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PwC and the Colonial Bank Fraud: A Perfect Storm

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Introduction

There is an expectation gap as to the parties responsible to prevent and detect financial fraud (Kenney, 2019). In general, management is the responsible party. But suppose management is the party committing the fraud? A survey by the Anti-Fraud Collaboration Group in 2013 found that eighty-seven percent of the respondents felt that financial executives had primary responsibility for deterring financial reporting fraud. However, twenty percent of the external auditors felt that the board of directors/audit committees were primarily responsible (Bramwell, 2013).

As for detecting fraud, fifty-two percent of the respondents indicated that financial management had the primary role, while thirty-one percent indicated that internal auditors were responsible. Twelve percent put the primary responsibility for fraud detection on the external auditors, and six percent believe the board of directors/audit committee has the most responsibility (Bramwell, 2013; Whitehouse 2013).

Two governing boards oversee external auditors and develop the professional standards for CPA professionals. The PCAOB controls the audits of public companies, and the AICPA oversee all other engagements. Both the PCAOB and AICPA state that an auditor's responsibility is "to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud."

A 2017 federal court decision, *The Colonial BancGroup, Inc. v. PwC and Crowe Horwath,* started the events to force external and outside internal auditors to begin seriously trying to detect fraud (2017 WL 4175026, 8/18/2017).

In 2018, an Alabama bench trial court ordered PricewaterhouseCoopers (PwC) to pay the FDIC $625.3 in damages. Accounting malpractice disputes rarely go to trial, but the FDIC is not allowed by law (Federal Deposit Insurance Corporation Act of 1991) to accept confidential settlements. Thus, the December 2017 PwC court battle provides transparency in the shadowy world of accounting malpractice. There are still two open years that will go before a jury trial.

Along Comes the $2.3 Billion Colonial BancGroup Disaster

The following summary of the background of the fraud, the fraud, Colonial's collusion, and the District Court's watershed decision are taken, unless otherwise noted, from the 2017 record of the District Court of the U.S. for the Middle District of Alabama Northern Division regarding *Colonial BancGroup v. PwC* and the *FDIC v. PwC*. Quotes from the court records are identified by page number.

Background

Colonial BancGroup (CBG) was a single bank holding company, the parent of Colonial Bank of Alabama (Colonial). In 2009, CBG had 340 branches and twenty-six billion dollars in assets, and was one of the twenty-five largest banks in the United States. For over twenty years (1980s–2008), Colonial was audited by PwC LLP. Since passage of SOX, PwC had been retained to conduct integrated audits of CBG on a consolidated basis. All of PwC's audits produced unqualified opinions. For at least the seven years prior to 2009, Crowe Horwath LLP had been Colonial's outside internal auditor. FDIC also sued Crowe Horwath, Colonial Banks's internal auditors for malpractice.

The mortgage lending activities of Colonial were conducted in their Mortgage Warehouse Lending Division (MWLD) located in Orlando, Florida. This division, which "provided [short-term] funding to over sixty mortgage-origination companies, represented approximately twenty percent of Colonial's operations" (District Court of the U.S., 2017, p. 9).

The MWLD was composed of a traditional lines of credit facility and two specialty facilities: the COLB Facility and the AOT Facility. These two facilities provided mortgage originators funding by buying (treated as sales rather than loans)

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short-term, ninety-nine percent participation interests in either single mortgages (COLB) or in pools of mortgages (AOT). The AOT Facility was dedicated to funding Taylor, Bean and Whitaker Mortgage Corporation (TBW) mortgages that had been bundled for sale to investors "...as mortgage backed securities (MBS) issued by government sponsored entities (GSE)." (District Court of the U.S. 2017, p. 14).

A participation certificate and the original promissory note evidenced each COLB transaction. These documents were held until the underlying mortgage was sold to an investor, at which time, Colonial received payment. These AOT transactions were governed by a master Mortgage Loan Participation Sale Agreement and by a Custodial Agreement. Under the Custodial Agreement, Colonial was required to retain documentation that included the original loan documents for each mortgage in the pool, a participation agreement (which was a detailed list of the mortgages in each pool), and a takeout commitment. The takeout commitment, which was assigned to Colonial, verified that a third-party investor (private backer) had committed to purchase the MBS. TBW's funding was held until all the required documents were received by Colonial's Custody Department. When the MBS was subsequently sold, Colonial would be paid.

The Fraud

In August 2009, an FBI raid brought to light "a massive, multi-faceted, multi-billion-dollar fraud" (District Court of the U.S., 2017, p. 5) that had been ongoing since 2002. The fraud was perpetuated by Colonial's largest customer, mortgage originator TBW. The fraud was facilitated by the collusion of Colonial employees. Neither PwC, Crowe Horwath, nor Alabama banking regulators discovered the fraud. The fraud took place in Colonial's Mortgage Warehouse Lending Division (MWLD), managed by senior vice president Catherine Kissick. The fraud had three phases: the MWLD phase, the COLB phase, and the AOT phase. At each successive phase, the fraud grew in size and complexity.

The MWLD Phase

The fraud began when TBW over drafted their operating account. For the first three weeks of the overdrafts, Joyce Shultz, the MWLD's vice president and operations director, began "sweeping" the account—moving the operating account overdrafts to other TBW accounts—to avoid showing TBW's overdrafts on the overdraft reports. After three weeks, Shultz informed Christine Kissick about TBW's overdrafts, which had by then grown to about ten million dollars. Under Kissick's direction, TWB's growing overdrafts continued to be excluded from the overdraft reports. This method of concealing TBW's operating account shortfalls continued until the overdrafts reached about $120 million (District Court of the U.S., 2017).

The COLB Phase

TBW's overdraft, which was referred to by Colonial employees as "the hole," was then moved to the COLB Facility. In this phase TBW acquired funding by selling Colonial ninety-nine percent participation interests in worthless mortgages—single mortgages that had already been sold to other investors. Thus, a growing asset on the books of Colonial had no real value (District Court of the U.S., 2017).

The AOT Phase

When "the hole" had grown to about $600 million, the fraud was moved to the AOT Facility. Instead of single worthless securities being sold to Colonial, TWB now sold Colonial pools of worthless mortgages. By the time of the raid in 2009, the fraud had grown to about $2.3 billion (District Court of the U.S., 2017). There are similarities between the Colonial fraud and the old Equity Funding Corporation of America (Equity Funding) fraud that began in 1964, so auditors have not learned from history.

Equity Funding Fraud

In the Equity Funding fraud, the company created phony life insurance policies and sold them to reinsurers. With over 64,000 bogus insurance contracts, the fraud reached nearly two billion dollars in false revenues. Equity Funding even killed off some of the phantom people to collect money from the reinsurers. At least seventy to 100 employees had knowledge of the fraud. There were twenty-five million dollars in counterfeit bonds and $100 million in missing assets.

The auditors would telephone from the Equity Funding office to the individual branches to determine their business. Fred Levin had the switchboard route these calls directly to him, and he would use the appropriate voice and accent to confirm the bogus amount. The imaginary insurance policies were denoted in the computer files as code ninety-nine. A tip from a

disgruntled employee reported the fraud at Equity Funding (Woolf, 2012). An interesting novel uses a similar technique with a computer to hide fake leases (Golden, 2018).

