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Public Company Accounting Oversight Board

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of Melissa K. Koeppel, CPA	PCAOB File No. 105-2011-007
	FINAL DECISION
Respondent	December 29, 2017

Appearances

Mark W. Porter, Esq., and Michael W. Davis, Esq., Washington, DC, for the Division of Enforcement and Investigations

Gary F. Bendinger, Esq., Linton J. Childs, Esq., and Brian S. Shull, Esq., Sidley & Austin LLP, for Respondent Melissa K. Koeppel

I.

In this disciplinary proceeding, Respondent Melissa K. Koeppel is charged with violating PCAOB rules and auditing standards in annual audits she led of an issuer's financial statements for the fiscal years ending June 30, 2006, 2007, and 2008. At issue as to each audit is the testing of the issuer's journal entries for potential material misstatement due to fraud and audit work on particular issuer accounts into which journal entries flowed: analytical procedures relied on as substantive tests of net sales; support for the reliability of internal reports provided by the issuer for use in audit testing of net sales, sales allowances, accounts receivable, and inventory; and particular testing of accounts receivable for the latter part of the 2008 audit period, all against the background of certain perceived limitations or deficiencies in the issuer's internal systems and processes, which generally were not tested in the audits. In these areas, Koeppel is charged with failing to exercise due professional care, including professional skepticism, failing to obtain sufficient audit evidence and assurance, and other violations. Ultimately, the issuer restated its financial statements for fiscal years 2008 and 2009, principally to reflect adjustments relating to what it described as fraudulent, unauthorized transactions by members of its accounting department occurring from at least fiscal year 2005 through December 2009 and totaling about $31.5 million over that period, when the issuer reported $22.3 million in total net income.

After a hearing, the hearing officer issued an initial decision dismissing the charges. The initial decision found that the Division of Enforcement and Investigations had proven by a preponderance of the evidence that the performance of some, but not other, work in the 2006, 2007, and 2008 audits "did not fully comply with applicable PCAOB auditing standards," but held that the Division had not "established a legally cognizable basis" for imposing sanctions on Koeppel, who had not personally performed, and was not charged with failing to plan, delegate, or supervise, that audit work. The Division seeks Board review, challenging certain of the initial decision's findings about the audit work performed, the decision's ultimate holding that no valid theory of violation was presented, and its rejection of the requested sanctions and arguing that Koeppel committed violations and should be sanctioned. As sanctions, the Division seeks a bar from associating with a registered public accounting firm, with leave to petition to associate in three years; a $150,000 civil penalty; and "requirements for additional professional education and training that are specifically targeted (1) on the design and performance of journal-entry testing (100 hours), and (2) on the design and performance of substantive analytical procedures (100 hours), given the nature of the violations in this case." Koeppel cross-petitions for review of the decision's adverse findings about the audit work performed. And the parties oppose each other's petitions.

Based on our *de novo* review, in light of the briefs and oral argument, we find that Koeppel violated PCAOB rules and auditing standards in certain of the respects charged. She did so by failing to exercise due professional care, including professional skepticism, and failing to obtain sufficient audit evidence, among other violations. We further find that this conduct constituted repeated instances of negligence and calls for the imposition of strong sanctions. As we explain in Section VI(B) below, the appropriate sanctions for us to impose at this stage, under the unique circumstances of this case, are a two-year limitation on Koeppel's activities and a censure.

II.

In our determination, the Board, on August 16, 2011, following a properly authorized investigation, appropriately issued an Order Instituting Disciplinary Proceedings (OIP) alleging violations of PCAOB rules and auditing standards by Melissa K. Koeppel, in auditing the consolidated financial statements of Koss Corporation (Koss) for the fiscal years ending June 30, 2006, 2007, and 2008. At all relevant times, Koss was an issuer, as defined by Section 2(a)(7) of the Sarbanes-Oxley Act of 2002, 15 U.S.C. 7201(7), and PCAOB rules, and Koeppel was a person associated with a registered public accounting firm—Grant Thornton LLP—as defined by Section 2(a)(9) of the Act, 15 U.S.C. 7201(9), and PCAOB rules. Koeppel filed her Answer (Ans.) on September 27, 2011. After a nine-day hearing in June and October 2012, the hearing officer issued the initial decision on January 29, 2013. The Division petitioned for review of the decision, and Koeppel cross-petitioned for review. Briefing concluded on June 7, 2013. The Board heard oral argument on October 22, 2013.[1/]

[1/] Documents on the Index to the Record on Review are cited as Record Document (R.D.) __. We refer to the parties' post-hearing submissions as DPHS, DPHR, KPHS, KPHR; review petitions as DPet.,KPet.; and briefs to us as DOB, DRB, KOB, KRB.

III.

The OIP's charges against Koeppel, as the auditor with final responsibility for the 2006, 2007, and 2008 Koss audits, concern alleged "acts and omissions" in two main respects: (1) "failures to adequately examine Koss's journal entries for evidence of possible material misstatement due to fraud" and (2) "[failures] to audit adequately" certain financial statement assertions and a related account. The latter area consists of (a) the revenue-related matters of (i) Koss's financial statement assertions about the occurrence and valuation of net sales, Koss's largest income statement account, (ii) Koss's related, material "cooperative advertising and promotion allowances" account (as pertinent here, consisting of sales discounts and rebates), and (iii) Koss's financial statement assertions about the existence of accounts receivable, one of the two largest components of the current assets reported on Koss's balance sheet; and (b) Koss's financial statement assertions about the existence of inventory, the other of the two largest components of Koss's reported current assets. *E.g.,* R.D. 1, OIP at 1-4, 20-22 ¶¶ 1, 2, 6, 10, 73, 75, 80, 81.

In those aspects of each audit, in which the pertinent work of audit assistants was allegedly apparent to and accepted by Koeppel, the OIP charged that Koeppel violated PCAOB Rule 3100, *Compliance with Auditing and Related Professional Practice Standards*, and Rule 3200T, *Interim Auditing Standards*, by:

- failing to exercise due professional care and skepticism, in violation of AU § 150, *Generally Accepted Auditing Standards*, and AU § 230, *Due Professional Care in the Performance of Work*;
- failing to obtain sufficient competent evidential matter to afford a reasonable basis for an opinion, in violation of AU § 150 and AU § 326, *Evidential Matter*;
- failing to perform audit procedures to obtain reasonable assurance about whether the financial statements under audit were free of material misstatement caused by fraud, in violation of AU § 110, *Responsibilities and Functions of the Independent Auditor*, and AU § 316, *Consideration of Fraud in a Financial Statement Audit*;
- failing to adequately address the risk of management override of controls, in violation of AU § 316;
- failing to comply with AU § 319, *Consideration of Internal Control in a Financial Statement Audit*;
- failing to comply with AU § 329, *Analytical Procedures*;

- failing to comply with AU § 313, *Substantive Tests Prior to the Balance Sheet Date*; and

- failing to comply with Auditing Standard (AS) No. 3, *Audit Documentation*, to the extent that audit work bearing on the aforementioned charges was performed but not documented.

E.g., OIP 7-17, 19-22 ¶¶ 21, 27, 29, 30, 34, 37, 39-43, 45, 47-50, 52-54, 57, 59, 68, 69, 71, 72, 74, 75, 79-81. According to the OIP, Koeppel's alleged violations resulted from intentional or knowing conduct, including reckless conduct, or involved repeated instances of negligent conduct, each resulting in a violation of the applicable professional standards. *Id.* at 22-23 ¶¶ 82-83.

In summary, the alleged factual grounds for the charges before us are as follows.

Journal entries (*e.g.*, OIP 7-10 ¶¶ 20-28):

- In all three audits, despite a PCAOB inspection comment on the 2005 Koss audit and firm-wide Grant Thornton training in 2006 and 2007 calling attention to the need to select journal entries for fraud testing from a complete population, journal entries were not selected for audit testing from Koss's general ledger but from sets of paper records provided by members of Koss's accounting department from which entries could have been excluded.

Revenue-related accounts:

Net sales (*e.g.,* OIP 10-14 ¶¶ 30, 31, 34, 37-43):

- In all three audits, use was made, in testing Koss's net sales, of analytical procedures, which involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor, yet the procedures lacked sufficiently precise expectations to provide adequate support for the valuation and occurrence of net sales;

- In each of the three audits, reliance was placed on two particular net sales analytical procedures that used reports generated by Koss's information technology system without adequately supporting the completeness and accuracy of those reports, where the decision had been made not to test the operating effectiveness over the audit period of related Koss internal controls, *i.e.*, processes at Koss that individually or in combination were likely to prevent or detect material misstatements; and

- In the net sales analytical procedures in all three audits, there was a lack of documentation of sufficiently precise expectations and of evaluations of significant unexpected differences between expectations and recorded amounts.

Sales allowances (*e.g.*, OIP 10-12, 20-21 ¶¶ 30, 31, 34, 73-79):

- In all three audits, use was made, in testing Koss's sales discounts and rebates, of reports generated by Koss's information technology system without adequately supporting the completeness and accuracy of those reports, where the decision had been made not to test related Koss internal controls.

Accounts receivable (*e.g.*, OIP 10-12, 14-16 ¶¶ 30, 31, 34, 37, 44-49, 51-54):

- In all three audits, a report generated by Koss's information technology system was used to test Koss's accounts receivable as of a date two months before the balance sheet date, but the completeness of the report in establishing the population from which invoices would be selected for confirmation testing was not adequately supported, where related internal controls had not been tested;

- In the 2006 audit and the 2007 audit, reports generated by Koss's information technology system were used in an effort to extend audit conclusions based on the interim accounts receivable testing to the balance sheet date through a so-called rollforward procedure, but the completeness of the reports was not adequately supported, where related internal controls had not been tested; and

- In the 2008 audit, without explanation, no rollforward procedure was performed to assess the reasonableness of Koss's accounts receivable recorded during the remaining period between the interim date and the balance sheet date.

Inventory account (*e.g.*, OIP 10-12, 17, 19-20 ¶¶ 30, 31, 34, 37, 58-60, 67-71):

- In assessing the reasonableness of Koss's recorded inventory for the two-month remaining period after interim audit testing, use was made, in a rollforward procedure in all three audits, and in analytical procedures in the 2007 and 2008 audits, of reports generated by Koss's information technology system without adequately supporting the accuracy and/or completeness of those reports, where the decision had been made not to test related Koss internal controls.

IV.

Based on our review of the record, we find the facts in this case to be as follows:

A. Background On The Performance Of The Audits In Question

1. Koeppel Was the Auditor With Final Responsibility for the 2006, 2007, and 2008 Audits of Koss Corporation, a Family-Run Consumer Electronics Company.

Koeppel was the auditor with final responsibility, or engagement partner, for Grant Thornton's audits of the financial statements of Koss Corporation (Koss) for the fiscal years ending June 30, 2006, 2007, and 2008. R.D. 1 at 1-2 ¶ 2, 4 ¶ 10 (OIP); R.D. 22 at 2, 6 (Ans.); Tr. 738, 746, 753; *see generally, e.g.*, AU §§ 230.06, 311.02, 312.17, 316.74 (contemporaneous standards referring to auditor with final responsibility for the audit). The audits were to be conducted in accordance with PCAOB standards. Tr. 738 (Koeppel); Exs. J-65 at 1, J-173 at 1, J-276 at 1. Aside from certain audit procedures applied to Koss's journal entry processes, the audits did not test the operating effectiveness of Koss's internal controls for the audit period. Tr. 1254-57.

Koeppel began her accounting career with Arthur Andersen in 1986, became a partner at that firm in 1997, and, after that firm went of business in 2002, joined Grant Thornton as a partner in its Milwaukee office. Tr. 736-37. From 2002 to 2008, Koeppel was the Milwaukee office's audit practice leader, in charge of overseeing the practice, including providing audit training, and from April 2008 to April 2011, was the office's managing partner. Tr. 738-40, 795, 1203-08.

Grant Thornton began auditing Koss in 2004 and also conducted reviews of Koss's quarterly financial information. Tr. 271-72; Exs. J-65 at 2-3, J-173 at 2-3, J-276 at 2-3. Koeppel, who participated in the firm's successful bid for the engagement, also led the 2004 and 2005 Koss audits, though only the 2006 to 2008 audits are in question here. R.D. 1 at 4 ¶ 10; R.D. 22 at 6; Tr. 271-72, 738. Koss was one of Koeppel's first two public company audit clients at the firm, having brought none over from Andersen. Tr. 737-38. Koeppel testified that, at Grant Thornton, she typically would lead audits of three to five public companies in a given year and that Koss was a "midsized" or "middle market" company in terms of size and "most akin, probably, to my private [company] clients, where they had large family ownership," "weren't terribly complex operations," and "did not put huge dollar sums into [their information technology] systems." Tr. 1178-79, 1221-22, 1301, 1342, 1375, 1484-86 (Koss management "preferred to put their dollars to" product research and development "rather than internal systems"), 1502 ("this isn't a big company at about 50 million of sales" and its "management team had been around for many years"). Certain limitations or deficiencies in Koss's internal systems and processes impacted the audit work in ways that will be discussed later.

Working directly under Koeppel on the Koss audits, and assisting her in part with supervision of the work, was the same individual (Audit Manager), who acted as audit manager and held the title of manager or senior manager during 2006 to 2008. Tr. 746, 1163-64 (Koeppel). Koeppel testified that Audit Manager, who had also joined Grant Thornton from Arthur Andersen, had "significant experience" auditing public companies and specialized in audits of consumer industrial product companies. *Id*. The Koss audit teams also included several junior auditors, three of whom testified at the hearing: (1) a member of the 2006, 2007, and 2008 audit teams who was assigned to the engagement about eight months after joining Grant Thornton from college (2006-2008 Staff/In-Charge Auditor); (2) a member of the 2007 and 2008 teams who was assigned to the engagement about seven months after joining the firm from college (2007-2008 Staff/In-Charge Auditor); and (3) a member of the 2007 and 2008 teams who was assigned to the engagement as his first public company audit after about four months as an intern at the firm and about a month after receiving a master's degree in accountancy (2007-2008 Staff Auditor). Tr. 374, 375, 421, 442, 446-47, 529, 563, 638, 753.

For the 2006, 2007, and 2008 Koss audits, the auditors performed some of the field work in the accounts receivable and inventory areas as of an interim date of April 30 and the audit work in the net sales and special sales allowance areas as of June 30. Overall, the auditors generally did two days of planning in March or April, were usually in the field two days a week in late April or early May for the interim work and to largely document Koss's internal controls over financial reporting, and were back in the field the second or third week of July, often followed by another day or two in the field for follow-up and concluding procedures. *E.g.*, Tr. 270-71 (2006-2008 Staff/In-Charge Auditor); Ex. R-509 at 13-16 (Audit Manager); *see* Ex. J-239 at 5 (audit firm's timeline of 2008 Koss audit); Exs. R-202 at 7, 8, R-295 at 4, 5, 6, R-393 at 4, 6 (planned schedules).

Koss designed, manufactured, and sold stereo headphones and related accessories. The company's headquarters and main plant were located in Milwaukee, Wisconsin, and Koss employed between 115 people in 2006 and 76 in 2008. It sold its products in the United States through domestic sales representatives, dealers, and retail outlets and internationally through domestic sales representatives and a sales office in Switzerland that utilized independent distributors in several foreign countries. R.D. 1 at 5 ¶ 14; R.D. 22 at 8; Exs. J-59 at 5-7, 38, J-172 at 6-8, 39, J-268 at 4-6, 37; Exs. J-54 at 2, J-153 at 3, J-250 at 5 (inventory audit programs for 2006, 2007, and 2008 Koss audits, stating that there "is one physical location for Koss"); Tr. 1411-12.

During the relevant period, the family for which the company was named owned approximately 75% of its stock. Tr. 1220. One family member, Koss's founder, served as Koss's chairman of the board; one of his sons was vice chairman, president, chief executive officer, chief operating officer, and chief financial officer (President/CEO); and another son was vice president for sales (VP-Sales). Exs. J-59 at 41, J-172 at 42, J-268 at 12, 39; Tr. 93, 145, 154, 1220. Koss's accounting department, which did not include any members of the family, was led by a vice president of finance and principal accounting officer (VP-Finance), who was in charge of Koss's accounting and financial reporting function and, unlike President/CEO and other members of the department, was an accountant. The department was otherwise staffed by Senior Accountant and Junior Accountant, who reported directly to VP-Finance. *E.g.*, R.D. 1 at 2 ¶ 4; R.D. 22 at 3; Tr. 1478 (Koeppel); Tr. 46-48 (2006-2008 Staff/In-Charge Auditor); Tr. 548 (2007-2008 Staff Auditor); Ex. R-509 at 55 (Audit Manager's investigative testimony); Exs. J-6 at 1-2, J-103 at 1-2, J-203 at 1-2; Ex. J-7 (2006 audit work paper); Ex. J-304 at 5, 7, 29, 68 (Koss disclosure). These executives and accounting department members all worked at Koss's Milwaukee headquarters office, where the company accounted for all operations and financial reporting. Exs. R-202 at 3, R-295 at 3, R-393 at 3.

Koss reported to the public that it prepared its financial statements in accordance with Generally Accepted Accounting Principles (GAAP). Exs. J-59 at 20, J-172 at 21, J-268 at 19. The company generally recognized revenue from sales upon shipment of the product to the buyer, rather than when payment was received. Koss offered sales incentives to certain of its customers, including rebates and discounts, primarily by issuing credit memoranda that the customers applied to their outstanding invoices from Koss, rather than by making cash payments. When recognizing revenue, Koss recorded the estimated cost of these sales allowances as a reduction to sales, reporting net sales on its income statement. At the end of fiscal years 2006, 2007, and 2008, the total amount of discounts and rebates that, according to Koss, had been earned by customers and recorded in its income statement but had not yet been settled through either a payment to the customer or a credit to Koss's accounts receivable were reported in a financial statement note as the "cooperative advertising and promotion allowances" component of the accrued liabilities line item on Koss's balance sheet. Tr. 154, 1118-21; Exs. J-59 at 19, 30, J-172 at 19, 31, J-268 at 17, 29; Exs. J-6 at 7, J-103 at 6; Exs. J-43 at 2, J-136 at 2, J-229 at 2; Exs. J-41, J-133, J-226; R.D. 1 at 20 ¶ 73; R.D. 22 at 30-31. Also, Koss reported on its balance sheet a figure for the value of its fiscal year-end inventory, which consisted of raw materials and finished goods. Exs. J-59 at 27, 31, J-172 at 28, 32, J-268 at 26, 30.

Specifically, for fiscal years 2006, 2007, and 2008, respectively, Koss reported: (1) annual net sales of about \$50.9 million, \$46.2 million, and \$46.9 million, which was by far the largest line item on its income statement each year; (2) year-end unsettled discounts or rebates of some \$1.2 million, \$1.3 million, and \$740,000, representing by far the largest component, at between 41% and 58%, of Koss's reported accrued liabilities and between 13% and 32% of Koss's reported total current liabilities at year end; (3) year-end accounts receivable, net of allowance for doubtful accounts, of more than \$6.8 million, \$7.9 million, and \$10.1 million, representing between 22% and 34% of Koss's reported year-end total current assets; and (4) year-end inventories of about \$10.5 million, \$9.9 million, and \$9.4 million, representing between 31% and 37% of Koss's reported total year-end current assets. Exs. J-59 at 26, 27, 36, J-172 at 27, 28, 31, 38, J-268 at 25, 26, 36. It is undisputed that each of these amounts was material to

Koss's respective financial statements. OIP 12, 14, 17, 20 ¶¶ 38, 44, 58, 74; Ans. 19, 21, 25, 30-31 ¶¶ 38, 44, 58, 74; Tr. 153-54, 875-76, 1018-20, 1086-87, 1121.

Koeppel, on behalf of Grant Thornton, authorized the issuance of audit reports expressing unqualified opinions on Koss's financial statements for fiscal years 2006, 2007, and 2008. R.D. 1 at 2 ¶ 3, 4 ¶ 10; R.D. 22 at 2, 6; Tr. 741, 745-46. Each audit report bore a date in the latter half of August and was included in Koss's Form 10-K, filed a few days to a week later with the Securities and Exchange Commission (Commission or SEC). Exs. J-59 at 25, J-172 at 26, J-268 at 24. Koss's stock was publicly traded on the NASDAQ Stock Market. R.D. 1 at 5 ¶ 14; R.D. 22 at 8; Exs. J-59 at 3, 13, J-172 at 4, 14, J-268 at 3, 12.

On December 24, 2009, and January 4, 2010, Koss filed Forms 8-K with the SEC stating, in part, that Koss's previously issued financial statements included in Form 10-Ks for its fiscal years ending June 30, 2005, 2006, 2007, 2008, and 2009 should no longer be relied upon "because of the discovery of unauthorized financial transactions" that were subject to an ongoing "internal investigation under the supervision of an independent committee of the Board of Directors with the assistance of independent counsel and forensic accountants." Ex. J-305 at 2, 3; Ex. J-304 at 5. On June 30, 2010, Koss filed a Form 10-K/A with the SEC restating its 2008 and 2009 financial statements. A restatement corrects an error in previously issued financial statements that is due to facts that existed at the time they were prepared. *See* Accounting Principles Board Opinion No. 20 ¶ 13, *Accounting Changes*; Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections*, ¶¶ 2.h & j.

According to Koss's Form 10-K/A, the restatement was required principally to reflect adjustments related to fraudulent unauthorized transactions made by the three above-described members of Koss's accounting department, in collusion with each other. Ex. J-304 at 5, 7, 29-30, 41, 48-50, 52, 68. Koss noted that VP-Finance had been indicted in connection with the misappropriations. *Id.* at 5. Koeppel testified in the present case that the plea agreement resolving those criminal charges stated that VP-Finance began committing fraud at Koss in 1997. Tr. 1216. Koss's filing stated that the wrongful transactions from fiscal year 2005 through December 2009 totaled some $31.5 million. Ex. J-304 at 5. Of that amount, about $2.3 million, $3.5 million, and $5.1 million, respectively, were determined to have been misappropriated from the company in fiscal years 2006, 2007, and 2008, when Koss had originally reported net income of about $6.2 million, $5.2 million, and $4.5 million, respectively. *Id.* at 6; Ex. J-268 at 25.

Koss's Form 10-K/A stated that the misappropriation was carried out largely through unauthorized transactions involving wire transfers and cashier's checks to pay VP-Finance's personal expenses, in circumvention of Koss's internal controls and other operating procedures. Koss explained that to hide the true nature of the transactions, the persons involved had manipulated its internal controls and procedures relating to its computer system for processing financial transactions; recorded numerous false journal entries in various accounts, understating net sales and overstating assorted costs of goods sold and administrative expenses; delayed posting cash received against outstanding invoices and failed to provide an allowance for certain doubtful accounts, overstating accounts receivable; and failed to properly perform and review on a regular basis and at the end of reporting periods key account reconciliations, including cash, which was overstated. Ex. J-304 at 5, 7, 29-30, 41, 48-50, 52.

2. In Planning the Audits, Koeppel Recognized the Need To Address the Risk of Management Override of Internal Controls Through Testing Koss's Journal Entries, and She Viewed the Revenue and Inventory Areas as Posing the Greatest Risk of Material Misstatement, and as Requiring the Heaviest Focus and Most Rigorous Audit Procedures, of Any of the Audit Areas.

Koeppel led the planning of the 2006, 2007, and 2008 Koss audits. *E.g.*, Tr. 747, 1237 (Koeppel: "very involved" in planning); KPHS 5 ("directly participated in planning the audits"). This included making materiality determinations; seeking to obtain an understanding of the financial reporting process and internal controls in place at Koss; assessing audit risk; considering the particular risk that Koss's accounting records might be manipulated through inappropriate or unauthorized journal entries; and identifying, in its business processes and financial statements, what the auditors called "significant transaction cycles with critical assertions," all for consideration in determining the nature, timing, and extent of the audit procedures. *E.g.*, Exs. R-202 at 2-7, R-295 at 2-5, R-393 at 2-5 ("Developing the Audit Plan" work papers for 2006, 2007, and 2008 Koss audits); Tr. 839-40 (Koeppel); *see generally, e.g.,* AU §§ 311.03, 312.01., 16, .19, 316.02, .58 & n.23, 319.05, .81. Koeppel approved the audit programs that set forth the procedures believed to be necessary to accomplish the audit objectives. *See, e.g.*, Tr. 774-79, 1237-40, 1242-45, 1248-54, 1437 (Koeppel); Ex. D-4 at 120 (Audit Manager testified in investigation that she and Koeppel "worked together in designing and outlining the [revenue] audit plan and the approvals of the tailoring and the procedures that were outlined"); Exs. R-202 at 9, R-295 at 6, R-393 at 6 (statement, initialed by Koeppel, in work papers for 2006, 2007, and 2008 audits that "[a]s engagement partner, I approve the audit plan, including the audit approach"); *see generally* AU § 311.09.

Koeppel testified that she applied a Grant Thornton methodology to develop the strategies and organize the work in the Koss audits in question. *E.g.*, Tr. 867, 870-71. In each of the audits, she grouped together various related income statement and expense accounts and balance sheet accounts—for example, revenue-related financial statement elements including sales, accounts receivable, allowances, and cash receipts or inventory-related elements including inventory, accounts payable, and cost of goods sold—into a "transaction cycle" to "reflect normal business processes, double entry bookkeeping, and the functioning of accounting and control systems" and "permit us to account for the interrelationships among audit procedures and assertions for income and expense accounts and corresponding elements on the balance sheet." Exs. J-60 at

12, 13, 23, J-139 at 15, 16, 27, J-269 at 10, 11, 22-23 (Grant Thornton audit manuals for relevant period). The approach focused audit attention on "significant transaction cycles with critical assertions," also referred to as "critical cycles," "where there is a risk of material misstatement." Exs. J-60 at 13, J-139 at 16, 17, J-269 at 11, 12; Exs. R-202 at 3, 6, R-295 at 3, 4, R-393 at 3, 4 (planning documents for 2006-2008 audits).

Identification of a cycle as critical resulted in additional attention and focus on that area in the Koss audits. *See, e.g.,* KPHS 58; Tr. 115 (2006-2008 Staff/In-Charge Auditor: designation as critical "increased the work and the scope performed there"); Ex. J-200 at 4 (2008 audit work paper). According to Koeppel, a "critical assertion" was a financial statement assertion that had a reasonable possibility of material misstatement. Tr. 843-44; *see* Exs. J-60 at 13, J-139 at 16, 17, J-269 at 11, 12 (firm audit manuals, explaining that audit procedures "are focused on assertions" referred to as "critical to the audit," "where material misstatements are more likely to exist").[2/]

In each Koss audit, Koeppel concluded that 11 transaction cycles should be identified, that two should be designated as critical, and that, within those two cycles, a total of three assertions pertinent here should be deemed critical. Specifically, Koeppel considered "Revenue" to be a critical transaction cycle at Koss and "Existence/Occurrence" and "Valuation - Net" to be the critical assertions within that cycle. And Koeppel considered "Inventory – Purchasing (US Manufacturing)" to be Koss's other critical transaction cycle, with "Existence/Occurrence" a critical assertion within it. *E.g.*, Tr. 845-47, 874; *see* Exs. J-15 at 1, 3, J-109 at 1, 3, J-209 at 1, 3 & Exs. J-13, J-107, J-207 (2006-2008 audit planning work papers); Ex. J-49 at 1, 4 (2006 work paper); *see also* Exs. J-60 at 12, 17, J-139 at 15, 20-21, J-269 at 10, 15-16 (2006-2008 audit manuals); *see generally* AU §§ 326.04 ("Assertions about existence or occurrence address whether assets or liabilities of an entity exist at a given date and whether recorded transactions have occurred during a given period."), .07 ("Assertions about valuation or allocation address whether asset, liability, equity, revenue, and expense components have been included in the financial statements at appropriate amounts."). As summarized by a 2008 Koss audit planning work paper that Koeppel reviewed, "revenue and inventory have been deemed critical which will allow us to focus heavily on those areas during the audit." Ex. J-200 at 4, 7; *see* Tr. 1751-52 (Koeppel).

[2/] *See generally, e.g.,* AU §§ 326.03 ("Assertions are representations by management that are embodied in financial statement components."), .13, .25; Auditing Standard (AS) No. 2 ¶ 70 (applicable to 2006, 2007 Koss audits, defining "relevant assertions" as "assertions that have a meaningful bearing on whether the account is fairly stated"); AS No. 5, Appendix A9 (applicable to 2008 Koss audit, defining "relevant assertion" as "a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated").

For each audit in question, the audit program Koeppel approved for revenue included substantive procedures for testing net sales and accounts receivable. *See* Exs. J-16, J-110, J-210; Tr. 874. She testified that she considered sales allowances, as well as net sales and accounts receivable, to be part of the revenue cycle and that she relied, in part, on the audit testing of those allowances to form conclusions concerning the validity of Koss's assertion that it reported sales at their net realizable value. Tr. 845-46, 874, 1082, 1119, 1127; *see* OIP 20 ¶ 74; Ans. 31 ¶ 74; Exs. R-300 at 15 & R-398 at 15 (2007 and 2008 Koss audit planning documents identifying "Credits, sales allowances" as a transaction within the "Revenues" cycle); Ex. R-509 at 151 (Audit Manager's investigative testimony). And each year the audit program Koeppel approved for inventory included substantive procedures for testing inventory and related accounts such as cost of goods sold. *See* Exs. J-54, J-153, J-250; Tr. 1391-92.

Grant Thornton's audit methodology "emphasized" a general type of substantive procedure—either "Test of Details" or "Analytical"—for the balance sheet side of a critical cycle and for the income statement side. *E.g.*, Exs. J-60 at 21, J-139 at 25, J-269 at 20 (audit manuals); *see generally* AU § 319.108 ("The substantive tests that the auditor performs consist of tests of details of transactions and balances, and analytical procedures."); AU § 329.05 (analytical procedures "involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor" by "identifying and using plausible relationships that are reasonably expected to exist"). The type of procedure emphasized for the balance sheet elements and for the income statement elements depended upon how the auditor assessed both inherent risk and control risk. According to the firm's audit manuals, "to determine the type and extent of audit procedures to perform that will reduce the risk of material misstatement to a low level," "we apply" a methodology, "[f]or all critical assertions," that "matches the nature, timing, and extent of substantive audit procedures to our assessment of two components of audit risk – inherent risk and control risk." The approach "combines the inherent and control risk assessments" in a chart called "the ABC Audit Strategy Matrix," which "moves from heavy emphasis on tests of details in situations of high risk to minimizing tests of details, where possible, in situations of low risk" and calls for substantive procedures that "may be grouped into three separate strategies"—either A, B, or C. Exs. J-60 at 12, 13, 19, 20, 22, J-139 at 15, 17, 23, 24, 26, J-269 at 10, 11, 18, 19, 21, 22-23; Ex. R-483 at 2 (June 2, 2006 firm bulletin); *see* Tr. 850 (Koeppel).

In planning each audit, Koeppel concluded that the inherent risk of misstatement for each critical assertion was low. Tr. 1249-50; Exs. J-13 at 1, J-107 at 1-2, J-207 at 1-2; see Exs. R-509 at 73 & D-4 at 73 (Audit Manager's investigative testimony). This assessment was based in part on evaluation of a list of general inherent risk indicators, categorized as economic, industry, external, management, fraud, governance, operating, or financial. She deemed most of these indicators "not applicable" to Koss, including "Unskilled or inexperienced accounting personnel," "Ineffective accounting or information systems," and "Difficult to audit transactions or balances." Tr. 1243; J-70, J-178, J-278; *see generally* AU § 319.47 ("The information system relevant to financial reporting objectives, which includes the accounting system, consists of procedures, whether automated or manual, and records established to initiate, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity.").

The inherent risk assessment was also based on consideration of the potential that the financial statements were materially misstated due to a half-dozen risks at the financial statement level, each of which Koeppel regarded as "Low" for Koss, including "Errors in the accounting system," "Fraudulent financial reporting," "Misappropriation of assets," and "Errors in accounting for non-routine transactions." Tr. 1245-47; Exs. J-72, J-180, J-275. Additionally, Koeppel considered a list of inherent risk indicators at the level of each critical assertion, viewing no more than a few of these indicators in any given year as "applicable" and the rest, including "Potential for fraudulent financial reporting," and, as to revenue, "Potential for misappropriation of assets," as "not (rarely) applicable." Tr. 1243-44; Exs. J-71, J-179, J-279.

It was further noted by Koeppel in audit planning that "[d]ue to the small size of the organization, there is a risk that the lack of segregation of duties may cause rise to fraudulent financial reporting." Exs. J-100 at 1, 3, 6, J-200 at 1, 3, 7 (2007 and 2008 memoranda documenting audit planning meeting led by Koeppel); *accord* Ex. J-3 at 1, 3 (2006 memorandum); OIP 6-7 ¶¶ 20, Ans. 10 ¶ 20; Tr. 779-80, 810, 829-32 (Koeppel); Tr. 708-09 (2007-2008 Staff Auditor). To Koeppel, segregation of duties meant that no one person was responsible for the authorization, recordkeeping, and custody of transactions, and she testified it was "very important" that a "senior official should not have access to both create, post and approve journal entries" and that she "would want to take careful note of" circumstances that "could've resulted in a lack of segregation of duties." Tr. 1301-03, 1307-08, 1473-74; *see* Ex. J-2 at 15-16 (Grant Thornton IT specialists commented in a 2004 "IT Review" of Koss, on which Koeppel relied in the 2006-2008 audits, that "[s]egregation of duties is a primary consideration and requires multiple individuals to be involved in all material transactions, including granting access rights to material processes"); pp. 23-26 below. As Audit Manager explained in the investigation, "Ideally, you want an environment where you've got custody, authorization and record keeping being separate. You can typically have some overlap of one or two of them, but you certainly don't want any one person who can…have full custody, authorization and record keeping of all aspects…one person doing everything from start to finish through a process without any other supervision or monitoring in place." Exs. R-509 at 37-39 ("appropriate checks and balances in place" rather than "incompatible roles, that someone may be wearing multiple hats") & D-4 at 68-69.[3/]

[3/] *See generally* AU § 319.20 (a breakdown in segregation of duties "could result in unauthorized transactions or changes to programs or data that could affect the financial statements"); O'Reilly, Vincent M., *et al.*, Montgomery's Auditing (12th ed. 1998), p. 11-10 ("If internal control is to be effective, there needs to be an adequate division of responsibilities among those who perform accounting procedures or control activities

With regard to control risk, it was stated in audit planning that "primarily due to the lack of segregation of duties, GT did not conclude" that "a number of controls in place to mitigate the risk of loss and/or fraud" at Koss "brought control risk to a LOW level," and "[a]s such, GT has not placed reliance on those controls, nor did we perform any testing of said controls." Exs. J-3 at 1, 3, 4, J-100 at 1, 3, 4, 6; *see* Ex. J-200 at 1, 3, 4, 7; Tr. 779-84, 808-13, 1146, 1302-03 (Koeppel). In addition, Koss was exempt during the relevant period from the internal controls testing requirement in Sarbanes-Oxley Act Section 404, and engaged Grant Thornton to perform a financial statement audit, not an integrated audit of both financial statements and internal control over financial reporting. *See, e.g.*, Ex. J-268 at 21; Exs. J-65 at 1, J-173 at 1, J-276 at 1. Koeppel testified she took that into consideration, as well as reasons of efficiency based on the timing of the Koss audits and her view that controls were not necessarily documented at a company of its size, in deciding that, aside from certain audit procedures applied to journal entry processes, the audits would not test the operating effectiveness of Koss's internal controls for the audit period. Tr. 1254-57.

Instead of testing Koss's internal controls over critical cycles and assertions, the auditors would seek to obtain an understanding of those controls sufficient to plan the audits by performing procedures to understand the design of relevant controls and determine whether they had been placed in operation; would assess control risk by setting it at the maximum level; and would seek to restrict detection risk to an acceptable level by performing only substantive tests, not tests of internal controls.[4/]

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and those who handle assets. This segregation of duties consists of assigning different people to authorize a particular class of transactions, perform control activities when the transactions are processed, monitor those activities, maintain the related accounting records, and handle the related assets. Such arrangements reduce the risk of error and limit opportunities to misappropriate assets or conceal other intentional misrepresentations in the financial statements [and]…serve[] as a deterrent to fraud or concealment of error because of the need to recruit another individual's cooperation (collusion) to conceal it.").

[4/] *E.g.,* Tr. 784, 851-60, 918, 1025, 1253-56, 1287, 1307-10, 1345, 1468 (Koeppel); *see* Tr. 114, 116-17, 262, 270, 314 (2006-2008 Staff/In-Charge Auditor); Tr. 689-90 (2007-2008 Staff Auditor); Exs. D-4 at 32-33, 35, 54, 60, 73-74 & R-509 at 156 (Audit Manager's investigative testimony); Exs. J-132 at 2 (2007 audit "includes consideration of internal control over financial reporting" as "a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control or to identify deficiencies in internal control"), J-39 at 2 (similar for 2006 audit); Ex. R-483 at 4 (June 2, 2006 Grant Thornton bulletin to its auditors: "If controls are not tested or if controls are tested and not operating effectively, control risk must be assessed as High for the assertion."); Exs. J-3

Where, as here, inherent risk was assessed as low and control risk was assessed as high for the critical assertions, the Grant Thornton methodology applied by Koeppel in the Koss audits at issue called for a "combined medium risk" strategy named the "'B' Approach." *E.g.*, Ex. R-483 at 7-8; Exs. J-15, J-109, J-209 (work papers identifying the letter of the strategy used for assertions within each of the applicable critical and non-critical cycles). Grant Thornton proprietary software used in those audits generated audit programs populated with firm-suggested procedures consistent with that approach and audit planning information entered by the auditors. Tr. 754-55, 1176-77, 1180, 1238-39 (Koeppel); Tr. 274, 314-15 (2006-2008 Staff/In-Charge Auditor). Koeppel described these work programs as "the starting point of the work that you needed to perform." Tr. 1177. Koeppel recognized that it was she who was ultimately responsible that the Koss audits be conducted in accordance with PCAOB standards. *See, e.g.*, Tr. 1438.

The firm's audit manuals explained that the "B" strategy "requires analytical procedures to be augmented with tests of details" and "emphasizes analytical procedures on income statement accounts and tests of details for balance sheet accounts." Exs. J-60 at 20, 21, J-139 at 24, 25, J-269 at 19, 20; *see* Tr. 870-75, 1263 (Koeppel); Tr. 318-20 (2006-2008 Staff/In-Charge Auditor); *compare, e.g.*, Ex. J-60 at 21 ("A" strategy emphasized analytical procedures for both categories of accounts and "C" strategy emphasized tests of details for both). For example, the revenue audit programs for the 2006, 2007, and 2008 Koss audits included analytical procedures on sales. *See, e.g.*, Tr. 1435; Ex. J-16 at 2, 4.

The manuals further noted that the "B" strategy "only represent[s] a starting point in tailoring substantive audit procedures" and that, "[i]n response to identified risks, the auditor may decide to substitute a more detailed procedure than the procedure suggested by the strategy." Exs. J-60 at 22, J-139 at 26, J-269 at 21; *see* Tr. 1439 (Koeppel). Koeppel claimed at the hearing, however, that "as it relates specifically to Koss, there were not a lot of unusual items or things that weren't already incorporated into the [firm's software-produced] work programs. So we did not have to do a lot of tailoring." Tr. 1176-77; *accord, e.g.,* Tr. 1263-64, 1430, 1494, 1498 (Koeppel); Ex. R-509 at 61, 64-65, 106, 163 (Audit Manager's investigative testimony). But there is no evidence that the audit programs, as produced by the firm's software, specifically reflected certain Koss system limitations and internal control information, discussed below (*see* pp. 18-21, 24-29), that mattered to the audits. Nor was the "'B' approach" of those audit programs, which equally applied to a low-inherent-risk-high-control-risk audit

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at 4 (2006: auditors assessed control risk "for critical cycles…at High," having not "perform[ed] any testing of said controls"), J-100 at 4 (same, 2007); Exs. J-12, J-106, J-206 (2006-2008 concluding procedures work paper: "no" tests of controls, "not performed"); Exs. J-13, J-107, J-207 & Ex. R-202 at 7 (2006-2008 work papers: "High" control risk); *see generally, e.g.,* AU § 312.30; AU §§ 319.02, .04, .25, .27, .65, .66.

and a high-inherent-risk-low-control-risk-audit, tailored to specific issues of reliability of client system-generated data posed by the former type of audit. *See, e.g.*, Tr. 1439-44.

