder" who was the talk of Wall Street.

The newspaper article triggered a chain of events that caused ZZZZ Best to collapse and disappear less than three months later. First, a small brokerage firm specializing in newly registered companies with suspicious earnings histories began short-selling ZZZZ Best stock, forcing the stock's price into a tailspin. Second, Ernst & Whinney, ZZZZ Best's law firm, and ZZZZ Best's investment banker began giving more credence to the allegations and rumors of financial wrongdoing by Minkow and his associates. Third, and most important, the article panicked Minkow and compelled him to make several daring moves that cost him even more credibility. The most critical mistake was his issuance of the May 28, 1987, press release that boldly reported record profits and revenues for his firm.

EPILOGUE

Among the parties most vilified for their role in the ZZZZ Best scandal was Ernst & Whinney. The transcripts of the Congressional testimony focusing on the ZZZZ Best fraud included a list of 10 "red flags" that the audit firm had allegedly overlooked while examining ZZZZ Best's financial statements (see Exhibit 5). Ernst & Whinney officials flatly rejected assertions that their firm was even partially to blame for the ZZZZ Best fiasco. In his Congressional testimony, Leroy Gardner, the West Coast director of accounting and auditing for Ernst & Whinney, maintained that when all the facts were revealed, his firm would be totally vindicated:

The ZZZZ Best situation proves at least one thing: a well-orchestrated fraud will often succeed even against careful, honest, hard-working people. . . . The facts that have begun to emerge establish that Minkow along with confederates both inside and outside ZZZZ Best went to extraordinary lengths to deceive Ernst & Whinney. For example, Thomas Padgett, an alleged conspirator, revealed in a recent televised interview that Minkow spent \$4 million to deceive Ernst & Whinney during a visit to one of ZZZZ Best's job sites. . . . Ernst & Whinney never misled investors about the reliability of ZZZZ

Best's financial statements. Ernst & Whinney never even issued an audit opinion for ZZZZ Best. . . . We are not part of the problem in this case. We were part of the solution.

In one of the largest civil suits stemming from the ZZZZ Best fraud, a court ruled that Ernst & Whinney was not liable to a large California bank that had extended ZZZZ Best a multimillion-dollar loan in 1986. The bank alleged that in granting the loan, it had relied upon the review report issued by Ernst & Whinney on ZZZZ Best's financial statements for the three-month period ending July 31, 1986. However, an appellate judge ruled that the bank was not justified in relying on the review report since Ernst & Whinney had expressly stated in the report that it was not issuing an opinion on the ZZZZ Best financial statements: "Ernst, because it issued only a review report, specifically declined to express an opinion on ZZZZ Best's financial statements. The report expressly disclaimed any right to rely on its content."⁵

In the late 1980s, ZZZZ Best's former stockholders filed a class-action lawsuit against Ernst & Whinney, ZZZZ Best's former law firm, and ZZZZ Best's former investment banker. An Internet publication reported in March 1996 that

5. "Ernst & Young Not Liable in ZZZZ Best Case," *Journal of Accountancy*, July 1991, 22.
8405831 2015/10/11 147.251.198.73

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1. The amounts called for by the insurance restoration contracts were unrealistically large.
2. The number of multimillion-dollar insurance restoration contracts reportedly obtained by ZZZZ Best exceeded the total number available nationwide during the relevant time period.
3. The purported contracts failed to identify the insured parties, the insurance companies, or the locations of the jobs.
4. The contracts consisted of a single page which failed to contain details and specifications of the work to be done, such as the square yardage of carpet to be replaced, which were usual and customary in the restoration business.
5. Virtually all of the insurance restoration contracts were with the same party.
6. A large proportion of the ZZZZ Best insurance restoration contracts occurred immediately, and opportunistically, prior to a planned offering of stock.
7. The purported contracts provided for payments to ZZZZ Best or Minkow alone rather than to the insured or jointly with ZZZZ Best and the insured, contrary to the practice of the industry.
8. The purported contracts provided for payments by the insurance adjuster contrary to normal practice in the industry, under which payments are customarily made by the insurance company directly to its insured or jointly to its insured and the restorer.
9. ZZZZ Best's purported gross profit margins for its restoration business were greatly in excess of the normal profit margins for the restoration industry.
10. The internal controls at ZZZZ Best were grossly inadequate.