Colonial Bank's Collusion

To facilitate the fraud, under what may have been the false hope of TBW improving its cash flows and eventually fully paying Colonial, numerous executives and employees of Colonial colluded with TBW executives and employees to hide the fraudulent transactions. The multifaceted collusion included falsifying data, forging documents, hiding impaired mortgages, hiding fraud related communications, and lying (either directly or indirectly—by omission) to the PwC auditors.

Falsifying Mortgage Data

In the COLB phase of the fraud, TBW provided Colonial with real details, such as mortgagee names, addresses and social security numbers, for the previously sold, worthless mortgages used to obtain funding. Colonial did not receive the mortgage documents or promissory notes "...presumably because those documents were with the entity that actually owned the mortgages" (District Court of the U.S., 2017, p. 18). When the fictitious mortgages became overdue, Colonial employees avoided showing the mortgages as past due on the aging report by using a procedure they referred to as "refreshing the data." TBW sent Teresa Kelly, an operations supervisor/analyst who worked under Kissick, fresh information at about thirty-day intervals. To circumvent a control that checked for duplicate data, Kelly collaborated with a TBW employee to ensure that the genuine mortgage data had not previously been submitted to the ProMerit system (MBMS)—a control system used by mortgage warehouses (District Court of the U.S., 2017, pp. 84–85).

Forged Documents

In the AOT phase of the fraud, Kelly again circumvented the ageing report control by "refreshing the data." Teresa Kelly collaborated with TBW's treasurer, Denise Brown, to regularly obtain "new" information for the pools of mortgages, which were the major assets of the AOT Facility. The loan pools sold to Colonial contained fictitious and/or "junk" loans. The "junk" loans were mortgages that could not be sold to investors due to default or other impairment. TBW supported the loan pools with forged documents that contained the same type of information provided for legitimate AOT loan pools (District Court of the U.S., 2017).

Impaired Mortgages Hidden

The AOT Facility did not track individual mortgage information. Kissick and Kelly used the AOT Facility to park or hide impaired single mortgages transferred from the COLB Facility....Kelly tracked these mortgages in a secret offline database that she did not share with regulators or auditors" (District Court of the U.S., 2017, p. 85). When the Office of the Comptroller of the Currency indicated concern regarding the age of mortgages held in the COLB Facility, Kamal Hosein, the treasurer of CBG, "directed...Kissick to move hundreds of millions of dollars of unsellable COLB Facility mortgages into the AOT Facility" (District Court of the U.S., 2017, p. 88). The impaired mortgages were hidden from both the auditors and the regulators.

E-mail Concealment

To avoid discovery of the fraudulent behavior by executives at Colonial headquarters, Teresa Kelly testified that she was instructed to use Blackberry PIN messaging, which was untraceable on the company's e-mail servers, and to use a private e-mail address to discuss transactions with Catherine Kissick, TBW's chairman Lee Farkas, and TBW's treasurer Desiree Brown. She also handled Lee Farkas' personal loans known as "Murla loans" or "friends of Lee loans." Brown received a six-year prison sentence and Kelly three months in prison, followed by three years of supervised release. TBW CEO Paul Allen received a prison sentence of forty months.

In Lee Farkas' trial where he was convicted and sentenced to thirty years in prison, the Assistant U.S. Attorney said that Farkas was the leader of the conspiracy, and his fraud scheme was one of staggering proportions and boldness. He ran one of the longest, largest fraud schemes. "He lived the high life. A jet, a seaplane, houses up and down the East Coast…He invented fake assets" (Hedgpeth, 2011).

No One Told the Auditors

PwC's inquiries of management were continually thwarted. For example, in the preliminary risk assessments conducted by PwC, Catherine Kissick repeatedly lied about her knowledge of fraud at Colonial, and she received eventually an eight-year prison sentence.

The sweeping of funds into and out of TBW's operating account during the MWLB phase was not a secret. In addition to Kissick, numerous other Colonial employees and executives knew about TBW's overdrafts. For example, MWLB employees, Kelly's entire department, two CBG internal auditors, employees in the "pay down" group, and a lending officer in the MWLD knew about the "sweeping." No one told the PwC auditors. In fact, in case the auditors inquired about the "sweeping" activities, Kissick e-mailed several employees "...examples of false explanations they could give if asked by PwC 'why we sweep'" This e-mail was forwarded to Lee Farkas, TBW's chairman, for his input (District Court of the U.S., 2017, p. 83).

A MWLD compliance specialist, Sarah Roland, testified that "she let lying take place and that she went along with the spin doctoring of documents...[She]...also admitted to signing overdraft reports and other documents that she believed at the time were false." According to Roland, several members of MWLD's risk control group, including its head, knew about the sweeping. Again, no one told the auditors (District Court of the U.S., 2017).

Colonial's assistant treasurer, Mary Lou Bathen, was informed by an internal auditor, Pam Vitto, that she had found anomalies in the way TBW was paying down its transactions. On investigating a mortgage originated by TBW, Vito had discovered that the mortgage was worthless—it had been foreclosed on and the certificate showing construction on the site had been falsified. Vito also found three mortgages that showed identical data. Bathen failed to notify PwC about the anomalies (District Court of the U.S., 2017, pp. 85–86).

Mary Lou Bathen had requested AOT mortgage details from Kissick who failed to respond. When CBG's treasurer, Kamal Hosein, told Kissick that they really needed the information, Kissick e-mail response was "...well let's not dig too much." The court indicated that "...it [was]...clear that neither...Hosein nor...Bathen told PwC that...Kissick had repeatedly failed to provide them with requested loan level detail" (District Court of the U.S., 2017, p. 87)

In addition to being complicit in the fraud, there is no question that Colonial BancGroup (CBG) was also negligent. The internal auditors, Crowe Horwath, failed to discover the fraud. The audit committee for CBG, which also functioned as the audit committee of Colonial, also missed the fraud. Further, federal and state auditors as well as a forensic accountant hired by Colonial BancGroup (when they became suspicious) did not catch the fraud. In each of the audit years 2002–2008, PwC issued unqualified opinions.

As is often the situation, the external auditors are the last parties standing with deep pockets. Under Alabama law Colonial BancGroup was not allowed to prevail in their lawsuit against PwC because they did not have "clean hands." But when the dust settled, in a bench trial on December 28, 2017, an Alabama federal court held PwC liable for $1.4 billion of the $2.3 billion lost by the FDIC.

PwC paid an undisclosed amount in 2016 to settle a claim involving TBW. The Justice Department settled with Deloitte for $149.5 million for its role in the TBW audit. Crowe Horwath settled their FDIC case for sixty million dollars for their internal auditing advisory services.

Will these winning recent lawsuits against PwC, Deloitte, and Crowe Horwath force external auditors to start guaranteeing against fraud as suggested by Daniel Fisher (2017) and McKenna (2018)?

District Court Judge's Watershed Opinion

The bench trial covered the PwC's consolidated audits of CBG for 2002–2005 and 2008. The audit years of 2006 and 2007 will be tried by a jury (PwC may have additional financial exposure related to these audits). CBG and the FDIC, as receiver for Colonial Bank, were the plaintiffs, and PwC and Crowe Horwath LLC were the defendants. Following discovery, the plaintiff's claims against Crowe Horwath and PwC were separated (bifurcated) such that PwC was the only defendant in the bench trial.