For non-critical assertions that nevertheless "may contain material monetary amounts," the firm's manuals identified a "D Strategy," which consists of "less extensive substantive audit procedures" and "concentrates on techniques such as inquiry and analytical procedures to identify items that warrant detailed examination." The firm manuals also noted that "we will often identify transaction cycles or assertions where no procedures will be necessary." Ex. J-60 at 21, 22; *see* Exs. J-139 at 24-25, 27, J-269 at 20, 22. All of the foregoing aspects of the firm's methodology were applied by Koeppel in planning the 2006, 2007, and 2008 Koss audits. *See, e.g.*, Tr. 1258-63 (Koeppel); Exs. J-15 at 1, 3, J-109 at 1, 3, J-209 at 1, 3 (2006-2008 audit work papers).

3. Koeppel Noted Particular Areas of Greater Risk That Needed To Be Addressed in Each Year's Audit Work on Koss's Journal Entries and the Revenue and Inventory Areas.

Although in leading the planning of the 2006, 2007, and 2008 Koss audits, Koeppel concluded that the overall inherent risk of material misstatement was low, she also concluded that there were particular areas of relatively greater risk to which the audits needed to respond. *E.g.*, Tr. 1273-74.

Koeppel testified that for each of the audits in question she participated in what PCAOB standards describe as "[a]n exchange of ideas or 'brainstorming' among the audit team members…about how and where they believe the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated" (*see* AU § 316.14). Tr. 778-79, 808-09; Exs. J-3 at 1, J-100 at 1, J-200 at 1 (work paper in each audit memorializing the meeting). These fraud brainstorming sessions took note of the circumstance described in PCAOB auditing standards that "[m]aterial misstatements of financial statements due to fraud often involve the manipulation of the financial reporting process by (a) recording inappropriate or unauthorized journal entries throughout the period or at period end, or (b) making adjustments to amounts reported in the financial statements that are not reflected in formal journal entries, such as through consolidating adjustments, report combinations, and reclassifications" (AU § 316.58). *E.g.*, Exs. J-3 at 4, J-100 at 4.

Relatedly, in each audit, Koeppel deemed it to be an applicable indicator of inherent risk at Koss and an "[a]rea[] where management override of controls may impact risk assessment" that "operating and financial decisions are dominated by a few individuals," and she believed that this risk factor could potentially result in a material misstatement and that the auditors needed to remain cognizant of it throughout the audit. *E.g.*, Exs. J-70 at 2, J-178 at 2, J-278 at 2; Ex. J-200 at 1, 2, 3, 4; *see* Tr. 300-02 (Staff/In-Charge Auditor); Ex. R-509 at 62, 67 (Audit Manager's investigative testimony).

Furthermore, it was noted in the fraud brainstorming sessions that "[d]ue to the small size of the organization, there is a risk that the lack of segregation of duties may cause rise to fraudulent financial reporting." Exs. J-100 at 3, J-200 at 3; *see* Ex. J-3 at 3; Tr. 830-32. The specific audit response approved by Koeppel to this identified risk was to "closely review unusual journal entries and perform journal entry control testing." Exs. J-3 at 1, 3, J-100 at 3, 6, J-200 at 3, 7; Tr. 778-81, 810, 829, 832 (Koeppel); OIP 6-7 ¶¶ 20, 22, Ans. 10-11 ¶¶ 20, 22; *see* Tr. 536-37 (2007-2008 Staff/In-Charge Auditor).

Koeppel approved an overall audit response to the risk of management override of controls that was summarized in the brainstorming sessions as follows: "understanding and considering any controls (or lack thereof) the entity has in place to address the identified fraud risk factors," which consideration "would need to include an added sensitivity to management's ability to override such controls" (Exs. J-3 at 1, 3 (2006), J-100 at 3, 6 (2007); Tr. 779); and understanding "through inquiries with staff and upper management, observations and walkthroughs as to the possibility of management override," assessing revenue and inventory as "critical which will allow us to focus heavily on those areas during the audit," and "test[ing] journal entry controls each quarter and at year-end, as well as review[ing] for unusual journal entries" (Ex. J-200 at 4, 7 (2008); *see* Ex. J-100 at 4, 6 ("GT will substantively test journal entries throughout the period and thoroughly review journal entries posted around year-end")).

More generally, the brainstorming sessions for the 2006, 2007, and 2008 Koss audits noted that the audits needed to respond to the risk of material misstatement due to fraud relating to revenue recognition. *E.g.*, Tr. 764-65, 1020-21, 1285-86; Exs. J-3 at 3, J-100 at 3, J-200 at 3, 4. The susceptibility of inventory to misappropriation was also identified in the sessions as a fraud risk. Exs. J-3 at 3, J-100 at 3, J-200 at 3; Tr. 1087 (Koeppel); see Ex. J-279 at 3.

Among other inherent risk indicators Koeppel deemed applicable in audit planning were "[h]eavy concentration of personal wealth in the business," "[i]neffective or absence of internal audit function," "[h]igh degree of competition, accompanied by declining margins," and "[p]ressure to meet expectations of analysts, creditors, and others." Exs. J-70 at 1, 2, 3, 4, J-178 at 1, 2, 3, 4, J-278 at 1, 2, 3, 4; Exs. J-3 at 2, 3, J-100 at 2, 3, J-200 at 1, 2, 3, 4; *see* Exs. R-205 at 4, R-299 at 4, R-396 at 3 ("The Company does not have an internal audit function due to the size of the organization."); *see generally* AU § 319.24 (noting that "when the nature of management incentives increases the risk of material misstatement of financial statements, the effectiveness of control activities may be reduced" and that an effective internal audit function "may constrain improper conduct by management").

4. In Each Audit in Question, the Audit Procedures Needed To Reflect Koeppel's Assessment of Maximum Control Risk and Identification of Control Deficiencies.

As noted, in planning the audits in question, Koeppel chose not to test the operating effectiveness of Koss's internal controls over financial reporting, including its financial statement assertions of existence/occurrence and net valuation of its revenue and existence of its inventory. She thus did not rely on internal control testing to reduce the substantive audit procedures required in those areas, and she set control risk at the maximum. Tr. 859, 1253, 1257-58, 1287; *see* Exs. D-4 at 35, 73, 74 & R-509 at 56, 73 (Audit Manager's investigative testimony). It was stated in Koss audit planning sessions led by Koeppel that assessment of control risk at that level "will impact necessary substantive testing to be performed through larger sample sizes or additional testing in critical areas including revenue recognition and inventory reporting." Exs. J-3 at 4, J-100 at 4. Koeppel testified that this lack of internal controls testing also meant that the auditors needed to obtain other audit evidence and perform additional audit procedures to support the reliability of data used in performing the substantive audit testing that was generated from Koss's information technology (IT) system. Tr. 847, 1025, 1142, 1443.

Additionally, Koeppel noted certain deficiencies in Koss's internal controls during the relevant audit periods, which at least had the effect of depriving the auditors of certain information relevant to the validity of Koss's journal entries and critical assertions and of placing greater weight on the other audit evidence obtained. Koeppel testified that if internal control issues were identified in the audits, "we do consider it to be part of our professional responsibility" to "bring those to the attention of management" and also "have a responsibility to assess how [each issue] impacts our audit plan and whether or not we need to modify our audit plan." Tr. 1179-80. In communicating these matters to Koss's board of directors, and in at least some cases just to its audit committee, prior to issuance of the audit reports each year, Grant Thornton, through Koeppel, explained that: (1) a "control deficiency" exists "when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis"; and (2) a "significant deficiency" is "a control deficiency, or combination of control deficiencies, that adversely affects a company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted auditing principles such that there is more than a remote likelihood that a misstatement of the entity's annual or interim financial statements that is more than inconsequential will not be prevented or detected." Exs. J-39 at 2, J-132 at 2 (August 30, 2006 and August 15, 2007 letters to Koss signed in firm's name by Koeppel); Tr. 1122-26, 1180 (Koeppel); *see* Ex. J-239 at 7, 9 (July 16, 2008 presentation to Koss's audit committee); *see generally* AU § 325.

Specifically, one of these matters concerned Koss's program of offering its discounts and rebates to its customers on the basis of informal, unwritten agreements. *See, e.g.,* OIP 20 ¶ 75; Ans. 31 ¶ 75; Ex. J-227 at 1. In 2006 and 2007, Koeppel advised Koss that the lack of "formalized contracts that document the terms of such agreements" was a control deficiency and that signed agreements would "allow for the proper documentation to be retained by the Company, and act as support so that these discounts are stated and accrued for correctly." Exs. J-39 at 4, J-132 at 3 (August 2006, 2007 letters to Koss); *see* Exs. R-202 at 2, J-37 (2006 audit planning work papers noting issue), R-295 at 2 (same, 2007). In 2008, she elevated the matter to a significant control deficiency, conveying to Koss's audit committee the "[p]otential impact" of the issue as follows: "By not having formal agreements in place, the Company does not have proper documentation to support the discounts given and the related accrual" (Ex. J-239 at 7). Tr. 1121-27, 1195, 1401-03 (Koeppel sought to "highlight that it is an area of concern and potential risk in their financial reporting process"); *see* Ex. R-393 at 2, Ex. J-227 at 1, Ex. R-482 at 723 (2008 work papers noting issue); Tr. 474-79. A 2008 work paper explained, "When considering the severity of this issue, GT has assessed this finding as a significant deficiency and has therefore included it in the internal control letter. Note that it has been our continued recommendation that some sort of formality be considered for these programs." Ex. J-226 at 1.

Regarding another control deficiency, Grant Thornton, through Koeppel, stated in an August 2006 letter to Koss that "overall controls appear to be designed effectively" but that Koss "currently has many detective and monitoring manual controls that identify problematic issues once they have already occurred. The risk in relying primarily on these types of controls is that they are detective instead of preventive in nature. The implementation of an increased number of preventative controls can further decrease the risk that material misstatements could occur." Ex. J-39 at 5. This point was made again in the corresponding letter to Koss in August 2007, as a "[r]ecommendation[] to strengthen internal control," rather than as an identified deficiency in internal control. Ex. J-132 at 4. This recommendation "that more automated and preventative controls be added" was addressed again in a 2008 audit planning work paper, which stated that VP-Finance responded that "there have been very few changes since PY [prior year]" and that "given the small size of the entity, correcting [this] deficienc[y] would simply not make sense from a cost-benefit perspective." Ex. R-393 at 2.

5. Koeppel Chose Not To Test Internal Controls Over Koss's Information Technology System, and Limitations of the System, as Koeppel Understood It, Impacted the Audit Work.

In planning the 2006, 2007, and 2008 Koss audits, Koeppel considered Koss's IT system as part of her effort to understand Koss's internal controls. Tr. 865-67, 1340-41 (Koeppel); Exs. R-202 at 6, R-295 at 4, R-393 at 5 (2006-2008 work papers). As with internal controls over financial statement assertions, however, Koeppel chose not to test the operating effectiveness of Koss's controls over its IT system for the audit period, explaining, "We audit the output of the system, rather than the system itself." Tr. 1336, 1473. Essentially, she operated during those audits on an understanding of Koss's IT system that was based on a 2004 review by Grant Thornton information technology specialists, based on subsequent audit team inquiry of Koss management and other personnel, observation on a particular day of certain Koss log-in and keystroke functions and end-of-the-day processes and review of documentation of the processing of some individual transactions as part of annual so-called walkthroughs of key controls over the revenue and inventory purchasing cycles, and based on experience using the output of the IT system in the audit work.[5/]

Part of Koeppel's understanding was that there were system limitations on access to financial data in Koss's electronic database. Tr. 789-90, 1329-30, 1347-48; KPHS 28, 60. As discussed below, such limitations complicated the audit tasks of obtaining a complete population of journal entries for fraud testing and supporting the reliability of Koss's system-generated reports used in the substantive audit testing of Koss's recorded revenue and inventory. *See, e.g.*, Exs. D-4 at 88 & R-509 at 124 (Audit Manager testified in investigation that "we cannot obtain an electronic version" and so "we were relying on the printouts of the system," but "[w]e were able to audit around it and get comfortable with things").

During the period of the audits, Koss used various standard software programs running on an IBM AS/400 computer. Tr. 1347 (Koeppel); *see* Ex. J-2 at 2 (2004 document carried over to 2006 audit); Ex. J-200 at 2 (2008 work paper). Koeppel described this as an "off-the-shelf system," which "was not complex," had "very little tailoring [to Koss] done within there," and "was so old [Koss] couldn't even get updates anymore." Tr. 1186, 1338-39, 1349, 1485-86; *see* Ex. R-509 at 167-69 (Audit Manager's investigative testimony). Although accounting department members and other Koss personnel entered financial data into the computer system, and VP-Finance

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5/ *E.g.,* Tr. 864, 1298, 1342, 1345 (Koeppel); Tr. 235-36, 290-291, 293, 295 (2006-2008 Staff/In-Charge Auditor: Koeppel's review of walkthrough); Exs. J-4, J-101, J-201 (2006-2008 audit memoranda summarizing interviews with VP-Finance and Senior Accountant about Koss's financial reporting controls); Exs. J-5, J-102, J-202 (2006-2008 audit memoranda on Koss's inventory expenditures process); Exs. J-6, J-103, J-203 (2006-2008 audit memoranda on Koss's revenue procedures); Ex. J-49 at 1, 4 ("GT selected 1 PO [purchase order] from an receipts register" and "1 invoice from an A/R register" and reviewed records of those already processed February 2006 transactions as part of July 12, 2006 walkthrough); Ex. R-300 at 15, 16, 21, 23, 31, Tr. 294-95, 390-392 (review of Koss records for one already processed $66.09 credit memo, $2,205.20 sale, and $21.11 warranty claim and observation of Senior Auditor matching individual credit memos to Koss credit memo report at day's end, as part of June 4-7, 2007 walkthrough); Ex. R-398 at 7, 8, 15, 20, 22, Tr. 701 (review of Koss records related to one already processed sale, inventory purchase, and warranty claim as part of June 3-4, 2008 walkthrough); Exs. R-205, R-299, R-396 (2006-2008 Koss audit memoranda summarizing conversations with VP-Finance about Koss's governance controls); Exs. R-298, R-397 (2007, 2008 "Who Performs Processes and Controls" work papers), Tr. 284.

or Senior Accountant were responsible for regularly reconciling subledgers with the general ledger and with paper records, Koss outsourced administrative responsibility for managing the computer system and programs to a third-party contractor. Tr. 46-48, 99-100, 1300; Ex. J-2 at 2, 5; Exs. R-205 at 4, R-299 at 4, R-396 at 4 (work papers).

Among other accounting data Koss maintained on its computer system was its general ledger, a compilation of all transactions recorded in the company's general ledger account. Koss also used electronic subsidiary ledgers to record various accounting transactions, including accounts receivable, accounts payable, and inventory. *E.g*., Tr. 187-88 (2006-2008 Staff/In-Charge Auditor); Ex. J-2 at 2, Ex. J-5 at 5, 6, Ex. J-6 at 2-6 (2006 audit work papers); Ex. J-200 at 2 (2008 audit work paper). Although the auditors did not observe the process, they understood that entries from Koss's subledgers were posted to its general ledger as "standard" journal entries on a monthly basis through an automated program that was initiated by the accounting department. *See, e.g.,* Tr. 563-64 (the process of posting from the accounts receivable subledger to the general ledger was not automatic), 698 (understanding of process based on discussion with member of accounting department, not observation) (2007-2008 Staff Auditor); Tr. 1961 (Koeppel's expert); Exs. J-49 at 1, 4, R-300 at 6, R-398 at 11. For example, they believed, sales transactions were accumulated in the accounts receivable subledger and posted to the general ledger monthly, and, although not observed or reviewed by them, reconciliations between the two were performed by that department on a monthly basis. And the auditors were aware that the department could post manual "nonstandard" journal entries directly to Koss's electronic general ledger, bypassing the respective subledgers. Tr. 49-50, 62-63, 77-78 (2006-2008 Staff/In-Charge Auditor); Tr. 698 (2007-2008 Staff Auditor); Ex. D-4 at 40, 58-59, 94, 115 (Audit Manager's investigative testimony); Exs. J-4 at 2, J-101 at 2, J-201 at 2 (2006-2008 audit memoranda); Ex. J-7, Ex. J-10 at 1-2, Ex. J-11 (2006 audit work papers).

In planning each audit in question, Koeppel concluded that the potential that Koss's financial statements were materially misstated due to errors in its accounting system was low and that the general inherent risk indicator of ineffective accounting or information systems was not applicable. *See* Tr. 1188; *see also* Exs. J-70 at 2, J-178 at 2, J-278 at 2 & Exs. J-72, J-180, J-275 (2006-2008 work papers). A 2008 Koss audit planning document approved by her stated that the AS/400 is a "reputable system[] that ha[s] proven reliable for many companies across various industries," and, "[a]s such, GT considers there to be a very low risk of systematic errors produced by the accounting systems." Ex. J-200 at 2, 7. In this regard, Koeppel testified she took comfort from her belief that Koss was "using the same [computer keystroke] inquiries to generate reports repeatedly," that the inquiries "were standard, or if they had been customized, they had been customized years before," and that Koss "didn't have complex transactions to process." Tr. 1485-88. She also cited "overall access controls to the system" that she believed were in place at Koss, based on audit team inquiry of Koss and its third-party IT contractor, observation of certain system users during the walkthroughs, and testing of selected Koss journal entries. Tr. 1342, 1349, 1489; *see* Tr. 523 (2007-2008 Staff Auditor); Ex. J-7; Exs. J-10, J-105, J-205; Exs. J-49, R-300, R-398; Exs. R-298, R-397.

Koeppel also stressed her understanding that Koss had an "integrated system," consistent with double-entry bookkeeping, in which, for example, "when a [Koss] shipment occurred, [its computer system automatically] relieved inventory and then also recorded the sale in accounts receivable" and "in revenue, when an invoice is generated, it hits sales and it hits accounts receivable [by automated application program]." Tr. 1186, 1349, 1357, 1360-61, 1397-99, 1465-66, 1489.[6/] Further, in investigative testimony, Audit Manager distinguished Koss's "centralized system" from a situation, for example, of "multiple location items" in which a company "had sales reports coming from various systems and various subsidiaries, and it was coming from a number of different sales reports to reconcile to the receivables and centralized billing in some cases and not in others." Ex. R-509 at 167-69. Additionally, Koeppel testified

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[6/] *See, e.g.,* Tr. 121-22, 389-92 (2006-2008 Staff/In-Charge Auditor stated similar understanding); Exs. J-6 at 3-5, J-103 at 3-4, J-203 at 3-4 (audit memoranda: based on discussions with Koss's accounting department, "there is an integrated database between the sales order and invoicing applications"; recording shipment of goods in inventory subsystem "automatically relieves inventory and records the accounts receivable subsidiary ledger"); Exs. J-5 at 5, 6, J-102 at 6, J-202 at 6 (audit memoranda: based on inquiry, "Upon printing checks, the system will remove the payable amounts. As such, it is deemed that the databases are integrated."); Ex. J-49 (2006 Internal Control Walkthrough document) at 4 (based on inquiry, "Shipping documents are sent to AR to record shipment and generate the invoice which posts AR, inventory, sales, and [cost of goods sold]."); R-300 (2007 Walkthrough Test Summary Report) at 8 ("GT viewed the AP ledger noting once an invoice is paid it is automatically removed from the AP ledger."), 25 ("The AS/400 is a fully integrated system. Once goods are shipped and updated in the system by the shipping department, the invoice is automatically released and can be generated. GT observed this process."), 23 & 27 ("Once the invoice is generated, it is automatically recorded in the accounts rec[ei]vable subsystem"; claims "GT observed this process" on June 5, 2007 but "using [an] invoice" dated April 12, 2007, leaving only other stated basis "interview[]" with Senior Accountant), 27-28 ("GT observed a screen shot of th[e] process" whereby the AS/400 system "automatically checks the individual transactions against batch totals"); Ex. R-398 (2008 Walkthrough Test Summary Report) at 12 ("integrated database between payables and payment applications"; no source cited other than interview), 22 & 24-25 ("GT notes the AR is automatically posted when the invoice is generated."; although states that "GT observed [on June 4, 2008] the posting of the AR through the Transaction Information entered [for a particular sale]," payment for that sale is listed as received on May 19, 2008, leaving only other stated basis as "interview[]" with Senior Accountant); Exs. R-298 at 2-4, 7-9 & R-397 at 2-4, 7-8 (2007, 2008 "Who Performs Processes and Controls" documentation; similar information, based on audit inquiry).

that she believed that "[h]aving a third-party provider, in itself, provided a level of comfort, because you have separated activities." Tr. 1342.[7/]

In considering Koss's IT system, Koeppel testified she relied on "the foundational work" of Grant Thornton IT specialists brought in to obtain an understanding of that system in connection with the firm's first audit of Koss in 2004. Tr. 862-63, 864-67, 1342, 1345. Documentation of that 2004 IT review took the form of a six-page "IT Question[n]aire" and a 19-page July 2, 2004 "Summary Review Memo." The stated objectives of the IT review were described as follows in the IT review memo: (1) to "[a]ssist the financial audit team in assessing the Company's overall control environment," (2) to "[d]etermine if it would be possible to rely on program change, database administration, and user access controls," (3) to "[a]ssess the Company's use of leading IT management practices," and (4) to communicate findings, conclusions, and any recommendations for improvement to the audit team and Koss management.

The IT questionnaire (Ex. J-1) identified controls said to be in place within Koss's IT system in the areas of (1) management and organization (develop and implement plans, identify and assess risks, operate reliable systems, hire and retain people, and manage third-party services, with two to four highly general controls listed for each); (2) applications (acquire and maintain operating and database systems (four controls listed relating to software upgrades) and acquire and maintain applications (nine controls relating to development projects and programmer access); and (3) security (administer policies and procedures (five controls), protect data and enforce segregation of duties (11 controls relating to use of user and group profiles, identifications, and passwords), limit external access to systems (11 controls), protect physical assets (six controls)). This was "followed by a narrative that gives a little bit more background on the discussion that was had with the individuals at Koss to determine this." Tr. 1343.

[7/] *See* Tr. 1330 (asserting that Koss "used very credible third-party specialists to oversee their IT department"); Ex. J-2 at 1 (according to a 2004 Grant Thornton review of Koss's IT system, the IT staff "is outsourced to two main individuals," described as "knowledgeable and helpful"); Ex. R-202 at 6 (2006 work paper: "Management of the information systems is outsourced….As such, the potential for internal 'tinkering' with the system is limited. See journal entry testing for the testing of the posting and approval of journal entries."); Ex. J-100 at 4 (2007: "The use of IT processing adds some additional risks of the susceptibility of information. GT will discuss the potential of risks with management. [Per discussion with Junior Accountant], management of the information systems is outsourced. As such, the potential for internal 'tinkering' with the system is limited."); Ex. J-200 at 2, 7 (2008: Koss "performs some internal IT processing which adds additional IT risks as it relates to the susceptibility of altering information. However, Koss has outsourced the management of such systems to offset the risk of internal 'tinkering' with the systems. GT therefore considers there to be a very low risk of man-made errors in the accounting systems.").

After stating the objectives, the IT review memo noted, "We reviewed the [Koss IT] systems as communicated by the client," and specified these procedures as having been performed: "Inquiry of outsourced IT personnel," including meeting with those two individuals; "Tour of the Milwaukee computer room"; "Review of selected client documents"; and "Testing the IBM AS/400 user profiles for previous sign-on attempts, sign-on attempts not valid, and status." Ex. J-2 at 1. It is undisputed that the 2004 IT review was not a test of the operating effectiveness of the internal controls over the IT system for 2004 or any of the three years at issue. *See, e.g.*, KOB 27; Tr. 1342, 1473.

The body of the IT review memo began with summary descriptions of Koss's computer hardware and software, the organization of Koss's IT department, and the vendors who provided support for that department. Then the memo: (1) discussed Koss's "General Computer Controls" ("Planning," "Developing," and "Operating"); (2) noted that "[d]uring the IT Controls Review, we collected user profiles for the IBM AS/400 in the network," "observed 48 user profiles," and "found that 12 users had not signed onto the system in over a year and that their profiles were still enabled," though two were then disabled, three others had been "automatically created for the latest software release" and "cannot be accessed by users," and a "compensating control does exist in that passwords expire after 90 days," so the seven other identified users "will have to contact the AS/400 Administrator to gain access"; (3) made three pairs of overall findings and recommendations, characterizing one issue as "Moderate Risk" (lack of formal procedures for changes to Koss's database by its outside administrators) and the other two issues as "Low Risk" (one: lack of regular reviews of user access and segregation of IT duties and failing to disable inactive user profiles; two: certain areas for improvement in Koss's user identification and password policies, which "d[id] not consistently follow leading practices") and noting, and in one instance commenting on, Koss management's responses; (4) offered four lesser "Observations" (suggesting that Koss should continue its effort to "develop a formal disaster recovery / business resumption plan to anticipate operational problems related to IT system failures," "consider keeping the door to the computer room closed and locked at all times," "confirm[] the effectiveness of controls around [the] IT process" of a vendor that serviced the "electronic commerce website" on which Koss then did a level of business "not considered material to [its] financial statements," and formalize Koss's computer help desk function); and (5) stated "Additional Management responses" and a "Reviewer Comment." Ex. J-2 at 2-18. The memo also included a "Conclusion" section. *Id.* at 1.

The IT review memo set forth the following as its "Conclusion" (*see id.* at 1, 2), including critiques of Koss's internal controls over the IT system:

> The Company has IT processes in place for managing program changes, managing access to production data around application controls, and managing user access to the Company's CRT software system [used for Koss's "Accounting (AP, AR, GL), Order Entry, Sales Reporting, Invoicing, Distribution, Payroll" functions]. The controls related to those processes

> appear to be primarily detective rather than preventative, although regular reviews of detective controls suggest that these controls are probably ineffective. The IT vendors appear focused at functionality with little understanding or appreciation of IT control standards. In addition, Company management appears to rely completely on the IT vendors.

Regarding those outside personnel, among the findings in the IT questionnaire was that Koss's "IT management (vendors) do not appear to fully understand IT control standards" and "do not provide the Company with formal third party attestations" that "could confirm their understanding and use of leading IT Controls." Ex. J-1 at 1, 3.

The Grant Thornton IT specialists also found that Koss "does not perform regular user access / segregation of [IT] duties reviews" and that, "[a]s a result, some users may have excessive access to the Company's financial systems." Ex. J-2 at 15; *see id.* at 12; Ex. J-1 at 5. The IT review memo recommended not only that "a policy be established to review and disable inactive AS/400 users, despite their status or title," but also that "the IT department prepare quarterly user access lists that can be reviewed for inappropriate access rights by department managers / vice presidents." Ex. J-2 at 15. As to user access, management responded that "[t]here are 20 users and very little turnover" and "[m]aybe 5 are here less than 3 years," concluding that "I would rate this low risk…On a scale of 0 to 10 this is maybe a 2." As to segregation of duties, management responded, "The operative word is may have in the sentence about having excessive access. I think the recommendation is appropriate and once again I think this is low risk. On a scale of 0 to 10 it [is] maybe a 1." As to the number of user profiles in the system, management responded there were 55 live user profiles that were not "software and operating system related" profiles inaccessible to users, and concluded, "Once again I think this is low risk. On a scale of 0 to 10 this is maybe a 1." *Id.*

In reply to these points, the IT review memo stated, "User access is a key control in an IT environment. Segregation of duties is a primary consideration and requires multiple individuals be involved in all material transactions, including granting access rights to material processes." According to the memo, "Executive management's (CEO, CFO, CIO, etc.) ability to administer user access and grant transactional rights is a consideration because this right suggests that one individual with extraordinary authority can alone grant access rights. The ability of any one individual to grant access rights without oversight, regardless of position, is an inappropriate segregation of duties." The memo's reply to management concluded, "Regular reviews of user access can act as an appropriate control in a small user environment. The number of users or the frequency of turnover is not a control when assessing the effectiveness of segregation of duties and user access controls." *Id.* at 15-16.

Furthermore, the IT review memo contained an exchange between Koss management and the Grant Thornton IT specialists that indicated that management placed a high degree of responsibility on its personnel at the departmental level and that its business perspective diverged from an audit perspective on internal controls. Specifically, management stated, "I think it is important to note our IT is in the hands of the users. Each area is responsible for it[s] data and the accuracy of that data." According to management, "There are controls in place where we know daily if something is out of sorts. We have backup systems in place and security systems in place which have been utilized and allow us to smoothly move through a problem when it occurs." Management concluded, "The books have been accurately closed on the first day of the month for over 10 years. I say this because it is an affirmation of a well oiled machine." *Id.* at 17. The IT reviewer commented in reply, "Auditing standards focus on IT Governance and controls rather than how 'well oiled' the process may seem. Reviews of this Company's IT controls by regulators, investors, or buyers would find control gaps that would be unacceptable based on IT control standards." *Id.* at 18.

Koeppel testified that the purpose for which she used the 2004 IT review in each Koss audit was to "determine whether or not the IT system had deficiencies that we needed to take into consideration in connection with planning and performing our audit." Tr. 862-67. According to Koeppel, she "took these two documents in their entirety" but "focused on" the recommendation portion of the memo. *Id.* at 866-67. She stated that any IT system deficiencies would have been identified in each audit's documented understanding of controls and in the Summary of Control Findings, a document which formed the basis for a Grant Thornton communication each year to Koss. Tr. 1179-80, 1346-47; *see* Tr. 297-98 (2006-2008 Staff/In-Charge Auditor). Yet, Koeppel asserted, no deficiencies in controls over IT systems were identified in the 2006, 2007, and 2008 Koss audits that rose "to a level beyond [that] of a control deficiency that we provided to management," except for the 2004 IT review's observation that Koss lacked a formal disaster recovery plan (Ex. 1 at 2; Ex. J-2 at 17), which Koeppel regarded as a "prospective issue" that did not "directly impact the financial reporting system of the period we're auditing." Tr. 1343-44; *see* Exs. J-38, J-225 (2006, 2008 work papers); Exs. J-39 at 3-6, J-132 at 3-4, J-239 at 7 (2006-2008 communications to Koss).

As Koeppel describes it, the information from the 2004 IT review was carried forward in the 2006, 2007, and 2008 audits as a "good foundation" for understanding Koss's internal controls over its IT system. Tr. 862-64, 1345, 1348; *see, e.g.*, Ex. J-1 at 7 & J-2 at 20 (2004 IT questionnaire and memo included in 2006 audit work papers). She testified that over the audit years in question "[w]e had discussions" with the third-party administrator of Koss's IT system, as well as with Koss personnel, "about whether or not they made any changes to their system"; observed the processing of some individual Koss transactions; examined the records of how selected journal entries were processed; inquired about "the expertise and experience of the individuals who were performing work" relevant to financial reporting and "whether there had been changes in the individuals…[or] in [their] responsibility"; noted that Koss was providing the same types of system-generated reports for each audit; and concluded that no significant changes had been made to the IT environment at Koss. Tr. 1186-87, 1298, 1342, 1345, 1347-48, 1488; *see, e.g.,* Tr. 233-35 (2006-2008 Staff/In-Charge Auditor); Ex. R-202 at

2 (“PDW [VP-Finance], the IT environment has not changed at all in the past few years. As such, the IT documentation from fis[c]al 2004 is still accurate.”); Exs. R-205 at 2 (initialed by Koeppel), R-299 at 1, R-396 at 1 (initialed by Koeppel) (2006-2008 audit planning memoranda: “Many of the individuals in financial reporting have been performing their responsibilities for a number of years.”).

Finally, Koeppel testified that, throughout the audits in question, she understood that IT system limitations affected auditor access to financial information maintained electronically by Koss. For audit purposes, she deemed an electronic copy or printout of Koss’s entire general ledger or detailed listing reports of particular general ledger accounts to be “definitely the preferred method to get the information.” Tr. 1330, KPHS 28, 65; *see* Tr. 412 (2006-2008 Staff/In-Charge Auditor: “ideally” would have those). But, as Koeppel explained it, based on audit team inquiries of Koss and its third-party AS/400 administrator and on experience with other audit clients of similar size, “older,” “basic systems” like Koss’s did not have the “kind of data access and search capabilities” that could produce an electronic download or computer-generated list of all general ledger entries for the year under audit. Tr. 789-90, 1329-31, 1483, 1487; *see* Tr. 99-100, 102, 106, 110-11 (2006-2008 Staff/In-Charge Auditor: per Koss’s accounting department and outside contractor, “it was a limitation in Koss’s software that prevented [Koss] from getting a download of all journal entries in electronic format” or printing a full list; Koss “couldn’t perform a query function” to do that); Tr. 522-23 (2007-2008 Staff/In-Charge Auditor); Ex. J-205 at 3 (2008 work paper: “[Per VP-Finance], the G/L system does not allow Koss to print out listing of journal entries recorded during the year.”).

Nor, according to Koeppel, could Koss’s IT system produce detailed listings of transactions recorded in particular general ledger accounts: “It was not a static system. So once time passed, you couldn’t go back and get the aggregate information. You had to walk through a series of [periodically printed] reports, because it was summarized…we knew they couldn’t go back and regenerate, for example, an accounts receivable report once time passed.” Tr. 1347-48; *see, e.g.*, Tr. 575-77, 583-84 (2007-2008 Staff Auditor: IT system could only provide a listing of sales for a one-day period; Koss would print out the invoice listing every day and accumulate them in a binder); Ex. J-125 at 3, 6 (2007 work paper: “Because of restrictions imposed by Koss’s accounting system, a detailed listing of all cash receipts and invoices could not be produced.”); Ex. J-48 at 3 (2006 work paper: “Koss cannot produce a[n] [inventory] purchases report”); Exs. J-55 at 2 & J-155 at 1 (2006, 2007 work papers: a detailed accounts payable listing by invoice “cannot be generated” by Koss’s IT system); Exs. J-54 at 5, J-153 at 4, J-250 at 6 (2006-2008 work papers: when used in audit testing, Koss fiscal year-end physical inventory report “was only in paper,” “is only available in paper form”). *See generally, e.g.,* AU § 311.09(d) (“Documents that are used to enter information into the computer for processing, certain computer files, and other evidential matter that may be required by the auditor may exist only for a short period or only in computer-readable form.”).

Although Koeppel knew that the auditors could directly view Koss's electronic general ledger at a Koss computer terminal, she testified it was her experience that the only way audit clients would allow this was for the auditor "to work with a member of accounting staff to obtain that access and to navigate through the system," with the auditor sitting at the computer screen next to the client's employee, who would operate the computer. Tr. 1322, 1324-25, 1328, 1332-33, 1491; *see* Tr. 523 (2007-2008 Staff/In-Charge Auditor); Ex. D-4 at 13-14 (Audit Manager's investigative testimony); Ex. J-302 at 5. Further, a junior member of the 2006, 2007, and 2008 Koss audit teams testified that when Koss's accounting staff "pulled up transactions" on the computer screen "and when you got to the detail of the journal entry, they only were able to show that transaction," so it "would have been hard" and "a very time-consuming process" to "go through every journal entry posted in a month or a week or a year." Tr. 415-16.

As we discuss, Koeppel was well aware that in substantive testing in the 2006, 2007, and 2008 audits, the auditors, citing system limitations, did not directly access Koss's electronic general ledger. She also knew they did not secure the assistance of a professional with specialized IT skills or apply computer-assisted audit techniques to help obtain a complete population of journal entries for testing or to help support both the completeness and accuracy of Koss's IT system-generated reports. *See, e.g.*, Tr. 1324; Ex. R-509 at 125-26 (Audit Manager's investigative testimony).[8/]

[8/] *See generally* AU §§ 311.10 ("a professional possessing" "specialized skills," who could be "either on the auditor's staff or an outside professional," could provide assistance "to consider the effect of computer processing on the audit, to understand the controls, or to design and perform audit procedures"), 316.52 ("the auditor may choose to employ computer-assisted audit techniques to gather more extensive evidence about data contained in significant accounts or electronic transactions…[such] techniques may enable more extensive testing of electronic transactions and account files…[and] can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample"), 316.54 ("Computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions."), 316.61 ("Electronic evidence often requires extraction of the desired data by an auditor with IT knowledge and skills or the use of an IT specialist. In an IT environment, it may be necessary for the auditor to employ computer-assisted audit techniques (for example, report writers, software or data extraction tools, or other systems-based techniques) to identify the journal entries and other adjustments to be tested."), 319.32 ("Procedures that the auditor may assign to a professional possessing IT skills include inquiring of an entity's IT personnel how data and transactions are initiated, recorded, processed, and reported and how IT controls are designed; inspecting systems documentation; observing the operation of IT controls; and planning and performing tests of IT controls."), 319.79 (as "computer-assisted audit techniques may be used to test automated controls or data related to assertions" and auditor "may use other automated tools or reports produced by IT to test the operating effectiveness of general controls, such as program change

Instead, as Koeppel knew, and as discussed below, the auditors relied on manually prepared journal entry forms, reports periodically generated by Koss's computer system of journal entries posted to the general ledger, and system-generated reports or spreadsheets of subsidiary ledger details and general ledger trial balances. As an audit team member for each of the pertinent years testified, "When we first got into the field on the first day, there was usually a stack of a ton of documents," including spreadsheets and reports, on which the auditors then went to work. Tr. 158-60 (2006-2008 Staff/In-Charge Auditor); *accord, e.g.*, Tr. 590-91 (2007-2008 Staff Auditor audited off of paper copies of trial balance or balance sheet provided by Koss).

6. While the 2006 Koss Audit Was Underway, Koeppel Received a PCAOB Inspection Comment on the 2005 Koss Audit That Focused Her Attention on the Issue of the Completeness of the Population of Journal Entries Selected for Fraud Testing.

Prior to completion of the 2006 Koss audit, the PCAOB conducted an inspection of Grant Thornton and reviewed components of selected issuer audits that had been completed by the firm, including the 2005 Koss audit. *E.g.*, R.D. 1 at 8 ¶ 24; R.D. 22 at 11-12. After that review of the 2005 Koss audit, PCAOB inspectors issued to the firm an inspection comment form, dated July 26, 2006, on that audit, which Koeppel received while field work on the 2006 Koss audit was ongoing. Tr. 413, 758-59, 762, 1490-92; Ex. D-1; Ex. D-4 at 18-19, 20, 25 (Audit Manager's investigative testimony); *see* Ex. J-59 at 1, 25 (audit report on Koss's fiscal-year-2006 financial statements was dated August 30, 2006 and filed by the company with the SEC on September 6, 2006).

The comment form stated, under the heading "Facts" (Ex. D-1 at 1):

> The engagement team's fraud audit procedures consisted of a review of the journal entries for the month of June, noting no unusual or improper entries included in the monthly binder of standard and non-standard journal entries maintained by the issuer. The team noted the examination of journal entry worksheets focusing on high-dollar entries and non-standard journal entries, noting whether entries had a proper approval and support. The actual identification of the entries and the tests performed were not documented in the audit work papers.
>
> The engagement team did not perform procedures to determine whether the data represented a complete population of journal entries.

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controls, access controls, and system software controls," auditor "should consider whether specialized skills are needed to design and perform such tests of controls").

In connection with completing and returning the form to the PCAOB, Koeppel signed at the bottom of this section of the form as the "Firm Representative," acknowledging that she had "read the facts as presented above and agree[s]."

The PCAOB inspection comment continued, under the heading "Issue" (*id.*):

> The engagement team's procedures were not sufficient to comply with AU 316, *Consideration [of] Fraud in a Financial Statement Audit*, in that they did not include the following or did not include documentation of why such procedures were unnecessary:
>
> - Ensuring the completeness or accuracy of the data population
> - Testing of journal entries from throughout the period
>
> In addition, for those journal entry procedures that were performed, the engagement team's documentation was insufficient to comply with Auditing Standard No. 3, *Audit Documentation*, as it did not include documentation of the journal entries selected for testing.

To this section of the comment form, Grant Thornton submitted the following response:

> [An audit work paper] outlines that we reviewed the journal entry binders maintained by the client and reviewed all entries. The documentation, however, does not list each individual entry[,] as we looked at all entries. The process for accumulating all entries in the binder and the lack of issues noted during the testing of reconciliations and other audit work allowed us to conclude that the journal entry binders we reviewed were complete.
>
> Additional documentation is warranted.

Id. at 2. Under the heading "Firm's Remedial Action(s)," it was further stated on behalf of the firm that (*id.*):

> To supplement the work previously performed over the journal entry testing, the engagement team will detail the specific entries reviewed; document unusual items noted for the specific entries evaluated[;] and complete an assessment (upstream/downstream testing) as to the completeness of the journal entries provided.