EXHIBIT 5
TEN RED FLAGS
THAT ZZZZ
BEST'S AUDITORS
ALLEGEDLY
OVERLOOKED

this lawsuit had been settled privately. The defendants reportedly paid the former ZZZZ Best stockholders \$35 million. However, the contribution of each defendant to the settlement pool was not disclosed.⁶

Barry Minkow was released from prison in late 1994. Minkow secured the reduction in his 25-year prison sentence for "good behavior and efforts to improve himself."⁷ These efforts included earning by correspondence bachelor's and master's degrees in religion from Liberty University. Shortly after being paroled, Minkow married a young woman introduced to him by a fellow inmate. That inmate was a former subordinate of Charles Keating, the principal architect of the massive Lincoln Savings and Loan fraud.

In early 1995, Minkow began serving as the associate pastor of an evangelical church in a

community near his hometown of Reseda. Two years later, Minkow was appointed the senior pastor of a large nondenominational church in San Diego. Besides his pastoral duties, Minkow served as the spokesperson for an Internet company, the Fraud Discovery Institute, which markets various fraud prevention and detection services.

For more than a decade, Minkow regularly presented lectures and seminars across the United States that focused on his "experience" with corporate fraud. He spoke to groups of CPAs, educational institutions, and, most notably, the FBI Academy at Quantico, Virginia. Minkow often chastised the accountants and auditors in his audience. During one presentation, Minkow noted that, "CPAs are creatures of habit. You're interested in making tick marks and footnotes, not in thinking

6. C. Byron, "\$26 Million in the Hole," *Worth Online*, March 1996.

7. M. Matzer, "Barry Minkow," *Forbes*, 15 August 1994, 134.

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outside of the box.”⁸ Minkow also chided auditors for being overly willing to accept weak forms of audit evidence, such as client representations. He warned auditors, “Don’t give up objectivity for convenience.”⁹

Unfortunately, the redemptive phase of Barry Minkow’s life ended abruptly in 2011. In May of that year, Minkow pleaded guilty to conspiracy to commit securities fraud. Law enforcement authorities established that Minkow had participated in a scheme during January 2009 to drive

down the stock price of Lennar Corporation and to extort money from the company’s executives. At the time, Minkow wrongfully accused Lennar of fraudulently misrepresenting its publicly released financial statements.

On July 21, 2011, Barry Minkow appeared before Judge Patricia Seitz in a federal courtroom in Miami, Florida. Judge Seitz denied Minkow’s request for leniency and sentenced him to five years in federal prison, the maximum sentence requested by federal prosecutors.

Questions

1. Ernst & Whinney never issued an audit opinion on financial statements of ZZZZ Best but did issue a review report on the company’s quarterly statements for the three months ended July 31, 1986. How does a review differ from an audit, particularly in terms of the level of assurance implied by the auditor’s report?
2. Professional auditing standards identify the principal “management assertions” that underlie a set of financial statements. The occurrence assertion was particularly critical for ZZZZ Best’s insurance restoration contracts. ZZZZ Best’s auditors obtained third-party confirmations to support the contracts, reviewed available documentation, performed analytical procedures to evaluate the reasonableness of the revenues recorded on the contracts, and visited selected restoration sites. Comment on the limitations of the evidence that these procedures provide with regard to the management assertion of occurrence.
3. In testimony before Congress, George Greenspan reported that one means he used to audit the insurance restoration contracts was to verify that his client actually received payment on those jobs. How can such apparently reliable evidence lead an auditor to an improper conclusion?
4. What is the purpose of predecessor–successor auditor communications? Which party, the predecessor or successor auditor, has the responsibility for initiating these communications? Briefly summarize the information that a successor auditor should obtain from the predecessor auditor.
5. Did the confidentiality agreement that Minkow required Ernst & Whinney to sign improperly limit the scope of the ZZZZ Best audit? Why or why not? Discuss general circumstances under which confidentiality concerns on the part of a client may properly affect audit planning decisions. At what point do client-imposed audit scope limitations affect the type of audit opinion issued?
6. What procedures, if any, do professional standards require auditors to perform when reviewing a client’s pre-audit report but post-year-end earnings press release?

8. T. Sickinger, “Ex-Con Artist Helps Find Fraud,” *The Kansas City Star*, 18 October 1995, B1.

9. *Ibid.*