The complaint against PwC included defendant claims for professional negligence, wantonness, and breach of contract. The court denied the claims of CBG against PwC for professional negligence and breach of contract and the claims of the FDIC for breach of contract and wantonness. Nevertheless, the FDIC's claim for professional negligence was granted.

District Court Judge Barbara Rothstein ruled on December 28, 2017, that PwC had an obligation to design its audits to detect fraud; they did not, so they violated audit standards (AICPA, 2002a, AU §110.02; PCAOB, AS 2101). In her bench trial ruling, Judge Rothstein found that PwC:

- Had failed to design its audits to detect fraud;
- Did not obtain sufficient competent evidence of transactions to sign its audit report;
- Failed to inspect the underlying loan documents;
- Failed to obtain other competent evidence of the asset's existence;
- Did not obtain sufficient evidence of AOT transactions to sign its audit reports;
- Never gained an understanding of AOT transactions;
- Did not test for the physical existence of AOT assets; and
- Failed to obtain other competent evidence of the AOT asset existence.

Although Colonial BancGroup could not win because of the audit interference rule (National Securities Corp., 1939), the FDIC stepped into CBG's shoes and won under Alabama law.

As bad as this decision is, the financial hit against PwC could have been much worse. Judge Rothstein did hold PwC guilty of professional negligence. However, she held that the Colonial BancGroup's professional negligence suit against PwC was denied because CBG did not have "clean hands," and CBG's breach of contract suit was denied. Important, also, was the denial of FDIC's breach of contract and wantonness claim against PwC.

The Damage Phase of the PwC Lawsuit

Washington Federal Judge Barbara J. Rothstein released her twenty-four-page damage report of the bench trial on July 2, 2018 (Case No. 2:11-CV-746-BJR, 2018). By a preponderance of evidence, she found that PwC's negligence proximately caused the FDIC's asserted damages. Rothstein awarded FDIC $625.31 million, but gave the parties ten days to jointly file a status report as to PwC's setoff rights with respect to a sixty-million-dollar settlement paid to FDIC by Crowe Horwath.

The judge used the calculations of damages prepared by FDIC's expert Kenneth J. Malek, and indicated the report was reasonably certain and amply supported by reliable evidence. The parties agreed that there were $1.473 billion in fake trades on the bankruptcy date of the bank. Kenneth Malek's simple calculations of damages were as follows:

Phantom loans		$1,473,000,000
Less:		
Pre-audit damages	$229,000,000	
Colonial, TBW net income	$365,000,000	
FDIC recoveries	$254,000,000	$848,000,000
Total Damages		$625,000,000

PwC argued that some of the mortgage's loans (so-called blue mortgages and REO mortgages) should not be included in the fraud. Thus, they argued that the FDIC should only receive $306,745,851. In March 2019, PwC and the FDIC agreed to a reduced penalty of $333 million, even though the FDIC had argued that the Colonial Bank bankruptcy caused insurers and investors as much as five billion dollars. Why did the FDIC agree to such a reduction?

Judge Rothstein stated that the 2006 and 2007 audits of CBG were not tried in this bench trial because the FDIC did not waive its rights to a jury trial, and the jury trial has not been scheduled yet.

The judge ruled that the CBG claims against PwC are barred by the doctrine of *in pari delicto,* the *Hinkle* Rule, and the audit inference rule. She granted the motion to dismiss CBG's claims against Crowe Horwath, with the right to refile should this court's determination be reversed on appeal.

Contributing Factors

PwC Audit Failures

The following summary is limited to details supporting PwC's professional negligence, includes both violations of Generally Accepted Auditing Standards (GAAS)—both GAAS violations cited in the bench trial record, and non-court cited GAAS violations suggested by the authors. Potential violations of ethical standards also are discussed.

Audit Not Designed to Detect Fraud

PCAOB Auditing Standard 110.02 states (in part) that "the auditor has a responsibility to plan and perform an audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud" (AICPA, 2002c, AU §110.02). At trial, CBG lead audit partner Gary Westbrook testified that PwC did have an obligation to design their audit of CBG to detect fraud. However, in a previous suit for negligence brought against PwC by TBW's bankruptcy trustee, several key PwC participants in the audit of CBG, including Westbrook, had testified to the contrary:

- Gary Westbrook, lead PwC audit partner: "audits are not designed to detect fraud."
- Kim Jackson, PwC engagement partner: "Our audit procedures were not designed to detect fraud."
- Wes Kelly, PwC audit manager: "[PwC] did not design audit procedures to detect fraud."
- Phillip Rivers, audit associate: "PwC had no obligation to look for fraud."

(District Court of the U.S., 2017, p. 28)

Based on this prior testimony, the court ruled that by not planning the audit to detect fraud, PwC violated GAAS (AICPA, 2002b, § 150; AICPA, 2002f, AU § 314; PCAOB, AS 2401).

The ethics of not adequately planning the audit was not addressed by the court. According to the Due Care provision of the AICPA Code of Professional Conduct, CPAs are required to "...plan and supervise adequately any professional activity for which he or she is responsible" (AICPA, 2002, June 1; AICPA, 2013, June 1). Thus, in addition to a GAAS violation, not adequately planning the audit was an ethics violation.

Inspection of Documents

At the end of 2003, the COLB Facility had an asset balance of about $378 million. By the end of 2004, the balance had grown to about $678 million. Of these amounts, about $175 million at the end of 2003 (forty-three percent), and about $269 million at the end of 2004 (forty percent) were fake (District Court of the United States, 2017). Despite PwC's pre-audit risk assessments having identified fraud by a mortgage originator as "...MWLB's biggest risk," and despite TBW being the largest client of the MWLB, PwC failed to inspect any of the supporting documentation for TBW originated mortgages (e.g., participation agreements and original promissory notes) which supposedly were held as collateral by Colonial.

The court conclude[d] that given the [the declining real estate market] conditions that were present with respect to the 2003 and 2004 audits...it was unreasonable for PwC to sign off on the COLB asset without first physically inspecting at least some of the underlying documents for the TBW COLB mortgages...Kissick testified that if PwC had asked to see even just ten loan files, [t]he jig would be up. (District Court of the U.S., 2017, p. 32)

Other Competent Evidence

PwC did not deny their failure to inspect any of the TBW COLB documents. However, they argued that their alternative procedures were sufficient to substantiate the asset's existence. These procedures were composed of agreeing balances on internally generated subsidiary reports (pipeline reports) to the general ledger, and confirming the money sent by Colonial to TBW. The court ruled that agreeing numbers on management-generated documents was not a substitute for inspection. Moreover, the judge questioned the auditor's lack of professional skepticism. PCAOB Auditing Section 1015.07 (AICPA, 2002d, AU § 230.07) requires auditors "...to maintain an attitude that includes a questioning mind and a critical assessment of audit evidence." According to the trial court, PwC's acceptance of the TBW COLB confirmation, which was signed by TBW's chairman, Lee Farkas, was an example of a lack of required auditor skepticism. The 2002 working papers had indicated that "due to a dispute ...[Farkas] had with Fannie Mae" (District Court of the U.S., 2017, p. 34) he was supposed to be taking a reduced role at TBW. Thus, Lee Farkas' signing of the confirmation should have been an audit "red flag." In addition, the TBW confirmation was inadequate in that it lacked critical information—the confirmation did not ask for details of the mortgage documents that had been sent by TBW to Colonial (District Court of the U.S., 2017).