Koeppel signed as the "Firm Representative Responsible for the Firm's Response and/or Remedial Action(s)." *Id.*; Tr. 766. According to her, that was the only description of the remedial procedures that was provided to the PCAOB inspectors. KPHS 31.

Koeppel testified that the statements made on behalf of Grant Thornton on the comment form reflected her discussions with the Audit Manager and others at the firm, some of whom reviewed the form before it was submitted to the PCAOB. The others were the managing partner of the firm's Milwaukee office, who was also a concurring partner on the 2005 Koss audit; the local professional standards partner; the regional professional standards partner; and two partners in the audit practice quality group. Tr. 1319-20, 1326. Koeppel made the judgment that the idea of "upstream/downstream testing" was, in her words, "an effective way of testing the completeness of the information," "mak[ing] sure we had a complete set of journal entries," and "get[ting] comfortable" about the completeness of the population from which to select entries for fraud testing, after discussing with the regional professional standards partner "the fact that we couldn't get an electronic download" of Koss's general ledger and that its journal entries were not "numbered sequentially." Tr. 1322-23, 1329. In Koeppel's view, the idea of "sending [Grant Thornton's] IT advisory group out to Koss to check" on the system limitations "never came up" because "we had clients who had older systems and these kind of limitations were not unique to Koss." Tr. 1324; *see* Tr. 800, 1483-87.

As Koeppel testified, "[n]obody discussed with" her or Audit Manager "one specified way of doing" the so-called upstream/downstream testing or "the variety of procedures that we could use" to determine the completeness of the journal entry binders at Koss. Tr. 1322-24, 1452-55. Koeppel did not discuss with Audit Manager why Audit Manager ultimately chose a certain approach for 2005 or later audits or discuss that approach with anyone else, nor was it revealed by the firm's statements on the inspection comment form, which did not describe how that testing would be performed; and Koeppel never asked anyone outside of the audit teams to review the remedial work on the 2005 audit or the different "upstream/downstream testing" used in the 2006, 2007, and 2008 Koss audits before authorizing issuance of the audit reports for those years because she "did not see a need to elevate that to somebody outside of the engagement team." Tr. 766-71, 1452-55, 1491-92; *see* Tr. 767-68 (noting that "[t]here's multiple ways to perform upstream/downstream testing" and that it did not necessarily "include[] taking a selection of journal entries from journal entry binders maintained by the client and tracing them to the system"). Although Koeppel has stated that in late 2006 or early 2007, a partner in the audit practice quality group requested and received copies of the remediation work papers and that Koeppel heard nothing further about that at the time, the "upstream/downstream testing" used for the remedial work, unlike the testing by that name used in the 2006 to 2008 Koss audits, did not rely exclusively on paper records from Koss. *E.g.*, Tr. 768-71, 1325-29, 1490-92 (Koeppel).

The remedial work for the 2005 audit was performed by Audit Manager and reviewed and approved by Koeppel in September 2006. Tr. 768-70, 1157-58, 1327-28, 1491 (Koeppel); Ex. D-4 at 15 (Audit Manager's investigative testimony); Ex. J-302. To do the so-called upstream/downstream testing, Audit Manager "obtained all of the fiscal 2005 journal entry binders" from VP-Finance. Ex. J-302 at 5; Ex. D-4 at 13. A July 8, 2005 work paper from the 2005 Koss audit described these binders, based on a discussion with VP-Finance: "Koss maintains a binder of standard and non-standard journal entries for each month of the fiscal year. There is a journal entry checklist…for all standard monthly journal entries. Journal entries are manually recorded on journal worksheets detailing the accounts affected by the entity and the corresponding amounts recorded to each account. In most cases, documentation supporting the entry is attached to the back of the journal entry worksheet." Ex. R-141.

Koss's standard journal entries have been described by audit team members as automated or manual and typically "happen[ing] on a recurring basis," such as "when inventory is sold, the release of inventory," "the posting of depreciation expense that is going to be of a recurring, routine nature of a similar amount based on an activity that's in place," or "an automated posting or uploading of accounts payable from a subledger to the general ledger," "initiated by an employee." Koss's nonstandard journal entries were depicted by those auditors as "of unique nature for typically a specific transaction" or "things that would not be recorded on a routine basis or less frequently than on a monthly basis," such as an entry "to increase an accrual," for which "there's a manual journal entry form, someone keys it in" by computer. Tr. 62-63, 77-78 (2006-2008 Staff/In-Charge Auditor); Ex. D-4 at 38-40 (Audit Manager's investigative testimony).[9/]

For the remedial work, Audit Manager selected five items, all standard journal entries, from the monthly form binders and "had [Senior Accountant at Koss] put in the journal entry number and pulled it up on [Koss's electronic general ledger] accounting system and saw that the information on the screen matched what was in the binder." Audit Manager "then randomly selected a journal entry number from various months"—again constituting five standard journal entries—"and had [Senior Accountant] pull that up on the screen, saw the details there, and then went and looked in the binders, also noting that the items in the binders going in the other direction agreed." Ex. D-4 at 13-14 (Audit Manager's investigative testimony); *see* Tr. 1322, 1324-25, 1328, 1491 (Koeppel); Ex. J-302 at 5. As will be discussed below, the "upstream/downstream testing" performed in the 2006 to 2008 Koss audits relied on using a second set of paper records instead of viewing Koss's electronic general ledger.

Koeppel has represented in this proceeding that she had the inspectors' concerns about the completeness of the journal entry population in mind not only in

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[9/] *See generally* AU § 319.51 (an entity's financial reporting process used to prepare the financial statements typically includes (1) "the use of standard journal entries that are required on a recurring basis to record transactions such as monthly sales, purchases, and cash disbursements, or to record accounting estimates that are periodically made by management such as changes in the estimate of uncollectible accounts receivable" and (2) "the use of nonstandard journal entries to record nonrecurring or unusual transactions or adjustments such as a business combination or disposal, or a nonrecurring estimate such as an asset impairment").

reviewing and approving the remedial work for the 2005 Koss audit but also in leading the 2006 audit, which was in progress when those concerns were expressed, and the 2007 and 2008 audits. Tr. 766, 813-14, 1325, 1327, 1329, 1490-91; KPHS 31, 69.

7. Koeppel Attended Firm-Wide Training in 2006 and 2007 That Highlighted the Importance of Obtaining a Complete Population of Journal Entries for Fraud Testing and the Risk of Relying on Management-Provided Lists or Binders of Journal Entries.

In testimony, Koeppel referred to "the years of training that I've had over journal entries." Tr. 1330. In particular, in August 2006 and in January 2007, Grant Thornton conducted, and Koeppel attended, firm-wide training that discussed findings from recent PCAOB inspections in which firm audits had been reviewed. Tr. 795-808 (Koeppel); Ex. D-4 at 25-28 (Audit Manager's investigative testimony); Ex. J-306; Ex. J-130. This training included a module on journal entry testing. Ex. J-130; Ex. D-4 at 26-27.

At the time of the 2006, 2007, and 2008 Koss audits, Koeppel believed that, as the training instructed, auditors "must address completeness" of the population used to select journal entries for fraud testing. *See, e.g.*, Ex. J-130 at 4, 20; Tr. 801-04 (Koeppel). A training slide stressed, "We need to make sure the population is the **entire** population." Ex. J-130 at 20 (bold in original). This statement was underscored in the slide's speaker notes, which observed: "If you do a good job testing journal entries but you never had the full list of journal entries, what have you accomplished? Don't waste your time on an incomplete file!" *Id.* Koeppel agreed with these points, too, during the audits in question. Tr. 802-05. Another training slide specifically warned that when management creates a listing of journal entries or provides paper copies of journal entries maintained in a binder for the auditor, "if there was fraud, management probably would not include the fraudulent entries" on the list and "[c]opies of fraudulent journal entries would likely not be in the binder." Ex. J-130 at 21-22. Koeppel testified that this slide also reflected her view at the time of the audits. Tr. 805-08.

B. The Performance Of The Audits In Question

Koeppel led the conduct of the 2006, 2007, and 2008 audits, and, in particular, reviewed certain work papers in areas of higher risk. *See, e.g.*, Tr. 747-53, 1157-58.

1. Journal entries

Koeppel approved each audit's approach to testing Koss's journal entries, and, in particular, "was aware of the procedures that we performed" to "make sure we had a complete set of journal entries." *E.g.*, Tr. 774-75, 778-79, 785-87, 790-92, 808-09, 813-14, 818-19, 822-23, 829, 832, 835-37, 1144, 1185-86, 1327-29, 1336 (Koeppel); KPHS 28, 30, 32, 65-71; Exs. J-3 at 1, 3, J-100 at 1, 3, 6, J-200 at 1, 3, 4, 7 (documenting 2006-2008 audit planning discussions led by Koeppel); Ex. R-300 at 6, 33 (section of

2007 walkthrough summary, initialed by Koeppel, making reference to authority and access controls as to journal entries); Exs. J-7, J-8, J-9, J-73 (2006 audit program for journal entry control testing and audit step responses initialed by Koeppel); Exs. J-10 at 1, 4, R-465 at 1, 4 (2006, 2008 journal entry control testing work papers initialed by Koeppel); *see* Tr. 92, 290-91, 411-12 (2006-2008 Staff/In-Charge Auditor); *see also, e.g.,* Tr. 335-40 (outlining 2007 audit program on journal entry testing). Koeppel testified that she understood at the time of the audits that PCAOB standards provided that the auditor's procedures should include selecting journal entries from the general ledger and understood that it was necessary to obtain a complete population of journal entries to perform journal entry testing. Tr. 764-65, 772-77, 792-94, 802-05; *see* I.D. 34. As Audit Manager summarized in investigative testimony, "[t]he journal entry testing is a fraud test, one of the few specific fraud tests that are required by professional standards," and "we were looking to validate" that "we were given a complete listing of journal entries to test and evaluate, looking at who posted and who authorized, and that there was appropriate support for the ones that were noted." Ex. D-4 at 82.

The approach followed in the three audits included what Koeppel described as testing journal entry controls in place at Koss, based on an understanding of them gained in audit planning. The work papers for each audit contained a memorandum by a junior audit team member, dated between late April and early June, stating that "Koss has policies and procedures established for financial reporting responsibilities and security access" and summarizing an interview with VP-Finance and Senior Accountant, in part about recording journal entries. According to each memorandum, those two individuals "have access to create standard and non-standard JE's." Senior Accountant "posts" or "books" "all entries." No other users have access to book entries, it stated, specifically attributing that statement in 2007 and 2008 to VP-Finance. The memoranda further stated that "[President/CEO] and [VP-Finance] review all entries booked each month and at year-end before the final statements" (2006) or "booked for the month" (2007, 2008) and that Senior Accountant compiles, and VP-Finance and President/CEO review, "the interim and year-end financial statements." Exs. J-4 at 1, 2, 3 (2006, initialed by Koeppel), J-101 at 1, 2 (2007), Ex. J-201 at 1, 2, 3 (2008, initialed by Koeppel); *see* Exs. R-202 at 3-4, 9, R-295 at 3, 6, R-393 at 3-4, 6 (each year's audit plan, approved by Koeppel, to which financial reporting controls memorandum and others attached under work step "[u]nderstanding and documenting internal control"); Tr. 279-80; Tr. 508-10 (2007-2008 Staff/In-Charge Auditor); Ex. D-4 at 37-54.[10/]

[10/] In each audit, the financial reporting controls memorandum was cross-referenced in a work paper purporting to document an understanding, but not any testing of the operating effectiveness over the year, of Koss's internal controls for "Record standard recurring and consolidating journal entries" and "Record non-standard journal entries." *E.g.*, Tr. 1288-94, 1467-73 (Koeppel); Tr. 533-35 (2007-2008 Staff/In-Charge Auditor); Tr. 690 (2007-2008 Staff Auditor); Ex. D-4 at 53-55 (Audit Manager's investigative testimony). For these processes, the work paper, without discussion, listed and checked boxes next to eight items: "Authorization policies and procedures understood

A notation on a 2006 Koss audit program elaborated on this understanding, in effect, by stating based on discussion with VP-Finance that "only [Junior Accountant and Senior Accountant] can initiate and record journal entries" and that "[a]ll journal entries are authorized by" VP-Finance. Ex. J-7; *see* Tr. 1143, 1149 (Koeppel); Ex. R-509 at 94-95 (Audit Manager's investigative testimony). Similarly, a notation on the 2007 audit program stated, per discussion with Senior Accountant, that VP-Finance "rev[ie]ws all standard and non-standard JE." Ex. J-104.

An understanding of Koss's journal entry process was also expressed in a memorandum on "Journal Entry Review," initially dated May 16, 2006 (a day after the financial reporting controls memorandum), authored by a different junior audit team member, and updated on August 28, 2006. This second memorandum declared, "GT notes that all journal entries are created on paper by" VP-Finance "and entered into the system by" Junior Accountant. President/CEO "reviews [VP-Finance's] journal entries through review of the monthly financial statements." Ex. J-11 at 4.

Addressing the two memoranda in investigative testimony, Audit Manager first explained that VP-Finance "had the ability" to post entries in the general ledger, but "[b]ased on our understanding of their policies and procedures, any entries that were created by" her—that "she would post and review"—"needed to be approved and reviewed by" President/CEO. Ex. D-4 at 40-44 ("Based on our understanding of the policies and procedures, any entries that were created by [VP-Finance] th[e] [President/CEO] would review, as it relates to things that she would post and review. In our testing of journal entry testing, I do not recall <u>seeing</u> any that [VP-Finance] generate[d] or created. She was <u>typically</u> the reviewer, based on <u>the samples that we tested</u>.") (emphasis added), 52. Later in the questioning, however, Audit Manager expressed the belief that it "may be inaccurate" or "was not entirely accurate" to say VP-Finance had "the ability to access and create" journal entries "because of the additional testing and looking at the IT profiles" that was done in the 2006 audit. Ex. R-509 at 140-41. Audit Manager further claimed, based on the testing of a sample of journal entries in each audit, that the second memorandum's statement that all journal entries were created on paper by VP-Finance "was a typo." *Id*. at 138. That is, "[b]ased on certain calculations in certain areas, it was possible that they [Koss's accounting department] were outlining what the calculations and what the entry was that should be recorded"

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and communicated"; "Policies and procedures established"; "Security access controls restrict access to appropriate people"; "Comparing actual to expected results and followup of exceptions"; "Security access controls restrict ability to record journal entries to appropriate people"; "Manual authorization of journal entries"; "Periodic observation of operational controls"; "Duties of senior financial reporting personnel do not include the ability to make journal entries." Exs. R-274 at 252, 262, 819, R-379 at 244, 254, R-482 at 324, 334, 718; *see* Tr. 1307-10; Tr. 236, 246-49, 258-59.

and VP-Finance "may work on the origination and tell individuals what the entries needed to be," but "based on support that we saw in the binders" of these paper records of journal entries provided by Koss's accounting department, Junior Accountant or Senior Accountant "booked the entries, [VP-Finance] reviewed them, [so] based on testing, while [VP-Finance] had some involvement, she wasn't the only one" and if "she wrote them up on paper," they "were entered by others and [she] looked at the details." *Id.* at 135-37, 139, 142-44; Ex. D-4 at 47-48.

Yet the statements in the financial reporting controls memorandum about VP-Finance's access to create journal entries and Junior Accountant's lack of access to book or post journal entries persisted throughout all three audits. This was despite the fact that the document was "provided to management in this form asking them to review and update and provide back to us as well as the follow-up inquiries" and review. Ex. D-4 at 50; *see* Tr. 249-50, 289 (2006-2008 Staff/In-Charge Auditor); Ex. R-202 at 4 (2006: "These memos [attached to audit plan, including the one on reporting controls] were reviewed and updated by [Senior Accountant] and [VP-Finance] at prelim.").

Koeppel testified that she considered President/CEO to be part of Koss's overall internal controls over the journal entry process. Tr. 1448. According to Koeppel, in her experience with him, he appeared to be "very active and very knowledgeable" when it came to Koss's financial performance and "very involved" in reviewing its financial information, with a "significant interest" economically in "the operations and financial aspects of the company" due to its "compensation program" and the family's ownership of "about 75 percent of [its] shares." Tr. 1219-22, 1449. Another audit team member testified that President/CEO made general statements that he was "very involved with day-to-day operations, so he was well aware of things that were going on," and she believed he was "very involved in the company as a whole and in the financial statements." Tr. 96, 264-65 (2006-2008 Staff/In-Charge Auditor). According to Audit Manager's investigative testimony, in "our discussions with [President/CEO] over the financial statements in any period, he was very well versed in the financial statements and the requirements of such," "[h]e surrounded himself by individuals who were accountants," and "[w]hen there were any questions or doubts, he asked intelligent questions to make sure he had a thorough understanding." Ex. R-509 at 55.

Nevertheless, President/CEO "did not profess to be a GAAP expert" and was not an accountant by training. *Id.* Koeppel generally understood that President/CEO reviewed journal entries only on occasion, she could not recall him ever telling her that he reviewed journal entries monthly, she did not know how he would have conducted any review of individual entries, and she was not aware of any documentation of such a review. Tr. 1448-50. This was consistent with another audit team member's testimony that President/CEO said he reviewed journal entries "on a topside" basis, "through review of the financial statements or through review of supporting documentation. He didn't specifically look at every one." Tr. 251-52, 263-65 (2006-2008 Staff/In-Charge Auditor). Otherwise, that auditor elicited from President/CEO only general statements that he had "comfort in the journal entry process." Tr. 93-96. She did not specifically discuss with him the way the accounting department maintained records of the journal entries or how he would have reviewed any individual entries. Tr. 93-96, 101, 263-64.

Audit Manager testified in the investigation that she understood President/CEO and VP-Finance would "spend the time going through those journal entry binders and reviewing them" as "part of the close process," "in conjunction with the financial statements." Ex. D-4 at 45. But the only basis she could identify for this understanding was that VP-Finance and possibly also Senior Accountant told the audit team that President/CEO "was involved in the process." *Id.* at 45-51. Audit Manager stated, "I would have no way of knowing if [he] reviewed all of [the journal entries]" because "[w]e test on a sample basis." *Id.* at 47. She could not recall "any specific ones that I see or saw [him] signing off on," any specific conversation with him on the subject, or making any attempt to verify whether he reviewed any journal entries. *Id.* at 47-48, 51. Nor was she aware of any documentation of his review of the financial statements. Exs. R-509 at 79 (anything she knew about this was "through discussions"). She understood he reviewed VP-Finance's reconciliation of accounts to the financial statements simply because VP-Finance told her so. Ex. D-4 at 70-72.

As described, the audit approach relied heavily on representations from Koss personnel, coupled with broad, general references to asserted indirect support. *See, e.g.,* Exs. D-4 at 51 ("Based on the documentation and everything else that we saw in the files as it relates to auditing all of these other areas and looking at adjustments, we had no reason to believe it was anything other than what was being represented to us."), 88 ("there was no indications that we weren't provided with everything and that that was our conclusion, and we were ready to move on") & R-509 at 79-80 ("All the audit procedures that are pulled together to support our opinion and address the risks in total."), 131-32 ("everything from looking at reconciliations from looking at the variance analysis, absent exceptions in any of these other areas, we completed our testing…the testing that we had done across these areas, understanding the procedures, understanding that we saw these entries, nothing unusual coming through, we looked at the support, we saw the reconciliations and the activities going through every other area, and absent exceptions, our testing was complete").[11/]

[11/] Two further memoranda prepared each year by a junior audit team member, dated between late April and early June, made some mention of journal entries. *See* Exs. R-202 at 3-4, R-295 at 3, R-393 at 3-4 (audit plan each year, cross-referencing memoranda). The first of these two memoranda, which documented a discussion with VP of Finance and Senior Accountant about Koss's "Revenue Procedures," stated generally, "Limits of authority are established as the system will only allow authorized users to make journal entries. Access is limited by the use of user ID's and passwords," as well as "[VP of Finance and President/CEO] compare actual financial results to expected results." Exs. J-6 at 5, 7, 9 (2006; initialed by Koeppel), J-103 at 4, 7 (2007), J-203 at 4, 7, 8 (2008; initialed by Koeppel). The second memorandum purported to

Additionally, a work paper in each audit summarized a junior audit team member's early June or mid-July "walkthrough" of various aspects of Koss's processing of transactions, to determine whether key activities-level controls over critical cycles were implemented. Tr. 1238, 1292-93 (Koeppel); Tr. 289 (2006-2008 Staff/In-Charge Auditor); Exs. R-202 at 4, R-295 at 3, R-393 at 4 (audit plans for 2006, 2007, 2008). The 2006 work paper referred to several journal entries related to the processing of "1 invoice from an A/R register within the fiscal 2006 period (February 2006)" and of "1 PO from an receipts register within the fiscal 2006 period (February 2006)"—the revenue and inventory purchasing transactions selected for review in the walkthrough—but did not discuss journal entry processes, other than to state generally, "A system log-on and password are necessary to access the [IT] system." Ex. J-49 at 1, 4-5, 8 (indicating work paper not reviewed by either Koeppel or Audit Manager). And the audit team member who prepared the work paper acknowledged at the hearing that, as she had documented them, "those journal entries [related to the invoice] don't make much sense to an accountant" and were "kind of misleading," ascribing the problem to "probably a poor typing by myself" and stating, "I probably should have described better each journal entry and then saying what I could tie each to." Tr. 112-22 (2006-2008 Staff/In-Charge Auditor: "you normally don't debit AR and credit inventory," rather than crediting sales, or debit cost of goods sold and credit sales, rather than crediting inventory).

According to the 2007 walkthrough work paper, "GT observed [Senior Accountant and Junior Accountant] access the system by use of user names and passwords, noting that they have authority to post journal entries in g/l." Ex. R-300 at 6; *see id.* at 18 (based on "observ[ing] past adjustments made," "noting [Senior Accountant] is the only person who is authorized to make manual entries to the [doubtful accounts] allowance"); Tr. 287 (2006-2008 Staff/In-Charge Auditor: "the AS 400 system had some security in place that would require passwords for individuals, and it was able to break out into different sections so that some people were only allowed to import vendor master files, whereas others could record sales, for example"). The work paper further asserted that Senior Accountant and Junior Accountant "are the

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"outline the conversation held with [VP of Finance], covering the overall governance controls in place at Koss." Exs. R-205 at 1 (2006; initialed by Koeppel), R-299 at 1 (2007); *see* R-396 at 1 (2008; initialed by Koeppel). It contained general statements that "[VP of Finance] and [President/CEO] monitor the financial reporting process and are aware [of] activities throughout the organization."; "The management of the Company is highly involved in the day-to-day operations of the organization."; "Management is on-site and monitors the performance of internal controls on a regular basis."; "Management does conduct reviews of the data to ensure that the information they have received and are relying upon has integrity." Exs. R-205 at 2-4, R-299 at 1-4, R-396 at 1, 3-4. But the only specific reference to journal entries was that "[p]ersonnel are required to document the performance of key controls, e.g., monthly journal entry completion and supporting documentation." Exs. R-205 at 4, R-299 at 3-4, R-396 at 3.

only employees that have authority to record journal entries in the system" and that VP-Finance "reviews all entries," attributing these statements to interviews with Junior Accountant and/or Senior Accountant. Ex. R-300 at 1, 2, 6. It also stated, based on interviewing VP-Finance, that she and President/CEO "review monthly F/S." *Id.* at 1.

The 2008 walkthrough work paper stated that "GT viewed as [an individual identified as "Accounts Payable Staff"] entered her username and password to access AS 400, whereupon she did not have the authority to create and/or post journal entries," but Junior Accountant "did have such access." Ex. R-398 at 1, 2, 10-13; Ex. J-202 at 5; Tr. 291-93. It also referred to examination of two records that were consistent with the description the auditors were given of the roles of VP-Finance and Senior Accountant regarding journal entries. Ex. R-398 at 1 ("noting a stamp and [Senior Accountant's] initials" on a journal entry adjusting the inventory impairment reserve), 17 (referring to interview with VP-Finance and to "signature on JE" as "evidenc[ing]" "manual authorization of journal entries" for "6/30 [doubtful accounts] Allowance Calculation").

Turning to what Koeppel has described as journal entry control testing, part of those procedures in 2006 was to "[o]btain the list of individuals who initiate, authorize and record journal entries" and "evaluate the appropriateness of the individuals on this list." Ex. J-7 (2006 Test of Journal Entry Controls audit program). According to a notation on this work paper, reviewed by Koeppel, the three accounting department members "appear appropriate as only a limited number of people have access and these individuals have adequate knowledge to be posting entries." *Id.*; Ex. J-9 (sign-off page); *see* Tr. 1145 (Koeppel). It went on, "GT notes that these individuals do prepare reconciliations of the accounts that they post entries to," but responded to this concern by citing VP-Finance's assertion that "she reviews all account reconciliations and the journal entries must be authorized by [her] as well." Ex. J-7; *see* Tr. 1145-47, 1150.[12/]

[12/] Work papers reviewed by Koeppel in the 2006, 2007, and 2008 Koss audits stated that "[b]ank statements are reconciled on a monthly basis by" VP-Finance, who approved the related journal entries, had access to, and could sign Koss checks, approved credit memos and inventory adjustments, and was responsible for any write-offs of Koss accounts receivable. *See, e.g.*, Exs. J-5 at 5, 7, 13, J-202 at 6-8 (2006, 2008 Inventory Expenditures Process Memorandum); Exs. J-6 at 6, 7, 9, J-203 at 5, 6, 8 (2006, 2008 Revenue Procedures Memorandum); Ex. R-300 at 8, 21, 29, 33 (2007 Walkthrough Test Summary Report); *see* Tr. 1474-76 (Koeppel); Exs. D-4 at 61-65, 69-72 & R-509 at 57-59 (Audit Manager's investigative testimony). Such work papers additionally stated that Senior Accountant, with review by VP of Finance, reconciled Koss's sales and its accounts payable to the general ledger; evaluated any accounts that needed to be specifically reserved for; opened new customer accounts; received check copies and deposit slips from Koss's bank and entered them into the computer system; received, and kept a manual log of, direct cash payments to Koss; was involved by 2008 in the bank reconciliation process; oversaw the reconciliation of accounts receivable accounts on a daily and monthly basis; compiled the financial statements;

While this audit program directed, "Verify the completeness and accuracy of the list [of individuals who initiate, authorize and record journal entries] by comparing it to the system settings," the notation under that work step, also reviewed by Koeppel, merely stated, without explanation, "IT provided a list of all user profiles. The user profile of 'Accounting' indicates the ability to post entries to the general ledger. Per review of the listing only [Senior Accountant and Junior Accountant] have this user profile." Ex. J-7; Ex. J-73; *see* Tr. 826, 1142-44, 1148-49. Audit Manager testified in the investigation that the purpose of this procedure was "to validate the discussion we had had that only [those two individuals] had access to post entries." Ex. R-509 at 96-99, 112. Under the further work step, "Determine how often the list of individuals authorized to access the application is reviewed and by who," a notation stated, "[Per discussion with VP-Finance], as the list of individuals is so small and due to the fact that [she] reviews each journal entry that is posted, no review is done of the list of authorized individuals. GT concurs that this is reasonable for a company of this size." Ex. J-7. Audit Manager could remember no audit consideration of the outside IT contractor's expertise or audit procedures performed to test the list's completeness or consideration of what information the contractor used to generate the list. Ex. R-509 at 109-12.

While acknowledging that it "would be important to know" whether the user profile list was for the entire period of fiscal year 2006 or only a point in time, Audit Manager could not tell this from the work paper and could not recall. Instead, she stated, "One of the things we inquire about throughout the audit is understanding changes in controls and processes, so in that section, when we're obtaining the understanding, any changes, asking about control changes throughout the period, would have been noted there." Ex. R-509 at 97, 98-99 (investigative testimony). According to Audit Manager, "inquiry, observation, and the lack of exceptions noted in our sample testing" of journal entries were the procedures performed in the 2006 audit to verify that access to post journal entries did not change over the fiscal year, yet she could not recall any

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had access to Koss checks; and was authorized to process Koss wire transfers, as well as posting journal entries and compiling and maintaining binders of Koss's journal entries. Exs. J-5 at 5-6, 9, 13, J-202 at 6, 8; Exs. J-6 at 5-6, 7, 9, J-203 at 4-6, 7, 8; Exs. R-300 at 6, 7, 8, 28-30, 33, R-398 at 11-13; *see* Tr. 1475; Tr. 654, 699-703 (2007-2008 Staff Auditor); Exs. D-4 at 67 & R-509 at 60-61, 164-66. The auditors did not test management representations about who had check-signing authority at Koss and how it was being exercised or gain an understanding of Koss's wire transfer procedures, beyond stating in 2007 and 2008 walkthrough workpapers, based on discussion with Senior Accountant or Junior Accountant, that wire transfers were not "integrated into the AS400 software," VP-Finance approved them, and afterward "a copy of approved wire transfer form is given to [an individual identified as "Accounts Payable Staff"] to update in AP subledger." *See, e.g.*, Tr. 1475-76; Exs. D-4 at 64, 66-67 & Ex. R-509 at 60; Exs. R-300 at 7, 8, R-398 at 12-14; Exs. J-5 at 4, J-102 at 5, J-202 at 5.

conversation about inquiry into VP-Finance's access, nor locate any work step about evaluating VP-Finance's access, in that regard. *Id.* at 99-100, 101-06.

When asked if any procedures were performed in the audit to verify the information provided on the user profile list, Audit Manager answered that "the level of testing that was done was a review of that listing," which, she said, without remembering the details, was obtained by the audit team from Koss's "third-party [IT] consultant," an "independent source"; that it was "a very short list of individuals, all of which were easily identifiable and known to the audit team," though she did not gain an understanding of all of the user profiles that existed at the time in Koss's IT system, including whether anyone at the company had a "super user profile"; and that "[t]he testing that we did was to look at the underlying journal entries and saw no exceptions and had no reason to believe anything further," referring in part to so-called "upstream and downstream testing" that used two sets of paper records to "make sure we were looking at everything for the journal entries" and "found [no] exceptions to our understanding, and, as such, did not perform any further verification." *Id.* at 99-102, 105-13. Audit Manager's investigative testimony was emphatic that "we did not test the operating effectiveness of the[] controls" over access of Koss personnel to post journal entries and that she believed Koeppel understood this. Ex. D-4 at 53-57.

Although at times Koeppel has referred generally to "[a]ccess controls" as part of the journal entry control "testing" in the audits (Tr. 826, 1493), the work papers for the 2007 and 2008 audits do not refer to obtaining, let alone testing, a user profile list. *E.g.*, Tr. 1143 (Koeppel: "In 2006, we had a separate program entitled Journal Entry Control Testing, where we performed steps related to access and segregation of duties."), 1306 ("Particularly in 2006, we looked at access. We got information from the IT department as to who had access to actually make journal entries within the system."); Ex. R-509 at 141 (when questioned in investigation about post-2006 audits, Audit Manager referred back to "those IT profile lists [obtained in] the prior year," meaning 2006).

Rather, as Koeppel stated in other, more particular testimony, the auditors proceeded in those "subsequent years" "based on our understanding of the process, based on our understanding that there had been no changes in the process," based on "validat[ing] that through testing segregation of duties," and based on the view that "the walk-throughs showed that there were appropriate access controls, there were appropriate segregation of duties, and there was appropriate monitoring of people's work." Tr. 1300-01, 1306, 1342, 1345; *see* Ex. D-4 at 55-57 (Audit Manager's investigative testimony: "We would perform walk-throughs over specific critical areas, and to the extent that those walk-throughs would have corroborated any [IT system access] controls,...the steps that are tailored [in the audit program are] to obtain an understanding of those controls, not to test operating effectiveness of controls….I believe so [that this reflected Koeppel's view as well].").

The audit plan for those latter years, like 2006, contained the general work step, "Determine whether the IT Profile in [audit documentation of Koss's internal controls carried over from the prior audit] reflects the current IT environment." Exs. R-202 at 2, R-295 at 2, R-393 at 2. Only in 2006 was an entry inserted underneath this work step to explain what work was done: "[Per discussion with VP-Finance], the IT environment has not changed at all in the past few years. As such, the IT documentation from fis[c]al 2004 is still accurate." Ex. R-202 at 2. The work papers for the 2007 and 2008 audits each included an "IT Profile Report," initialed by Koeppel. The document was a two-page, high-level summary list of technologies used by Koss for certain general business functions, under the categories "Computer Systems," "Applications / Spreadsheets," and "Transaction Processing." Exs. R-297, R-395. But no mention was made there of user access controls. *See generally* Tr. 222-23, 233 (2006-2008 Staff/In-Charge Auditor inquired generally of Koss's outside IT consultant "one of the years about updating just to get his general information on the systems in place, if they had changed, any improvements they put in place" and in 2008 inquired primarily of Junior Accountant).

As noted, testing of journal entry controls in the 2006, 2007, and 2008 audits also included review of paper records of Koss journal entries. The 2006 journal entry review memorandum expressed the understanding, based on a discussion with VP-Finance, that "Koss has standard journal entries that are entered every month," that a "journal entry log is maintained with the standard journal entry numbers," and that "[t]here are also non-standard journal entries [which] are identified by a non-standard journal entry number," *e.g*., "a standard journal entry number is 600, which is on the journal entry log" and a "non-standard journal entry number would be 600A." Ex. J-11 at 1.

Elaborating on that understanding, the 2006 journal entry testing work paper stated that: "All journal entries are accumulated in monthly binders. At the front of each binder there is a checklist of numbered standard/recurring entries. As the entries are made they are checked off of the list. This list is also reviewed and initialed by [VP-Finance]." Ex. J-10 at 2; *see* Tr. 790-92 (Koeppel); Tr. 213 (2006-2008 Staff/In-Charge Auditor). According to testimony, if one of the numbers in the sequence on the log or checklist were not used that month, this would be "indicated with a slash or a zero on that line," and the numbers of the nonstandard journal entries posted to Koss's general ledger that month were handwritten at the bottom of the list. Tr. 71, 72-73, 87, 89. Each year, VP-Finance told the auditors that "not all entries [in the binders] have support attached to the journal entry due to the fact that many entries are recorded based on large system reports." Exs. J-10 at 2, J-105 at 2, R-452 at 1, R-465 at 1 (work papers); *see* Ex. J-205 at 1 ("not all entries have support in the binder as some entries are calculated based on large system-generated report"); Ex. J-11 at 1, 3, 5 (examination of binders showed "some entries had support and others didn't" and "not all standard journal entries had support behind them"); Tr. 51-52, 252-53 ("for example, when they posted, like AP from the subledger to the [general] ledger," an automated process with a system-generated entry, "they didn't print off the entire ledger, they only printed off, maybe, the last page," so "there wasn't always really detailed support") (2006-2008 Staff/In-Charge Auditor).

For standard entries, Koss reserved ranges of up to 100 numbers for journal entries in each of seven subject matter areas (such as revenue or inventory), from 001-099 to 600-699, and did not exhaust all of the available numbers within each range, leaving gaps. Tr. 74-77, 83, 87-90. Nonstandard entries did not follow a numerical sequence, utilizing as many letters as "they would need" added to one or another standard journal entry number, and the amount of nonstandard entries could vary from month to month, depending on "whatever they need to do for that month." Tr. 72-73, 85-86; *see* Tr. 550 (use of letter suffixes). Although the 2007 and 2008 walk-through work papers stated the audit team understood that Koss's IT system did not allow the creation of duplicate vendor, customer, inventory, invoice, credit memo, or warranty claim numbers (Exs. R-300 at 4, 5, 10, 16, 19, 22, 31, R-398 at 3, 4, 10, 15, 18, 20; Tr. 293), there is no evidence that this was true of journal entry numbers (*see, e.g.*, Ex. R-509 at 86, 92-94 (testifying in investigation, Audit Manager acknowledged that it would be a matter of concern if Koss's IT system allowed duplicate entries to be posted with the same journal entry number but stating that she could not recall whether it did)).

In 2006 and 2007, as part of the fiscal year-end audit work, "GT haphazardly selected 30 journal entries" that it understood to have been entered in Koss's general ledger over the course of the fiscal year, and in 2008, "haphazardly selected 10 journal entries" each quarter, "to test to ensure that only authorized individuals post and review all non-system generated entries." Exs. J-10 at 1, J-105 at 1, J-205 at 1, R-452 at 1, R-465 at 1; *see* Exs. J-7, J-104, J-204 (audit programs); Tr. 57-59, 62-63; Ex R-509 at 115, 121 (the testing sample included both standard and nonstandard manual journal entries). The work papers for the testing stated that journal entry forms were "written out and initialed" by the person initiating and posting the entry, were reviewed by VP-Finance, and, after being entered into Koss's IT system, were placed in the monthly form binders, which, according to testimony, were maintained by Senior Accountant, were stored on a bookshelf in her open and accessible office, and were provided to the auditors. Exs. J-10 at 2, J-105 at 2, J-205 at 1, R-452 at 1, R-465 at 1 (work papers); Tr. 47, 49, 50-51 & Ex. J-303 at 1 (example of completed journal entry form, stamped "Entered," above Senior Accountant's initials, and initialed in upper corner by VP-Finance); Tr. 785-87, 790-92, 813-14, 818, 822, 824-25, 834-45 (Koeppel); Tr. 46-50, 51, 57-59, 88, 342-44 (2006-2008 Staff/In-Charge Auditor); Tr. 426 (2007-2008 Staff/In-Charge Auditor); Tr. 548-49, 561-62, 657-60, 705 (2007-2008 Staff Auditor); Exs. D-4 at 83 & R-509 at 84, 88, 145, 146-47 (Audit Manager's investigative testimony).

Based on a junior audit team member's examination of the manually completed forms for the journal entries selected for testing, the work papers identified either Senior Accountant or Junior Accountant as the person who initiated and posted, and VP-Finance as the person who approved, each of those entries. Exs. J-10 at 1-2, J-105 at 1-2, J-205 at 1-2, R-452 at 1, R-465 at 1; *see* Tr. 1311 (Koeppel testified that she never saw a journal entry posted by VP-Finance); Tr. 337-38 (2006-2008 Staff/In-Charge Auditor: did not see any entry that conflicted with the understanding reflected in the audit work papers). Consistent with the other years, a 2008 work paper noted that "[t]his is not a completeness test" but "simply a review of" journal entries "for reasonableness and proper approval." Ex. R-452 at 1 (stating conclusion that "[p]er testing performed, GT deems JEs to be reasonable at 12/31/2007"); *see* Ex. J-10 at 2 (2006: "Per the above testing the controls over journal entry process appears to be working effectively."); Ex. J-105 at 1-3 (2007: "Per testing performed, GT deems JE to be reasonable at 6/30/07," "[b]ased on review" of support in the journal entry binder and "based on knowledge of business operations"); Ex. J-205 at 1 (same for 2008; "this is not a test of the completeness of the detail provided to GT").[13/]

A junior audit team member testified, without being able to find express support for it in the audit documentation, to keeping Koss's "standard method of numbering" in mind when consulting the checklist pages and "flip[ing] through all of the binders" of paper records as part of the journal entry audit work (Tr. 70-74, 80-81, 87-88, 91-92), but Koeppel recognized this was not a viable means of determining the completeness of the binders because it "was not the case" at Koss that "all entries were numbered sequentially" (Tr. 1322-23). Indeed, this was apparent from the junior auditor's own testimony. *See, e.g.*, Tr. 71-77, 83, 85-86, 91 (2006-2008 Staff/In-Charge Auditor).

13/ The 2006 journal entry review memorandum described certain additional audit work on the entries that appeared in the monthly form binders, stating that "GT": (1) "reviewed all non-standard journal entries and inquired about non-standard journal entries that appeared unusual or were over" 10% of tolerable error of $330,000, noting that in some cases "support was attached [to the manual journal entry form] to show how the entry was derived" and "[e]xamin[ing] [any] underlying support for all entries identified," or, for one cash-in-transit entry, "[a]gree[ing] to bank statement"; and (2) noted standard journal entries for May, June, and July 2006 that "appeared unusual" or were above tolerable error, noted whether all entries identified were included on the standard journal entry listing and generally whether "the descriptions on [the listing] appear reasonable," and examined support for certain May-July 2006 entries, though none existed for most over $330,000. Ex. J-11 at 1-5. The memorandum concluded, "Per the above testing, it is noted that the non-standard and journal entries appeared to [be] appropriate through GT's review of the journal entry support and GT's inquiry of the client." *Id.* at 5-6. In 2007, the following notation was made on the journal entry audit program under the work step, "Identify significant and unusual journal entries and other adjustments made at or near the end of the period": "GT reviewed all JE posted from 6/25/07 through 7/5/07, specifically noting all JE over TE of $260,000. Through review of the JE support for each of these JE, GT deems all significant JE around YE to be reasonable." Ex. J-104; Tr. 60-62, 70, 393 (2006-2008 Staff/In-Charge Auditor used Koss system-generated "update reports" to identify the journal entry forms to examine). No description of audit work was inserted under that work step in 2008. Ex. J-204.