Sufficient Evidence Not Obtained

As previously indicated, TBW was the only customer of the AOT Facility. In each of the years audited by PwC, the asset balances in the AOT were considered by the court as material to the fair presentation of the consolidated financial statements of CBG: 2004, $490 million; 2005, $589 million; 2006, $605 million; 2007, $2.05 billion; and, 2008, $1.56 billion. For

each of these years, the asset values were in reality close to zero. Most of the mortgages included in the pools, which were to be sold to investors, were composed of fake or defaulted mortgages (District Court of the U.S., 2017).

Not Understanding the AOT Transactions

PCAOB, AU Section 311.06 states that "the auditor should obtain a level of knowledge of the entity's business that will enable him to plan and perform his audit in accordance with generally accepted auditing standards." Moreover, PCAOB AU Section 330.25 indicates that the nature of information to be confirmed with third parties is predicated on "the auditors understanding of the client's arrangements and transactions with third parties…"

A walkthrough is a procedure suggested by PCAOB Auditing Standard No. 5, Section 37. A walkthrough provides a way for auditors to develop and document their understanding of how a client's transactions are initiated, processed, and recorded. Standard No. 5 states, in part, that "in performing a walkthrough, the auditor follows a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records, using the same documents and information technology that company personnel use" (PCAOB, AU Standard No. 5 § 37).

PwC violated these GAAS standards, and then some. From the first to the last year of the audit of the AOT Facility, Phillip Rivers, the PwC auditor in charge of this part of the field work, failed to develop an understanding of AOT's three-party transactions. A walkthrough was never completed. Instead, Rivers developed a working paper for the AOT by erroneously using a PwC template for a two-party reverse purchase agreement and created a chart that incorrectly purported to show the flow of AOT transactions. This working paper only referenced one needed supporting document, the trade assignment (District Court of the U.S., 2017). The critical participation certificate and takeout commitment—the document that assured Colonial of future payment—were not included. "...At trial, Rivers testified that the AOT transactions were 'complex' and 'above his paygrade'" (District Court of the U.S., 2017, p. 36). External auditing is premised on auditors having a full understanding of the details of what is being audited. Without such an understanding, a proper audit is impossible—to paraphrase the court, one cannot audit what one does not understand (District Court of the U.S., 2017, p. 35).

Given that Mr. Rivers did not understand the transactions he was auditing, he should have sought guidance from his superiors on the audit team (e.g., manager, partner). There is no indication in the court record that this communication occurred. In addition, the court was mute on whether anyone charged with audit oversight checked Phillip Rivers' work, especially whether audit superiors questioned his, and thus PwC's, understanding of the way the AOT Facility transacted their three-party transactions. Again, from a lack of mention in the court record of Rivers' superiors questioning his work, including his understanding of the AOT Facility transactions, one must assume that there was a lack of adequate supervision. Thus, there was a violation of the first standard of audit field work which states that "the work is to be adequately planned and assistants, if any, are to be properly supervised" (AICPA, 2002e, AU § 311.01; PCAOB AU §150.02).

If Phillip Rivers and his supervisors were unable to develop an understanding of the AOT Facility transactions, PCAOB Auditing Standard 1210 Section .06 (AICPA, 2002i, AU § 336.06) requires that specialists be consulted: "During the audit ...an auditor may encounter complex or subjective matters potentially material to the financial statements. Such matters may require special skill or knowledge, and the auditor's judgment require using the work of a specialist to obtain appropriate evidential matter" (PCAOB, AS 1210.06). A PwC specialist was consulted after an inquiry was made by the Office of the Controller of the Currency regarding the treatment of COLB transactions as sales (District Court of the U.S., 2017, p. 53). Nevertheless, it appears that a specialist was not consulted regarding AOT Facility transactions—another potential violation of GAAS.

The auditors' need to consult specialists (either inside or outside of the audit firm) also is addressed by the AICPA Code of Professional Conduct (Code) on Due Care (AICPA 2002d, AU § 230.07). AICPA § 0.300.060.04 (AICPA, 2014, December 14; AICPA, 2002m, ET § 56.03) states that "[competence]...also establishes the limitations of a member's capabilities by dictating that consultation or referral may be required when a professional engagement exceeds the personal competence of a member or a member's firm." In effect, the Code requires CPAs to not only acknowledge their limitations but to also seek the help of those more knowledgeable—the use of specialists. To quote the character Harry Callahan (Dirty Harry) from the 1973 movie Magnum Force, "a man's got to know his limitations" (IMDb, n.d.). In this case, Phillip Rivers knew his limitations, but he took no action to mitigate his shortcomings—in today's vernacular, he "winged it."

Phillip Rivers lack of understanding of the AOT transactions, a lack of understanding that began with the first audit of the AOT Facility, was perpetuated through all the subsequent audits. The misleading and inaccurate working paper from 2004 appears to have been copied and pasted into working papers of later years. This procedure was especially egregious during

the 2005 audit. In that audit, Rivers "supervised" Alice Whitstone, a college intern, who was given the job of evaluating this $589 million asset (District Court of the U.S., 2017). Probably as instructed by Rivers, Whitstone "cut and pasted the 2004 working papers into the 2005 audit workpapers" (District Court of the U.S., 2017, p. 37). Again, there appears to have been a lack of competent supervision as required by GAAS. PCAOB Auditing Standard 1010.03 (AICPA, 2002c, AU § 210.03) includes the following statement regarding supervision of a junior: "The junior assistant, just entering upon an auditing career, must obtain his professional experience with the proper supervision and review of his work by a more experienced superior." In this instance, competent supervision of Whitstone by Rivers was critical since this neophyte auditor (an inexperienced intern who had not yet embarked on her accounting career) was assigned the task of evaluating a "significant asset."

Quality review is a topic that can be related to adequate supervision in that it is envisioned in SOX as an overall review of audit work and related audit conclusions. Section 103 of SOX (2002) requires that the PCAOB provide a quality review standard for audits by registered firms. This procedure is to be conducted by "...a concurring or second partner [who provides a] review and approval of such audit report (and other related information), and concurring approval in its issuance, by a qualified person." In 2009, after the time of PwC's audits, procedures for an Engagement Quality Review were codified in PCAOB Auditing Standard No. 7. Section 7.11 of Standard No. 7 states that "in an audit, the engagement quality reviewer should evaluate whether the engagement documentation that he or she reviewed...(a) indicates that the engagement team responded appropriately to significant risks, and (b) supports the conclusions reached by the engagement team with respect to the matters reviewed." The court was silent as to the status of PwC's quality review of the CBG audit. Since Standard No. 7 did not become effective until years beginning after December 15, 2009, PwC was not required during the years they audited CBG to have a quality review by a second partner. Nevertheless, having a quality review and thus meeting this SOX requirement before being required to do so by a formal standard, would seem to have been a prudent action on the part of PwC. Were quality reviews performed? If so, were they merely perfunctory in nature? Was this SOX requirement also violated—at least, was it violated in spirit?

Test of Physical Existence

A complete AOT Facility transaction, as previously indicated, included Colonial acquiring a ninety-nine percent interest in a pool of TWB originated mortgages that were subsequently converted by a GSE into a MBS and then sold to an investor. Colonial received payment for the amounts advanced to TWB at the time the MBS was sold. Documents critical to a completed transaction included "...participation certificates, list of loans, underlying mortgage documents, [and] takeout agreements..." (District Court of the U.S., 2017, p. 38).

The PwC auditors failed to examine any of these AOT Facility documents. Considering that TWB was the AOT's sole customer and the material nature of this asset to the fair presentation of the financial statements, not inspecting these documents resulted in the most reliable audit evidence of the existence (or in this case, the non-existence) of this asset not being utilized. PCAOB, Auditing Standard No. 15, Section 8 (AICPA, 2002h; AU § 326.21) states that evidence obtained directly by the auditor is more reliable than evidence obtained indirectly." The fact that the PwC auditors did not inspect any of these AOT Facility documents is perplexing and quite inexplicable. Not doing so may have also been a violation of AICPA, ET Section 56.4 on Due Care, which requires CPAs to be diligent in their work: "Diligence imposes the responsibility to render services...carefully, to be thorough and observe applicable technical and ethical standards" (AICPA, 2002m, ET § 56.4).

Other Competent Evidence

In addition to the COLB assets being confirmed by Lee Farkas, he also confirmed the AOT assets. Again, the AOT confirmation was only regarding the amounts advanced to TBW. As with the COLB confirmation, details regarding the existence of the phantom mortgages, which made up the mortgage pools (subsequently converted to MBSs), were not confirmed. The court also cited this confirmation failure as another instance a lack of professional skepticism—another violation of PCAOB AU Section 1015.07 (AICPA, 2002d, AU § 230.07). The court stated that "confirming the existence of the AOT assets through Farkas alone is the opposite of professional skepticism and is not a critical assessment of the audit evidence" (District Court of the U.S., 2017, p. 39).

During audit fieldwork conducted in December 2008, the PwC audit team finally got around to testing, for the first time, the existence of the AOT assets. The limited procedures performed included agreeing balances, matching dates, and recalculations. Only ten trades (all subsequently found to be fraudulent) underlying an asset balance of $1.56 billion were

sampled; still, none of the required AOT documents (e.g., Participation Certificate, list of mortgages, original mortgage documents, Takeout Assignment, etc.) were inspected (District Court of the U.S., 2017, pp. 39–41).

To reiterate the AOT process, prior to Colonial funding AOT transactions, TWB was required to have pre-sold the pooled mortgages that were to be included in MBSs. This pre-selling was required to be evidenced by an assigned Takeout Commitment provided by TBW and held by Colonial until third-party investors purchased the MBSs and Colonial had been repaid. These supporting documents continued to be held by Colonial after repayment for the benefit of the GSE. Thus, they remained available for inspection by the PwC auditors (District Court of the U.S., 2017, pp. 14–16).

Advances made to TWB from the AOT Facility should have been recouped within about 30 days. Therefore, by December 2008 the PwC auditors expected to find all the previously tested trades to have been fully paid (subsequently paid by investors who had agreed in advance to purchase the MBS). However, PwC's audit workpapers for 2008 indicated that "...three of the trades failed PwC's expectations because there was no incoming wire information evidencing that the three trades had settled or that Colonial had been paid by the end investor" (District Court of the U.S., 2017, p. 40).

Despite a failure rate of thirty percent of their sample, the PwC auditors did not follow up with an inspection of the underlying documents. Moreover, instead of following up on the subsequent collection of the three problem trades the auditors inexplicably picked three other trades for testing. No subsequent procedures were performed on the three problem trades. The court indicated that if the three problem trades had been followed up on with alternative audit procedures, including retesting, (PCAOB AU §350; AICPA, 2002j, AU § 350) "...[the PwC auditors] would have discovered that those loans had different loan inception dates, different settlement dates, and slightly different purchase amounts in February 2009 than they did in December 2008" (District Court of the U.S., 2017, p. 40).

From an ethical standpoint, not properly following up on a significant number of errors found in an audit sample may have been a violation of Due Care (AICPA, 2002m, ET § 56). In addition, it may have violated the application of sensitive professional judgment (AICPA, 2002k, ET § 52, Article 1—Responsibilities).

There is no indication by the court of the method used by PwC in arriving at a sample size of ten trades. Considering the $1.56 billion size of the AOT asset in 2008, and an assumed large number of underlying mortgages, it is apparent that non-statistical sampling (judgment sampling), instead of statistical sampling, was used—a sampling technique that could, nevertheless, have exposed the fraud. Such a sample having been drawn with no follow-up on the errors found in almost a third of the tested trades seems to the present authors to indicate that the sampling was perfunctory in nature—perhaps done to just "check a block" on the audit work papers.

No matter what type of sampling method is utilized in an audit, it is imperative that any sampling errors be evaluated (PCAOB, AU § 350; AICPA, 2002j, AU § 350.25). PCAOB AU Section 350.26 indicates that "the auditor should project the misstatement results of the sample to the items from which the sample was selected." With the AOT asset balance in 2008 at $1.56 billion (District Court of the United States, 2017, p. 34), extrapolation of a thirty percent error to the population computes a potential understatement of $468 million. Such a potential material error pointed to an audit risk that had to be investigated. In court, "Gary Westbrook admitted the failure of thirty percent of PwC's test sample 'raised question'" (District Court of the U.S., 2017, p. 40). Not following up on such a material sampling error certainly raised questions that necessitated further investigation. In the view of the present authors, not doing so was grossly negligent.

The audit of CBG by PwC was fraught with violations of GAAS, which supported the FDIC and CBG's charges of negligence. In addition, employees at CBG/Colonial were guilty of ethical lapses; and auditors at PwC violated numerous provisions of the AICPA/PCAOB Codes of Ethics.

Ethical Lapses of Colonial Employees

Slippery Slope

In the early phase of the fraud, when Christine Kissick informed senior vice president Art Barksdale, her superior, about the overdrafts and sweeping. Barksdale told her "...to get this fixed" (District Court of the U.S., 2017, p. 67). Pressure to "fix" the problem also came from TBW. "...Farkas repeatedly told Kissick that TBW was not really overdrawn and that the apparent overdrafts reflected a problem on Colonial's end" (District Court of the U.S., 2017, p. 68.). The pressure from Farkas and his insistence that Colonial had made an accounting error caused Kissick to continue to doubt the reality of the overdraft. To isolate the supposed problem in the TBW's operating account, the overdraft was first transferred to the COLB

Facility. Kissick and Teresa Kelly "...intended for the COLB [transfer]...'to be a one-time thing' that would stop the overdraft from continuing to grow" (District Court of the U.S., 2017, p. 69).