Although the work papers are not clear on the point, Audit Manager testified in the investigation that the 30 journal entries "pulled" from the monthly form binders and examined to test Koss's journal entry controls in the 2006 audit (*see* Ex. J-10 at 2) were selected by month and number in part from the form binders and in part from another set of Koss paper records. Ex. R-509 at 122-23, 129, 133 & Ex. D-4 at 84. For the 2007 audit, the work papers state that half the journal entries used for the control testing were selected by month and number from each source. Ex. J-105 at 1. The procedure used for the 2008 fiscal year varied by quarter as to whether all or only half the journal entries used for control testing were selected from the monthly form binders, and five extra entries, beyond the 40, were selected from the other source for additional fiscal year-end audit testing. Exs. J-205 at 1-4, R-452 at 1-2, R-465 at 1, 3; Tr. 343.

Koeppel testified that during these years she understood the audit team traced journal entries selected from the binder of journal entry forms to the binder of update reports, and vice versa, as a test of the completeness of the journal entry population provided by Koss's accounting department. *E.g.*, Tr. 822-23 (Koeppel); *see, e.g.,* Ex. R-509 at 111, 122 (Audit Manager's investigative testimony); Ex. R-452 at 1 (2008: "GT tests completeness of journal entries as part of the year-end audit"). This procedure was referred to in testimony as "upstream/downstream" testing. *E.g.*, Tr. 770-71, 828, 835-37, 1185-86, 1327-29 (Koeppel); Tr. 54, 70, 341-42, 411-12 (2006-2008 Staff/In-Charge Auditor); Ex. D-4 at 81, 84-86 & Ex. R-509 at 110, 130. Koeppel understood that no attempt was made as part of this testing in the 2006, 2007, and 2008 audits to trace paper records of Koss's journal entries to its electronic general ledger. Tr. 770-71, 792, 818-19, 822-23, 1329; *see, e.g.,* Tr. 103-05, 414, 432; Tr. 559, 705-06. Nor, Audit Manager stated, were alternative procedures performed to test the completeness of the journal entries in the binders such as to reconcile the beginning and ending account balance for any general ledger account using the so-called update reports (discussed below) for the fiscal year, which purportedly were generated by Koss's IT system when journal entries were posted. Exs. D-4 at 127 & R-509 at 127-28, 179 (investigative testimony). Even so, as Audit Manager explained, "it's important to do some testing to see that the population you were given was complete" because "[w]hen evaluating whether or not you're looking for things that are unusual in nature and nonstandard, you can't evaluate what's not there"; "you can only evaluate what you're seeing, and if it's not there, you can't appropriately evaluate." Exs. D-4 at 82-83 & R-509 at 94.

Specifically, as a work paper related, VP-Finance said "the G/L system does not allow Koss to print out [a] listing of journal entries recorded during the year" but "noted that each time a journal entry is recorded, an 'update report' is automatically generated by the system, which confirms that the entry hit the G/L. Therefore, because there is no system generated JE listing, GT used the 'update reports' to perform the completeness test." Ex. J-205 at 3 (2008); *see* Exs. J-10 at 2 (2006), J-105 at 2 (2007), R-452 at 1 (2008), R-465 at 1 (2008); Tr. 787-89, 835-37, 1491 (Koeppel); Tr. 53, 90-92, 102-03, 106, 110-12 (2006-2008 Staff/In-Charge Auditor); Tr. 424-26 (2007-2008 Staff/In-Charge Auditor); Tr. 552-55 (2007-2008 Staff Auditor); Ex. R-509 at 129, 132. Audit team members testified they understood the so-called update reports represented all the journal entries posted to Koss's general ledger. *See, e.g.*, Tr. 431-32 (2007-2008 Staff/In-Charge Auditor: for 2008 testing, "I sat down with" Senior Accountant at her "computer screen, and I just asked her to kind of walk me through the whole process of how these update reports get generated" and "my takeaway from that conversation was that…the update reports were reflective of what was in the general ledgers"); Tr. 559, 705-06 (2007-2008 Staff Auditor understood, "[e]ither from Koss management or from the [audit] team," that the update reports provided complete population of journal entries); Ex. R-509 at 129, 132 (Audit Manager's investigative testimony: audit team believed "the accumulation of all of those update reports did reflect the GL").

Senior Accountant compiled the update reports, organized by month, and stored them in binders on a bookshelf in her office, and VP-Finance or, in part of 2007 and in 2008 Senior Accountant, made them available to the auditors. Ex. J-10 at 2 (2006); Exs. J-105 at 2, R-452 at 1, R-465 at 1 (2007); Ex. J-205 at 1 (2008); Tr. 770-71, 787-89, 822 (Koeppel); Tr. 52, 53-54, 102, 334-35; Tr. 555 (update reports kept in common area in accounting department); Ex. R-509 at 87-88 (maintained by "the accounting group," which "offices are open, so they're accessible"). Koss's outside IT contractor had no involvement in preparing or maintaining the monthly binders of journal entry forms or the monthly binders of update reports. Tr. 99-100, 334-35. Nor was there audit testing of any controls over the preparation of either set of journal entry binders or over the generation of the update reports. *See, e.g.*, Tr. 827, 1473 (Koeppel).

According to an audit team member, the update reports were produced on "green bar" paper from "an old school printer" at Koss, "weren't printed out together for an entire quarter or period," and, depending on how many journal entries a report included, it would be "wrapped, so it would be like one big sheet, and they just folded it," not "ripped apart." Tr. 412-13, 417 (2006-2008 Staff/In-Charge Auditor); *see* Ex. R-509 at 88 (Audit Manager's investigative testimony: Koss "printed just about everything on large green bar" paper). An update report could reflect a single journal entry or it could reflect a batch of journal entries posted to the IT system at one time. Tr. 770-71, 788-89 (Koeppel testified that she understood that Koss's IT system printed a separate update report each time journal entries were recorded and that a member of the accounting department manually compiled the individual reports into a set); Tr. 555-56 (2007-2008 Staff Auditor: there could be a single entry on an update report and then the next time a journal entry or entries were posted, the new entry or entries would be reflected on a new and separate update report, not physically connected to any other); Tr. 52-53, 90, 412-13 ("they often posted a lot of journal entries together, so you could see that there were usually a lot around month end" and "you had a little more comfort in that [such entries] were in big batches," with a "bunch of them together" in one report); Ex. R-509 at 118-20, 129 (stating that update reports were "a series" of individual reports and, although "the majority of [journal entries] were done at month-end," Koss "did have the ability to post things throughout the month"). Thus, it was not evident from looking at the update reports provided by Koss's accounting department whether reports relating to certain entries had been removed from the binders. Tr. 557, 705-06.

For the 2006 audit, a junior audit team member "agreed" by "Month" and "Journal Entry #" 24 of the 30 journal entries used in the journal entry control testing both "to written journal entry in monthly je binder" and "to 'Journal Entry Detail Update' report," viewed as "a system print out of all journal entries recorded during the year." Ex. J-10 at 2 (work paper); *see* Tr. 789 (reference in work paper to a "binder with a system print out of all journal entries recorded during the year" simply meant a binder of the Koss accounting department's manual compilation of multiple individual update reports), 792-94, 817, 822-23 (Koeppel).[14/] Additionally, "to test the accuracy of the checklist [at the front of each monthly binder of manually completed journal entry forms], each month GT selected 2 standard entries from the checklist and verified that entry was included in the binder. No differences were noted. As such, GT is reasonably comfortable that we were provided with the entire population of entries." Ex. J-10 at 2.

The 2007 work paper stated, "In order to test for both completeness and exist[e]nce/occurrence GT made half of the selections [of 30 journal entries] from the listing [*i.e.*, the update reports] and half of the selections from the monthly JE [form] binders." Ex. J-105 at 1. It documented that these entries were agreed, by month and journal entry number, to the update report and the manual forms. Ex. J-105 at 1, 3; *see* Tr. 815-19, 822-23 (Koeppel); Tr. 63-70, 337-38 (2006-2008 Staff/In-Charge Auditor).

In 2008, according to the audit documentation in the record, the auditors "[a]greed [ten journal entries, by number and date, from July 2007 to May 2008, selected from the update reports] to written journal entry in monthly JE binder" and "[a]greed [nine journal entries, by number and date, from July 2007 to May 2008, selected from the 40 entries from the binders of manually completed forms used in the other 2008 journal entry testing] to 'Journal Entry Detail Update' report." Exs. J-205 at

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[14/] Notations in the "Initiated & Posted By" and the "Approved By" columns of the work paper were agreed only to the respective manual journal entry form, not to an update report. Ex. J-10 at 1-3. At the hearing, an audit team member who performed Koss journal entry testing during the relevant period identified two one-page examples of update reports generated by Koss's IT system, neither of which showed who initiated, posted, or approved the journal entry (Ex. J-303 at 2, 3). Tr. 54-56 (2006-2008 Staff/In-Charge Auditor explaining that first example was report printed in response to posting of manual journal entry reversing entry to accrue accounts payable). In the investigation, Audit Manager also testified that Koss's update reports did not identify who approved a journal entry, and although she suggested she recalled that the update reports did show who initiated and posted an entry, she acknowledged she did not perform the journal entry testing in the 2006, 2007, or 2008 Koss audits. Ex. D-4 at 82 & Ex. R-509 at 117, 131, 149. There is no claim or evidence that Koss's IT system required an electronic approval to post a journal entry to the general ledger. *See, e.g., id.* at 117-18, 142.

1-4, R-465 at 1, 3; Tr. 832-38 (Koeppel); Tr. 341-42; Tr. 427-432; Tr. 546-47, 551-54, 557-60, 562-63; Ex. 509 at 145-46, 147-49 (Audit Manager's investigative testimony). The stated conclusion was, "Based on the above testing, GT concludes that it appears the population we selected for our <JE testing> was complete." Ex. J-205 at 3, 4.

Koeppel has acknowledged that the "upstream/downstream" testing in the 2006, 2007, and 2008 Koss audits, which compared two sets of paper journal entry records with each other, would not identify any journal entry missing from both sets. Tr. 795, 837-38, 1151-53, 1493; *see* Tr. 106-10 (2006-2008 Staff/In-Charge Auditor); Tr. 705-06 (2007-2008 Staff Auditor). No work step in any of those audits specifically addressed that issue. *See* Tr. 825-29, 1142, 1451 (Koeppel); Tr. 560 (2007-2008 Staff Auditor); Ex. D-4 at 84-88 & Ex. R-509 at 127-28 (Audit Manager's investigative testimony: "it was not a specific risk that was added or specifically tested for"). The audit work on access controls over Koss's IT system did not do so. Tr. 827, 1149. Nor did the audit determination that segregation of duties actually existed within Koss's accounting department, which relied on being able to test a sample from the whole population of journal entries. *See* Tr. 1306, 1311 (Koeppel); Tr. 706-07 (2007-2008 Staff Auditor).

Nor did what Koeppel characterized as "journal entry testing in the walk-throughs" (Tr. 825; *see* Tr. 860-61, 1292), which consisted of viewing a small number of isolated entries as part of gaining "a basic understanding" of Koss's "overall control structure" and "validating our understanding of [certain] process[es]" and key internal controls in place, with no cross-reference to or from the purportedly systematic journal entry testing (Ex. D-4 at 32-33, 65 (Audit Manager's investigative testimony)). *See* Exs. J-49 at 1, 4 (2006), R-300 at 1, 18 (2007), R-398 at 1, 17 (2008); Tr. 1287-88 (Koeppel); Tr. 105 (in one-off situation where had specific inquiry and Senior Accountant "used the system to help me understand things,…I wasn't doing it, I guess, for the specific [journal entry] test"), 414 ("go[ing] to the computers" and having Koss accounting staff "show me things and explain things" was not "journal entry testing specifically") (2006-2008 Staff/In-Charge Auditor); *see also* Tr. 523 (2007-2008 Staff/In-Charge Auditor: referring to "actually sitting at the client's computer screen, seeing how transactions kind of flow through these systems" to gain "understanding of how the control structure worked"). And there is no evidence in any of those audits of specific testing of the operating effectiveness of controls over the production of the update reports, to determine whether Koss's IT system generated a report every time a single journal entry or batch of entries was posted to the general ledger, or of controls over the creation and maintenance of the sets of paper records. *E.g.*, Tr. 825-29, 1473 (Koeppel). Nor was any effort made in the audits to take all of the update reports for any fiscal year and use them to reconcile the beginning and ending balance for any particular general ledger account. Ex. D-4 at 127 & Ex. R-509 at 179 (Audit Manager's investigative testimony).

Beyond the foregoing, the journal entry audit work also included "[i]nquir[ing] of individuals involved in the financial reporting process if they were requested to make unusual entries during the period or if there is a possibility of accounting misstatements resulting from adjusting or other entries." Ex. J-11 at 4 (2006); *see* Exs. J-104 (2007), J-204 (2008); Tr. 1198, 1270 (Koeppel); *see generally* AU § 316.58d. According to the testimony in the case, these audit inquiries were made of each of the three accounting department members individually, in separate in-person meetings with each. Tr. 1198 (Koeppel); Tr. 339 (2006-2008 Staff/In-Charge Auditor); Tr. 661-62, 707-08 (2007-2008 Staff Auditor); Ex. R-509 at 50-54 (Audit Manager's investigative testimony).

In 2006, the work papers stated that, per discussion with VP-Finance, Senior Accountant, and Junior Accountant, "none of them has been requested to make unusual entries, is suspicious of fraud, or is aware of anything out of the ordinary as it relates to management." Ex. J-16 at 4; *see* Ex. J-11 at 4. In 2007, the work papers gave the same account: "PDW [Senior Accountant] and [Junior Accountant] they were not requested to make any unusual entries during the current year." Furthermore, based upon discussion with Senior Accountant, "the majority of journal entries posted are standard entries," which "are usually system generated," so "she feels that there is minimal risk of an accounting misstatement"; "both she and [Junior Accountant] have been with Koss for a number of years and are very familiar with the business"; and VP-Finance "rev[ie]ws all standard and non-standard JE," which "further mitigates the possibility of accounting misstatements." Ex. J-104; *see* Tr. 338-40, 394-95.

Similarly, the 2008 work papers documented, "GT inquired of [Senior Accountant and Junior Accountant] as to whether either has been asked to make unusual entries during the period, noting both negatively responded. Through journal entry testing performed at the quarterly reviews and at year-end, GT notes no entries initiated by an individual other than [these two persons]." In addition, "PDW [Senior Accountant and Junior Accountant], the risk of accounting misstatement resulting from adjusting or other entries made during the period is minimal. GT notes [these two persons] have been employed in their current roles for several years and are therefore very familiar with the Company's operations, thereby further mitigating the risk of unintentional misstatement." Ex. J-204; *see* Tr. 661-62, 710 (2007-2008 Staff Auditor).

Finally, Koeppel notes that each year President/CEO and VP-Finance stated in a letter to Grant Thornton on or around the date on which the financial statements for the fiscal year under audit were filed with the SEC that, among other things, all "[f]inancial records and related data" have been "made available to you"; there are "no material transactions that have not been properly recorded in the accounting records underlying the financial statements"; and "[w]e have no knowledge of fraud or suspected fraud affecting the Company involving" management, employees who have significant roles in internal control, or others where the fraud could have a material effect on the financial statements. *See* Exs. J-67 at 2-3, J-182 at 1-2, J-280 at 1-2; Tr. 1232-36 (Koeppel).

2. Revenue-related accounts

Koeppel testified that the approach to testing revenue that she used in leading the 2006, 2007, and 2008 Koss audits was, "We focused on tests of details of the balance sheet and analytics as it relates to the income statement." Tr. 1353. She stated she was familiar, in general, with the revenue procedures in the audits. Tr. 1430.

a. Net sales

Koeppel testified that she planned in each audit for the use of analytical procedures as substantive tests of the occurrence and valuation of the net sales Koss reported on its income statement. Tr. 871, 875, 938-39, 944-46, 955, 992-93, 1002, 1009, 1022, 1078, 1369-70, 1435-36; *see, e.g.,* OIP 14 ¶ 43; Ans. 21 ¶ 43; Tr. 689 (2007-2008 Staff Auditor); Ex. R-509 at 74-75, 161 (Audit Manager's investigative testimony). During her tenure on the audits, Koeppel participated in firm training related to analytical procedures and signed off on a number of work papers documenting such procedures in the audits, and she has stated she was broadly familiar at the time with the analytical procedures performed. *See, e.g.*, Tr. 1027-28, 1188, 1499; KPHS 40.

Koeppel and other audit team members have testified that the strategy and execution of the Koss audits did not include tests of details of income statement accounts, such as obtaining, reviewing, or tying to Koss's general ledger any detail listings of the transactions in Koss's sales accounts or reconciling those accounts with sales figures from Koss's accounts receivable subledger or underlying invoices. Tr. 961-65, 987-90, 1010-13, 1067-68, 1081-83, 1409-11, 1488 (Koeppel); Tr. 151-52, 196, 220-21, 401 (2006-2008 Staff/In-Charge Auditor); Tr. 713-14 (2007-2008 Staff Auditor); Ex. R-509 at 150, 153, 161-62, 165-66 & Ex. D-4 at 106-108, 114-20 (Audit Manager's investigative testimony). But, according to Koeppel, she did consider the analytical procedures on the sales accounts in conjunction with audit work on other revenue-related accounts, including tests of details of accounts receivable and sales allowances reported on Koss's balance sheet, which we discuss later. *E.g.*, Tr. 1191, 1360. And she recognized that to address Koss's net valuation of sales, audit work was necessary not only on Koss's gross sales but also on the sales allowances that were subtracted from gross sales in arriving at Koss's net sales. Tr. 964, 1014, 1082.

The Division's expert witness identified, without contradiction, 81 separate analytical procedures, performed by the engagement teams for the audits in question or for quarterly reviews during those audit years, "that had some relationship to net sales, accounts receivable, inventory and/or the cooperative advertising and promotion allowances." Ex. D-2 at 54; *see, e.g.,* DPHS 34-35 & n. 22 (noting that of 83 total procedures listed by the expert, two had been included in the work papers twice under different bates numbers); R.D. 88 at 42-45 (cross-referencing procedures identified by the expert to hearing exhibit numbers); KPHS 74. The expert explained that, although the work papers did not necessarily indicate which of the procedures were intended or considered to be substantive tests (*see* AU §§ 329.09-.21), he assumed for purposes of his report that all of them may have been so, as opposed to having been used only in the planning or overall review stages of the audits (*see* AU §§ 329.06-.08, .23). Ex. D-2 at 54; *see* Tr. 1023-24 (Koeppel). As noted, Koeppel testified that substantive analytical procedures were used to test net sales, and she further asserted that each year she "took all the information" from "all of our analytics," "including work on the quarters," "into consideration" as evidence to support the audit opinion she formed. Tr. 992. We evaluate the analytical procedures, whether substantive or not, for the weight they may have contributed to the audit work on the existence and valuation of Koss's revenue.

Of the 81 analytical procedures, the Division's expert witness categorized four as relating only to inventory, not also to revenue. Of the remaining 77 procedures, the Division's expert identified three as limited to sales allowances, and, because the purpose of those work papers was to test liability accounts, he viewed them as providing "little" or "minimal to no support" for net sales. Ex. D-2 at 118, 125, 130. Four other procedures used sales figures for one or two fiscal years and for June to test the reasonableness of Koss's returns reserve, all as reflected in Koss trial balance reports. *Id.* at 61, 117, 119, 125, 130; *see* Exs. J-52 at 7-9 & J-53 (2006: "obtain[ing] average return rate for the year based on yearly returns and sales figures" and "multiply[ing] the calculated return rate" by "June sales figure to estimate probable returns related to these sales"); J-152 at 12 (2007: same), J-248 at 4 (2008: same, except calculating average return rate over current and prior year). According to the Division's expert, "Because this testing was performed on the sales return liability, however, these analyses by their nature provide little support for the existence and valuation of Koss's net sales." Ex. D-2 at 61. Koeppel did not contest any of these points.

Of the remaining 70 procedures, the Division's expert categorized 45 as trend analyses and 25 as ratio analyses. Ex. D-2 at 54, 55, 58, 117-131. By these terms, according to audit guidance cited in his report, the expert meant, respectively, "'the analysis of changes in an account balance over time'" and "'the comparison of relationships between financial statement accounts (between two periods or over time).'" *See* Ex. D-2 at 49, 55, 58, citing *AICPA Audit Guide: Analytical Procedures* ¶¶ 1.24, 1.28 (New York, NY: AICPA, 2001). Koeppel's expert witness stated that 38 of these procedures were prepared for quarterly reviews. Ex. R-507 at 91; *see* Tr. 992. By our count, the number is 37: 25 trend analyses and 12 ratio analyses. Koeppel's expert explained that the quarterly review procedures "were never intended to meet the criteria for analytical procedures performed in annual audits under AU § 329." Ex. R-507 at 91; *accord* Tr. 2075-76. Furthermore, the Division's expert pointed out, without contradiction, that eight of the 13 remaining ratio analyses (two performed in the fiscal year-end audit and six prepared during the quarterly reviews, in either 2007 or 2008) calculated various expense amounts as a percentage of net sales and did not develop expectations or provide support for the net sales figure itself. Ex. D-2 at 59 (referencing Exs. J-149, J-161, J-166, J-171, J-244, J-258, J-263, J-267).

The trend analyses compared Koss's current-year sales figures with prior-year amounts, noting in six year-end procedures in 2006, nine quarterly procedures in 2007, and two year-end and four quarterly procedures in 2008 an expected increase or decrease but not defining any specific amount or percentage. Where the work papers referred to changes in Koss's operations, such as new sales contracts during the current year, the auditors simply expressed their expectations in broad terms, rather than formulating specific expectations of differences from prior-year sales amounts.

Indeed, the expectations of differences from prior-year sales amounts in these trend analyses were stated so generally that they did not capture identified changed circumstances with any meaningful level of precision that would have enabled the auditors to identify differences that might be potential material misstatements. *See, e.g.*, Exs. J-25 & J-26 at 1 ("significantly higher" sales), Tr. 135-38, 966; Ex. J-48 at 4, 8, 17 (same); Ex. J-233 at 1 (expecting "increase" in sales for third quarter 2008, "down" for the nine-month period ending with that quarter; Koss "entered into two new agreements with" two large discount retailers in "Mass" sales account) & Ex. J-266 at 1 ("Budget Variance Analysis," noting decrease in budgeted to actual third-quarter 2008 sales in "Mass" account "caused by loss of the [product] line" for one of the two retailers and a third retailer), Tr. 1049-50; Ex. J-254 at 1 ("comparable (if not reduced)"); *compare* Ex. J-144 at 2 (fiscal year-end 2007 analytical procedure stating expectation of "overall decrease" in sales while noting that "export sales continue to increase"), citing Ex. J-167 at 1 (expecting "declining trend" of sales "generally down" for third quarter 2007), *with* Ex. J-168 at 2 (third quarter 2007 analytical procedure that "noted a pull-back in 'Export' sales" for the second quarter and stated, "GT would anticipate 'Export' sales to continue on it[]s declining trend through Q3").

Further examples of such imprecise trend analyses include the following, all in work papers specifically signed off on by Koeppel: Ex. J-17 at 2, 13 (sales will be "up"); Ex. J-18 at 1, 5 (up for quarter where, to date, "sales for the year are up over last year"); Ex. J-22 at 1, 4 ("significantly higher" sales; Koss had been "securing new customer agreements"); Ex. J-23 at 1, 4 ("increase" in sales; "Koss focused on selling its products in new markets"), Tr. 938-39, 942-43, 949; Ex. J-24 at 1, 3 ("mostly higher" revenue; "new demands such as headphones in cars for cars that come with TV's" and "Koss wanted to expand the European market to help[] its product grow on a global level"), Tr. 944-46, 949; Ex. J-141 at 2, 4 ("weak," "drop," or "strong" in certain sales; one customer "suffering from the effects of a slumping auto market," "the loss of contracts" with two electronics stores, "promotional event" with third electronics store); Ex. J-147 at 1, 6 ("down," "declining trend"; a "pull back (or leveling off)" from "the tremendous sales growth Koss experienced in the prior year"); Ex. J-158 at 1, 6 ("decreased" sales; "pull back in sales was bound to occur" "eventually" "[d]ue to Koss's continued growth in sales over the past year"), cross-referenced in Ex. J-143 at 2 ("decrease"); Ex. J-162 at 2, 6 ("increased sales" over prior-year period; "the continued increase in export sales"); Ex. J-163 at 2, 5 (certain sales "increased" or "down"; "continued success of [export] market segment," "loss of the [two electronics stores] contract"); Ex. J-168 at 2, 6 ("declining trend," "down," "decrease" in certain sales; "pull-back in 'Export' sales," "loss of contracts with" the two electronics stores, "shipped new models to [the third electronics store] in the PY"), Tr. 985-93; Ex. J-211 at 1, 22 (fourth-quarter 2008 sales expected to "slightly outpace" fourth-quarter 2007 sales, "increase"; "the addition of two new agreements" with two buyers "during Q1 [2008], which were expected to drive sales higher as these discount retailers expose their massive customer base to the family of Koss products") & Ex. J-266 at 1 (noting decrease in budgeted to actual third-quarter 2008 sales in "Mass" account "caused by loss of the [product] line" for one of the two retailers and a third retailer), Tr. 1059-63; Ex. J-241 at 1, 3, 10 ("downward trend," "decrease"; "Koss is coming off a period when their sales were at an all time high"); Ex. J-259 at 1-2, 6 ("comparable (if not reduced)").

Similarly, a quarterly 2007 ratio analysis signed off on by Koeppel stated that: "GT deems [AR/sales] ratio reasonable" because a "reduction" in Koss's sales was anticipated. Ex. J-169 at 1.[15/] At the hearing, Koeppel observed that "how we do analytics today and the amount of documentation we do as it relates to expectations is significantly more than I acknowledge what we did on Koss." Tr. 1499; *see* Tr. 1188.

The Division's expert identified certain trend analyses in which the expectations were potentially more precise because they had been developed "based on data disaggregated by either month, product line or both." Ex. D-2 at 56. As Koeppel explained, "breaking [the sales data] down by more than just account level," "mov[ing] from looking at it on account basis to quarterly, also looking at it on a monthly basis" was done in the audits "[b[ecause disaggregation is more precise." Tr. 1382.

Specifically, each audit included two analytical procedures that compared certain Koss sales data for all and parts of the current fiscal year to the corresponding data from the prior fiscal year, using reports generated by Koss's IT system. An analytical procedure performed in all three audits ("Variation Analysis" or "Variance Analysis") compared total gross sales amounts for the current and the prior fiscal year for 14 "product line" categories (*i.e.*, detailed income statement sales accounts), such as "Education," "Export," "Mass," "OEM," "PX and Prison," "Radio Shack," "Record Music Books," "Specialty," "Superstores," and "Internet/Catalog," which accounts could include

[15/] The report of the Division's expert witness also identified 34 revenue-related analytical procedures in which the auditors appeared to have formed the expectation that Koss's current-year amount would be unchanged from its prior-year amount, despite changed circumstances from the one year to the next being noted in the same work papers to explain significant unexpected differences between the expectation and the recorded amount. In the expert's view, this indicated that the changed circumstances had not been considered in forming the expectation, "undermining the precision of the expectation and the effectiveness of the analysis." *See* Ex. D-2 at 50, 117-120, 123-131 (describing 19 trend analyses (13 fiscal year-end, 6 quarterly) and 15 ratio analyses (11 fiscal year-end, four quarterly)).

multiple customers. Exs. J-25, J-118, J-214; Tr. 142, 987, 1008-10, 1015, 1076-78. Each of these work papers referred to another work paper for a discussion of changes in the balances of those sales accounts. Exs. J-25 at 1, J-118 at 1, J-214 at 1.

In the 2006 audit, the other work paper consisted of a list of notes under a statement of "Expectations" and "Scope." Ex. J-26 ("Variation Analysis"); Tr. 955-56. Additionally, a separate 2006 audit work paper documented a "Revenue by Month" analytical procedure comparing Koss's total recorded net sales for each month of the current to the prior fiscal year. Ex. J-24. In the 2007 audit, the annual Variance Analysis highlighted changes from the prior year in certain of the 14 sales accounts and cited a "Monthly Sales Analysis" for "an analysis of changes in revenue," but the cross-referenced document discussed certain year-over-year changes in aggregate monthly net sales without addressing each of the noted accounts. *See* Ex. J-115; Tr. 1001-02 (Koeppel); Tr. 200-02 (2006-2008 Staff/In-Charge Auditor). The closest the 2007 work papers came to doing so was an analysis consisting of comparisons of Koss's gross sales for the third quarter of the current and the prior fiscal year, broken down by month and by the 14 categories, which, according to Koeppel, was consistent in methodology with the sales analyses performed as part of quarterly reviews for prior quarters in fiscal year 2007. *See* Ex. J-168 ("Sales by Month by Product Line"); Tr. 989. For 2008, the annual Variation Analysis cited a work paper consisting of comparisons of Koss's gross sales for all quarters of the current and prior fiscal years, broken down by month and by the 14 categories. *See* Ex. J-213 ("Sales by Month by Product Line").

Koeppel initialed the 2007 and 2008 work papers for the annual analysis and testified that "I suspect I would have looked at" the 2006 work paper when it was prepared. Exs. J-118 at 14 & J-214 at 14; Tr. 954, 965. The 2006 and 2007 work papers for the monthly analysis bear Koeppel's initials, indicating her review of the procedures, and she testified that she would have typically reviewed the 2008 work paper as well, at least in draft form, and that it was consistent with her understanding at the time of the audit. Exs. J-24 at 3 & J-168 at 6; Tr. 1064-65, 1072-73. Another audit team member testified that Koeppel was very involved in analyzing and discussing the variances in the sales data. Tr. 180-85 (2006-2008 Staff/In-Charge Auditor).

As Koeppel was aware, however, those annual and monthly variation analyses were based on data in reports provided by Koss's accounting department. *E.g.*, Tr. 983-86, 1000, 1009, 1078, 1349-50; Exs. J-25, J-118, J-214 (each annual analysis, which cross-referenced the other work paper, was documented in handwriting on "Detail Schedule By Company, Income Statement, Koss Corporation"); Exs. J-24, J-168 at 5, J-213 at 20 (audit work papers identifying Koss reports used in the monthly analyses). There is no indication in the record that in the current or prior year audit procedures were applied to those Koss reports to support their reliability. *See, e.g.,* Tr. 1000; Ex. D-4 at 105 (Audit Manager's investigative testimony). Koeppel testified that consistency of the product line groupings was a fundamental question that needed to be asked when performing such a variance analysis, though she was not specifically aware of it having been asked during the Koss audits. Tr. 987-88, 1067-68; *see* Tr. 151-52 (similar testimony from 2006-2008 Staff/In-Charge Auditor). Koeppel further testified that it was not part of the approach or execution of the audits to test whether sales were allocated consistently to accounts between periods or assigned properly to each month. Tr. 940-41, 946, 961-65, 987-90, 995-96, 1000, 1010-13, 1067-68, 1080-83, 1409-10, 1488; *see* Tr. 151-52, 196, 220-21; Ex. D-4 at 120 (Audit Manager testified in investigation to being on the same page with Koeppel on these points).[16/]

For all of the analytical procedures performed in the Koss audits, Koeppel testified that to identify significant unexpected differences from expectations, the auditors used as a "baseline" the "tolerable error" amount established for the audit ($330,000 for 2006, $260,000 for 2007, and $220,000 for 2008), made judgmental determinations about whether variances that exceeded, or were less than, tolerable error should be investigated, and evaluated differences that they concluded were both significant and unexpected. Tr. 840-43, 1015, 1069-70 (Koeppel); *see* Tr. 140-42, 190-95, 206-09 (2006-2008 Staff/In-Charge Auditor); Ex. J-26 Exs. R-202 at 3, R-295 at 2, R-393 at 3 (audit work papers stating tolerable error).[17/]

16/ In briefing, Koeppel cites an additional procedure in the 2007 and 2008 audits not noted by any expert witness. She refers to it, without discussion at the hearing or in briefing, as an "Export Sales Analysis" relevant to testing of Koss's April 30-June 30 accounts receivable. KOB 50 (citing only 2008 procedure); KPHS 40-41 (citing it in both years). The work paper for the procedure purported to contain a breakdown of sales to customers in Koss sales territory #55 by month and quarter for the current and prior fiscal years, along with year-to-date totals, listing percentage changes between the two years in the quarterly and annual totals, all apparently based on attached Koss printouts titled "Customer Sales History By Territory Within Company #" as of May and June of the current year. Exs. J-146 ("Koss Corp. Q4 Export Sales (Europe), A: 06/30/07") & J-231 ("Q4 North American Export Sales, A: 6/30/08"). As the Division points out (DRB 30 n.157), there is no evidence in the record that any audit procedures were applied to those Koss reports to support their reliability, and on the face of each work paper, there is no evidence that anything more was done than to agree prior-year figures to the prior-year work papers, test for clerical accuracy, and trace fourth-quarter and year-to-date totals and the percentage change from prior year to a press release. The procedure appears only to have addressed around a third or less of Koss's purported total fourth-quarter sales. *See, e.g.*, Exs. J-116 at 1, J-118 at 1, J-213 at 1, J-214 at 1.

17/ Koeppel testified that tolerable error represented an estimate of the maximum amount of misstatement that could be accepted in an individual account or a group of related accounts. Tr. 840-42; *see generally* AU §§ 350.18 ("tolerable misstatement" is "a planning concept and is related to the auditor's preliminary judgments about materiality levels in such a way that tolerable misstatement, combined for the entire audit plan, does not exceed those estimates"), .48.

The work papers for the analytical procedures contain examples in which particular variances from expectations were identified as warranting evaluation and explanations were offered. *E.g.*, Ex. J-17 at 3; Ex. J-18 at 2; Exs. J-25 at 1 & J-26; Ex. J-115 at 1; Ex. J-147 at 1; Ex. J-163 at 2; Ex. J-212 at 2; Ex. J-223 at 2, 4; Ex. J-266 at 1-2, Tr. 1053-58. But repeatedly, differences that exceeded tolerable error went without any documented evaluation or explanation for why one was not made. *E.g.,* Ex. J-25 at 1 ("Mass" sales), Tr. 143; Ex. J-144; Ex. J-213 at 1-3, 13-14, 18-19 (certain sales), Tr. 216-220, 1063-73; Ex. J-254; Ex. J-255; Ex. J-257; Ex. J-264 (no explanations of variances), Tr. 491-92. Further examples, in work papers specifically signed off on by Koeppel, include Ex. J-23, Tr. 943; Ex. J-24 ($1 million decrease in April net sales compared to prior year), Tr. 947-49; Ex. J-147; Ex. J-168 at 2 ($665,000 decline in "Mass" sales), Tr. 990-92; Ex. J-241; Ex. J-260; and Ex. J-262.

Other audit procedures cited by the parties (*e.g.*, KPHS 40, 41) that are specific to net sales involve scanning end-of-fiscal-year Koss sales data, to address the existence or occurrence of its revenue. Each year, the revenue audit program included the two steps, "Scan the sales records for the last business day of the year for large or unusual entries and verify that they were recorded in the proper period" and "Scan the revenue accounts in the general ledger for large or otherwise unusual entries." Exs. J-16 at 1, 4, J-110 at 3, 4, J-210 at 2, 3; *see* Tr. 1429-32 (Koeppel); Tr. 357, 366, 368, 382 (2006-2008 Staff/In-Charge Auditor); Tr. 664 (2007-2008 Staff Auditor).

As to the former step, in addition to cross-referencing shipping "cut-off testing" (which did not involve the tracing of invoices to a sales account, Tr. 401, 713-14, and is discussed in the next section below), there was a notation on the audit program in 2006 and 2007. The notation stated, "GT reviewed the sales records for the last week of June noting no large or unusual entries" (Exs. J-16 at 1, J-110 at 3; Tr. 664-66, 668-69); and in 2008 stated, "To complete this step, GT reviewed the sales journal for the end of June 2008. Per review, GT noted no entries greater than Tolerable Error of $220,000 and no entries which GT would deem unusual" (Ex. J-210 at 2).

As to the latter step, a 2006 entry stated, "GT reviewed the sales recorded during June on the AR Distribution Report (Sales Journal) and notes that nothing appeared unusual" (Ex. J-16 at 4); the 2007 and 2008 entries stated, "GT reviewed the 'Month to Date – Commissions' report as of [6/30/2007 or 6/30/2008] which includes all sales detail during the month of June. Per the review of this report, there were no unusual or significant items noted that need further investigation. As such, no further work is required" (Exs. J-110 at 4, J-210 at 3). Koeppel specifically signed off on the last-noted, 2008 entry. Ex. J-219 at 1; see Tr. 1429-32, 1434 (Koeppel).

Thus, these audit tasks were performed using Koss system-generated reports provided by its accounting department and without accessing its electronic general ledger. Tr. 383, 1434. Moreover, there was no audit documentation or testimony that the reports were reconciled to Koss trial balance reports. Tr. 385. When questioned about this at the hearing, an audit team member expressed the view that reconciling company reports to the general ledger was generally important to do because "[i]t adds to the validity of the support that they're providing," and also noted that Grant Thornton "told us maybe a million times if [work] wasn't documented, it wasn't done," but stated that the reconciliation was not necessary for the review of the end-of-year sales records because "It's not specifically that we're tying in a balance. This is just some additional analysis of large or unusual records recorded at or near year-end, so it's more of a specific kind of review of items." Tr. 266, 385-86 (2006-2008 Staff/In-Charge Auditor). In response, however, to the question from Division counsel at the hearing, "If you didn't have a complete set of sales for the last week of June, how could you get comfort that, in fact, your scanning procedure was, in fact, appropriate?", another audit team member recognized, "It would not be ideal." Tr. 716 (2007-2008 Staff Auditor).

b. Special sales allowances

As noted, Koeppel testified that in the 2006, 2007, and 2008 audits she relied, in part, in assessing Koss's net valuation of sales, on the audit testing of the sales incentives that Koss recorded as a reduction to sales on its income statement and as a liability on its balance sheet. Tr. 845-46, 1082, 1119, 1127; *see* OIP 20 ¶ 74; Ans. 31 ¶ 74. Koeppel has admitted that in each audit she understood Koss's sales incentives program, including the particular sales allowances pertinent here and that they were a judgmental accrual, and was aware of the audit testing of the management-prepared schedules that purported to show the activity in those allowances. OIP 20 ¶ 75, 21 ¶ 79; Ans. 31 ¶ 75, 32 ¶ 79; *see* Tr. 1117-21, 1135 (Koeppel: audit procedures regarding the testing of so-called special sales allowances were similar in all three audits), 1480; Tr. 184-85 (2006-2008 Staff/In-Charge Auditor had numerous discussions with Koeppel during the audits about the special sales allowance testing); Ex. J-41 (2006 "Accrued Special Sales Allowance Testing," reviewed by Koeppel); Ex. J-52 (2006 "Credit Memo Analysis," reviewed by Koeppel); Ex. J-152 at 15 (notation on 2007 audit program discussing approach to credit memo review around year end, reviewed by Koeppel); Ex. J-230 (2008 "Accruals Lead Descriptions," reviewed by Koeppel, with an entry "[r]elate[d] to special sales allowances paid to customers"); Ex. J-248 (2008 work paper referencing review of fourth-quarter credit memos, reviewed by Koeppel).

At issue here are the sales incentives recorded in Koss's "Accrued Special Advertising" or "Accrued Special Sales Allowance" balance sheet accounts, consisting of discounts and rebates, which, in the fiscal years 2006, 2007, and 2008, reduced the net sales reported on Koss's income statement and constituted all or most of the amounts reported as the "Cooperative advertising and promotion allowances" component of the accrued liabilities line item on its balance sheet. *See, e.g.,* Exs. J-59 at 27, 36, J-172 at 28, 38, J-268 at 36 (Koss Form 10-Ks); Exs. J-43 at 2, J-136 at 2, J-229 at 2 ("Accruals Lead" sheets); Exs. J-44 at 2, J-137 at 2, J-230 at 2 ("Accruals Lead Descriptions"); Exs. J-41, J-133, J-226 (2006-2008 memoranda "document[ing] [the audit] understanding" of the "two components of the special sales allowance accrual" or the "2 different special sales allowance accounts" and approach to testing them); Exs. J-25 at 2, J-118 at 2, J-214 at 2 (contrarevenue accounts on Koss's June 30, 2006, 2007, 2008 detailed income statements); Tr. 1016, 1117-21, 1127-29 (Koeppel); Tr. 176-77, 182, 344-47 (2006-2008 Staff/In-Charge Auditor); Exs. R-509 at 154-55 & D-4 at 121-23 (Audit Manager's investigative testimony).