Finally, the overdrafts were transferred to the AOT Facility. In the end, the "one-time fix" had grown into a multi-year, multi-billion-dollar fraud: the ten-million-dollar one-time fix had mushroomed into a two-billion-dollar fraud that "...cost thousands of employees their livelihood" (District Court of the U.S., 2017, p. 6). In addressing her lack of a personal financial motivation in facilitating the fraud, Kissick stated (emphasis added) that "it was my own fault because *I didn't stand up to them*, but I did not do this for any gain personally at all" (District Court of the U.S., 2017, p. 74).

Colonial is a prime example of the all too familiar "slippery slope" of unethical behavior: the initial unethical act at manipulating the accounting, which is usually justified as a small temporary fix—a one-time adjustment that will adjust itself the next period—becomes an ongoing fraud (e.g., Betty L. Vinson at WorldCom). The WorldCom and HealthSouth accounting scandals, which present scenarios like that at Colonial Bank, are only two examples of the many instances where accountants have become embroiled in a fraud due to not having the courage to JUST SAY NO when pressured to take that initial unethical act. By participating in the unethical act, they subordinated their professional judgment to that of an unethical superior (AICPA 2002l, ET 54, Article III).

In addressing the unethical actions of the accountants at WorldCom, Cynthia Cooper, the head of WorldCom's audit department whose team uncovered the fraud, stated the following regarding the slippery slope down which accountants at WorldCom rapidly slid out of control:

> People do not wake up and say, 'I think I'll become a criminal today.' It is a slippery slope and we lose our footing one step at a time. Our character is not forged at the crossroads of a major event. The foundation of our character is laid brick by brick, decision by decision throughout our lives. (Cynthia Cooper, personal communication with Ariail, February 24, 2017)

In his book titled *HealthSouth: The Wagon to Disaster*, Aaron Beam indicated that if he had just had the courage to stand up to Scrushy and refuse to manipulate the financial statements, the accounting fraud could have been stopped at its inception (Beam and Warner, 2009). In court, Beam testified as follows concerning his lack of courage at the fraud's inception:

> ...I should have stood up to Richard Scrushy and said no, but I didn't. I still think that the HealthSouth fraud may never have happened if I had said no to Richard back in 1996. I will never escape that the fraud began on my watch. (Beam and Warner, 2009, p. 160)

As in the accounting fraud at WorldCom, what began as a one-time acquiesce on the part of two accountants, grew into a long-lasting fraud. Both WorldCom and HealthSouth point to the dangers of accountants starting down the slippery slope of unethical behavior—the critically hard decision point.

Unethical Tone-at-the-Top

When the TBW overdrafts were relatively small, Kissick sought the guidance of her supervisor, Arthur Barksdale, who instructed Kissick to "get this fixed." According to Kissick, this order was accompanied by Barksdale stating that

> ...he was too old to find a new job and had a son starting law school and a daughter starting college....Kissick described...Barksdale's reaction as consistent with Colonial's culture, which was not receptive to 'bad news' and discouraged reporting the same. (District Court of the U.S., 2017, pp. 67-68)

Arthur Barksdale's statement suggests that Colonial, like Enron, WorldCom, and HealthSouth, had an unethical culture. Unethical cultures, which are often driven by unethical tones-at-the-top (e.g., Ebbers at WorldCom, Scrushy at HealthSouth, and Skilling at Enron), have been found related to some frauds that occurred around the turn of the century. Both Amernic and Craig (2013) and Campbell and Goritz (2014) suggested that a war mentality communicated by management was indicative of corrupt organizations. With a war mentality, the company is seen as being in economic competition for its life. In the survival mode, which is fostered by a war mentality, subordinates feel justified, if not actually encouraged, to do whatever is necessary (which includes unethical acts) to protect the organization. The end (organizations survival and prosperity) justifies the use of unethical means. In such an environment, unethical conduct becomes normalized (e.g., Amernic and Craig, 2013; Campbell and Goritz, 2014). Of course, by protecting the organization, employees also protect their jobs.

In addition to the indication that management did not want to hear bad news, comments made in depositions by Kissick and Kelly suggest that a war mentality was part of the culture at Colonial. That is, that Colonial employees felt they needed to help the company:

Christine Kissick said "desperate not to alienate and perhaps lose their largest customer, 'they tried everything to figure out what [the problem] was' that was causing the overdrafts" (District Court of the U.S., 2017, p. 68). Kissick also said "...basically all my biggest fears were my whole staff imploding and my customers losing their bank" (District Court of the U.S., 2017, p. 69).

PwC's Ethical Violations

As previously indicated, in addition to the violation of numerous GAAS standards, PwC's auditors also violated ethical standards regarding Due Care. Due Care requires that CPAs adequately plan and supervise their work (AICPA, 2002m, ET § 56.05); that CPAs must be competent, which requires judgment as to when specialists need to be consulted (AICPA, 2002m, ET § 56.03); that CPAs must be diligent ("render services carefully") in their work (AICPA, 2002m, ET § 56.04); and that CPAs have a responsibility to apply sensitive profession judgment (AICPA, 2002k, ET § 52, Article 1).

Specifically, not planning the audit to detect fraud indicates a lack of the required planning (AICPA, 2002e, AU § 311; AICPA, 2002m, ET § 56). Not understanding the transactions of the AOT Facility suggests that the PwC auditors lacked competence (AICPA, 2002m, ET § 56.02) and thus should have consulted specialist (AICPA, 2002i, AU § 336; AICPA, 2002m, ET § 56.03). Not inspecting any of the AOT Facility documentation indicates a lack of diligence (AICPA, 2002m, ET § 56.4) and not following up on audit sample errors suggests a lack of sensitive professional judgment (AICPA, 2002k, ET § 52, Article I).

The potential ethical violations of the PwC professionals were not before the court in the bench trial. Nevertheless, the CPAs involved in the audit of CBG/Colonial appear to have individually violated the Code of Professional Judgment and Ethics of the AICPA (2002, June 1; AICPA, 2013, June 1). These violations could potentially be actionable by the AICPA, applicable state societies of CPAs, and/or state boards of accountancy/NASBA. Did these "gatekeepers" of the accounting profession sanction any of the CPAs involved in the Colonial Bank Fraud? If not, why not?

One of the present authors is a prior long-term member of a state society's ethics committee. While this committee heard many ethics complaints that were subsequently referred to the AICPA, none involved unethical actions committed by CPAs working for one of the Big Four firms. As illustrated by the Colonial Bank fraud, auditors at the large firms are not always ethical in the conduct of their audits. In the opinion of the present authors, CPAs auditing public companies should be exemplary in their compliance with ethical standards. If the "gatekeepers" (e.g., PCAOB, AICPA, state societies of CPAs) of the ethics of the accounting profession do not investigate, sanction, or discipline ethics offenders who work at the large firms, a negative message is sent to many CPAs who work at local or regional firms.

Audit Implications

Due Care in the Conduct of Audits

The many indications of audit failures on the part of PwC point to the need for greater due diligence in the conduct of audits. Many of PwC's failures seem to point to the auditors performing perfunctory task just for the sake of checking off a box of audit procedures. Audit fee pressures can necessitate that audits be completed quickly in order to be profitable. In such an environment, corners are apt to be cut (e.g., Coram, Ng, and Woodcliff, 2004; Knechel, Krishnan, Pevzner, Shefchik, and Velury, 2012; Jankowski, 2016).