Koss offered these so-called "special sales allowances" either (1) in fixed dollar amounts, payable by month or by quarter, for specific situations or (2) based on a percentage of sales that could be subject to negotiation and change by VP-Sales every year, every month, or every other week. Exs. J-41, J-133, J-226 at 1; Exs. J-40 at 1, J-134 at 1, J-227 at 1; Exs. J-44 at 2, 4, J-137 at 2, J-230 at 2, 4; Ex. J-52 at 6; Ex. J-228 at 1; Tr. 152-55, 174-75 (2006-2008 Staff/In-Charge Auditor). According to a 2006 audit work paper, Koss's customers eligible for them "can come back at any time to redeem the accrual whether it be one year later or three years later." Ex. J-52 at 6. Consistent with the understanding expressed in 2006 and 2007 as well, a 2008 audit work paper stated generally, "These allowances are not firm commitments and nothing is in writing to verify the fixed or percentage allowance given to customers." Ex. J-226 at 1; *see* Exs. J-41 (2006) & J-133 (2007); *see also, e.g.,* Ex. J-227 at 1 (2008: "Per [VP-Finance] and [Senior Auditor], there are no formal contracts to validate the fixed allowance payment."); Exs. J-38 at 1, R-274 at 826, J-225 at 1, R-482 at 723 (internal control findings from 2006, 2007, 2008); Tr. 1121-27 (Koeppel); Tr. 476-82 (2007-2008 Staff/In-Charge Auditor); Tr. 173-74 (2006-2008 Staff/In-Charge Auditor: sales allowances not in writing, with couple of exceptions of customers with fixed allowances).

The work paper also noted, "As we are relying on management's representation to determine reasonableness and adequacy of the accrual, GT has added this issue to the management representation letter." Ex. J-226 at 1; *see* Ex.J-280 at 4 (August 22, 2008 Koss letter to Grant Thornton: "There are no formal contracts or agreements in place that document the terms of the sales allowance program with customers. Management believes the Special Advertising Accrual is reasonable and adequate."). At the hearing, Koeppel explained, "I felt it was important on a judgmental accrual when we could not tie to third-party support or a contract to make sure that management understood that we were relying on their representation that this was a complete and accurate and reasonable accrual at the end of the period." Tr. 1403. Having identified the special sales allowance program's lack of formalized contracts as a control deficiency in 2006 and 2007 (Exs. J-39 at 4, J-132 at 3), Koeppel designated it as a significant control deficiency in 2008 (Ex. J-239 at 7). She testified this was a situation in which "I don't have anything to tie [the account balance] to, and so we perform work that we can, but as it related to special sales allowances, I was uncomfortable with the fact that management had not addressed it by doing anything different and wanted to make sure that it was elevated to a higher level of importance in 2008 to the audit committee and also include it in the representation letter," such that President/CEO "was clearly aware that this was a concern." Tr. 1195-96; *see* Ex. 227 at 1.

Koss estimated the amount of sales allowances it expected to grant to each customer to whom they were offered, but no audit procedures were performed to test whether or not the customers had reached the qualifying sales volumes because, as Audit Manager explained in the investigation, "So while [Koss] represented to us that it may have [been that customers] had to reach 100,000 in sales and they get 5 percent, it really could have been anyone's guess. It was a representation based by management that this is what they had agreed to, and there weren't formal contracts." Ex. D-4 at 123-24. Another 2008 work paper summarized the implications of the situation at Koss this way: "given the limited amount of information provided to us (i.e. no support for percentage or fixed allowances), GT notes there is no way to fully validate the allowances given." Ex. J-227 at 1; *see* Tr. 474-79 (2007-2008 Staff/In-Charge Auditor).

In each audit, Koeppel tried to assess the reasonableness of the fiscal year-end amount of special sales allowances recorded by Koss, representing the amount of the discounts and rebates that had been earned by customers but not yet paid to them or deducted from Koss's accounts receivable. The auditors obtained from Koss's accounting department a paper copy of an allowance schedule generated by Koss's IT system and variously described by the work papers as a "spreadsheet" or "rollforward." Exs. J-41 at 1, J-133 at 1, J-226 at 1; Tr. 156-62, 167-70, 183 (2006-2008 Staff/In-Charge Auditor). It purported to list, for each customer that received the allowances during the fiscal year, each month's opening balance, allowance activity, and closing balance. Exs. J-42, J-135, J-228. Although in each audit this report was used in performing certain procedures, no procedures were applied to the report to substantiate management's assertions that it was complete. Tr. 171-73, 183-185 (2006-2008 Staff/In-Charge Auditor trusted that Koss's accounting department gave her a complete listing, never performed any procedures to ensure it was complete, and had numerous discussions with Koeppel about the special sales allowance audit work), 397, 1132.

Rather, on a customer-by-customer basis, the auditors compared the July 1 opening balance on the current year's spreadsheet to the June 30 closing balance on the version used in the prior year's audit. Exs. J-41 at 1, J-133 at 1, J-226 at 1; Tr. 162-66. They also tied the total outstanding balance at the current fiscal year end to a trial balance report generated by Koss's IT system. Ex. J-42 at 7, J-43 at 2, J-44 at 2 (2006); Ex. J-135 at 5, Ex. J-136 at 2, Ex. J-137 at 2 (2007); Ex. J-228 at 4, Ex. J-229 at 2, J-230 at 2 (2008); Tr. 347-50, 395-96, 1404. They did not tie the balance on the spreadsheet, representing balance sheet accounts, to a report of the details of the corresponding contrarevenue accounts on the income statement because, according to Koeppel, that was not part of the methodology of the audits. Tr. 185, 1082-83, 1409-10. Koeppel summarized the foregoing audit work as follows: "We tied the total of the report to the GL [meaning a trial balance report], indicating that the…accrued balance was supported by specific accruals or reserves for each individual customer who had a[n] incentive program or a co-op allowance….We performed some clerical tests on that report, too, indicating that it flowed through appropriately. So we had a reasonable basis to determine that the report was accurate." Tr. 1404.

Furthermore, the auditors tested a sample of the claims activity depicted on Koss's report. "GT haphazardly selected 5 customers from the 65" customers for 2006 and 2007 and the 52 customers for 2008 shown on the spreadsheet as "receiving a special sales allowance, and two months of sales activity, for testing." Exs. J-40 at 1, J-134 at 1, J-227 at 1. For these five customers, the auditors checked the mathematical accuracy of the spreadsheet's calculation of the running totals, from month to month throughout the year, of available allowance amount. Each year, four of the selected customers were listed by Koss as receiving allowances on a percentage-of-sales basis and one on a fixed-amount basis. For two selected months in non-consecutive quarters (or in one case in 2006 of a customer to whom no sales were made in either of those months, "additional months"), the auditors recomputed each of the four customers' allowance percentages shown on the spreadsheet for the month by dividing its allowance amount shown for that month by a corresponding sales figure, derived from a monthly sales report generated by Koss's IT system. Exs. J-40 at 1, 2 ("GL Sales Detail by Month"), J-134 at 1, 2 ("Customer Sales History by Terr With[]in Company #"), J-227 at 1, 3 (same). Also, "GT traced [the special sales allowance percentages for those months] to PY [prior year] noting percentages have not changed." Exs. J-40 at 1, J-134 at 1, J-227 at 1. *See* Tr. 1130-35 (Koeppel); Tr. 469-73 (2007-2008 Staff/In-Charge Auditor); Tr. 187-88 (2006-2008 Staff/In-Charge Auditor); Ex. D-4 at 123-24 (Audit Manager's investigative testimony). No audit procedures were applied to the sales reports used in the special allowance testing to determine their completeness or accuracy. Tr. 187-89, 473, 1134-35; Exs. J-40 at 2, 3, J-134 at 2, 3, J-227 at 3.

According to the work papers, for the one selected 2006 customer listed on Koss's spreadsheet as having a fixed-amount allowance, the auditors were able to review a written contract specifying the amount. Ex. J-40 at 1-2. Although a summary memorandum in the 2007 audit work papers (Ex. J-133 at 1), as in 2006 and 2008 (Exs. J-41 at 1, J-226 at 2), stated, "For those customers that accrued using the fixed allowance method, GT gained an understanding of how the amount is derived and traced to appropriate documentation," the 2007 detailed work paper contained a blank space next to the selected "Fixed-based" customer, with no indication that any procedures were performed or conclusions reached as to its allowance. Moreover, while the 2006 and 2008 work papers concluded that, based on the audit testing, the special sales allowances were or appeared to be properly calculated (Exs. J-40, J-227), the corresponding 2007 work paper stated no conclusion. Ex. J-134 at 1; Tr. 185-87 (2006-2008 Staff/In-Charge Auditor). According to the 2008 work paper, the testing of the allowance for the "Fixed-based" customer selected for that fiscal year was limited to "vouch[ing] a payment (in the form of a credit memo)." Ex. J-227 at 1.

Work papers for the 2006 and 2007 audits stated that, in addition, "GT tested one [allowance] claim [included on Koss's spreadsheet] for each of the [five] customer[]s selected" for the other testing by comparing the claim to a credit memo issued by Koss and noting that the claim was redeemed at the stated amount, but, in 2007, only four claims bear the relevant tick mark, none belonging to the five customers selected for the other testing. Ex. J-41 at 1 & Ex. J-42 at 1-3 (2006); Ex. J-133 at 1 & Ex. J-135 at 1, 4-5. In 2008, the auditors "haphazardly selected [from Koss's spreadsheet] 10 claims during the year for testing" by use of credit memos, three of which were for "fixed allowance rather than percentage based." Ex. J-226 at 2; Ex. J-228 at 1-4. The work paper for this testing in 2006 stated the conclusion that "accrual is reasonable at 6/30/06" (Ex. J-42 at 2), whereas the counterpart work paper for 2007 and 2008 stated no conclusion (Ex. J-135 at 2 (left blank); Ex. J-228 (no line item for conclusion)).[18/]

Regarding credit memos, the revenue audit program for each audit included the work step of "[o]btaining or prepar[ing] a schedule of sales returns" for the beginning of the next fiscal year and "identify[ing] large or unusual items to verify that they were recorded in the proper period." Exs. J-16 at 1, J-110 at 3, J-210 at 2. Noting the "close" proximity of the final field work to fiscal year end, the auditors stated that they instead (1) "reviewed credit memo activity prior to year end," "assuming the activity would approximate activity subsequent to year end," as part of the field work, which was described in the 2006 and 2007 work papers as "the primary test," and (2) "will review credit memos issued subsequent to year end" but before Koss's filing of its Form 10-K as part of post-field-work audit update procedures. Exs. J-16 at 1 & J-110 at 3, 5; Exs. J-52 at 1 & J-152 at 1, 6; Ex. J-248 at 1; Tr. 406-07 (2007-2008 Staff/In-Charge Auditor); Ex. R-509 at 159, 172-73 (Audit Manager's investigative testimony).

[18/] The documentation for each audit contained an "Accruals Lead" work paper that consisted of handwritten notations on a Koss IT-system generated report called "Detail Schedule by Company, Balance Sheet, Koss Corporation, Period Ending June 30," which included account totals for the special sales allowances for the end of the current and prior fiscal years. Exs. J-43, J-136, J-230. This was accompanied in each audit by an "Accruals Lead Description" work paper, which purported to address the difference in those totals. For 2006 and 2007, the stated analysis consisted simply of a cross-reference to the above-described audit work for the proposition that "rates and fixed amounts are consistent with PY and deemed reasonable." Exs. J-44 at 2, 4 (item M), J-137 at 2 (item M); *see* R-231 at 1 (notation on 2006 accruals audit program cross-referencing Accruals Lead and Accruals Lead Description); Tr. 344-47 (2006-2008 Staff/In-Charge Auditor). In 2008, the work paper stated, as to the year-over-year difference, that "allowance reduction is reasonable" based on a cross-reference to the above-described audit work, along with a recitation of an untested assertion by VP-Finance and a general citation to separate credit memo testing (which we discuss next): "GT noted a significant decrease in the accrual which is against our expectations [that it also would remain consistent due to the consistency of sales between years]. PDW [VP-Finance], the decrease is due to the fact that many customers did not meet their minimal sales requirements in order to earn the special sales dollars. In addition, several customer allowances were reduced through issuance of credit memos. See testing of credit memos @ [work paper number] 7006." Ex. J-230 at 2, 4.

In 2006 and 2007, what was described as the field work component of the credit memo "review," although focused on the returns reserve, assessed the adequacy of the special sales allowance accrual (or reserve) at fiscal year end, apparently as reflected in a trial balance report, by comparing it to the total amount of the credit memos attributable to special sales allowances on a management-prepared schedule of "all credit memos issued in the last quarter of the year." Exs. J-52 at 1-6, 10-11 & J-152 at 1-4, 14-15 ("Credit Memo Analysis" work papers); *see* Exs. J-43 at 2 & J-136 at 2 (Koss detailed balance sheets). In addition, "GT haphazardly selected" 10 to 12 items on Koss's fourth-quarter credit memo schedule and traced them to a copy of the underlying credit memo, "to verify the accuracy of the schedule." In 2006, part of testing the returns reserve involved dividing the credit memos on Koss's fourth-quarter listing into six categories "by relying on the description given and [Senior Auditor's] assistance," and totaling the balances of the four of those categories related to returns to obtain a "High-end range," "assum[ing] a 3-month lag" for the reserve. Ex. J-52 at 6, 7.

The counterpart in the 2008 audit to these "Credit Memo Analysis" work papers, entitled "Returns Reserve Analysis," stated that "GT reviewed the credit memo listing for the 4th quarter of FY'08 noting no large or unusual credits." Ex. J-248 at 1; *see* Tr. 406 (2007-2008 Staff/In-Charge Auditor). No mention was made there of any other accrual or reserve than sales returns (as to which a notation was made that "historically, returns have been low") or of any procedure applied to Koss's credit memo listing. Ex. J-248. Entries on the audit programs each year noted that, during field work, inquiry was made of VP-Finance, who asserted that "there were no write-offs or larger [or "significant"] credit memos issued subsequent to" year end. Exs. J-16 at 5, J-110 at 5, J-210 at 4.

The documentation of the post-field-work credit memo "review" in 2006 described it as comparing two items on a Koss-prepared listing of credit memos to the underlying credit memos and in 2007 and 2008 described it as scanning a Koss-prepared credit memo listing for significant or unusual items and also in 2006 and 2008 as comparing the total balance of credits listed since year end with the returns reserve.[19/]

19/ **2006**: Ex. J-16 at 5 ("GT will review credit memos issued subsequent to year-end in Septembe[r] before the 10-K is filed."), Ex. J-52 at 1 (similar), Ex. J-51 at 1-2 ("GT selected all credit memos over $5,500 (1/2 of Listing Scope) through 8/28/2006, the last day of fieldwork from a Credit Memo Analysis, listing all credit memos issued since YE. This analysis was prepared by Koss."; $5,900 special sales allowance item and other $9,963.14 item on the listing were "T/A to credit memo"; "Based on testing performed above, GT deems subsequent credit memos to be reasonable. Based on total credit memos issued through 8/31/06, GT deems the reserve at YE to be adequate. Further, as no credit memos issued as of 8/31/06 are individually significant[], GT will pass on any other work."); **2007**: Ex. J-110 at 5 (after inquiry of VP of Finance during field work, "[s]ubsequent credit memos will be reviewed again in the post fieldwork update audit procedures…to be completed before the filing of the 10-K."), Ex. J-151 ("GT reviewed the credit memos listing from 6/30/07 through 7/19/07 noting nothing significant or

As Koeppel knew, no effort was made in the accounts receivable confirmation testing in any of the audits to confirm with customers the terms or amount of any sales allowances they might have received from Koss. Tr. 1404-05; *see* Ex. R-509 at 174-78 (Audit Manager's investigative testimony). The work papers for the three audits document, however, just over a dozen total instances in which alternative audit procedures used when an invoice or debit memo was not confirmed involved matching the unconfirmed amount to a debit memo (a sales allowance claim) or a credit memo (a granted sales allowance), as to one customer identifying the type of allowance ("coop allowance"). Exs. J-30 at 1-2, J-123 at 1-8, J-220 at 44-46.

c. Accounts receivable

In the 2006, 2007, and 2008 audits, the existence of Koss's accounts receivable at the June 30 balance sheet date was tested principally by performing procedures as of an April 30 interim date. *See, e.g.,* KOB 18; OIP 14-15 ¶¶ 46-47, 15-16 ¶ 51; Ans. 22 ¶¶ 46-47, 23 ¶ 51; Tr. 876-77, 918, 1360 (Koeppel); Exs. J-16, J-110, J-210 (2006-2008 audit programs for revenue). Koeppel explained that the interim procedures consisted primarily of confirmation testing of a sample of outstanding Koss unpaid invoices as of April 30, "an area that I would focus on" during the audits. Tr. 1353 (the primary test of details used to obtain audit evidence on Koss's accounts receivable was "[c]onfirmations"), 1357. Confirmation requests were sent to customers to confirm the dates and amounts of the invoices or debit memos (representing sales incentive claims, *see, e.g.*, Exs. R-300 at 15, 21, R-398 at 15) chosen for testing, responses were reviewed, and alternative audit procedures were performed to try to verify receivables that were not confirmed. Exs. J-30, J-123, J-220; Ex. R-194 (2006 returned confirmations); Tr. 360-61, 402-03, 438-39, 876-78, 908, 935-38, 1353-55, 1358; Ex. D-4 at 58 (Audit Manager's investigative testimony). In addition to the interim audit work, substantive audit procedures were performed in an attempt to cover the remaining period from May 1 through June 30. *E.g.*, Tr. 887-89, 893, 918-19, 937-38, 1479.

As Koeppel knew, for the confirmation testing, the audit team selected a sample of receivables by obtaining an April 30 AR Aging Report (a subledger listing generated by Koss's IT system of all outstanding receivables at a given point in time), and, according to Koeppel, modifying the report in certain respects. Items as to which

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unusual. As such, GT deems the reserves at 6/3/07 to be reasonable."); **2008**: Ex. J-210 at 4 (like Ex. J-110, plus notation, "No significant credit memos or writeoffs were noted during th[e] post fieldwork review."), Ex. J-246 at 1 ("GT reviewed the credit memo listing from 6/30/08 through 7/16/08, noting that $20,202 in credits have been issued subsequent to year-end. When considering the balance of the returns reserve @ 6/30/08 of $145,000…, GT considers the returns reserve to be adequate."), Ex. J-248 ("Returns Reserve Analysis") at 1 ("Per testing, GT noted no significant credit memos during our update audit procedures. Reasonable.").

"sending a confirmation would not be appropriate," in her view, were removed, such as intercompany accounts (transactions with a related party) and bankrupt customers' accounts specifically reserved for by Koss. Tr. 878-81, 905-12, 935-36, 1337-39 1359, 1408 ("the bulk of their operations was in one entity, but they actually had several other entities that they ran transactions through"); *see* Exs. J-30 at 4-5, 6, J-123 at 2, 10-12, J-220 at 1, 47, 48 (2006, 2008 sample selection and 2007, 2008 sample testing work papers, all reviewed by Koeppel); *see also* Tr. 433-37, 440-42, 444-46 (2007-2008 Staff/In-Charge Auditor); Ex. J-124 at 1, 83, 86 (2007 sample selection work paper).

In 2006, 2007, and 2008, the sample for the accounts receivable confirmation testing was drawn from an April 30 population of about $9.3 million, $6.8 million, and $4.7 million in gross receivables, respectively, compared to Koss's total net sales for those fiscal years of about $50.9 million, $46.2 million, and $46.9 million. Exs. J-30 at 1, J-123 at 2, J-220 at 44; Exs. J-59 at 26, J-172 at 27, J-268 at 25. Thus, even assuming all of Koss's recorded April 30 receivables related to sales occurring in that fiscal year, at least 81.7% to 90% of Koss's net sales each year was not subjected to the confirmation procedures in the Koss audits. [*See* D-2 at 63-65; Tr. 1578 (McGrath).]

Koeppel understood that, under AU § 350.24, items should be selected for testing in such a way that the sample could be expected to be representative of the overall population from which it was chosen. Tr. 881-83. She agreed that Grant Thornton's audit methodology at the time reasonably provided that, because an item erroneously excluded from a population to be sampled cannot be selected for testing, supplementary procedures should be performed to assure that the sample population is complete. Tr. 885; *see* Exs. J-60 at 160, J-139 at 269, J-269 at 273 (2006, 2007, 2008 firm manuals, stating that an example of such a procedure would be "footing the population and agreeing it to the general ledger"). As a Koss audit team member admitted at the hearing, receiving confirmations back from customers does not necessarily indicate that all items that should have appeared on the AR Aging Report were there. Tr. 403 (2006-2008 Staff/In-Charge Auditor).

In this regard, Koeppel testified that she believed it was a "customary procedure" to reconcile the accounts receivable balance used to perform confirmation testing to the client's general ledger. Tr. 908-09, 936-37. On this point, the parties' expert witnesses agreed. *See* Ex. R-507 at 69 (Koeppel expert: "reconciliations between the report used to perform accounts receivable confirmations and the general ledger is the preferable approach"), 94 ("it would have been preferable to have such a reconciliation"); Ex. D-2 at 36 (Division expert: reports used to select samples for confirmation of accounts receivable are "typically reconciled to the client's general ledger"; "it is a basic audit procedure to trace the total of an account analysis (such as an accounts receivable aging) to the general ledger control account, because of the audit risk that the general ledger may not agree to the subsidiary ledger"). During each of the three audits in question, Grant Thornton's audit manual stated, "Because an item erroneously excluded from a population to be sampled cannot be selected for testing, supplementary procedures should be performed to assure that the sampled population is complete (population completeness tests)." The manual then provided two examples of "[o]ther audit procedures [that] will often provide assurance about population completeness": (1) "footing the population and agreeing it to the general ledger"; and (2) "tests for unrecorded transactions and balances (e.g., search for unrecorded liabilities or unrecorded sales)." Exs. J-60 at 160, J-139 at 269, J-269 at 273.

It is undisputed that no such reconciliations were documented, performed, obtained, or reviewed in the 2006, 2007, and 2008 audits. *See, e.g.,* Tr. 886, 892, 908, 912-13, 935-37, 1361 (Koeppel); Tr. 405 (2006-2008 Staff/In-Charge Auditor); Tr. 445-46, 524-25 (2007-2008 Staff/In-Charge Auditor); Tr. 2095 (Koeppel expert); Exs. J-30 at 4-5, J-123 at 1, 8, 10-11, J-220 at 1, 47. A member of the 2007 and 2008 audit teams testified that "we didn't feel [such a reconciliation] was necessary" and explained that the modified accounts receivable balance "wouldn't have reconciled because we removed certain vendors." Tr. 435, 445-46, 524-25 (2007-2008 Staff/In-Charge Auditor). Only as of the June 30 balance sheet date did the auditors try to reconcile Koss's AR Aging Report to its general ledger, modifying the report balance by adding or subtracting items and comparing the resulting receivable balance to a trial balance report called a lead sheet generated by Koss's IT system, not to its electronic general ledger. Exs. J-32, J-126, J-221 (2006-2008 work papers, each reviewed by Koppel and each concluding "AR appears to be properly stated per the above testing"); Tr. 1359, 1366-67 (Koeppel); Tr. 364-65, 404-05 (2006-2008 Staff/In-Charge Auditor); Tr. 524-25.

As Koeppel notes (KOB 49), Koss's AR Aging Report was subjected to shipping cut-off testing in each audit. *See* Tr. 1362-64; *see also, e.g.,* Tr. 358-59, 400-01 (2006-2008 Staff/In-Charge Auditor); Tr. 671 (2007-2008 Staff Auditor); Ex. J-110 at 3; Ex. J-153 at 4. At interim, the testing compared Koss's last three product shipments before and first three shipments after April 30, based on Koss shipping documents and invoices, to its April 30 AR Aging Report, concluding that the report properly included or excluded these invoice amounts. Exs. J-28 at 1 ($3,552, $2,147, and $2,532 shipments before and $1,450, $254, and $32 shipments after April 30; reviewed by Koeppel), J-121 at 1-2 ($1,356.96, $1595.28, $1,436.40 shipments before, $36,858.36, $1,631.28, $1,546.32 after April 30), J-217 at 1-2 (three $175.70 shipments before, $1,923.84, $188.59, $720 shipments after April 30). Such audit testing was also performed as of the balance sheet date, using Koss's June 30 AR Aging Report. Tr. 1359; Exs. J-28 at 2 (shipments of $186, $9,823, $1,688 before and three $186 shipments after June 30), J-120 at 1-2 (shipments of $38.36, $881.50, $176.30 before, $176.30, $1,380.45, $176.30 after June 30), J-218 at 3 (shipments of $3,916.32, $175.70, $175.70 before, $3,065.34, $6,118.56, $119.00 after June 30) (all reviewed by Koeppel). Except for the June 2008 testing (Ex. J-218 at 3, Tr. 1448), these work papers purported to explain gaps between the numbers of the invoices selected, and Koeppel understood that Koss used "sequential invoice numbers," which, in her view, "was a good indication that there was appropriate cut-off" (Tr. 1364). The work papers variously stated the conclusions that based on the cut-off testing, "Koss appears to be recording inventory shipments in the correct period" and "AR is properly stated at 6/30/2006" (Ex. J-28 at 1, 2), "inventory shipments have been recorded in the proper periods" (Ex. J-120 at 1), and "inventory has been shipped and entered in the proper period" (Ex. J-218 at 3).

Audit team members who performed the procedure acknowledged, however, that the invoices subject to the cut-off testing, all dated immediately around period end, represented a very small or miniscule amount of the receivables on Koss's AR Aging Report at any given time. For example, the three June 2007 transactions that were examined totaled about $1,100, or .02% of Koss's $48 million in fiscal year gross sales, and the three transactions examined in April 2006 totaled only $8,000 and in June 2008 only $500. Tr. 712-13, 723-24 (2007-2008 Staff Auditor); Tr. 400-401 (2006-2008 Staff/In-Charge Auditor). Further, only the six tested items after April 30 and before June 30 each year fell within the rollforward period, which, according to Koss IT system-generated reports, encompassed total sales of well over $8 million in 2006 and 2007 and around $9 million in 2008. *See, e.g.,* Ex. J-18 at 1; Ex. J-31 at 1; Ex. J-115 at 1; Ex. J-125 at 1; Ex. J-213 at 1-2. And these team members did not trace the selected invoices to Koss's income statement sales account or regard the shipping cut-off testing as support for the completeness of the AR Aging Report. Tr. 713-14; Tr. 401-03.

In addition, Koeppel points to (KOB 49) work papers from the 2006 and 2008 audits stating that "GT haphazardly selected 10 invoices from the AR Aging as of" June 30 to assess whether the receivables were being properly aged and, according to the audit programs, thereby to "[t]est the allowance for doubtful accounts." This testing compared a copy of each of those invoices to Koss's June 30 Aging Report, finding that each invoice appeared in the correct "aging bucket" ("Current," "Past Due" or "Over 30," "Over 60," or "Over 90" days) in the report. Exs. R-227 & Ex. R-426 at 4-6; Exs. J-16 at 5 & J-210 at 4; *see* Tr. 1362, 1367-69. The 2006 work paper actually lists 12 invoices, which total $143,369.59 out of an overall June 30, 2006 AR Aging Report balance of $8,715,737.82. Ex. R-227 at 1; Ex. J-32 at 1. The 10 invoices listed in the 2008 work paper total $118,503.12 out of an overall June 30, 2008 report balance of $11,703,608.79. Ex. R-426 at 4; Ex. J-221 at 3. The 2007 audit program refers to "attached" "AR Aging Testing" (Ex. J-110 at 5), but the work paper, cited in passing in a Koeppel expert report, is not among the admitted exhibits, nor was testimony elicited about the details of that work. *See* Ex. R-507 at 29 n.89, 64 n.286, 72 n.320, 117 (expert's citation, corresponding to proposed exhibit R-333 on Koeppel's pre-hearing list (R.D. 49 at 12), which absent from her Index to Exhibits Admitted at Hearing (R.D. 79)).

In the 2006 and 2007 audits, to test the remaining period activity in Koss's accounts receivable account, a so-called rollforward of its receivable balance from the interim date to the balance sheet date was performed, using subledger and trial balance reports from Koss's IT system. Exs. J-31, J-125 (2006, 2007 work papers for the procedure, both reviewed by Koeppel); *see* Tr. 887-89 (Koeppel); Tr. 567-68 (2007-2008 Staff Auditor). As Audit Manager explained in investigative testimony, "we're opining on the financial statements as a whole as of a balance sheet date and for the [fiscal] year ending," and, "because we are not testing internal controls...we needed to do some substantive assessment to roll forward this material balance." Ex. D-4 at 90-92. Another audit team member further explained that, conceptually, a rollforward procedure involves taking a beginning balance that was tested at the end of an interim period and adding to it transactions that affect that balance in the remaining period to arrive at an ending balance that is reconciled with the general ledger. Tr. 567-68. Koeppel admittedly was aware of and approved the performance of this planned procedure in 2006 and 2007. Tr. 887-89, 894, 912-14; *see* Exs. J-31 at 5 & J-125 at 10.

The 2006 rollforward took Koss's April 30 accounts receivable balance from a Koss trial balance report, added to it Koss's May and June sales and credit balances and subtracted from it Koss's May and June cash receipts and Koss's inventory still on consignment at a retailer at the end of June ("Office Depot Reclass"), with a further addition or subtraction from the receivable balance for May and June cash in transit, depending on whether, and by the amount, that account had fallen or risen over the course of the month, to arrive at a June 30 balance. That resulting balance was then compared with a Koss June 30 trial balance report.

The sales and cash receipts data for each of the two months in the 2006 rollforward came from an AR Distribution Register, a monthly Koss subledger report that "gives a grand total of all invoices and cash distributions" for the month (*see* Ex. J-125 at 3). Ex. J-31 at 1, 4. The receivable balance thus "rolled forward" to June 30 was then compared to the June 30 balance reflected on a Koss trial balance report. *Id.* at 1-2 (noting but passing without further audit work a $3,463.98 difference). The work paper concluded, "Per the testing of the AR rollforward, AR appears to be properly stated as of year-end." *Id.* at 2. *See* Tr. 889-92, 894-99 (Koeppel); Tr. 576, 580-84 (2007-2008 Staff Auditor); Ex. D-4 at 90-92 (Audit Manager's investigative testimony).

The 2007 rollforward procedure took Koss's April 30 accounts receivable balance from a Koss trial balance report called a Detailed Balance Sheet, added to it Koss's May and June sales and credit balances, and subtracted from it Koss's May and June cash receipts, cash in transit, and certain other items, to arrive at a June 30 balance. The sales and cash receipts data for each of the two months again came from a Koss AR Distribution Register. The computed June 30 receivable balance was then compared to the June 30 balance on a Koss trial balance report, resulting in the same stated audit conclusion as in 2006. Ex. J-125 at 1, 2, 9. *See* Tr. 912-18; Tr. 568-73.

Additionally, in the 2007 audit, the AR Distribution Register reports used in the accounts receivable rollforward were reconciled to another Koss subledger report, some of the entries on which reports were compared to source documents. The work paper stated that the two reports were needed "[b]ecause of restrictions imposed by Koss's accounting system," namely that "a detailed listing of all cash receipts and invoices could not be produced." Ex. J-125 at 3; *see* Tr. 921-22 (Koeppel); Tr. 573, 575 (2007-2008 Staff Auditor). Instead, the auditors believed, Koss could only provide a listing of sales for a one-day period and so printed out the invoice listing every day and collected the accumulated reports in a binder maintained by Senior Accountant. Tr. 577.

Specifically, "to further validate the year-end A/R balance," "GT haphazardly selected 10 dates from the months of May and June" and "selected 1 cash receipt and 1 invoice from each date." Ex. J-125 at 3, 6, 10 (work paper, initialed by Koeppel). According to the work paper, the details of the selected invoices and cash receipts were traced and agreed to Koss invoices and checks or wire transfer payments. Also, the "detail of each invoice was traced and agreed" to Koss's Invoice Summary Register, a subledger report printed out daily "which displays invoice detail by date and provides a total of all invoices for a specific day." Ex. J-125 at 3, 6, 9; Tr. 576-80. Then "[t]he total of all invoices, by date" and "[t]he detail of each cash receipt" were tied to the corresponding day's entry in the AR Distribution Register, which "gives a grand total of all invoices and cash distributions" for the month and "ties directly to the revenue rollforward." Ex. J-125 at 3, 9. *See* Tr. 919-24, 927, 932-35; Tr. 564-67, 573-75. According to Koeppel, that "we tied in various reports…gave us comfort that the system was operating effectively and that the reports were accurate." Tr. 1406.

In addition, the record shows that in the 2007 and 2008 audits, the post-field-work audit update procedures included a "[r]eview of significant cash receipts" from a Koss-provided report. In 2007, the work paper stated, "GT reviewed all cash receipts listing from 6/30/07 through 7/27/07 noting nothing unusual or unexpected. Further, GT notes no receipts over TE of $260,000, as such, no testing deemed necessary." Ex. J-151. In 2008, "GT reviewed the cash receipt listing from 6/30/08 through 7/16/08, noting one significant cash receipt of $349,810 that was recorded" in July 2008; then "GT reviewed a copy of the wire transfer confirmation" and "a copy of the invoice," dated and showing shipment in late May 2008; and "[b]ased on this testing, GT conclude[d] that the sale and cash receipt were recorded in the correct period." Ex. J-246.

The accounts receivable confirmation testing showed that there could be a delay by the accounting department in applying cash receipts to reduce accounts receivable. With regard to one item not confirmed, a 2007 audit work paper stated, "Per review of lockbox printout, GT notes payment was received into Koss's bank account on 4/26/07. GT inquired with [Senior Accountant] to investigate. Per [Senior Accountant], A/R wasn't reduced until Koss received notification from the bank that the payment was actually received (notified several days later <u>after</u> 4/30/07. To adjust A/R as of 4/30/07 month-end, [Senior Accountant] makes a manual journal entry to increase cash and reduce A/R (via entry to a Cash-in-transit Account which offsets A/R….As payment was adjusted for as of month-end, GT deems client treatment proper." Ex. J-123 at 2-6. Similarly, another payment "was received (via wire-transfer on 4/30/07). PDW [Senior Accountant], a manual journal entry was made to increase cash and reduce AR at 4/30/07 (via entry to Cash-in-transit account with offsets AR…)." *Id.* at 3, 6.

There is no documentation or testimony that in the 2006 and 2007 audits, the April 30 receivable balance that represented the population sampled in the confirmation testing (derived from the AR Aging Report and limited to invoices and debit memos) was reconciled to the overall April 30 account balance (reflected on that same report or a trial balance report and representing not only invoices and debit memos but also offsetting cash receipts and credits) that was used to begin the receivable rollforward. Tr. 886, 892, 912-14 (Koeppel); Ex. R-509 at 170-74 (Audit Manager's investigative testimony); *compare* Ex. J-30 at 1 ($9,290,117 for 2006 sampling) *with* Ex. J-31 at 1 ($7,803,330 for 2006 rollforward), and Ex. J-123 at 2 ($6,821,607 for 2007 sampling) *with* Ex. J-125 at 1 ($6,835,022 for 2007 rollforward). Nor, it is undisputed, were any of the Koss system-generated reports used in the receivable rollforwards reconciled to Koss's electronic general ledger. *See, e.g.,* Tr. 1329, 1456-62 (Koeppel); Tr. 569-70, 583-84, 590-91 (2007-2008 Staff Auditor). And in 2006, no audit procedures were applied to the AR Distribution Register to obtain evidence of its reliability. Tr. 898-99 (Koeppel); Ex. R-509 at 160-61 (Audit Manager's investigative testimony).

It is also undisputed that in the 2008 audit no accounts receivable rollforward was performed for the remaining period. Tr. 937-38, 1365; Tr. 446-47. The work papers do not show any such rollforward, and no witness testified one was performed. Nor do the work papers document any reason why the rollforward was not performed in 2008 or denominate any other procedures as substitutes for the rollforward.

3. Inventory account

In the 2006, 2007, and 2008 audits, the existence of Koss's inventory at the June 30 balance sheet date was tested principally by performing procedures as of the interim date of April 30, including inventory observation procedures and related test counts of inventory on hand, which were then supplemented by audit procedures meant to cover the remaining period from May 1 through June 30. *See, e.g.,* KOB 18; OIP 17 ¶ 60; Ans. 26 ¶ 60; Tr. 1087-89, 1387-90, 1395 (Koeppel); Tr. 368-73 (2006-2008 Staff/In-Charge Auditor); Tr. 447-50, 454-56, 525-28 (2007-2008 Staff/In-Charge Auditor); Tr. 670, 674 (2007-2008 Staff Auditor); Exs. J-54, J-153, J-250 (2006-2008 audit programs for Koss's inventory purchasing). Koeppel is not charged with any violation for the conduct of the interim period audit work on Koss's inventory.

The charges before us in the inventory area focus largely on a so-called "rollforward" of the inventory balance from the interim date to the balance sheet date, performed in each audit using reports generated by Koss's IT system. Exs. J-33, J-127, J-222; *see* Tr. 1090-92, 1097-99, 1105-06, 1396-97 (Koeppel); Tr. 452 (2007-2008 Staff/In-Charge Auditor); Tr. 588-605, 673, 718 (2007-2008 Staff Auditor). Koeppel specifically signed off on the inventory rollforward in the 2007 and 2008 audits. Tr. 1097, 1104; Exs. J-127 at 10, J-222 at 9. The inventory audit program for the 2006 Koss audit, which Koeppel reviewed, was similar to that followed in the later years. *See, e.g.*, Tr. 373 (2006-2008 Staff/In-Charge Auditor). A cover page to the Koss inventory audit program in 2006, 2007, and 2008 contained a half-dozen answers to questions that helped tailor the work program, one of which was "Yes" an inventory observation would "be made prior to year end." Exs. J-54 at 1, J-153 at 1, J-250 at 1; *see* Tr. 369 (2006-2008 Staff/In-Charge Auditor), 1176-77 (Koeppel). She testified she "definitely" was aware that Koss's inventory was tested in the 2006 audit, understood that procedures were performed in each of the three audits to cover Koss's remaining period inventory activity, and believed that "inherent in our methodology," as applied in the Koss audits, was that "doing a roll forward" was part of what "gave us comfort that the system was working appropriately" and that Koss IT system-generated reports were reliable. Tr. 1092, 1186-88. Koeppel specifically signed off on the 2006 rollforward in the accounts receivable area that closely resembled the approach of the 2006 inventory rollforward. *See, e.g.*, Tr. 887-89, 894-99, 919-20; *compare* Ex. J-31 *with* Ex. J-33.

The rollforward procedure added the April 30 balances from eight to eleven inventory subaccounts, as reflected in a Koss trial balance report, and, using several Koss subledger detail reports, either added or subtracted May transactions affecting the inventory account, such as purchases, cost of sales, inventory in transit, prepaid inventory, returns, scrap, and adjustments, to derive a month-end May balance. Koss's monthly Detail Inventory Accounting Listing was used as the source of remaining period data on the two single largest items in the rollforward—inventory purchases (added in the rollforward) and cost of sales (subtracted)—as well as several miscellaneous items. Two other Koss detail reports provided data on returns (added in the rollforward) and scrap from returns (subtracted). Exs. J-33, J-127, J-222.

The inventory account balance thus "rolled forward" from April 30 to May 31 was then compared to the sum of the May 31 balances of the same eight to eleven inventory subaccounts from a Koss trial balance report. The process was then repeated for the month of June, using the May 31 sum as the starting point and going through the same process for June as for May. The audit work papers noted differences between the rollforward balances and trial balances at the end of May and June: -$732 and -$2,222 in 2006; -$6,124 and +$7,228 in 2007; -$9,833 and -$1,238 in 2008, respectively. No explanation for the differences was obtained, however, because the amounts were below tolerable error for the audits. Exs. J-33 at 2, 5, J-127 at 2, 5, J-222 at 2, 5.

There is no audit documentation, or testimony, that in any of the three audits the April 30 balance reflected on the detail report generated by Koss's IT system that was used to select a sample of inventory for the interim date audit testing, called an Inventory Listing, was reconciled to the sum of April 30 trial balances that was used to commence the inventory rollforward. Tr. 455-56, 594, 673, 676, 718-22, 1094-96, 1102-04, 1112-14, 1392; *compare* Ex. J-56 at 4, Ex. R-196 at 1 ($8,946,732 for sampling) *with* Ex. 33 at 1 ($9,312,614 for rollforward), Ex. J-154 at 1 ($7,928,996 for sampling) *with* Ex. J-127 at 4 ($9,275,963 for rollforward), and Ex. J-251 ($6,791,865 for sampling) *with* Ex. J-222 at 1 ($8,179,922 for rollforward). Koeppel acknowledged at the hearing, "There's differences between the general ledger, which includes multiple account balances"—including inventory in transit and prepaid inventory—"and the report [used at interim to select inventory for test counts], which is going to be specific to inventory that is on location" at Koss for physical observation. Tr. 1192, 1396-97; *see* Tr. 673, 675 (2008 Staff Auditor). Further complicating the matter in 2008, as Koeppel knew from review of the 2008 inventory test count work paper, "the inventory population increased by $147,644 (from $6,791,865 to $6,939,509) from the unadjusted to the adjusted listing" "[d]ue to (1) count adjustments made during physical [count] and (2) updates to standard costs." Ex. R-433 at 1, 7 ("This change is less than the planning materiality of $220,000, as such GT will pass on further investigation.").

Based on the work step "Foot and extend the inventory listing and agree with the general ledger control" on the Koss inventory audit programs, accompanying notations, and evidence that Koss trial balance reports were used as "the general ledger control" in the audits, the Koss Inventory Listing was reconciled to Koss's general ledger only through a Koss trial balance report and only at the end of the fiscal year. *E.g.*, Ex. J-47 at 2. And even then, the auditors did not check that the total balance and each of the subtotals stated on the Inventory Listing was in fact the sum of all of the individual items on the entirety or respective subsection of the report. That is, the auditors did not "foot" the entire report. *See* Exs. J-54 at 5 ("GT tested a portion of the year-end physical inventory listing to see that it footed. The inventory listing was only in paper. C[l]erical accuracy was tested by footing one section. The section footed w/o/e."), J-153 at 5 ("As it is only available in paper form, GT tested a portion of the 06/30/2007 Physical Inventory Report to ensure subtotals properly footed. The accuracy of the report was validated by footing one section of the report, noting it footed w/o/e."), J-250 at 6 ("As the physical inventory report is only available in paper form, GT footed a selection of the report, noting it footed accurately."); *see also* Ex. R-196 at 2, 4-5 (2006 Substantive Sample Workpaper). Moreover, it is undisputed the auditors did not reconcile any Koss reports used in the inventory audit work directly to Koss's electronic general ledger. *See, e.g.*, Tr. 1329, 1456-62 (Koeppel); Tr. 569-70, 590-91 (2007-2008 Staff Auditor).

The charges also focus on analytical procedures performed in the 2007 and 2008 audits that compared the April and May month-end balances of the categories of data used in those year's inventory rollforwards with the balances at those month ends in the prior year. Exs. J-128, J-223; Tr. 1400. The procedure was specifically signed off on by Koeppel in the 2008 audit. Ex. J-223 at 7. In the analyses, explanations were sought from Koss's Vice President of Operations (VP-Operations) and deemed satisfactory for the overall increase or decrease in month-end May or June inventory compared to the year before, and for what the auditors viewed as one or two of the most significant variances by category of data (*e.g.*, prepaid inventory, purchases, finished inventory on hand, inventory in transit). Ex. J-128 at 2, 4; Ex. J-223 at 2, 4; Tr. 603-24, 675. Koeppel testified that she understood that VP-Operations, who was not part of Koss's accounting department, "had been in that role for many years" and "had very good hands-on knowledge of the activities and operations that related to inventory." Tr. 1388; *see* Ex. R-509 at 573-74 (Audit Manager claimed in investigation that VP-Operations was "all over her cost sales numbers and her inventory purchases and any variances left and right" and VP-Sales, "as it relates to monitoring sales in general, and looking at commissions, knew what he was selling"); Tr. 681-82 (2007-2008 Staff Auditor, who performed the 2008 rollforward analytical procedures, stated that on rare occasions during Koss audits he spoke to VP-Sales). The underlying data for these analytical procedures came from the same reports used in the rollforwards. *E.g.*, Tr. 606.[20/]

Among the audit work specific to the inventory area that Koeppel has cited in this litigation (*see* KOB 18, 30; KPHS 42-43; Tr. 1092, 1099-1100, 1107, 1110, 1399-1400) is a procedure, accompanying the inventory rollforwards in 2007 and 2008, "to further validate the year-end inventory balance" by testing certain shipments and receipts occurring between May 1 and June 30. Specifically, "GT haphazardly selected" 10 receipts and 10 shipments each in May and June from the respective Detail Inventory Accounting Listing and "traced the activity to supporting documentation," namely shipping orders, invoices, and more Koss IT system-generated reports (receiving reports and a cost of sales (scrap) report also used in the rollforward procedure). Exs. J-127 at 7-9, J-222 at 6-8. The work papers did not specify the dollar amounts of the 20 shipments; the 20 receipts totaled about $567,000 for 2007 and $573,000 for 2008, out of total May-June inventory purchases for those years, according to the Koss data used in the rollforwards, of $4.4 million and $4.2 million, respectively. Exs. J-127, J-222. For each of these further tests, the conclusion stated in the work papers was that inventory receipts and shipments were properly recorded or accounted for as of May and June. Exs. J-127 at 7, 8, J-222 at 6, 7.

A member of the Koss audit teams claimed this further testing "provides some support for the validity" of the Detail Inventory Accounting Listing, but conceded that the only support provided is that the report contains data from 20 transactions compared to it each year and that this testing "does not satisfy completeness." Tr. 595-96, 601-03, 606 (2007-2008 Staff Auditor). Another member agreed that procedures were not applied to the report to determine its completeness. Tr. 453 (2007-2008 Staff/In-Charge Auditor). Koeppel repeatedly described the approach of not doing so as "inherent in our methodology," as applied in the audits. Tr. 1092, 1100, 1107-11, 1390, 1394.[21/]

[20/] A separate trend analysis was also performed in each audit that compared the current and prior fiscal year-end inventory balances, as reflected on Koss trial balance reports, though it used a different June 30 inventory balance than did the rollforward procedures. *See* Exs. J-47, J-147 at 3-4 (reviewed by Koeppel), J-234 (same).

[21/] The same reports were used on a task that appeared on the inventory audit programs for the 2007 and 2008 Koss audits. That work step read, "Scan the entries in the general ledger inventory control account during the rollforward period for unusual activity," but a notation stated that "[p]er review" of the Detail Inventory Accounting Listings for May and June, "there were no unusual or significant items that require additional investigation" and "no unusual activity is noted." Exs. J-153 at 5, J-250 at 6.

Additionally, Koeppel points out audit work summarized in a work paper as "GT calculated certain key inventory-related ratios and compared the ratios to the prior year in order to identify significant trends and outcomes that differ from expectations" (Ex. J-252 (2008 audit); *see* Exs. J-57 & J-156 (2006, 2007 work papers); Exs. J-54 at 4, J-153 at 5, J-250 at 6 (2006-2008 inventory audit programs). This work, performed in each of the three audits, entailed listing balances for sales, cost of goods sold, inventory, and accounts payable as of June 30 of the current year, tied to Koss trial balance reports, alongside the balances for the prior year (or in the 2008 audit, the balances for the two prior years), making calculations of ratios for each year's gross profit, inventory turnover, days sales in inventory, and accounts payable turnover, and noting the differences between the ratios from the one year to the next. Audit inquiry was then made of VP of Operations and, in one instance in 2008, of Junior Accountant, about the differences between the last three ratios (the differences between the gross profit ratios each year were viewed as too small to warrant inquiry). No further follow-up was deemed necessary, according to the work papers.[22/]

Finally, Koeppel cites cut-off testing of inventory receipts. In each audit, this testing consisted of comparing information about the last three Koss inventory receipts before and after April 30 and June 30, drawn from "an inventory listing by invoice" generated by Koss's IT system, with receiving reports, invoices, and an inventory parts number report. Exs. J-55 (tracing inventory receipts of $4,500, $4,317.30, and $42,500 before and $7,540.85, $2,860, and $1,688.28 after April 30, 2006), J-121 (receipts of $54,740, $3,712.80, and $7,056 before and $27,216, $409.20, and $10,800 after April 30, 2007), J-155 (receipts of $14,664, $800, and $1,248 before and $24,300, $34,925, and $18,638 after June 30, 2007), J-217 (receipts of $1,697.28, $66.72, and $43,600 before and $2,580, $1,265, and $1,100 after April 30, 2007), J-218 (receipts of $2,486, $2,688, and $2,773 before and $1,460, $11,064, and $61,837 after June 30, 2008); Tr. 672, 678, 722-24, 1394-95. The conclusions from the testing were variously stated in the work papers as that inventory was "properly stated at" April 30 and June 30 (Ex. J-55 at 1, 2); that inventory had been "received and entered in the proper period" (Ex. J-155 at 1; Ex. J-218 at 1, 3); and that "inventory cutoff controls were in place and operating effectively" at April 30 (Ex. J-121 at 2, 4; Ex. J-217 at 1, 3).

Also, a notation on the 2006 inventory audit program stated, "GT reviewed the goods received during the last week of June and noted nothing unusual." Ex. J-54 at 3.

[22/] In each audit, the ratio analysis work paper did not explain why the current-year June 30 inventory balance used in the procedure ($12,023,106, $9,928,786, $9,374,344) differed from the respective June 30 balance used in the inventory rollforward ($9.6 million, $9.1 million, $8.7 million), or, as to 2006 and 2007, from the respective financial statement balance ($10,522,605, $9,923,544). *Compare* Exs. J-57 at 1, J-156 at 1, J-252 at 1 (Koeppel signed off) *with* Exs. J-33 at 5, J-127 at 2 (Koeppel signed off), J-222 at 5 (same) *with* Exs. J-59 at 27 & J-172 at 28 (Koss Forms 10-K).

V.

We turn to the disposition of the charges before us. The Division bears the burden of proving by a preponderance of the evidence that Koeppel engaged in an act or practice, or omitted to act, in violation of PCAOB rules and auditing standards, as charged in this case. PCAOB Rule 5204(a); *see* Sarbanes-Oxley Act Section 105(c)(4), 15 U.S.C. 7215(c)(4); PCAOB Rule 5300(a). Our findings are based on a *de novo* review of the record. PCAOB Rules 5460(c), 5465. We apply PCAOB rules and auditing standards as they existed at the time of the alleged violations.

A. Koeppel's Liability As Auditor With Final Responsibility For The Audits

As a threshold matter, we address Koeppel's contention that, even taking the Division's factual allegations as true, those allegations cannot support a finding that she, as the auditor with final responsibility for the audits, violated the specific PCAOB rules and auditing standards with which she is charged in the OIP. We reject her argument, and hold that the allegations, if proven, would support a finding that she violated the rules and standards charged.

The Division alleges that in each audit in question, Koeppel, the auditor with final responsibility for the audit, knew facts about the procedures performed and evidence obtained that would give rise to violations of PCAOB Rules 3100 and 3200T and various PCAOB auditing standards, as summarized in Section III above. The Division alleges, as a factual matter, that Koeppel did not direct audit assistants to take corrective action. And it alleges that she omitted to perform herself the additional audit work necessary to provide sufficient competent evidential matter to obtain reasonable assurance about whether the financial statements were free of material misstatement and thus support the unqualified audit opinion she developed and authorized to be issued.

Specifically, it is undisputed that Koeppel was the auditor with final responsibility for the audits of Koss's financial statements for the fiscal years ending June 30, 2006, 2007, and 2008, and that she authorized the issuance of Grant Thornton's unqualified audit opinions on those financial statements. The Division alleges that, in all respects relevant to this case, through work paper review or otherwise, Koeppel "was aware of the nature and extent of the procedures performed and evidence obtained in each of the charged audit areas" when she formed that year's audit opinion. *E.g.*, DOB 1, 2 n.3, 4, 6; DRB 3, 4; DPet. 9; OIP ¶¶ 5, 20, 27 & n.2, 30, 34, 39, 40, 43, 45, 47, 49, 53, 59, 60, 61, 68, 74, 75, 79. Yet, the Division further alleges, she "failed to obtain the evidential matter or reasonable assurance required under the standards" to support the opinion (*see* AU §§ 110, 326). *E.g.*, DOB 2-3, 4, 7; DPet. 3; OIP ¶¶ 81(b)-(c). And, it alleges, certain presumptively mandatory responsibilities, which PCAOB standards state "should" have been carried out in the audit, were not, nor is there evidence that their objectives were still achieved through alternative actions (*see* PCAOB Rule 3101(a)(2)).

Those responsibilities consisted of: (1) selecting from Koss's general ledger journal entries to be tested (*see* AU § 316.61); (2) obtaining evidence and performing procedures concerning the accuracy and completeness of data generated by Koss's information system where internal controls were not tested (*see* AU §§ 319.65, 329.16); (3) developing expectations for analytical procedures used as substantive tests that were precise enough to provide the desired level of assurance that differences between the expectations and recorded amounts that might be potential material misstatements would be identified for investigation (*see* AU § 329.17) and documenting the evaluation of significant unexpected differences (*see* AU § 329.22); and (4) applying substantive tests to provide a reasonable basis for extending to the balance sheet date the audit conclusions relative to certain assertions tested at the interim date (*see* AU § 313.08). *E.g.*, DOB 4, 6-7; OIP ¶¶ 29, 43, 50, 57, 71-72, 78-79, 81(d)-(h).

The Division concludes that Koeppel, knowing the pertinent state of the audit work at the time, "is liable because she formed an audit opinion without performing presumptively mandatory procedures" and "failed to obtain the required evidence or assurance," having not assigned anyone else to perform additional procedures or obtain additional evidence and assurance. *E.g.*, DOB 2-3, 4, 6, 34; DRB 3, 13; DPet. 9-10; DPHS 88-89; *see, e.g.,* OIP ¶¶ 5, 7-8, 27-29, 41-43, 47-50, 52, 54, 57, 69, 71-72, 77-79. In particular, the Division asserts that, due to these alleged acts and omissions, Koeppel failed to obtain reasonable assurance and sufficient competent evidential matter, as required by AU §§ 110, 150, and 326; failed to comply with AU §§ 313, 316, and 329; and failed to exercise due professional care, including professional skepticism, as required by AU §§ 150 and 230. *E.g.*, DOB 2-3, 7, 28-30, 34; DPet. 7-9; OIP ¶¶ 80-81.

Koeppel, relying heavily on the initial decision, urges us to hold, as the hearing officer did, that the Division "failed to establish a cognizable basis for imposing disciplinary sanctions on Koeppel" (I.D. 83, 85). KOB 1. Essentially, Koeppel argues that the Division "expressly disclaimed" reliance on PCAOB standards that "address[ed] her conduct in the roles she actually performed" (I.D. 79-83) and instead asserted grounds of liability that were inapplicable or invalid. KOB 2, 3-4, 21, 31-35.

According to Koeppel, the functions she performed as the auditor with final responsibility for the audits in question included planning and delegating the audit work, "review[ing] selected workpapers in critical audit areas," and "determin[ing] in her judgment that appropriate work had been performed to support the issuance of the audit opinion[s]," but not otherwise personally performing the field work. KOB 12, 20, 31-32; *see* I.D. 76; Tr. 747, 1193. Koeppel concurs with the initial decision's assessment that she "assigned responsibility for performing the audit procedures, including obtaining evidential matter, to the other members of the engagement teams" (I.D. 82). KOB 21, 32-33. Although Koeppel surely shaped the overall field work through her involvement in planning and supervising the audits (*see, e.g.*, Tr. 180-81, 184-85, 276, 376-78, 686, 1237-38, 1242, 1244, 1267), the Division acknowledges that "[a]s is typical in larger firm audits, team members (other than Koeppel) performed tests of details and analytical procedures, collected audit evidence, and drafted and reviewed work papers documenting this work." DOB 7; *see* DOB 1, 27-28, 29; DRB 1, 2-3.

Koeppel, like the initial decision, submits that audit planning and supervision are obligations that PCAOB auditing standards "distinct[ly]" (I.D. 77) impose on the auditor with final responsibility for the audit (KOB 6, 35; *see* I.D. 77, citing AU §§ 150.02, 230.06, and 311), and states that these standards "clearly permit [that auditor] to delegate the performance of audit procedures" (KOB 7; *see* I.D. 76, citing AU § 311.02). In this regard, Koeppel argues that the other field work standards refer generally to "the auditor" (*e.g.*, AU § 326.25) and so do not "assign specific responsibilities" to perform audit procedures to the auditor with final responsibility for the audit. KOB 5-6, 7, citing PCAOB Standing Advisory Group Meeting, Panel Discussion – Engagement Team Performance, at 1 (June 21, 2007) (Board interim auditing standards "do not provide direction as to which members of the engagement team have the responsibility to perform the auditing procedures"). Yet in this case the Division "elected not to rely on th[e] standards" governing planning, delegation, or supervision (I.D. 78, 80, 81), as the Division has acknowledged (DRB 4 n.13; DPHR 4; Tr. 2358-59). KOB 2, 12, 33, 34, 35.

Drawing these threads of argument together, Koeppel takes the position that the charges in this case, including failure to exercise due care, are "based on Koeppel's performance of her responsibilities in reviewing workpapers prepared by others," which is a "supervisory responsibility under AU § 311," and therefore, unlike here, the charges could only be validly asserted as or with an AU § 311 charge or, if not so stated, would at least have to be "place[d]" implicitly "within the context of the engagement partner's responsibilities to plan and supervise the audit." KOB 12, 32-33, 34-35; *see* I.D. 79 n.29, 81-82. To hold otherwise, she claims, would "erase" or "obfuscate" the "difference between performing audit procedures and supervising the performance of those procedures" and ignore "the professional judgments exercised by the engagement partner in performing her supervisory responsibilities under AU 311." KOB 7-8, 32-33.

Additionally, Koeppel argues that, to the extent the Division advocates what the initial decision called "a broad standard requiring an engagement partner to 'ensure' that all members of the engagement team comply with PCAOB auditing standards during an audit" (I.D. 79-80), there is no valid basis for such a theory of violation. According to Koeppel, it would constitute strict or vicarious liability, "[i]mputing conduct by individual engagement team members to the engagement partner" "without consideration of the facts and circumstances of the engagement partner's conduct"; would "effectively eliminate th[e] element of professional judgment" exercised by the engagement partner; would "eviscerate the protections afforded to supervisory personnel by section 105(c)(6) of the Sarbanes-Oxley Act," 15 U.S.C. 7215(c)(6); and would be untenable under existing authority. KOB 3, 7-9, 31-32, 33-34; *see* I.D. 10-11, 78-83, 84-85.

After careful consideration of the parties' arguments and applicable authority, we conclude that the Division has set forth a cognizable basis for finding violations and imposing sanctions against Koeppel. The charges before us against Koeppel are validly grounded in application of basic principles to the case as alleged by the Division.

The Board may sanction a registered public accounting firm or an associated person of the firm if the Board finds, based on all of the facts and circumstances, that the firm or individual "has engaged in any act or practice," or "omitted to act," in violation of certain statutes, rules, and standards, including the rules of the Board and professional standards. Sarbanes-Oxley Act Section 105(c)(4), 15 U.S.C. 7215(c)(4). PCAOB Rule 3100 states that the firm and its associated persons shall comply with all applicable auditing and related professional practice standards. PCAOB Rule 3200T specifies the auditing standards with which such firm and persons shall comply in connection with the preparation or issuance of any issuer audit report (*see* Rule 1001(a)(vi)). Accordingly, such firm and persons must comply with PCAOB auditing standards in the planning, conduct, and reporting of the results of an audit of issuer financial statements. *See, e.g.,* AU §§ 110.01, 150.01, 230.02.

PCAOB auditing standards use the term "auditor" to refer to the audit firm and its associated persons, unless the context otherwise requires. *See, e.g.,* PCAOB Rule 1001(a)(xii) (when used in PCAOB rules, unless the context otherwise requires, "The term 'auditor' means both public accounting firms registered with the Public Company Accounting Oversight Board and associated persons thereof."); Rule 3101 (addressing certain terminology used to describe the degree of responsibility, such as presumptively mandatory responsibility, imposed on "auditors" by the Board's auditing and related professional practice standards, including the interim standards adopted in Rule 3200T); AU § 201.01 ("[t]he general standards are personal in nature"); AU § 230.02 ("each professional within an independent auditor's organization" is responsible for observing the standards of field work and reporting); AU § 210.03 (individual audit firm personnel "must meet the responsibilities attaching to the varying gradations and functions of their work"). Under the standards, the auditor is responsible for planning and performing the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. AU § 110.02. In conducting the audit, the auditor is required to exercise due professional care, including professional skepticism. AU §§ 150.02, 230. Due professional care "imposes a responsibility upon each professional within an independent auditor's organization to observe the standards of field work and reporting." AU § 230.02. The third standard of field work requires the auditor to obtain sufficient competent evidential matter concerning the assertions in the financial statements under audit to afford a reasonable basis for any opinion the auditor develops regarding the financial statements. *E.g.*, AU §§ 150.02, 230.11, 326.22, 326.25. Most of the auditor's work in forming an opinion consists of obtaining and evaluating evidential matter concerning those assertions. AU § 326.02. Auditing procedures are acts the auditor performs during the course of the audit to comply with auditing standards. AU § 150.01.

A firm has an obligation, in connection with work on a particular audit, to assign to the audit an engagement partner with sufficient knowledge of the relevant professional standards and of the client. AU § 230.06. This individual, the auditor with final responsibility for the audit, personally performs the audit work necessary to support any audit opinion that would be issued or assigns a portion of the work to other firm personnel, subject to PCAOB auditing standards, and performs the rest. *See, e.g.*, AU §§ 150.02 ("The work is to be adequately planned and assistants, if any, are to be properly supervised.") (emphasis added), 230.06 ("The auditor with final responsibility is responsible for the assignment of tasks to, and supervision of, assistants."), 311.02 ("The auditor with final responsibility for the audit may delegate portions of the planning and supervision of the audit to other firm personnel."; all firm personnel other than that auditor are referred to as assistants, for purposes of AU § 311, *Planning and Supervision*) (emphasis added); *Gregory M. Dearlove, CPA*, SEC Rel. No. 2779, 2008 WL 281105 (Jan. 31, 2008), *10 (engagement partner "did not pursue, or direct his team to pursue," the "reason behind the dramatic reduction in [the audit client's] net receivable balance"), *16 (he "did not confirm, nor ask his team to confirm, that the assets were actually available for application against the co-borrowed debt as well as unencumbered"), *27 (he "had a duty to inquire in more detail about the direct placements, or to direct his staff to do so"). Where the auditor with final responsibility for the audit fails to do either one, he or she may be charged with violating various PCAOB auditing standards, such as those governing planning, delegation, supervision, and/or performance of audit work. *See, e.g., Dearlove*, 2008 WL 281105, *4, *10 & n.41 (as to one audit area, finding that engagement partner violated AU §§ 230.07-.08, 312.17, 316.27, 326.22 & 334.09, as well as supervision standard AU §§ 311.01, 311.11), *17 & nn.60-61 (as to a separate audit area, finding that he violated AU §§ 230.01, 230.07-.08, 312.17, 333.02 & 334.09, not including supervision standard).

This rule of decision, repeatedly invoked by the Commission in *Dearlove*, is firmly grounded in PCAOB auditing standards, which vest the engagement partner with responsibility for the use of audit assistants and with a continuing responsibility as the auditor with "final responsibility" for the audit. It is a ground for decision of this case, as alleged, that encompasses not only the assignment of audit procedures, but alternatively their performance, by the auditor with final responsibility for the audit. Thus, as pertinent here, that auditor must act with due care to see that the audit team—of which he or she is a "key member[]" (*see, e.g.*, AU § 316.14, .17)—performs all of the audit procedures that are required under the circumstances by PCAOB auditing standards, obtains reasonable assurance that the financial statements under audit are free of material misstatement, and obtains sufficient competent evidential matter to afford a reasonable basis for the audit opinion.

Koeppel's reductionist, binary approach, in which an engagement partner either performs detailed audit procedures in the first instance or has nothing but a supervisory role to play in the audit, ignores that "auditing in fact involves a continuous process of gathering, updating, and analyzing information throughout the audit" (AU § 316.03) and that the partner has the capacity and responsibility to act in multiple roles, if necessary. Inert passivity in the face of known facts constituting shortcomings in the audit does not insulate the partner from liability, simply because that inaction might be viewed, but is not charged, as deficient supervision. It need not be. As the auditor with final responsibility, it was Koeppel's responsibility to follow up on such matters either by directing her assistants to address them or by doing so herself. As the Division argues, "the allegations in the OIP that Koeppel failed to obtain the required evidence or assurance herself or ensure that procedures were performed to obtain such evidence" are consistent with the Commission's holding in *Dearlove* that the engagement partner in that case "directly violated various [auditing] standards when he had failed to perform necessary audit procedures himself or ask his team to perform the procedures to obtain the required audit evidence." DPet. 9-10; *see, e.g.*, DOB 30-31, DPHS 88-89.

The initial decision was thus incorrect in narrowly describing the "SEC decision" as "rest[ing] on the supervisory responsibilities of an engagement partner" (I.D. 79). That description ignores the larger principle that omitting to act in the face of known facts requiring action before forming an audit opinion and authorizing the issuance of an audit report subjects the auditor with final responsibility for the audit to direct liability for auditing standards violations. If, as alleged here, that auditor did not respond to those facts by assignment and supervision of further audit work to address the deficiencies, then she was responsible for herself performing the additional audit work necessary to support the opinion. It makes no difference that, in the first instance, she had "assigned responsibility for performing the audit procedures, including obtaining evidential matter, to the other members of the engagement team[]" (I.D. 82). As the Division correctly points out, "Adequate audit planning and supervision of assistants is a means to the objective of obtaining sufficient competent evidence on which to base an audit opinion. It does not replace that objective, and is not the exclusive standard that must be followed by engagement partners in conducting public company audits, regardless of whether they delegate work to assistants." DRB 3-4. Another means is for the engagement partner to perform necessary additional audit work himself or herself. By whatever means, that auditor needs to take action to address the deficiencies.

Koeppel's suggestion (*e.g.*, KOB 32-33) that the text of AU § 311, which makes particular reference to the auditor with final responsibility, essentially exhausts the obligations of that auditor, at least one who has at one time acted as a supervisor in the audit, lacks support in AU § 311 itself. Paragraphs 11, 12, 13, and 14 refer to "directing the efforts of assistants"; "direct[ing]" assistants to "bring [significant accounting and auditing questions raised during the audit] to [the] attention" of the auditor with final responsibility and "assess[ing] [the] significance" of those questions; "reviewing the work performed" by each assistant "to determine whether the results are consistent with the conclusions to be presented in the auditor's report"; "determining whether [the audit] objectives were accomplished"; and "dealing with differences of opinion among firm personnel" with a view toward "resolution of the matter." But AU § 311 does not specify what the supervisor is supposed to do if, after undertaking these tasks, the objectives are not accomplished and the results would not be consistent with the report. Other standards bear on those matters. *E.g.*, AU §§ 312.02 n.3, .38, 326.25. Similarly, AU § 311.11 refers to "the objectives of the audit," but it does not specify those objectives. Other standards describe audit objectives. *E.g.,* AU §§ 110.01, 230.11, 326.09-.13, .22, & .25. And AU § 311.13 refers to "the conclusions to be presented in the auditor's report" without specifying how those conclusions are formed or developed.[23/]

In passages of the initial decision cited and quoted by Koeppel (KOB 2), the hearing officer stated that the Division had "made no effort to prove that Koeppel, herself, performed any audit work that violated PCAOB auditing standards, but rather focused on the work of the other engagement team[] members, noting, where applicable, evidence of Koeppel's general awareness of that work in her supervisory role," and stated that "I have never presided over, or reviewed, a case in which prosecuting counsel offered so little evidence regarding the conduct of a respondent." I.D. 78, 79. These statements reflect no recognition that actionable conduct can consist of "omit[ting] to act" in the face of facts requiring action. *See* 15 U.S.C. 7215(c)(4). Nor do they recognize the role played in this case by the evidence of the audit planning and work paper reviews. The Division used that evidence to try to establish the factual context in which its theory of violation operates by showing Koeppel's knowledge of the state of the audit work. Indeed, at one point, the initial decision acknowledged that Koeppel "has never denied having overall responsibility for the Relevant Audits," noted that the Division identified "many" "relevant work papers that she had reviewed," and cited examples of key facts underlying the charges that "she admits that she was aware of." *E.g.,* I.D. 79 n.29, 83, 84. Koeppel herself noted that she "testified over the course of three days about the work she performed." KPHS 5. But in the end the initial decision instead viewed the planning work and the work paper reviews as the theory of violation itself, consisting of an uncharged planning or supervision theory, because planning and review are "responsibilities under [AU § 311]," and thereby mistakenly treated that evidence as if it could only be relevant to charges not made here. I.D. 79.

Similarly, it reflects neither a proper description of the charges against Koeppel nor a proper effort at analysis of the particular facts of the case to suggest, as Koeppel does (KOB 12, 21), that the case cannot proceed without a general rule provided by an expert witness about how an engagement partner is supposed to supervise an audit. The case does not depend upon whether the Division and its expert "address[ed] the

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[23/] The PCAOB staff paper cited by Koeppel's brief (PCAOB Standing Advisory Group Meeting, Panel Discussion – Engagement Team Performance (June 21, 2007)) is of no assistance to her argument. Rather than stating that PCAOB auditing standards phrased in terms of "the auditor" cannot specifically apply to the auditor with final responsibility, as she implies (KOB 6), the paper states (p. 6) that "the auditing standards generally direct the auditor, who can be either the audit partner [*i.e.*, the auditor with final responsibility for the audit] or another member of the engagement team, to perform a specific audit procedure."

level of oversight" in reviewing others' audit work that "Koeppel was required to exercise in her role as the engagement partner" or "the extent to which an engagement partner, exercising due professional care" in a supervisory review, "should have identified" certain alleged facts about the work (I.D. 83, 84, cited by Koeppel)—facts that in at least some instances she admits to having known and that in the others might be apparent or reasonably inferred from the record. Likewise missing the mark is her argument that the charges here "effectively eliminate the engagement partner's ability to delegate portions of the supervision of the audit." *See* KOB 4, 8, 20-21, 32. The Division asserts a theory of violation based on Koeppel's fundamental, non-delegable responsibility as the auditor with final responsibility for the audits and her awareness of certain facts about the audit work. This is not a supervision theory, and if, as the Division contends, it has proven that Koeppel knew those facts, then the Division makes a compelling logical argument that whether she learned them "through a 'first-level review,' a 'second-level review,' or some other method is irrelevant" (DRB 4). If the Division did not prove that she was aware of those facts, then that is a failure of proof, not the lack of a cognizable theory.

For those and other reasons, there is no merit to Koeppel's additional contention that the Division's position would "eviscerate the protections afforded to supervisory personnel" under Sarbanes-Oxley Act Section 105(c)(6). Again, the Division is not asserting a supervision theory. As the Division correctly argues, Section 105(c)(6) "creates a new ground of liability" and "does not purport to limit liability under long-established auditing standards charged here, such as AU §§ 230 and 326," or purport to limit the Board's broad authority provided in Section 105(c)(4) to impose sanctions for all violations of PCAOB rules or standards. DRB 3-4 n. 13; *see* PCAOB Rel. No. 2010-005 at 1-10 (Aug. 5, 2010). In any event, Koeppel has not asserted an affirmative defense under Section 105(c)(6)(B), and the theory the Division advances is inherently incompatible with satisfaction of the statutory conditions for that affirmative defense.

Finally, contrary to Koeppel's claims (KOB 8-9 & n.5, 31, 32, 33), this case is not about strict or vicarious liability, under which sanctions could be imposed on her for an act, practice, or omission of someone else, irrespective of the circumstances of her own conduct. As she notes, the initial decision construed the Division's citation of certain language in the OIP and in SEC and PCAOB settled orders as taking the positions that an engagement partner is "required to either perform the audit work herself or 'ensure' that the engagement teams' work conformed to PCAOB auditing standards" and that the "ensure" phrasing means "imposing disciplinary sanctions on a respondent based on the imputed conduct of others" (I.D. 78-80, 87). KOB 31-32. But the Division has repeatedly stated that the charges against Koeppel are based on her own conduct. *See, e.g.*, DOB 2, 4; DRB 3; DPet 3; DPHS 1-4; DPHR 3, 27 n.40, 51-57. Thus, we read the Division's citations to the "ensure" part of the quoted formulation as simply referring to the uncontested fact that Koeppel made no effort to address the allegedly evident facts giving rise to the violations through assignment and supervision of additional audit work. Nor did she personally perform the additional work required to support the audit opinion. The overall point is that she took no corrective action of any kind in response to the facts about the audit work the Division alleges were known to her. We hold that her role as the auditor with final responsibility for the audits does not have the effect of insulating her from a finding that she violated the specific rules and standards charged in the OIP if the evidence establishes the facts alleged in the OIP.

B. Analysis of the Evidence of Koeppel's Alleged Violations

The ultimate matter for decision, then, is whether the Division proved by a preponderance of the evidence that in the 2006, 2007, and 2008 Koss audits, Koeppel, the auditor with final responsibility for the audits, violated PCAOB auditing standards, as charged, by omitting to perform audit work necessary to comply with those standards. There is no dispute that in each of those audits Koeppel ultimately accepted the work performed and results obtained in the charged audit areas as adequately performed and sufficient to support the unqualified opinions she developed and authorized to be issued. We address below whether, in fact, those procedures were adequately performed and those results were sufficient, and, if not, whether the facts known to Koeppel at the time put her on notice of that. We do so against the backdrop of applicable PCAOB auditing standards and certain decisions Koeppel made or approved in leading the audits that affected the performance and results of the work.

The standards require that audits be planned and conducted to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. AU § 110.02; *see* Tr. 772, 850 (Koeppel); Exs. J-65 at 1, J-173 at 2, J-276 at 1. Under the standards, the auditor obtains an understanding of the entity's internal control and uses that understanding and consideration of audit risk and materiality in determining the nature, timing, and extent of the audit procedures. *E.g.*, AU §§ 312.01, .12, 319.05.

Specifically, the auditor is required to obtain an understanding of the entity's internal control sufficient to plan the audit, which includes determining whether controls that are likely to prevent or detect material misstatements in financial statement assertions have been placed in operation. *E.g.*, AU §§ 319.01 (citing AU § 150.02 (second standard of field work)), .02, .14, .27, 316.44-.45, .60. In the process, the auditor should obtain knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics, and should consider the methods it uses to process accounting information and prepare financial statements, such as its IT system, and how they may affect relevant controls. *E.g.*, AU §§ 319.02, .25, .27, .29, .30, .43-.47, .51, .58, 316.43, .44, .58 & n.23, .60, 311.06, .07, .09. The objective of those procedures is to provide knowledge necessary for audit planning. AU § 319.84. The auditor uses such information to, for example, identify types of potential misstatement, consider factors that affect the risk of material misstatement, and design substantive tests. *E.g.*, AU §§ 150.02 ("A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed."), 319.01, .02, .05, .25, .29, .71, .106, 316.43, .47, 312.16, 311.05.

The auditor is also required to consider audit risk and materiality in determining the nature, timing, and extent of audit procedures. AU §§ 312.01, .12. Audit risk is the risk that the auditor may unknowingly fail to appropriately modify the opinion on financial statements that are materially misstated. *E.g.*, AU §§ 312.02, .27, 319.63, 319.105.

Under PCAOB standards, the auditor, in planning the audit, should consider the three general components of audit risk and make an assessment of the risk of material misstatement due to error or fraud. *E.g.*, AU §§ 312.02, .16, .27, 319.63, 319.105. Those components are (1) inherent risk—the susceptibility of an assertion to a material misstatement, assuming there are no related internal controls; (2) control risk—the risk that a material misstatement that could occur in an assertion would not be prevented or detected on a timely basis by the entity's internal control; and (3) detection risk—the risk that the auditor will not detect a material misstatement that exists in an assertion. *E.g.*, AU §§ 312.27, 319.63; *see* Tr. 850, 857-58, 1241, 1503. The auditor uses the assessed level of control risk (together with the assessed level of inherent risk) to determine the acceptable level of detection risk for financial statement assertions. AU § 319.81. As the auditor's assessment of inherent risk and control risk decreases, the detection risk that can be accepted increases. *Id.*; *see* AU §§ 319.106, 312.28 ("Detection risk should bear an inverse relationship to inherent risk and control risk. The less the inherent and control risk the auditor believes exists, the greater the detection risk that can be accepted. Conversely, the greater the inherent and control risk the auditor believes exists, the less the detection risk that can be accepted."). The acceptable detection risk in the design of audit procedures "is based on the level to which [the auditor] seeks to restrict audit risk related to the account balance or class of transactions and on the assessment of inherent and control risks." AU § 312.32.

PCAOB standards require a specific assessment of the risk of material misstatement due to fraud. *E.g.,* AU §§ 312.16, 316; *see* Tr. 1264-65. In addition to overall responses to that risk and responses to address specifically identified fraud risks, the auditor should examine journal entries and other adjustments for evidence of possible material misstatement due to fraud to further address the risk that management might manipulate accounting records and prepare fraudulent financial statements by overriding internal controls. The additional procedures include selecting from the general ledger journal entries to be tested and examining support for those items. *E.g.*, AU §§ 316.42, .48, .51, .58, .61; *see* Exs. J-3 at 1, 3, 4, J-100 at 3, 4, 6, J-200 at 3, 4, 7; Tr. 773-79 (Koeppel); Tr. 707, 709 (2007-2008 Staff Auditor). AU § 316's repeated references to "the general ledger" in describing the required journal entry testing reflect that having a complete set of the entries is a prerequisite to the testing. *See* AU §§ 316.58 ("the auditor should design procedures to test the appropriateness of journal entries recorded in the general ledger"), .61 ("the auditor's procedures should include selecting from the general ledger journal entries to be tested"). As the initial decision noted, "Koeppel herself acknowledged that to achieve the objectives" of AU §

316.61, even if through an alternative to direct access to Koss's general ledger, "it was necessary to select journal entries from a complete population." I.D. 36 (citing Tr. 776).

Under AU § 312.13, "The auditor should plan the audit so that audit risk will be limited to a low level that is, in his or her professional judgment, appropriate for expressing an opinion on the financial statements." *Accord, e.g.*, AU §§ 312.19 ("In planning the audit, the auditor should use his or her judgment as to the appropriately low level of audit risk and his or her preliminary judgment about materiality levels in a manner that can be expected to provide, within the inherent limitations of the auditing process, sufficient evidential matter to obtain reasonable assurance about whether the financial statements are free of material misstatement."), .26 ("The auditor should seek to restrict audit risk at the individual balance or class level in such a way that will enable him or her, at the completion of the audit, to express an opinion on the financial statements taken as a whole at an appropriately low level of audit risk."), 319.15.

The auditor uses the acceptable level of detection risk to determine the nature, timing, and extent of the audit procedures to be applied to the account balance or class of transactions to detect material misstatements in the financial statement assertions. AU § 319.81; *see* AU § 319.82 ("As the acceptable level of detection risk decreases, the assurance provided from substantive tests should increase."). After considering the level to which he or she seeks to restrict the risk of material misstatement and the assessed level of inherent risk and control risk, the auditor performs substantive tests to restrict detection risk to an acceptable level. AU § 319.106. "Higher risk may cause the auditor to expand the extent of procedures applied, apply procedures closer to or as of year end, particularly in critical audit areas, or modify the nature of procedures to obtain more persuasive evidence." AU § 312.17. The evidential matter provided by the combination of the assessment of inherent risk and control risk and on substantive tests should provide a reasonable basis for the opinion regarding the financial statements under audit. AU §§ 326.13, 319.105.

Under PCAOB standards, "regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements." AU §§ 319.02 & .107; *accord, e.g.*, AU §§ 316.51 ("because management may have the ability to override controls that otherwise appear to be operating effectively" it is "unlikely that audit risk can be reduced to an appropriately low level by performing only tests of controls"), 312.32 ("not appropriate," where material misstatements could exist, "to rely completely on assessments of inherent risk and control risk to the exclusion of performing substantive tests of accounts balances and classes of transactions"); *see* Tr. 861, 1021.