Privity

The liability of auditors is still unsettled and depends upon the vagaries of state laws (Deitch and Skibell, 2018). In her decision, Judge Rothstein stated that the Ninth and Fourth Circuits agreed with her, but the Seventh Circuit and Federal Courts in Colorado, Maryland, and the Chancery Court in Delaware disagrees with her opinion that the FDIC can step into the shoes of CBG. Some experts believe the decision will be overturned on appeal. Either way, CPA firms will always be the deep pockets when a company goes bankrupt. The CPA firm is often the last entity standing, and burnt investors, creditors, the FDIC, and other Federal agencies will look for these deep pockets.

There are four major types of lawsuits against accountants:

- Breach of contract.
- Negligence (tort).
- Fraud.
- Violation of securities.

Proving negligence requires:

- A misrepresentation.
- Of a material fact.
- To a party whom an accountant owes a duty.
- Plaintiff justifiably relied.
- Proximate cause of the damage.

For a plaintiff to win, there must be privity (or a connection) before a party can enforce a contract by suing the other party. Thus, privity is required to claim a successful malpractice dispute. There are four views or standards to this concept of privity.

1. Restrictive privity (NV, PA, UT, and VA). Requires direct connection between accountant and other party.
2. Near-privity approach (about seventeen states). Releases accountants from mere blunders (e.g., LA, NY). Primary benefit.
3. Restatement second approach (about twenty-one states). Middle-of-the–road intended beneficiaries (e.g., CO, TX., CA., NC, FL, OH). Known users.
4. Reasonable foreseeability approach (e.g., MS, SC, WI). Almost endless.

This chart, adapted from Pacini et al. (2017), illustrates the range of privity standards (Pacini et al., 2000; Eckler, 2017).

Illustration of Privity	
	No. of States
Least Liability	
Restrictive Privity	2
Near Privity	17
Restatement 2nd	19*
Reasonable Foreseeability**	2
Most Liability	
*Owe duty to client and others whom the accountant and client intend the information to benefit. Does not require the accountant to know the identity of the specific parties, only that they be members of a limited group know to the practitioners. Texas and Minnesota have slightly more expansive view than the 19 other states. **Expand scope of liability.	

The *FDIC v. PwC* decision venue was in Alabama, which seems to follow a modified restatement second view of privity. Alabama does not require a strict standard but has a more liberal interpretation in Section 552 of the restatement of torts (Boykin, Jr., 1994). State laws are murky and unclear with many shades of grey. Some states seem to have no standard. Deitch and Skibell (2018) indicate that if the Colonial BancGroup (FDIC) dispute was in New York State, the decision would probably be different because New York has a more stringent privity law (Deitch and Skibell, 2018; Eckler, 2017; Crumbley et al., Chapter 10, 2017).

As in this case, the plaintiff's strategies often are:

1. Financial statements are wrong (did not follow GAAP).
2. Accountants did not perform their duties (did not follow GAAS).
3. Auditors should have found the problems (they ignored the red flags).

The defendant's strategies are:

1. But our financial statements are accurate.

2. There was no justifiable reliance.
3. Some other person or entity is at fault.
4. Our audit report does not say the numbers are correct.
5. CPAs' audit job is not to find fraud.

The Perfect Storm: Causes

Even if on appeal Judge Rothstein is incorrect about allowing the FDIC to "jump into the shoes" of the auditee, PwC did not do their job. So, why are CPA firms not detecting fraud? There are various possible reasons for the current string of mediocre audits.

Tracy Coenen (2013) provides interesting auditing and financial factors and explanations as to the difficulty of detecting fraud (mostly dealing with the business environment):

- External auditors (EAs) rely on internal controls that can be overridden by executives and owners.
- Many auditors use predictable audit tests year-after-year. The element of surprise is important in an auditor's tool kit.
- The business environment is more dynamic, with millions and millions of transactions.
- Because of the millions of transactions in a business, to save cost auditors sample.
- To work around scope and materiality, management understate that EAs must test the large numbers. So, fraudsters can use the smaller numbers to hide the fraud.
- Audit firms rely on inexperienced auditors.
- There is inadequate follow-up of exceptions.
- Detecting fraud is like finding the proverbial needle in a haystack.
- Parts of financial statements are based upon estimates, and auditors are at the mercy of management.

Of the above potential causes for fraud being difficult to detect, the Colonial Bank fraud provides examples of management overriding controls, a flawed use of sampling, the use of inexperienced auditors (an intern), and inadequate follow-up on exceptions.

With the passage of SOX, auditing firms have had to contend with increased regulation and audit complexity while being limited by competition in the fees they can charge for their audits. This change in the audit environment has caused pressure on audit staffs to get more done in less time. Such pressures adversely influence the quality of the audit. For example, auditors may indicate that audit procedures were completed when they were not, which undermines the audit plan and thus audit quality and effectiveness, or (two) auditors must eat time; that is, spend more time on the audit than they put on their time sheet. Eating time can result in audit fatigue, which also negatively affects the quality of the audit.

There are many other reasons, such as a post-SOX rise in non-audit services (e.g., fifty-five million dollars paid by Caterpillar for a tax reorganization), and advisory practices are growing faster than audit services. Steven B. Harris (while a board member of PCAOB) warned that the well-documented shift from auditing services toward consulting services has become a significant source of income. Growing at a faster pace than auditing service, this situation can lead to litigation risk (Gaetana, 2017).

Frank Abagnale, a former conman, suggests another important reason: technology. He believes it is 4,000 times easier today to con people (and businesses) than fifty years ago. Rather than using a ninety-feet long and fifteen-feet tall Heidelberg printing press, a fraudster can merely open a laptop to forge almost anything. Almost everything is on the internet. PittPatt can be used for facial recognition, and you can scan and deposit checks by iPhones. There are color printers, fax machines, electronic transfers, bitcoins, hacking, multiple money transfers, money laundering, debit/credit cards, cybercrime, and the list goes on (Solon, 2017).

With respect to fraud, technology is a double-edged sword. The 2018 PwC survey found that one-third of all respondents worldwide have been targeted by cyber-attacks. But technology opens major opportunities to tackle fraud of all kinds more efficiently and effectively. Companies are finding value in artificial intelligence and advanced analytics to combat and monitor fraud (PwC, 2018). But are they relying on technology rather than accounting/auditing skills?

The input quality of accounting employees faces a perfect storm of events causing a decline in the quality and work ethics of students hired by CPA firms. The five factors are:

1. Student evaluation of teachers.
2. Online test banks and solution manuals (technology).
3. Change in the publish-or-perish rules.
4. More adjunct professors and fewer tenure track faculty with CPA certifications (or any certification).
5. Less accounting/ auditing training at the firms.

One of the major impacts upon the quality of students hired by CPA firms is the inappropriate teaching performance measurement system in higher education (even in high school). Student Evaluation of Teachers (SET) were created in the 1960s to provide feedback to professors about their teaching effectiveness. Administrators now use SETs almost exclusively as a summative evaluative measurement. However, there is little linkage between student satisfaction and demonstrative learning (Flinn and Crumbley, 2009).