In the Koss audits, Koeppel considered the occurrence and net valuation of revenue and the existence of inventory to be what she described as "critical financial statement assertions." In particular, she recognized that Koss's revenue-related accounts of net sales, special sales allowances, and accounts receivable and Koss's inventory account were all material components of its financial statements and that the respective reported amounts embodied relevant financial statement assertions related to significant accounts. *See* pp. 8, 11-12; Tr. 1021; KOB 44; *see generally, e.g.,* AU §§ 319.02, .107, 326.13, .25. To Koeppel, this meant there was a reasonable possibility of material misstatement with respect to those "critical areas" and that the audits would devote "additional attention" to and "focus heavily" on them. *See* pp. 10-11 above.

With respect to the components of audit risk, Koeppel concluded in each of the Koss audits that the overall inherent risk of misstatement for those assertions was low. Koeppel chose not to test the operating effectiveness for the audit period of Koss's internal controls over those assertions or over Koss's IT system. Consequently, she assessed control risk at the maximum level and did not rely on internal control testing to reduce the substantive audit procedures required in those areas. *See* pp. 12-14, 18, 19 above. That level of control risk represented "the greatest probability that a material misstatement that could occur in a financial statement assertion will not be prevented or detected on a timely basis by [the] entity's internal control." AU § 319.03 n.3. As summarized in Koss audit planning sessions led by her, assessment of control risk at that level "will impact necessary substantive testing to be performed through larger sample sizes or additional testing in critical areas including revenue recognition and inventory reporting." Exs. J-3 at 4 (2006), J-100 at 4 (2007).

For the substantive audit testing, a "combined medium risk" strategy developed by Grant Thornton corresponded to these risk assessments and was purportedly applied by Koeppel in the Koss audits. Ex. R-483 at 7-8; *see, e.g.,* Tr. 1438-40 (Koeppel); Ex. D-4 at 76 (Audit Manager's investigative testimony: "You've got a combination here, control risk is high, inherent is low. The combination thereof is somewhere in between."). That strategy "emphasizes analytical procedures on income statement accounts," such as net sales, and "tests of details for balance sheet accounts," such as accounts receivable and inventory. *See, e.g.*, Ex. J-60 at 20, 21.

Analytical procedures "are an important part of the audit process." AU § 329.02. A "basic premise" underlying their application is that plausible relationships among data "may reasonably be expected to exist and continue in the absence of known conditions to the contrary." *Id.* The auditor obtains assurance from analytical procedures "based upon the consistency of the recorded amounts with expectations developed from data derived from other sources." AU § 329.16. Among the factors on which the expected effectiveness and efficiency of the procedure in identifying potential misstatements depend, PCAOB auditing standards specify "the availability and reliability of the data used to develop the expectation" and "the precision of the expectation." AU § 329.11; *see* AU §§ 329.16 ("The reliability of the data used to develop the expectations should be appropriate for the desired level of assurance from the analytical procedure."), .17 ("[t]he expectation should be precise enough to provide the desired level of assurance that differences that may be potential material misstatements, individually or when aagregated with other misstatements, would be identified for the auditor to investigate"),

.19 ("Expectations developed at a detailed level generally have a greater chance of detecting misstatement of a given amount than do broad comparisons.").

In addition, Koeppel adopted an approach in the Koss audits of applying principal substantive tests to the details of Koss's accounts receivable and inventory accounts as of an interim date rather than as of the balance sheet date. Where interim date audit testing is employed, substantive tests "should be designed to cover the remaining period in such a way that the assurance from those tests and the substantive tests applied to the details of the balance as of [the] interim date, and any audit assurance provided from the assessed level of control risk, achieve the audit objectives at the balance-sheet date." AU § 313.08. As pertinent here, considerations related to designing the substantive tests to cover the remaining period "in a way that will provide a reasonable basis for extending to the balance-sheet date the audit conclusions from the tests of details at the interim date" include the "potential incremental risk" of material misstatement that may arise from testing an asset or liability account, like accounts receivable and inventory, principally at an interim date; the impact of an assessment of control risk at the maximum on the effectiveness of the remaining period tests; and the capability of the entity's accounting system to provide sufficient information for use in those tests. *See* AU §§ 313.03, .05, .07; Tr. 887-89, 892-93, 919, 937, 1088, 1479.[24/]

Further, Koeppel made the judgment that for substantive testing in the 2006, 2007, and 2008 Koss audits it was not necessary to directly access Koss's electronic general ledger, the repository of all of Koss's recorded transactions and adjustments. *See* pp. 27-29 above. PCAOB auditing standards specified that "the auditor's procedures should include selecting from the general ledger entries to be tested and examining support for those items" (AU § 316.61) and that "the auditor's substantive procedures must include reconciling the financial statements to the accounting records" (AU § 326.19). As Koeppel knew, for these purposes the auditors relied for access to Koss's general ledger on: (1) a set of binders, compiled and provided to the auditors by

[24/] In particular, the cited sections of AU § 313 together specify that applying principal substantive tests to the details of an asset or liability account as of an interim date rather than as of the balance sheet date: (1) "potentially increases the risk that misstatements may exist at the balance sheet date that will not be detected by the auditor"; (2) makes it necessary where the auditor additionally "assesses control risk at the maximum during the remaining period," to consider "whether the effectiveness of certain of the substantive tests to cover that period will be impaired"; and (3) makes it necessary for the auditor to consider whether "the [entity's] accounting system will provide information concerning the balances at the balance-sheet date and the transactions in the remaining period that is sufficient to permit investigation" of "(a) significant unusual transactions or entries (including those at or near year-end), (b) other causes of significant fluctuations, or expected fluctuations that did not occur, and (c) changes in the composition of the account balances," such that "evidential matter related to" these matters would be "sufficient for purposes of controlling audit risk."

Koss's accounting department, of "update reports," each of which reports the auditors were told was generated by Koss's IT system when a member of the department posted a journal entry or batch of journal entries to Koss's general ledger; and (2) general ledger account balance reports (trial balance reports), also provided to the auditors by Koss's accounting department, that, the auditors were told, Koss's IT system could only generate at a particular point in time. *E.g.*, Tr. 1336-37, 1457-62.

Indeed, Koeppel knew that the substantive audit work depended heavily on general ledger account balance reports and subsidiary ledger detail reports that were generated by Koss's accounting department from the company's IT system. Her overall decision that only substantive tests, not internal control testing, would be performed to restrict detection risk to an acceptable level and that information provided by Koss's IT system would be used to perform the substantive tests meant that the auditors "should obtain evidence about the accuracy and completeness of the information" (AU § 319.65) and, before using the results obtained from substantive analytical procedures, should "perform other procedures" than testing the effectiveness of internal controls "to support the completeness and accuracy of the underlying information" (AU § 329.16). *See, e.g.,* Tr. 847, 1025, 1142, 1187-88, 1339-40, 1442-43, 1498 (Koeppel).

The OIP charged that in all three audits, Koeppel failed to exercise due care and to obtain reasonable assurance or sufficient audit evidence regarding Koss's journal entries, net sales, accounts receivable, sales allowances, and inventory, along with violations of more specific auditing standards in each of those areas. The charges in the journal entry area concern the audit work performed to determine the completeness of the sets of Koss paper records from which journal entries were selected for testing. The charges in the net sales area concern the precision of the expectations and the audit work performed to determine the reliability of the data used in the analytical procedures. The charges in the accounts receivable area concern the audit work performed to determine the completeness of the report from which a sample of receivables was selected for confirmation testing at an interim date and the adequacy of audit testing of the remaining period receivables, including the audit work performed to determine the reliability of data used in that testing. The charges in the sales allowance area concern the audit work performed to determine the reliability of data used in tests of details. The charges in the inventory area concern the work performed to determine the reliability of data used in remaining period tests of details and analytical procedures.

As discussed in detail below, we find that Koeppel led audits that, in the charged areas, were characterized by the lack of a proper foundation for the substantive audit testing. By foundation, we refer to the completeness of the population of Koss's journal entries subject to testing for material misstatement due to fraud, the completeness of the population of Koss's accounts receivable subject to confirmation testing, the reliability of Koss's data used in other substantive testing of its revenue and inventory, and a basic element of the substantive analytical procedures used to test its revenue.

Repeatedly, Koeppel was willing to resolve matters she insists she took seriously, such as the completeness of the journal entry population and the reliability of Koss internal reports, in ways that accepted the company's processes and accounting records at face value. That is, despite perceived system limitations on auditor access to financial data maintained electronically by Koss, the general lack of internal control testing in the audits, and an identified control deficiency each year in one of the revenue-related areas, Koeppel placed undue reliance on the scanning or comparing to one another of Koss internal reports (from the current or prior fiscal years) to which little or no audit procedures were applied, on employee representations about how the company's systems and controls were supposed to operate, on *ad hoc*, single-point-in-time observations, and on only part of the assessed risks of material misstatement. Furthermore, as an important substantive test of Koss's revenue in each of the audits, Koeppel used analytical procedures, a fundamental element of which is an expectation concerning the recorded amount. But the net sales analytical procedures employed in the Koss audits were founded on expectations so vague that they did not provide the necessary level of assurance that potential material misstatements would be identified.

In effect, in Koeppel's conception of the 2006-2008 Koss audits, as exemplified by her own arguments in this case, audit planning activities routinely assumed the role of, rather than simply informed, substantive audit procedures, "understanding" commonly took the place of testing in the audits, and great emphasis in considering the level of audit effort was placed on "low" assessed inherent risk, instead of on inherent risk combined with assessed maximum control risk. This left serious gaps in the audit evidence each year. We find Koeppel violated numerous PCAOB auditing standards.

1. Audit work on Koss system-generated reports generally

The charges of inadequate audit work on the reliability of Koss IT system-generated reports under AU §§ 319.65 and 329.16 run through the revenue-related and inventory areas of the 2006, 2007, and 2008 audits. Concerning those charges, the parties offer largely general arguments, rather than detailed attention to the role of the particular report in the particular substantive testing in the particular audit area. We address here those general arguments and devote the detailed attention necessary to resolve the charges in the sections that follow on the work in the individual audit areas.

In large part, the parties frame their arguments around the initial decision's up-front, across-the-board holding that in each audit the evidence "was sufficient to support the completeness and accuracy of standard reports generated by Koss's IT systems as a general matter" (I.D. 49). DOB 19-28; DRB 10-12; KOB 23-31. That holding rests on what Koeppel describes as the "very broad concept" of "evidence" in AU § 326.17. KOB 25. It also rests on a series of points consisting of her understanding of Koss's internal controls, her assessment of the risk of material misstatement of the financial statements, certain other audit work, and various asserted characteristics of Koss's controls and computer system. She focuses mainly on her background understandings and observations about Koss's systems and processes, not on audit procedures applied to the reports themselves, though she does refer to comparing Koss reports to one another and, in some instances, limited tracing of entries on subledger detail reports to underlying source documents. The Division describes the series of points as "nine observations, first compiled in Koeppel's post-hearing brief," though, for the most part, she cites some reference to them in the work papers, and the Division argues that the points were not "comparable" or "roughly equivalent" to evidence that would have been obtained from testing the effectiveness of controls. DOB 19-20, DRB 11-12 n.56.

The initial decision's holding is erroneous. Koeppel claims the cited information, gleaned mostly from audit planning procedures, "counts for" something and may "be considered" for present purposes, or in the words of the initial decision "bears on" system reliability (I.D. 40). KOB 25, 27. She further claims, without clearly explaining why, that this information is "appropriate evidence" (KOB 24) and "substantial evidential matter" "about the accuracy and completeness of the information produced by Koss's IT system which [she] believed provided a reasonable basis for her professional judgments regarding the issues criticized in the OIP" (KPHS 22). The Division is correct that these claims, along with Koeppel's "focus on AU § 326.17 in isolation," do not constitute an evaluation of the "sufficiency or competency of evidence," which involves "criteria [] such as relevancy, validity, and timeliness," and is necessary to resolve the AU §§ 319.65 and 329.16 charges before us. DOB 20 (citing AU §§ 326.02, .21); *see, e.g.*, AU § 319.90 ("The type of evidential matter, its source, its timeliness, and the existence of other evidential matter related to the conclusion to which it leads all bear on the degree of assurance evidential matter provides.").

The context specific to each of these charges is discussed in separate sections below, and we address there, to the extent it applies, the most directly relevant item Koeppel cites—her claim to have taken an audit approach that "incorporates into" and "embeds" in "our testing various tests of reports" used in the substantive audit procedures, namely "tying back to a supporting document or doing a roll forward or tying to the general ledger [by way of a trial balance report] or tying to a subledger [report]." Tr. 1186-88, 1340, 1348-49, 1457-62. For the reasons discussed in this section, the other cited information is too shallow and limited to provide the additional evidence of reliability necessary under the circumstances.[25/]

25/ The inadequacy of the initial decision's cursory analysis of the data reliability charges, which analysis Koeppel generally embraces, is illustrated by the fact that both Koeppel and the Division fault the hearing officer for inconsistency when, relying on general characteristics of Koss's IT system, he declared at one point that sufficient audit evidence was obtained "to support the completeness and accuracy of standard reports generated by Koss's IT systems as a general matter" (I.D. 43, 49) yet at another declared that the audit evidence about the reliability of a particular report was insufficient (I.D. 49-50). *See* DOB 14 & n.58, 18-19, 23; KOB 29 n.19; KRB 2, 12.

The audit work at issue on data reliability was integral to the substantive audit testing itself, which was all that was used in the Koss audits to restrict detection risk to an acceptable level for the "critical" areas of revenue and inventory (*see* p. 14 above). By its terms, the requirement in AU § 319.65 to obtain evidence about accuracy and completeness applies to information from an entity's information system that is used by the auditor to perform "substantive tests," where the auditor is performing "only substantive tests in restricting detection risk to an acceptable level," and the requirement in AU § 329.16 to "perform other procedures" to support completeness and accuracy applies to entity financial information "underlying" "substantive analytical procedures," where, likewise, the auditor does not "test the design and operating effectiveness of controls" over that information. And these charges before us are asserted in conjunction with AU § 326, which sets forth the auditor's objective "to obtain sufficient competent evidential matter to provide him or her with a reasonable basis for forming an opinion," and AU § 313, which concerns substantive audit tests "that are necessary to cover the remaining period in a way that will provide the appropriate audit assurance at the balance-sheet date." *See, e.g.*, OIP 11 ¶ 32, 12 ¶ 37, 13-14 ¶¶ 41-43, 15-16 ¶¶ 51, 54, 17 ¶ 57, 19-20 ¶¶ 67, 69, 71-72, 21-22 ¶¶ 77-79, 81(b), (e), (f). The performance of procedures and collection of evidence to determine the reliability of system information must be commensurate with the role of the information in the audit.

As AU § 326.16 makes clear, "without adequate attention to the propriety and accuracy of the underlying accounting data, an opinion on the financial statements would not be warranted." Financial reports produced by Koss's information system were merely representations of the underlying accounting data. In the Koss audits in question, those reports were a snapshot, which Koeppel understood could only be generated at a specific point in time, of Koss's subsidiary and general ledgers, which existed only in electronic form. She understood that data that accumulated in the subledgers had to be transferred monthly to the general ledger by journal entries initiated by Koss's accounting department and that the department could also post journal entries directly to the general ledger, bypassing the subledgers. *See* p. 21 above. The only access obtained to Koss's journal entries in the three audits was through binders of paper forms and Koss IT system-generated "update reports." Given that journal entries recorded in the system could affect the content of system-generated reports and alter the data reflected in them, such restricted access was not helpful to the audit work that, under PCAOB standards, "must" be performed to "reconcil[e] the financial statements to the accounting records" (AU § 326.19; *see* Tr. 883).

Audit testing of the design and operating effectiveness of an entity's internal control over the financial information generated by its IT system, or performing other audit procedures and obtaining audit evidence concerning the completeness and accuracy of that information, establishes a relationship between the system reports and the underlying data that helps guard against reliance in substantive audit testing on information that, for example, has been entered incorrectly on a large scale by entity personnel, captured, summarized, or reported incorrectly by its computer system, or manipulated by fraudulent entries or omissions. *See, e.g.*, AU §§ 312.06 (unintentional misstatements or omissions of amounts in financial statements may involve "[m]istakes in gathering or processing data from which financial statements are prepared"), 316.06 (fraudulent financial reporting may be accomplished by, among other things, "[m]anipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared" or "[m]isrepresentation in or intentional omission from the financial statements of events, transactions, or other significant information"), 319.19 (the specific risks IT may pose to an entity's internal control include "[r]eliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both," "[f]ailure to make necessary changes to system or programs," and "[p]otential loss of data"), 319.30 (IT presents risks such as that "improperly authorized, incorrectly defined, or improperly implemented changes to the systems or programs performing the calculations, or to related program tables or master files, could result in consistently performing those calculations inaccurately"). All of this highlights the importance in the audits in question—in which the operating effectiveness of internal controls over IT and critical assertions was not tested, in which Koss's electronic database was not viewed for the significant substantive evidence it contained, and in which the only window accessed by the auditors into the journal entries affecting that database was paper binders—of the procedures and evidence about the reliability of IT system-generated information used in the charged audit areas.

Koeppel's general arguments about the reliability of Koss's system-generated reports, except for the claim we address below in the sections on individual audit areas, are based on tasks performed and information obtained in planning the Koss audits. Of the eight of her points covered in this section, we first address her broad arguments about what she calls the "thorough understanding of Koss's controls over financial reporting, governance, revenue cycle procedures, and inventory cycle procedures" and "an extensive risk assessment process" in the Koss audits (KOB 13, 24, 28). Then we turn to her more particular other six points, which she says were the product of "an understanding of Koss's IT system" gained in the audits "as part of the procedures undertaken to obtain an understanding of Koss's internal controls" (KOB 24, 28-29).

As to understanding of internal control, Koeppel has contended that "for the purposes of a financial statement audit," by contrast to "an internal controls audit," an understanding of Koss's financial reporting system and related controls, obtained through audit team inquiry, observation, and walkthrough procedures performed for audit planning, "establish[ed] a baseline" and "provided good evidence to us" in terms of "audit support related to that a system is operating effectively." Tr. 1292-94, 1297-99, 1466-67, 1469-70. In Koeppel's view, based on that work, she "could certainly come to the conclusion" that Koss's internal controls "were designed and operating effectively," that Koss "had an internal control process" over IT that "was designed and operating effectively," and that its IT system could reasonably be relied upon in the performance of the audits. Tr. 1468-73. This was so, according to Koeppel, "not for th[e] purpose" of assessing or reducing the level of control risk but "for the purpose of determining whether or not I needed to modify my audit approach for deficiencies in the control system that would be identified during that process [of audit planning]." Tr. 1471.

Koeppel testified that, in her view, Koss had a "well-controlled process" or a "strong control environment" of "segregation of duties and the access controls that existed," as well as "monitoring controls that went on as it related to the overall financial reporting process and the active involvement by management," referring to President/CEO and VP-Finance, such that the controls were "actually working and in place" and "effective" and that "we did not need to modify our nature, scope or timing of our work." Tr. 1141-42, 1197, 1221-22, 1287-1294, 1296-99, 1305, 1311, 1328, 1334, 1387-88, 1451, 1471-73, 1493-94. She reasoned, "If I had identified that they were not operating effectively, then I would have identified control gaps or deficiencies that would have been run through the summary of control findings, and I would have needed to use that to modify my audit approach." Tr. 1469; *see* Tr. 1288, 1309-11, 1472-73. According to Koeppel, "we did not identify any issues with Koss's IT system," meaning that "it was working effectively and that it could be reasonably relied on, and that we did not need to expand our procedures beyond those that are customary." Tr. 1291-92; *see* Tr. 1288-90 (she sought in the audit planning process to "identify whether there are any issues, gaps or deficiencies in [Koss's] internal control environment that we need to take into consideration and adjust the work programs to address any control deficiencies that were noted" and to "validate our understanding of the control environment"), 1342 ("our walk-throughs validated our understanding of the system and demonstrated that it was operating effectively"), 1472-73; *see also* Ex. D-4 at 55 (in investigative testimony, Audit Manager suggested the walkthroughs "corroborated" Koss's claimed controls).

Koeppel's arguments based on her professedly "thorough understanding" of Koss's internal control (KOB 28) overstate the value of that information as evidential matter in, and understate the audit procedures and evidence necessary to, determining the reliability of the IT system-generated data at issue. As noted, understanding internal control is part of planning any audit governed by PCAOB standards. Representations from Koss personnel about how Koss's accounting and IT systems were supposed to work does not mean they actually worked that way. And as AU § 319.27 states, "Whether a control has been placed in operation at a point in time is different from its operating effectiveness over a period of time." *See, e.g.,* AU §§ 319.94 ("the observed application of a control might not be performed in the same manner when the auditor is not present"), .100 ("an observation is pertinent only at the point in time at which it is made"), 316.62 (material misstatements due to fraud "can occur throughout the period and may involve extensive efforts to conceal how it is accomplished").[26/]

[26/] Koeppel does not contest that a control being placed in operation at a point in time is different from its operating effectiveness over a period of time. Tr. 851. AU § 319.96 contains an instructive discussion of this issue, using the word "test" throughout (again, internal control was not even tested in the audits in question):

In discussing her understanding, Koeppel repeatedly uses the language of control testing ("operating effectively") and refers to the nature, timing, and extent of substantive testing, as if to imply she was entitled to reduce substantive testing that would otherwise be necessary, and with it audit work on data reliability, based solely on her understanding. To the extent that Koeppel, in her arguments in this case, treats an understanding of entity systems and controls not only as informing the design of substantive audit tests but also as itself becoming a substantive test, or a test of control effectiveness, that reduces the audit effort otherwise necessary for substantive testing, and in turn the support necessary for the completeness and accuracy of entity reports used in that testing, she is incorrect.

PCAOB auditing standards provide conditions and criteria for reducing otherwise necessary substantive testing, and this involves reducing control risk below the maximum through testing the operating effectiveness of the controls over the audit period. *E.g.*, AU §§ 319.03 (where it would be effective and more efficient than performing only substantive tests, or where it would not be practical or possible to do that, the auditor "should obtain evidential matter about the effectiveness of both the design and operation of controls to reduce the assessed level of control risk"), .76 ("Tests of controls directed toward the operating effectiveness of a control are concerned with how the control (whether manual or automated) was applied, the consistency with which it was applied during the audit period, and by whom it was applied."), .86 (procedures performed to obtain an understanding of internal control "are not sufficient to support an assessed level of control risk below the maximum level if

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> The timeliness of the evidential matter concerns when it was obtained and the portion of the audit period to which it applies. In evaluating the degree of assurance that is provided by evidential matter, the auditor should consider that the evidential matter obtained by some tests of controls, such as observation, pertains only to the point in time at which the auditing procedure was applied. Consequently, such evidential matter may be insufficient to evaluate the effectiveness of the design or operation of controls for periods not subjected to such tests. In such circumstances, the auditor may decide to supplement those tests with other tests of controls that are capable of providing evidential matter about the entire audit period. For example, for an application control performed by a computer program, the auditor may test the operation of the control at a particular point in time to obtain evidential matter about whether the control is operating effectively at that point in time. The auditor may then perform tests of controls directed toward obtaining evidential matter about whether the application control operated consistently during the audit period, such as tests of general controls pertaining to the modification and use of that computer program during the audit period.

they do not provide sufficient evidential matter to evaluate the effectiveness of both the design and operation of a control relevant to an assertion"), .88, .90 ("Evidential matter varies substantially in the assurance it provides to the auditor as he or she develops an assessed level of control risk. The type of evidential matter, its source, its timeliness, and the existence of other evidential matter related to the conclusion to which it leads all bear on the degree of assurance evidential matter provides."), .94, .96, .97, .100, .105-.107, 316.61, 312.30-.31. This instruction applies without regard to the reason controls might not be tested in any given case (*see, e.g.*, AU §§ 319.65-.69, 312.30), as Grant Thornton audit guidance recognized (*see* Ex. R-483 at 4 (June 2, 2006 firm bulletin to its auditors: "If controls are not tested or if controls are tested and not operating effectively, control risk must be assessed as High for the assertion.")).

Yet Koeppel admits that in the Koss audits internal controls were not tested or relied on to reduce the substantive audit work to be done. *E.g.*, Tr. 1287; KOB 13 (Koeppel "elected not to test or rely on Koss's internal controls in order to reduce the amount of substantive testing to be performed"); KPHS 12. Specifically, by her own account, she chose not to test the operating effectiveness for the audit period of internal controls over IT and critical assertions, she set control risk at the maximum, and she directed all of the effort in audit testing into "audit[ing] the output" of Koss's IT system, "rather than the system itself," using "a lot" of Koss reports. *E.g.*, Tr. 1254 ("we performed substantive tests rather than rely on controls"), 1336-37, 1468, 1473. As the work papers stated, "Control risk for critical cycles has been assessed at HIGH" and "GT has not placed reliance on those controls, nor did we perform any testing of said controls." Exs. J-3 at 4 (2006), J-100 at 4 (2007); *see* Ex. J-200 at 4 (2008).[27/]

For Koeppel then to say PCAOB auditing standards "do not require an auditor who is not relying on internal controls to perform [] tests of controls" (KOB 27) does not explain how, in relying heavily on untested controls for the reliability of Koss IT system-generated information and leading substantive-only testing for all critical assertions that,

[27/] *See also, e.g.,* Exs. D-4 at 35 ("We did not test controls….That would be a fair statement [that the audit team had no basis for relying on the effectiveness of Koss's preventative controls], and I would say we did not rely on controls…[but] did a highly substantive audit"), 54 ("So here I obtained an understanding this is what [Koss] represented their [control] design was, and we did not test the operating effectiveness of these controls….We were not testing the operating effectiveness of controls."), 55 ("the steps that are tailored in there [on the audit program are] to obtain an understanding of those controls, not to test operating effectiveness of controls"), 60 ("As I've stated numerous times already, controls were not tested. We obtained an understanding of processes and controls. It was not required and we did not test controls.") & R-509 at 182 ("No….As I said earlier, relying on [Koss's automated accounting process] would have meant we needed to test controls. We performed a highly substantive audit to validate the balances and assertions.") (Audit Manager's investigative testimony).

in turn, relied heavily on that system-generated information, she bridged the gap in evidence between how Koss's accounting and IT systems were supposed to operate for each entire audit period at issue and how they actually did operate.[28/]

Koeppel stated at the hearing that she did not "identif[y] control gaps or deficiencies" requiring her "to modify our nature, scope or timing of our work" (*see, e.g.*, AU § 311.03g (conditions "may require extension or modification of audit tests")), but

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[28/] The initial decision, in discussing in isolation the language "obtain evidence" and "perform other procedures" in AU §§ 319.65 and 329.16, repeatedly rejected any suggestion by the Division that the word "test" could be used in connection with those requirements, and indicated that the Division "offered no evidence" that "any auditor interpreted or applied [those standards] in that manner." I.D. 40-41, 50, 69 n.26, 73. To the extent Koeppel's briefing, perhaps to minimize those requirements, suggests at times (*e.g.*, KOB 24, KPHS 21) that the language of those standards could not under any circumstances call for audit testing, in terms of applying audit procedures to entity reports, and that no auditor in practice thought it did, that briefing is plainly mistaken.

As Koeppel has recognized (*e.g.*, KPHS 21, 26), an auditor may "obtain evidence" through audit testing. She has noted an instance in which PCAOB auditing standards refer to "procedures" as "substantive tests." KPHS 26, citing AU § 326.26. Tests surely can be "acts the auditor performs during the course of the audit to comply with the auditing standards," which is how AU § 150.01 describes "auditing procedures." In testimony, she referred on multiple occasions to "tests of reports," "testing of reports," "testing of these IT-generated reports," and "the need to test reports for completeness and accuracy." Tr. 1099-1108, 1187, 1340, 1351, 1442, 1498. As just and next discussed in the text, she links the level of substantive audit testing to the audit work on data reliability, and PCAOB standards provide that even where, unlike here, control risk is assessed at a low level, still the auditor should perform some substantive procedures for all relevant assertions related to all significant accounts (AU §§ 319.02, .107; *see* AU §§ 316.51, 312.32). Grant Thornton 2006 audit training materials on "Testing Client-Generated Data" stated, "Can use this information [in "system-generated reports"] without detail testing of underlying data…if we test the systems that generate the data." Ex. J-313 at 1, 10 (emphasis added, ellipsis in original), cited in DOB 9 n.42. Finally, we note that the *AICPA Audit Guide* in effect during the relevant period (and now) contained the following language (§ 204), evidently interpreting AU § 319.65: "[D]eveloping a preliminary audit strategy involves considering whether computer-produced records, such as accounts receivable aged trial balance, will be used as evidential matter to support an assertion. The auditor may test the computer-produced information by either of the following: [1] Testing the report substantively[;] [or] [2] Understanding the computer control activities that are intended to ensure the completeness and accuracy of such reports and performing tests of controls to assess the effective design and operating of such control activities" (emphases added).

the necessary audit work would have to have been done, absent control testing, to put her in a position to identify such matters, and the unmodified, "customary" audit work still needed to be adequate under PCAOB standards. A recurrent theme in the auditor testimony in this case, Koeppel's briefing, and the initial decision is that finding "no reason to believe" anything was amiss during the audits, based on an understanding of Koss's systems and controls, an assessment of inherent risk, Koss's IT system-generated reports, and Koss's paper binders of journal entries, necessarily supported the adequacy of the audit work. *See, e.g.*, Tr. 1334-35 ("We felt that based on the low financial statement risk, we had not identified any issues with reports generated by the IT system….Again, we did not identify anything that would cause us to dispute that we were receiving anything but all reasonable and appropriate information."), 1397 ("Again, we never saw any indication that reports generated by the system were not complete and accurate.") (Koeppel); KOB 24 ("the Division failed to point to any competent evidence that came to the engagement teams' attention that called into question the accuracy or completeness of the IT system-generated reports used in the Relevant Audits"), 29, 30; I.D. 43 ("the Division would have to show that" Koeppel "could not reasonably have relied on" Koss IT system-generated reports, rather than that insufficient audit work was done to determine their reliability one way or the other), 52 ("[t]he Division cited no circumstances that should have caused" Koeppel "to question the reliability of the trial balance reports," rather than evidence that she failed to obtain affirmative support for their reliability), 67 ("[the] Division offered no evidence that Koss ever reallocated customers among categories [in its sales reports], or that the engagement teams had any reason to believe that any such reallocation might have occurred," rather than that they did not affirmatively support the reports' reliability).[29/]

[29/] *See also, e.g.*, Tr. 82-83 ("the work that we did didn't contradict [Koss representations] at all") (2006-2008 Staff/In-Charge Auditor); Tr. 436 (no reason to think any of the information inputted into the accounts receivable confirmation testing sample was incorrect), 523 ("Based on our understanding of how the control structure worked, we…had no reason to believe that the system-generated reports were anything but accurate and the systems weren't producing accurate information"), 524-25 ("with our understanding of controls, and we had no…issues in prior years tying [the AR Aging Report] out, there was no red flag or anything to indicate that we needed to take it that additional step to tie it out at interim" and "it did tie out a year-end") (2007-2008 Staff/In-Charge Auditor); Tr. 714 ("I don't recall a reason to believe that I did not have the full listing [of last week of June sales].") (2007-2008 Staff Auditor); Ex. D-4 at 51 ("Based on the documentation and everything else that we saw in the files as it relates to auditing all of these other areas and looking at adjustments, we had no reason to believe it was anything other than what was being represented to us."), 85-86 ("Again, those [journal entries] were in the binders, and it was the upstream/downstream…we deemed them complete….Again, taking—going from the—their policy of the binders and then tracing them back in the other direction, finding [no] exceptions, we relied on the representations from management that they had provided everything…."[W]e found no exceptions in the journal entry testing that we did do. In looking at the analytics and the

In fact, the lack of contrary evidence asserted by Koeppel as a defense may well have been the very result of the audit work being inadequate. *See, e.g.*, AU §§ 326.25 (the auditor "should be thorough in his or her search for evidential matter and unbiased in its evaluation"), 316.08 ("Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively…. Management override of controls can occur in unpredictable ways."), .13 (the auditor "should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity"), .42 (as "there is a possibility that management override of controls could occur," "[e]ven if specific risks of material misstatement due to fraud are not identified by the auditor," the auditor should address that risk "apart from any conclusions regarding

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test of details that we did in every other area, finding no evidence of other adjustments to accounts through the review of the reconciliations or anything else, there was no reason for us to believe we needed to do anything further."), 87 ("Again, based on our assessment of the risks, we felt that the procedures we defined were sufficient to get us there, so, no, [that both sets of journal entry binders might be incomplete] was not a specific risk that was added or specifically tested for because there was no evidence that we were given anything other than what we relied upon."), 88 ("there was no indications that we weren't provided with everything" and "that was our conclusion, and we were ready to move on"), 127 ("So [sales revenue] was trending with our expectations. So there was no reason to test further.") & Ex. R-509 at 60-61 ("[Outstanding wire transfers did not] raise[] any additional red flags primarily because of our understanding of additional oversight and monitoring as well….There was no other evidence indicating in other areas that we need to dig further [concerning segregation of duties for cash]."), 110 ("The testing that we did was to look at the underlying journal entries and saw no exceptions and had no reason to believe anything further."), 127 ("in looking at the roll forward and reconciliations of numerous other accounts and the fact that there wasn't any other evidence that unusual adjustments in equity roll forwards or the roll forward for deferred accounts or any of the bad debt allowances, other accruals and looking at the activity that took place through those accounts, there is no evidence that we needed to do or follow-up anything further"), 132 ("Again, the testing that we had done across these areas, understanding the procedures, understanding that we saw these entries, nothing unusual coming through, we looked at the support, we saw the reconciliations and the activities going through every other area, and absent exceptions, our testing was complete."), 137 ("[as] we had no issues in reconciliations or anywhere else, we were done"), 144 ("Based on the sample [of journal entry forms] that we traced and lack of any evidence otherwise, that was the conclusion that we reached."), 147 ("Absent of exceptions, we deemed the binders to be complete and concluded our testing."), 179 ("We did completeness testing, pulling samples [from the journal entry binders], felt that we had everything and auditing those, we had no reason to believe that we had large reconciling items or other things that were showing up as anomalies.") (Audit Manager's investigative testimony).

the existence of more specifically identifiable risks"), .48 (in addition to other responses, auditor addresses risks of material misstatement due to fraud with "[a] response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur"), .57 ("[M]anagement is in a unique position to perpetrate fraud because of its ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding established controls that otherwise appear to be operating effectively. By its nature, management override of controls can occur in unpredictable ways."), 319.51 ("in planning the audit, the auditor should be aware that when IT is used to automatically transfer information there may be little or no visible sign of [inappropriate] intervention [by individuals] in the information systems"), .80 (identified risks of material misstatement due to fraud that have continuing control implications, "whether or not transactions or adjustments that could be the result of fraud have been detected," may need to be communicated to senior management and audit committee), .94 (the auditor should consider that "the observed application of a control might not be performed in the same manner when the auditor is not present"), 329.10 ("When designing substantive analytical procedures, the auditor also should evaluate the risk of management override of controls. As part of this process, the auditor should evaluate whether such an override might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions.").

Regarding Koeppel's reliance on what she calls "an extensive risk assessment process" in the Koss audits (KOB 13), assessing risk properly is a required part of planning any audit under PCAOB standards. Although she invokes the process in argument, she does not explain why the basis of the risk assessments in these audits made any particularly special contribution to determining the completeness and accuracy of system-generated reports used in the substantive audit testing.

Moreover, the nature, timing, and extent of required substantive audit testing (and by extension, of audit work on the reliability of Koss IT system-generated data) are affected not only by the assessed inherent risk, which Koeppel highlights, but also by the assessed control risk (*e.g.*, AU §§ 312.01, .16, .24, .26-.32, 319.81, .106), which she dismisses without taking any serious account of it (*e.g.*, KOB 13, 30 n.20). Her arguments thus proceed as if inherent risk, including a list of factors in the work papers such as fraud risk and risk of errors in the accounting system, assessed as low, was the only relevant risk consideration in the audits.

In fact, each year control risk was assessed as high, resulting in what Audit Manager described in investigative testimony as a combination of risk "somewhere in between" low and high and what Grant Thornton described in audit guidance during the relevant period as "combined <u>medium</u> risk" (emphasis added). Indeed, Koeppel's refrain that she “set control risk at maximum” as a “default level” and not because she “determined that there was a high risk of material misstatements not being prevented or detected by internal controls” (*e.g.*, Tr. 1253; KOB 30 n.20; KPHS 12) ignores that, due to the auditors’ admitted lack of control testing and their heavy reliance on mere understanding from company representations and on point-in-time observation, they were not in a position to identify or determine whether or how the controls actually operated over the audit period. This created a large gap in evidence.

Furthermore, even as to overall inherent risk, low risk did not mean no risk. Koss may, in Koeppel’s view, have “sold a single type of product, managed all of its operations from its Milwaukee headquarters, and had a simple capital structure and organization.” KOB 13 n.8. But even in assessing inherent risk as low, she identified certain risk factors as applicable that, as to the very least of them, meant that certain potential sources of mitigation were not present. *See* pp. 16-17 above, p. 124 below. And, as we discuss more in the journal entry section below, Koeppel recognized that fraudulent revenue recognition was a risk of material misstatement at the “very revenue focused” Koss. *E.g*., Tr. 764-65, 1020-21, 1274-75, 1285-87; Ex. J-200 at 3, 4. As AU § 316.41 explains, “Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition.” Koeppel also noted, “Due to the small size of the organization, there is a risk that the lack of segregation of duties may cause rise to fraudulent financial reporting.” Exs. J-100 at 3, J-200 at 3; *accord* Ex. J-3 at 3; Tr. 830-32. In terms of opportunity to commit fraud (*see, e.g.*, AU § 316.07, .33), Koeppel knew from the 2004 IT review, as noted above, that Koss management stated that it relied heavily on its personnel at the departmental level (Ex. J-2 at 17) and from audit memos that “[m]any of the individuals in financial reporting have been performing their responsibilities for a number of years” (Ex. R-205 at 2 (2006), R-396 at 1 (2008)). She determined that susceptibility of Koss’s inventory to misappropriation was a fraud risk. Exs. J-3 at 3, J-100 at 3, J-200 at 3; Tr. 1087. And she identified net sales, accounts receivable, and inventory as areas of relatively higher risk in each of the Koss audits, with a reasonable possibility of material misstatement. *See* pp. 10-12 above. The investors in a “small,” “simple” issuer are no more to be deprived of the protection of an audit conducted in accordance with PCAOB standards than those of any other issuer.

Further on this point, in assessing fraud risks from Koss’s IT system as low, Koeppel stresses that Koss’s use of an outside contractor to manage its IT system limited “the potential for internal ‘tinkering’ with the system,” in terms of system or program changes. But however that concern may have been addressed, it was still Koss personnel who actually entered data and used the system, and so the separate concern remained that “[t]he use of IT processing adds some additional IT risks as it relates to the susceptibility of altering information.” *See* Ex. R-202 at 6; Ex. J-100 at 4;

Ex. J-200 at 2, 7; Tr. 1340-41 (in describing Koss audits, Koeppel testified that "one of the areas that we consider as it relates to both fraud risk and whether or not we need to modify our audit approach is the IT processing system and whether there is aggregate segregation of duties and responsibilities from those who are actually processing the transactions"); *see generally, e.g.,* AU § 319.36 ("management's failure to commit sufficient resources to address security risks presented by IT may adversely affect internal control by allowing improper changes to be made" not only to "computer programs" but "to data," or by "allowing unauthorized transactions to be processed").

Indeed, aspects of the fraud risk from use of IT, even if low overall, that are separate from unilateral internal changes to systems or programs can include: "[u]nauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or nonexistent transactions or inaccurate recording of transactions"; "[i]nappropriate manual intervention"; "access privileges" given to or gained by users "beyond those necessary to perform their assigned duties," possibly causing "a breakdown in segregation of duties" that "could result in unauthorized transactions or changes to programs or data that affect the financial statements"; "lack of control at a single user entry point" to a common database of information that affects financial reporting, which "might compromise the security of the entire database, potentially resulting in improper changes to or destruction of data"; "[u]nauthorized changes to data in master files"; "[f]ailure to make necessary changes to systems or programs"; and "improperly authorized" changes to them. *E.g.*, AU §§ 319.19, .20, .30. The 2004 IT review and audit planning efforts in the 2006, 2007, and 2008 Koss audits recognized that these kinds of matters required attention from the auditors. *See, e.g.*, Ex. J-1 at 4-6; Ex. J-2 at 1, 14-16; Exs. J-3 at 4, J-100 at 4; Ex. R-202 at 2, 6; Ex. R-298 at 1, 3, 6; Ex. R-398 at 11, 18, 24. Also, when IT is used "to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may be more difficult to identify through physical inspection of printed documents." AU § 319.51. Koeppel recognized this circumstance needed to be confronted in the audits. *See, e.g.,* Tr. 1322-23, 1327-31; *see also, e.g.*, Exs. D-4 at 88 & R-509 at 124 (Audit Manager's investigative testimony).