Legislators and Boards of Trustees tell administrators to evaluate the effectiveness of university/college professors, and they in turn hire the inventory (students) to evaluate (audit) the professors. To move higher up the list of the best universities, higher graduation rates are important, so pressures are placed upon professors to fail fewer students. CPA firms "hire" student primarily with the top-grade point averages, so students and parents demand high grades from faculty (Flinn and Crumbley, 2009).

Both Agency Theory (Flinn and Crumbley, 2009) and common sense dictates that professors will focus on pecuniary benefits and inflate grades and decrease their course work to survive. A professor is personally better off inflating his/her grades rather than trying to really educate students. There is more and more current research that shows that a high grade has a significant positive impact on a professor's SET scores. The resulting grade inflation has led to higher retention rates and more tuition and tax revenues. However, Charles Murray (2008) says "dumbed down courses, flaky majors, and grade inflation have conspired to make the letters B and A close to meaningless. The light workload can make college today a joke." There are even accounting textbooks that do not teach debits and credits, entries, and "T accounts." Practice sets are almost non-existent.

Professors basically engage in SET management. Corporate executives go to prison for abusive earnings management (e.g., Lee Farkas, thirty years, and Christine Kissick, eight years), but professors are rewarded for SET management. Even as dysfunctional as this academic reward system is, no academic group (e.g., American Accounting Association) will take a position against the sacred cow. The academy must develop a way to measure learning, not satisfaction.

The second part of the perfect storm is the widespread use of students obtaining and studying from test banks and solution manuals. There is evidence that least forty-eight percent of students use publishers' test banks, and this use results in an approximately thirty percent advantage over students who are not cheating. Many professors use publisher test banks, and they essentially permit a large portion of the class to have a significant performance advantage over their peers, creating an unlevel playing field. Some professors may use test banks intentionally to increase the student's grades (e.g., SET management). A forensic detection technique to find the cheaters can be found in Cheng and Crumbley (2018). A cynic could argue that the large CPA firms over the past eight to ten years have been hiring the students with higher GPAs, who are the cheaters and possibly know less accounting/ auditing. The non-cheating and possibly more knowledgeable students have been hired by smaller firms, corporations, and government agencies.

There has been a significant change in the publish-or-perish rules for faculty members. Across the country there has been a conscious and increasing emphasis on research for promotion, tenure standards, and merit pay. Plus, practitioner-type research in journals such the *Journal of Accountancy* and *Tax Notes* no longer count as research. Only research in the top four or five esoteric academic journals is considered as worthy publications. There are around 8,000 accounting teachers in the U.S. and only about 300 articles are published in the top five accounting journals. With less than a four percent chance of hitting a top journal, teaching is not a priority. Retired Dean Lawrence Crosby (2018) states "too often business research is published not because it is useful or actionable in practice, but simply because it is theoretically or methodologically interesting to other scholars. Research-oriented universities tend to pay more and require less teaching." So why should a professor learn and teach technical accounting, auditing, or taxation when it is not required for their research?

Since accounting is a learned profession, the authors contend that the most relevant publications are those that are read and utilized by practitioners—journals that one can argue have the greatest impact on practice. A few examples would be AICPA publications (e.g., *Journal of Accountancy*, *The Tax Advisor*), IMA publications (e.g., *Strategic Finance*), *Tax Notes*, and IIA publications (e.g., *Internal Auditor Magazine*). For example, the *Journal of Accountancy* potentially impacts over

400,000 members of the AICPA, most of whom are practitioners. Conversely, the impact of academic journals is often based on the number of citations that articles published in a journal have had in other academic articles—a situation that could be considered academic incest.

One of the authors was a successful public accounting practitioner for over three decades. Until he entered academia, he had never even heard of any of the scholarly journals so highly regarded by the academy. He mainly kept up with tax law, GAAP, and GAAS changes by attending CPE and regularly reading the *Journal of Accountancy*.

There has been a change in the demographics of teachers. There are a few highly paid research professors, with more adjunct professors and instructors who have short-term contracts. These latter teachers are much more susceptible to grade inflation and course-work devaluation to keep their position. There are fewer tenure-track professors and accounting teachers with CPA certifications (or any certification).

So, the millennials with lower work ethic are receiving less technical accounting training in universities. Once hired by a CPA firm they receive less accounting and auditing training. One of the author's experience in 1969 with new auditor training at Arthur Andersen, was perhaps a precursor to the downward spiral in on-the-job training for accounting profession entrants. Arthur Andersen's audit training that took place in Chicago lasted three weeks, ten hours each day during the week, and eight hours on Saturday. Spouses could not come to Chicago. Eventually, with a more complex auditing environment, the training was reduced to two, five-day weeks. Soon the instructors were evaluated by the students, and the instructors began to let them out early and take them out for drinks. Along came Enron, David Duncan, deleted e-mails, and Arthur Andersen became history. Will this same scenario be the history for accounting firms?

Conclusion and Epilogue

The Colonial fraud was a perfect storm of collusion, incompetence, and ethical lapses. Colonial and TBW employees colluded both to perpetuate and to cover up the fraud. The PwC auditors violated numerous provisions of GAAS and GAAP. Moreover, both the executives and employees at Colonial and the PwC auditors exhibited unethical behavior. An unethical tone-at-the-top coupled with a war mentality that made the fraud appear to be justified in that the ends justified the means—saving Colonial was the end sought. The auditors at PwC violated numerous ethical standards including not being diligent in the conduct of the audit, not exhibiting due care, and not applying sensitive professional judgment. While collusion and the tone-at-the-top are uncontrollable by auditors, the authors suggest that the accounting profession can benefit from examining various environmental factors.

Although this story about one huge financial statement fraud is still not over,[1] a review at this point is important. At the beginning, Freddie Mac lost almost two billion dollars and Ginnie Mae lost around one billion dollars. Private banks like BNP Paribas and Deutsche Bank lost at least $1.5 billion. This disaster could have been avoided if Fannie Mae had only alerted Freddie Mac and Ginnie Mae that they had terminated their contract with TBW over discrepancies in 2000. The red flags were not communicated to the appropriate entities.

Thus, Deloitte and Touche was sued for $7.6 billion and agreed to pay $149 million in settlement. The outside internal auditors of Colonial Bank, Crowe Horwath, agreed to pay sixty million dollars. In March 2019, the FDIC reached a settlement with PwC for $335 million (over half of the judge's $625.31 million original damage award) without admitting liability. Of course, the plaintiff and defendant's lawyers made a bundle, along with the consultants and expert witnesses.

Grant Thornton's chief executive David Dunckley recently stated (Kenney, 2019):

> We're not looking for fraud, we're not looking at the future, we're not giving a statement that the accounts are correct…There has to be an acceptance that if there is a sophisticated fraud happening in a business, the audit as is now…[we] may never see it. We are saying [the accounts are] reasonable, we are looking in the past, and we are not set up to look for fraud.

CPA firms must stop using the expectation gap as an excuse and accept the reality that people expect them to find the fraud. Otherwise, companies must be forced to pay for a forensic audit every three or four years.

[1] The FDIC is asking for a jury trial to determine more damages involving Shipped Not Paid losses, which PwC argues were caused by Bank of America. PwC asked for a Partial Summary Judgment on January 28, 2019.

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