Additionally on the subject of risk, Koeppel makes the argument that existence or occurrence of Koss's revenue and inventory were the relevant assertions for purposes of the Koss audits and that "any fraud at Koss was more likely to involve overstatement" rather than understatement of those income items or assets, seeming at times to claim that little or no effort had to be expended in the audits to determine the completeness of Koss IT system-generated reports used in the substantive testing of revenue or inventory. *E.g.*, KOB 45; KPHS 73; Tr. 898-99 (referring only to audit work on report's accuracy, not completeness), 932-35 ("Our concern is overstatements, so we want to make sure that the invoice that is showing up in the invoice summary register and rolling up through the AR distribution register is an appropriate invoice….As part of the test, that is a test of completeness, considering the risk that we're trying to address."), 1000 (tying detail report to trial balance only work on data reliability documented in work paper), 1099-1101 (claiming that tying entries listed in a report to source documents was a "completeness test"), 1107-08 (referring only to accuracy), 1187-88 (same), 1367-69 (same), 1399-1400 (same); *compare* Tr. 1349-50, 1359, 1498 (describing tying detail report to trial balance as completeness work) *with* Tr. 703-04 (2007-2008 Staff Auditor: conceding such tying is not a substitute for evidence of completeness and accuracy in many instances); *see, e.g.*, Tr. 453 (2007-2008 Staff/In-Charge Auditor: no audit procedures were applied to a particular Koss report to support its completeness), 473 (same). If Koeppel actually took this flawed position during the Koss audits, which she admits was not documented in the work papers (*e.g.*, KPHS 11 n.4), then that counts against, rather than supports, the adequacy of the data reliability work.

As noted, the PCAOB standard stating that the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition refers to both overstatement and understatement of revenue. AU § 316.41. Koeppel does not claim that there was no risk of understatement but instead that she "believed that any fraud at Koss was <u>more</u> likely to involve overstatement of revenues" and she was "<u>focused</u> <u>more</u> on detecting an overstatement of revenues rather than an understatement." KPHS 11 (emphases added); *see* Tr. 1286-87 (understatement of revenue "was not something we saw as a <u>high</u> risk for Koss") (emphasis added); *see also* Ex. R-507 at 75 (report of Koeppel expert: "the <u>principal</u> audit risk for revenues at Koss was overstatement"), 90 ("The auditor's <u>primary</u> concerns in testing the occurrence of sales are overstatements of sales that have the effect of overstating income.") (emphases added); Ex. R-508 at 45 (report of second Koeppel expert: "in companies such as Koss, where there exist incentives to maximize sales, accounts receivable, and assets generally, there is a <u>greater</u> risk of overstatement of these accounts than understatement") (emphasis added); Ex. R-509 at 71-72 (Audit Manager's investigative testimony: "In a retail manufacturing environment, the typical risk and critical areas are going to be revenue existence, did it really occur, is it really a sale, and is it recorded appropriately."). Moreover, as noted, susceptibility of inventory to misappropriation, which could result in understatement of inventory to conceal the misappropriation, was identified as a fraud risk in the Koss audits.

There is another problem with Koeppel's argument about her emphasis in the audits on overstatement, not understatement. According to Koeppel, that emphasis flowed from her assessment of risk with respect to the existence or occurrence assertion, and she implies that this risk assessment essentially rendered all but inoperative the requirement to obtain evidence about the completeness of Koss system-generated reports, in addition to evidence about accuracy. But Koeppel's argument seems to conflate that <u>requirement of evidence</u> of data completeness with the <u>financial statement assertion</u> of completeness. *E.g.*, Tr. 932-35 (in revenue area, for example, "the typical scenario is the overstatement of revenue"), 1156; *see* Ex. R-509 at 68-72 (Audit Manager's investigative testimony, making overstatement point by reference to "the completeness assertion" and remarking, that "[i]t's not typical to have completeness be a relevant assertion"). In fact, the requirement under AU §§ 319.65 and 329.16 to perform procedures and obtain evidence about completeness of system-generated information where controls are not tested is not confined to any particular assertion.

As yet another problem with Koeppel's argument, valuation of revenue, not just existence or occurrence, was a critical assertion in the Koss audits and was the subject of charges in the OIP. But she draws no distinction between her audit approach to data reliability in the testing of net sales and special sales allowances—involving deductions from sales that, if misstated, could lead to an overstatement of revenue—and in the testing of gross sales and receivables. *See, e.g.*, Tr. 1134-35.

Nor does Koeppel address the fact, which we discuss in detail in the accounts receivable section below, that the existence or occurrence assertion can be affected not only by items that add to the balance but also by items that subtract from the balance, and overstatement can be achieved by omitting subtractive items, not just adding false items. This makes completeness of reports used in substantive testing of existence and occurrence a matter of concern to the risk of overstatement as well as understatement. Indeed, as PCAOB auditing standards make clear, fraudulent financial reporting may be accomplished by "[m]isrepresentation in or intentional <u>omission</u> from the financial statements of events, transactions, or other significant information." AU § 316.06 (emphasis added). Moreover, as the standards also point out, "Typically, management and employees engaged in fraud will take steps to conceal the fraud from the auditors and others within and outside the organization." AU § 316.09; *see* AU §§ 316.11, .31. Corporate fraud has involved recording fictitious, inappropriate, or unauthorized journal entries and "may involve extensive efforts to conceal how it is accomplished." AU § 316.08, .58, .62. The mere fact that the overall intent of a fraud may be to overstate an income item or asset does not mean that efforts to mask the fraud will not involve journal entries that understate such accounts. According to Koss's restatement disclosures, the fraudulent misappropriation of assets at Koss from 2005 through 2009 included overstatement of accounts receivable and cash. Ex. J-304 at 7, 48-50. Any notion that particular attention to the completeness of system-generated data can, in effect, be suspended wholesale in an issuer audit is misguided and insupportable.

Having considered Koeppel's two broad arguments about understanding of internal control and the risk assessment process in the Koss audits, and finding them to be unpersuasive, we now address her six other general arguments, which are all points about Koss's IT system. We come to the same conclusion as to these arguments that we did as to the two just discussed.

Koeppel, in further arguing that "substantial evidential matter was obtained about the accuracy and completeness of the information produced by Koss's IT system which [she] believed provided a reasonable basis for her professional judgments regarding the issues criticized in the OIP," relies on six claims concerning Koss's IT system and controls. KOB 24, 27-29; KPHS 22-24, 60-61; *see, e.g.*, Tr. 1342-47, 1349, 1397-99, 1485-90. Her briefs state those claims as follows: (1) the "comprehensive review of

Koss's IT systems performed in 2004 by GT IT specialists" "did not find any deficiencies that could impact the accuracy of the system's output"; (2) "an outside consultant managed Koss's IT system and was the only person authorized to implement changes to the system," providing "an additional level of control over the system by an individual who was not involved in the financial reporting process"; (3) "the AS/400 was a reputable, if aged, 'off-the-shelf' system" and "Koss had not extensively customized or altered the AS/400 standard financial programs," "so its functions were similar to what had been proven in the marketplace"; (4) "the system-generated reports were standard reports, used by Koss's own management in the ordinary course of business and produced through routine queries and commands"; (5) "Koss's accounting system was an integrated system, with transactions flowing automatically through various accounts and subledgers," which "minimized the opportunities for human error or intentional misrecording of transactions"; (6) "system access controls were in place, limiting changes to particular accounts to authorized users." KOB 28; KPHS 22-24, 60-61.

We have discussed the 2004 IT review in detail above. And the details matter. At one point, Koeppel's brief asserts that "it was appropriate to rely on the 2004 review as one piece of evidence supporting the completeness and accuracy of the system generated reports." KOB 27. According to her testimony, Koeppel carried forward the review in later audit years, relying on it as "a good foundation" and "foundational work," with "subsequent updating of that through discussions with the third-party provider," who managed Koss's IT system, "as well as management, about whether or not they made any changes to their system." Tr. 1342 (emphasis added), 1345. An audit team member elaborated that by 2008 the discussions "about updating just to get [the] general information on the systems in place, had they changed, any improvements they put in place," were primarily had with Junior Accountant. Tr. 222-23, 233 (2006-2008 Staff/In-Charge Auditor). We therefore examine the particulars and value of the 2004 IT review as a "piece of evidence" for what it may have contributed in relation to the purpose and extent of Koeppel's reliance on it. Neither she nor the initial decision, which she largely urges us to follow in this area, addresses that in any depth.

Contrary to Koeppel's contentions, addressing the full particulars of the review is not "tr[ying] to use isolated statements" instead of "view[ing] [it] as a whole" (KOB 22 n.8, 27 n.15). The details are considered here for what information they may have provided to an auditor required under the circumstances affirmatively to obtain support for the completeness and accuracy of system-generated information. Consideration of the details is not limited to whether they are "evidence that Koss's IT systems could not reliably provide accurate or complete information" (KOB 27 (emphasis added); *accord* I.D. 43), which is not what the Division needed to prove. It was enough to prove that the audit work did not provide adequate assurance of data reliability under the circumstances. Koeppel did not satisfy PCAOB auditing standards merely by noting that, as she vaguely and passively says, "no specific concerns about the reliability or integrity of the system surfaced through the work done by the audit teams to understand and document internal controls" (KPHS 60 (emphases added); *accord* I.D. 52, 67). And the details go to evaluating the weight of the review as a "piece of evidence" regardless of whether she did not categorize them as control deficiencies in the work papers documenting the understanding of internal control (KPHS 22 n.8). *See generally, e.g.*, AU § 319.102 ("Generally, when various types of evidential matter support the same conclusion about the design or operation of a control, the degree of assurance provided increases. Conversely, if various types of evidential matter lead to different conclusions about the design or operation of a control, the assurance provided decreases.").

The limited scope of the procedures performed in and to update the 2004 IT review, and the review's age, meant those procedures shed little light on whether Koss IT system-generated information used in the 2006-2008 audits was actually reliable. As Koeppel acknowledges, the review was conducted "to understand the system" and did not purport to represent tests of controls existing in 2004 or in any later audit periods. Tr. 1342, 1473; KOB 27. As the IT review memo itself stated, "We reviewed the systems as communicated by the client," and the review was based almost entirely on "Inquiry of outsourced IT personnel," "Tour of the Milwaukee computer room," and "Review of selected client documentation." Ex. J-2 at 1. The "review" was not meant to be, and was significantly more limited than, a test of IT controls.

Moreover, no subsequent review of Koss's IT system was undertaken in the Koss audits, and instead in the 2006 and 2007 audits, general inquiries were made of the contractor about whether the IT system had changed, and in the 2008 audit these inquiries were directed primarily to Koss's accounting department itself, which Koeppel recognized provided less assurance than "a person outside of the company's financial reporting process." *See, e.g.,* pp. 39-41 above; Tr. 1375; KPHS 23, 61, 79. PCAOB standards provide that the auditor should consider that "the longer the time elapsed since tests of controls were performed to obtain evidential matter about control risk, the less assurance they may provide." AU § 319.97. Koss's IT controls were not even tested in 2004, and the review—which, despite its limitations, raised some significant issues of potential concern—provided only an understanding of Koss's IT system. This highlighted the importance of control risk in the 2006, 2007, and 2008 Koss audits.

Furthermore, the IT review memo did not include Koss system reports in its statement of purpose and made no reference to performing work on reports of any kind. No procedures were performed to test Koss IT system outputs or the integrity and reliability of any reports. None of the memo's conclusions discussed the reliability of system-generated reports. And there is no indication that system reporting was part of the review. The memo touched only on "the Company's overall control environment," its "use of leading IT management practices" (stating that Koss followed about two thirds of some 30 applicable leading practices but that its "[u]ser ID and password policies do not consistently follow leading practices"), and its "program change, database administration, and user access controls." *Id.* at 1, 7-10, 16.

The only testing specified in the memo was of "the IBM AS/400 user profiles for previous sign-on attempts, sign-on attempts not valid, and status." *Id.* at 1, 13. This was documented in the IT review memo as "observ[ing] 48 user profiles from the IBM AS/400," which, based on management's response, did not capture all of the user profiles in the system and did not closely examine purported restrictions on the functions for which the users were cleared. *See id.* at 13-15. In any event, this testing resulted in a finding by the Grant Thornton IT specialists that "[t]he Company does not perform regular user access / segregation of duties reviews" and that "[a]s a result, some users may have excessive access to [its] financial systems," and resulted in the specialists' recommendations that "a policy be created to review and disable inactive AS/400 users, despite their status or title" and that "the IT department prepare quarterly user access lists that can be reviewed for inappropriate access rights by department managers / vice presidents. *Id.* at 15. The management responses provided in the IT review memo acknowledged that these matters did pose some risk but dismissed it as "low" ("[o]n a scale of 0 to 10, maybe a 2" as to user access and "a 1" as to segregation of duties and disabling user profiles). *Id.* This prompted a reply comment by the specialists that stressed the importance of the potential issues involved and pointed out, "Reviews of this Company's IT controls by regulators, investors, or buyers would find control gaps that would be unacceptable based on IT control standards." *Id.* at 16.

Overall, the IT review memo concluded (Ex. J-2 at 1, 14) that "[t]he Company has IT processes in place for managing program changes, managing access to production data around application controls, and managing user access to the Company's CRT software system" for "Accounting (AP, AR, GL), Order Entry, Sales Reporting, Invoicing, Distribution, [and] Payroll" but that "[t]he controls related to those processes" were questionable. Those controls, the memo concluded, "appear to be primarily detective rather than preventative, although regular reviews of detective controls suggest that these controls are probably ineffective," "[t]he IT vendors appear focused at functionality with little understanding or appreciation of IT control standards," and "Company management appears to rely completely on the IT vendors" and to share their outlook.

Thus, the 2004 IT review did not discuss, test, or conclude on the completeness and accuracy of Koss's IT system reporting. There is no indication that procedures in the review were specifically designed or intended to identify deficiencies in the IT system for the purpose of relying on system reports. Even with a limited scope of review, significant potential issues were raised, which will be further discussed in the rest of this section and in the journal entry section that follows. Inclusion in the IT review memo of only the three recommendations, one characterized as moderate risk and two as low risk, along with four further "observations," was a product of the review's limited scope, information, and procedures. The recommendations and observations must be viewed in that context, not as Koeppel sometimes suggests, as effectively a direct, fully informed seal of approval on the IT system's output. KOB 27 n.17 ("'GT's review of Koss's IT system found no significant deficiencies that would undermine the reliability of the standard IT reports used in the Relevant Audits'") (quoting I.D. 42);

KPHS 60 ("The 2004 IT review did not identify any control deficiencies suggesting that reports generated by the system were unreliable or inaccurate."). A 2004 "review" that did not test Koss's IT system or its output, the passage of years since that review, and the updating of the review through general inquiries provided her with little more than an understanding of how the system was supposed to work, in contrast to evidence about how it actually worked, to support the reliability of system-generated reports.

Similarly overstated is Koeppel's second claim, that her knowledge about the outside contractor's role as manager of Koss's AS/400 computer system and "the only person authorized to implement changes to the system" contributes to a conclusion that "substantial evidential matter was obtained about the accuracy and completeness of the information produced by Koss's IT system." Although the contractor did not take part in the financial reporting process and was deemed "knowledgeable and helpful" by the 2004 IT review, the review found, again, the "IT vendors appear focused on functionality with little understanding or appreciation of IT control standards" and Koss "appears to rely completely on the IT vendors." Ex. J-2 at 1; Tr. 1342, 1375; *see* Ex. J-1 at 1 ("IT management (vendors) do not appear to fully understand IT controls standards.").

Moreover, knowledge that the contractor is the only one "authorized" to implement system changes does not mean that he is the only one able to do so. An understanding from the 2004 IT review (*id.* at 4, 11) that "[t]he entire AS/400 system is backed up quarterly," that "[e]very time a program is altered a log of who generated the change is automatically compiled and stored in the computer room indefinitely," and that the contractor "will view this log for errors" does not mean that all of this, in fact, happened as envisioned. Although the 2004 IT review memo noted that "[f]or the AS/400, the departmental / functional vice president requests the addition, deletion, or change for a user" and "[t]he vice president also identifies which programs are to be made available to [the] user," the memo did not provide specific details about those processes. *See id.* at 6. Indicating potential difficulties in governing and corroborating actual practice at Koss, the memo more generally referred to vice presidents being "authorized to initiate change requests (verbally or via email)," noted that "[e]mail requests are retained for a short period of time" only, and found that Koss did not have "a formal change control process, including the formalization of change requests, a procedure for retaining all requests, [or] documentation of user approval." *Id.* at 4, 14. The memo also concluded that the controls related to "IT processes in place for managing program changes, managing access to production data around application controls, and managing user access" to Koss's software system for accounting, order entry, sales reporting, invoicing, and distribution were "probably ineffective." *Id.* at 1, 2.

Even more importantly, as noted above, it was Koss personnel, not the outside contractor, who actually entered data and used Koss's IT system, and there were other risks from use of IT than unilateral internal changes to systems or programs. This included "IT risks as it relates to the susceptibility of altering information" and the processing of unauthorized transactions. *See, e.g.*, Ex. R-202 at 6 (2006 Koss audit work paper). The 2004 IT review indicated that Koss management placed a high degree of responsibility on its personnel at the departmental level. As management stated, "I think it is important to note our IT is in the hands of the users. Each area is responsible for it[s] data and the accuracy of that data." Ex. J-2 at 17.

Koeppel's related third and fourth claims, that the IBM AS/400 computers used by Koss were "reputable, if aged," were "proven in the marketplace," had "standard financial programs" that Koss had not "extensively customized or altered," and produced, "through routine queries and commands," "standard reports, used by Koss's own management," as well as by the auditors, also lack the weight and quality to support a conclusion that sufficient competent evidential matter about the reliability of Koss IT system-generated information was obtained in the Koss audits in question. Both Koeppel and the initial decision repeatedly use the term "standard report" without ever specifying what they mean by it or the basis for their use of that description here. As the Division notes (DOB 24 & n.99), the only support Koeppel cites for her claim that the Koss IT system-generated reports used for the audits were also used by Koss in the ordinary course of business is her bare assertion at the hearing, without supporting explanation about the reports in the testimony or audit work papers. When asked at the hearing if the auditors at any point went behind Koss's IT system to look at what the reports were actually pulling from, Koeppel responded, in circular fashion, that "we didn't think to do that, again, because they were system-generated reports." She further asserted without elaboration that "[t]hey weren't queries that were being done specifically for us," "[t]hese were reports that management used," and "[they] were consistently processed and prepared by the system." Tr. 1488. Simply because a report has the same name or code number from one year to the next, which she stressed at the hearing (Tr. 1487-88), apparently to try to support these assertions, is not evidence that the contents of reports are complete and accurate. To bolster her last assertion, she also stressed the reports "tied out each time" to more Koss system-generated reports (Tr. 1350, 1485, 1488-89), which, as we discuss in detail later, was not adequate additional evidence of the reports' reliability.

Furthermore, merely because Koss management may have considered the company's IT system and the reports it generated to be good enough to manage the business, and in this sense "reputable" and "proven in the marketplace," did not mean that Koeppel could assume they were adequate for audit purposes. For example, pertinent here are the findings of the 2004 IT review about Koss's outside AS/400 contractor's apparent focus on functionality and poor understanding and appreciation of IT control standards, Koss management's apparently complete reliance on the contractor and sharing of its focus, prompting the Grant Thornton IT specialists to comment in the IT review memo, in response to management, "Auditing standards focus on IT Governance and controls rather than how 'well oiled' the process may seem." Ex. J-1 at 1; Ex. J-2 at 1, 18; *see* Tr. 1483-86 (recognizing that Koss "preferred to put their dollars to [research] and development of products rather than internal systems"); *see generally* AU §§ 319.14, .40 (noting that "[a]n entity's risk assessment," the purpose of which is "to identify, analyze, and manage risks that affect entity objectives," "differs from the auditor's consideration of audit risk in a financial statement audit," the purpose of which is "to evaluate the likelihood that material misstatements could occur in the financial statements"). At the hearing, Koeppel pointed out that the "marketplace" of users of IT systems like Koss's included most of her private company audit clients (Tr. 1483-85), which do not have the responsibilities of a public company like Koss and whose audits need not comply with PCAOB standards. Additionally, if an IT system error or a fraud is occurring at a company, then its system-generated reports naturally could be affected, and those reports could be used in the business by company personnel who were not aware of that fact, or the false appearance of such use could be created. Mere use of the reports by management or employees need not signal that the reports are reliable for use in substantive testing in an issuer audit.

As to Koeppel's claim that the "standard financial programs" running on Koss's computers had not been "extensively" customized or altered, she again displayed the lack of a clear understanding when she asserted at the hearing, again without elaboration in the testimony or discussion in the audit work papers, that there was "very little tailoring" and that "most of" the inquiries "were standard, or if they had been customized, they have been customized years before, and they were using the same inquiries to generate reports repeatedly." Tr. 1485-86. Her testimony thus indicates that there was some customization or altering of the computer or financial programs to Koss's business, which stands to reason, and potentially created an individualized opportunity, specific to Koss's circumstances, for error in the capture, summarization, or presentation of data or for fraud. She specifically points out that viewing Koss's general ledger, maintained only in electronic form, would be "mediated" by "the software and commands that were used to make particular journal entries appear on the computer monitor." KPHS 70. The printed output of Koss's IT system was likewise mediated by components of the system, yet, contrary to the claims Koeppel now makes in briefing (KOB 28; KPHS 24), they were not "thorough[ly]" understood in the audits.

Koeppel's fifth and sixth claims, about Koss's "integrated" accounting system and "system access controls [] in place" are likewise unavailing. To be sure, PCAOB auditing standards recognize that the audit client's use of IT can provide benefits that may mitigate the risk of misstatement. *See, e.g.,* AU §§ 319.18, .30, .43-.44 (discussing controls that "apply to the processing of individual applications" and "may be performed by IT"), .46 ("when IT is used in an information system, segregation of duties often is achieved by implementing security controls"), .51 (automated processes and controls "may reduce the risk of inadvertent error"), .78 ("Because of the inherent consistency of IT processing, the auditor may be able to reduce the extent of testing of an automated control."), .85 ("because of the inherent consistency of IT processing, performing procedures to determine whether an automated control has been placed in operation may serve as a test of that control's operating effectiveness, depending on such factors as whether the program has been changed or whether there is a significant risk of unauthorized change or other improper intervention"). But "IT also poses specific risks to an entity's internal control." AU § 319.19. These include fraud risks discussed above. Indeed, automation does "not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically passed to the general ledger or financial reporting system," and "when IT is used to automatically transfer information there may be little or no visible evidence of such intervention in the information systems." AU § 319.51. Also, "errors may occur in designing, maintaining, or monitoring automated controls." AU § 319.21. Other risks from use of IT include, for example, "[r]eliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both," "[f]ailure to make necessary changes to systems or programs," and "[p]otential loss of data." AU § 319.19. Correct information needs to be entered into the system and incorrect information needs to be caught. The auditor obtains evidence about the actual operation of controls over the audit period, not merely, as here, gains an understanding of how they are supposed to operate, including making fragmentary, incomplete observations of their operation at one point in time and accepting representations without any exploration. For these reasons, the information about Koss's "integrated system" and "system access controls" only scratched the surface of the issue of "opportunities for human error or intentional misrecording of transactions" (KOB 28).

This is exemplified by Koeppel's contention at the hearing that both system integration and access controls would prevent what the hearing officer referred to in questioning as a "garbage in, garbage-out problem." Tr. 1489-90. Koeppel argued that "if you had bad information in there, the system is going to fall apart…the reports are not going to be consistent." *Id.* In so arguing, she ignores the issue of management override of controls and manipulation of the system through false entries that could produce incorrect reports that nevertheless were consistent with one another or could make accounts balance. More generally, as the Division notes, "Koss's integrated accounting system" could create problems of its own for data reliability (DOB 23); incorrect information, like correct information, could be "simultaneously posted to relevant accounts" and "flow[] automatically through various accounts and subledgers" (KPHS 23, 61), and the risk existed that "the subledger accounts would not agree with the general ledger accounts, due to timing or to direct manual entries" (DOB 23). Koeppel further argued that, due to the "overall access controls to the system," "somebody else couldn't get into that system to put in garbage." Tr. 1489. Indeed, user identifications and passwords were emphasized in the documentation of the walkthroughs in the audits. *See, e.g.,* Exs. J-49 at 1, 4, R-300 at 16, 19, 22, 26-28, 30, 31, R-398 at 16, 21, 23, 25. But, again, that does not address the risk of fraud or error by persons authorized to use the system. Nor does it address the issue of system error in the computer system and financial programs, as applied to Koss's business.[30/]

[30/] In testimony, Koeppel claimed that using various Koss system-generated reports and tying them to one another "validat[ed] that information is accurate and consistent" because "we're getting the same information" "sliced and diced in different ways." Tr. 1336-37, 1349-50, 1371, 1488-89. But if those reports, which Koss staff printed out at a

Similarly, as to access controls, the narrow scope of the 2004 IT review and the potential concerns raised by the firm's IT specialists are discussed above. Koeppel argues that "[e]vidence about such access controls was obtained through journal entry control testing and through direct observation of user's access during walkthroughs." KOB 28. We address the inadequacies of the purported journal entry control testing, and related walkthrough observations, in detail in the journal entry section below.

We therefore reject eight of Koeppel's nine arguments that the evidence obtained in the 2006, 2007, and 2008 Koss audits was, as the initial decision put it, sufficient to support the completeness and accuracy of reports generated by Koss's IT system "as a general matter," or, as Koeppel puts it, constituted "substantial evidential matter…about the accuracy and completeness of the information produced by Koss's IT system which [she] believed provided a reasonable basis for her professional judgments regarding the issues criticized in the OIP." Discussion of Koeppel's ninth argument follows in the sections analyzing the audit work in the individual audit areas.

2. Journal entries

There is no dispute in this case that a fundamental prerequisite to performing journal entry testing, as required by applicable PCAOB auditing standards, is to obtain a complete population of journal entries for the year under audit. *E.g.,* Tr. 764-65, 776, 792-94, 801-05, 808 (Koeppel). Among Koeppel's "years of training" in journal entry testing, Grant Thornton's August 2006 and January 2007 training made clear that auditors "must address completeness" of the population used to select journal entries for fraud testing; that "We need to make sure the population is the **entire** population"; that "If you do a good job testing journal entries but you never had the full list of journal entries, what have you accomplished? Don't waste your time on an incomplete file!"; and that when management creates a listing of journal entries or provides paper copies of journal entries maintained in a binder for the auditor, "if there was fraud, management probably would not include the fraudulent entries" on the list and "[c]opies of fraudulent journal entries would likely not be in the binder." Ex. J-130 at 4, 20-22 (bold in original); Tr. 1330. Koeppel testified these statements reflected her views during the audits in question. Tr. 802-08. She said she made it a point in the audits to "make sure we had a complete set of journal entries" (Tr. 1329) or, as Audit Manager put it, to "make sure we were looking at everything for the journal entries" (Ex. R-509 at 111). As Audit Manager noted, "you can only evaluate what you're seeing, and if it's not there, you can't appropriately evaluate" and "[w]hen evaluating[,] whether or not you're looking for

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particular point in time and could not be reproduced after that date, were all individually subject to manipulation by Koss management or staff or were all drawing from the same block of data that was incorrectly entered or processed by staff or Koss's IT system, or that was being manipulated by management or staff in the various reports—matters with respect to which we find insufficient audit work was done—there is no "validating."

things that are unusual in nature and nonstandard, you can't evaluate what's not there." *Id.* at 94 & Ex. D-4 at 82-83 (investigative testimony). Koeppel does not contest that in the respects pertinent to the journal entry charges, she herself was aware of the audit procedures performed and evidence obtained. *See, e.g.*, KPHS 28, 30, 32, 65-71. We have discussed the facts of the journal entry work in detail above. *See* pp. 33-49.

In summary, completeness was specifically called to Koeppel's attention as a concern during the 2006 Koss audit, when the PCAOB inspection of the 2005 Koss audit included a negative comment in that respect on the 2005 journal entry testing. Again, the importance of having a complete journal entry population and the danger of relying on management-provided lists or binders, from which fraudulent entries could be excluded, was also impressed upon Koeppel in firm-wide audit training in August 2006 and January 2007. In planning each audit, she recognized that revenue recognition and management override of controls were fraud risks at Koss and identified the small size of the organization, including its three-person accounting department, as giving rise to a risk of fraud from lack of segregation of duties. In particular, she recognized that consideration of any controls (or lack thereof) Koss had in place to address identified fraud risk factors "would need to include an added sensitivity to management's ability to override such controls" and that it was necessary to "closely review unusual journal entries and perform journal entry control testing." Koeppel knew that, due to asserted limitations of Koss's IT system, the auditors did not have an electronic download or computer-generated list of all of Koss's journal entries, which she regarded as "definitely the preferred method to get the information." Tr. 1330. Nor was it feasible in the audits to use what Koeppel described as "a nice way to get comfort" by "identify[ing] numbers that were missing" because Koss's journal entries were not "numbered sequentially." Tr. 1322-23. It was therefore necessary to "audit around" the limitations by some other means. *See* Ex. R-509 at 93, 124 (Audit Manager's investigative testimony).

Yet, after consulting with another Grant Thornton partner in the latter half of 2006 and making the judgment that the general concept of "upstream/downstream testing" was "an effective way" to "make sure we had a complete set of journal entries," Koeppel did not provide any input into, and did not ascertain why Audit Manager decided to use, the particular approach to such testing she did in the 2006, 2007, and 2008 Koss audits. *E.g.*, Tr. 835-37, 1329, 1492. Koeppel also decided not to discuss that approach with anyone else because, according to her testimony, she "did not see a need to elevate that to somebody outside of the engagement team." Tr. 1322-3, 1329, 1452-55, 1492.

Instead, she simply approved, as the critical completeness test, that tracing back and forth of a sample of journal entries from one set of paper binders to another set, both openly accessible and prepared in a manner untested in the audits by a member of Koss's three-person accounting department. And she was ultimately content to accept, or infer from, their representations that each binder contained a complete set of the year's journal entries, in forming her audit conclusions and authorizing issuance of the audit opinions. *See, e.g.,* Tr. 1334-35 ("we did not identify anything that would cause us to dispute that we were receiving anything but all reasonable and appropriate information"); *see also* Tr. 92-96; Ex. D-4 at 85-86 (Audit Manager's investigative testimony). Koeppel concedes that the tracing would not identify items omitted from both sets of binders and that applying audit procedures to an incomplete set of journal entries would be a "waste [of] time." Tr. 795, 802-08, 837-38, 1151-53, 1493; *see* Tr. 107-110 (2006-2008 Staff/In-Charge Auditor); Tr. 705-06 (2007-2008 Staff Auditor).

The Division argues that Koeppel therefore violated AU §§ 110 and 316.61 and also failed under AU § 230 to exercise due professional care, including professional skepticism, with respect to the journal entry testing. *E.g.*, DOB 7-10. Koeppel counters with four main arguments. First, as in the other audit areas, she argues that the journal entry charges must be dismissed because she did not personally perform the detailed audit testing and the case could only be charged as a failure of supervision or planning. *E.g.*, KOB 20, 41, 42; KRB 4. Second, she contends that, in each audit, other work on journal entries and perhaps other work in the audit more generally compensated for any limitations of the upstream/downstream testing. *E.g.*, KOB 42-43; ArgTr. 63-64, 66, 67-68. Third, she seems to claim that she had or was provided with no alternative to the approach she took to the journal entry testing. KOB 23 n.14, 40. Fourth, she argues that the initial decision only found that the journal entry work did not fully comply with PCAOB auditing standards because the decision "inappropriately shifted the burden of proof" from the Division to her. KOB 40, KRB 5-6, 9. We agree with the Division. Our discussion of engagement partner responsibility in Section V(A) disposes of Koeppel's first argument, and we discuss and reject her other arguments below.

For Koeppel's second argument, she points to other procedures and information in each audit than the tracing a sample of journal entries from one paper binder to another. She contends that, "[i]n the context of the assessment of the fraud risk at Koss as 'low,'" these other items gave an "understanding" of "the overall control environment" or "well-controlled environment" of "segregation of duties," "monitoring controls," and "access controls" that "existed over journal entries" and served as "multiple additional sources of assurance" that "bear[] on the completeness of the population of journal entries being tested." KOB 42; KRB 7-8; Tr. 1142, 1300, 1328-29, 1493-94. Namely, she cites: (1) asserted "journal entry control testing"; (2) Koss's "use of consistent numbers for standard entries" and audit "review of the numbering" of entries; (3) Koss's printing of the so-called update reports "on multiple pages of greenbar paper that still had their perforated pages attached to each other"; (4) "information provided by Koss's third-party IT contractor and Koss's accounting staff" that its IT system generated an update report each time a journal entry was posted to the general ledger; and (5) responses by Koss's accounting staff to inquiries about "whether any improper journal entries had been made" and related management representations. KOB 42-43; KRB 6-9; KPHS 29-30, 67-68; Tr. 824-29, 857, 1143-44, 1300, 1451. But whatever "additional assurance" this spotty or surface-level work and information provided left the fundamental completeness problem intact.

As an initial matter, Koeppel frames her discussion of these five items by placing them in the context of the assessed fraud risk in the 2006, 2007, and 2008 Koss audits. Specifically, risk assessment work papers in each audit identified only one of the 12 listed fraud indicators under "Inherent Risk Indicators-General" as "Applicable" ("Pressure to meet expectations of analysts, creditors, and others") (Exs. J-70 at 3, J-178 at 3, J-278 at 3); identified all three "Fraud and Other" indicators listed under "Inherent Risk Indicators-Assertions" for revenue existence/occurrence and valuation as "Not (Rarely) Applicable," including "Potential for fraudulent financial reporting" and "Potential for misappropriation of assets" (Exs. J-71 at 1, J-179 at 1, J-279 at 1); and assessed as "Low" the "Financial Statement Risks" of "Fraudulent financial reporting" and "Misappropriation of assets" (Exs. J-72 at 1, J-180 at 1, J-275 at 1).

Yet, as noted above, this was in a larger context in which it was understood that overall inherent risk was assessed as low but control risk was assessed as high, calling for a combined <u>medium</u> risk strategy in the audits. And as also discussed above, even as to inherent risk, low risk did not mean no risk.

Moreover, "[e]xamining journal entries and other adjustments for evidence of possible material misstatement due to fraud" is a procedure that PCAOB auditing standards require "in addition" to "overall responses" to the risk of material misstatement due to fraud and "responses that address specifically identified risks" of such misstatement; it is a procedure that "should be performed to further address the risk of management override of controls," "given the unpredictable ways in which such override could occur" and given that material misstatements "often involve" the manipulation of the financial reporting process by "recording inappropriate or unauthorized journal entries" or other adjustments. AU §§ 316.02, .08 & n.6 ("[f]rauds have been committed by management override of existing controls using techniques such as…recording fictitious journal entries"), .48, .57, .58, .61; *see* AU § 316.42 (auditor "should address that risk"—override of controls—"apart from any conclusions regarding the existence of more specifically identifiable risks"). Still further, AU § 316's repeated references to "the general ledger" in describing the required journal entry testing (AU §§ 316.58, .61)—which reflect that a complete population of entries is a fundamental premise of the testing—are not tied to any particular level of assessed fraud risk. Nor are they dependent on any particular level of assessed control risk. Even where it is established through proper audit testing, not the so-called journal entry control testing in the Koss audits, that controls over journal entries are implemented and operating effectively, completeness is no less a prerequisite to the identification and testing of specific journal entries, which is still required under AU § 316.61. Work papers reviewed by Koeppel acknowledged the need for "an added sensitivity to management's ability to override" any controls "the entity has in place to address the identified fraud risk factors" and, in light of the risk of management override of controls and the risk of lack of segregation of duties, to "closely review unusual journal entries and perform journal entry control testing." *See* Exs. J-3 at 3, J-100 at 3, J-200 at 3, 4.[31/]

Although Koeppel suggests that what she calls journal entry controls testing mitigated the risk of material misstatement due to fraud and lessened the audit effort necessary in the journal entry area, PCAOB auditing standards make clear that "[e]ffective controls over the preparation and posting of journal entries and adjustments may affect the extent of substantive testing necessary, provided that the auditor has tested the operating effectiveness of those controls" and that "even though controls might be implemented and operating effectively, the auditor's procedures for testing journal entries and other adjustments should include the identification and testing of specific items." AU § 316.61 (emphasis added). Koeppel herself believed that "tests" and "testing" were key in the Koss audits "to validate or negate" the potential lack of segregation of duties (which she deemed relevant to the completeness of the journal entry binders) and to "validate," more so in 2007 and 2008 even than in 2006, "our understanding of the process" and "our understanding that there had been no changes in the process." Tr. 1144-47, 1199, 1300-03, 1306. As we discuss below, the journal entry control-related work did not test the operating effectiveness of those controls and, at best, provided little "additional assurance" of the completeness of the population of journal entries selected for audit testing, on which the value of that testing depended.

Koeppel also tries to frame the discussion of the five items by arguing broadly that to expect any more than the journal entry testing she accepted as adequate would adopt an "interpretation of AU 316.61" that is "novel" and "fundamentally incompatible" with PCAOB standards and that "would place an impossible burden on auditors" by requiring them to "anticipate *every* potential fraudulent scheme," "*all* fraudulent

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[31/] At the hearing and in briefing, Koeppel has seemed to try to downplay the reference to lack of segregation of duties by describing it merely as an identification of "a potential fraud risk" arising from Koss's "small accounting department" and "a consideration in our planning," "done on a preliminary basis," prior to the performance of audit tests "to validate or negate that potential lack of segregation," and by isolating "efficiency" as a factor in not testing Koss's internal controls. Tr. 779-84, 832, 1254-55, 1302-03, 1495; KOB 30 n.20, 42; KPHS 18; *see* Ex. R-509 at 40-41 (Audit Manager's investigative testimony). But that risk was significant enough to be "primarily" the reason "GT did not conclude that" "a number of controls in place to mitigate the risk of loss and/or fraud" at Koss "brought control risk to a LOW level" and, "[a]s such, GT has not placed reliance on those controls," and to call for "close[] review of unusual journal entries" and "journal entry control testing." *See* Exs. J-3 at 3, 4, J-100 at 3, 4; *see also* Ex. J-200 at 3, 4; Tr. 810. Koeppel testified that it was "very important" to her that a "senior official should not have access to both create, post and approve journal entries" and that she "would want to take careful note of" circumstances that "could've resulted in a lack of segregation of duties." Tr. 1302-03, 1307-08. And, as performed, the stated audit responses to the risk left a hole in the audit evidence, as we discuss below.

schemes," and "every potential fraud," "no matter how improbable and no matter how difficult it would be to perpetrate," or to "detect" the precise fraud that may have taken place. KOB 1, 41, KRB 4, 9. This hyperbole ignores the real issue here, which is that the auditor needs to respond to a clear gap in evidence on a critical point. As in *Wendy McNeeley, CPA*, "[t]he gravamen of the charge against" Koeppel "is not her failure to uncover the fraud itself, but her failure to adhere to [applicable auditing standards] during the audit." SEC Rel. No. 34-68431, 2012 WL 6457291, *12 (Dec. 13, 2012).

Koeppel has acknowledged that selection of journal entries from a complete population is necessary to proper journal entry testing under PCAOB standards, she was unable to identify any work in the audits in question that would have provided evidence that any items were missing from both sets of journal entry binders, and she has offered no argument why items could not be removed from two sets of binders at Koss as easily as from one. *See, e.g.,* Tr. 776, 827, 1149, 1493. Reminding auditors that "[w]e must address completeness" and that "[t]his must be done," Grant Thornton training that Koeppel attended during the relevant period specifically observed from experience that "common excuses" why an audit team "believes they tested completeness or why they could not test completeness," such as obtaining a client-prepared "list of journal entries" or "'paper copies of journal entries maintained by the [client] in a binder,'" are "no excuses" because, quite commonsensically, the list "would probably not include [any] fraudulent entries" and "[c]opies of fraudulent journal entries would likely not be in the binder." Ex. J-130 at 20-22. The auditor needs to test journal entries, and that requires effectively addressing what is an essential premise of doing the testing in the first place—that the population subject to testing is complete. This is not a matter to be left to hypothesis or prediction about a particular method of fraud.

Completeness, and the audit work necessary to confirm it, is so important precisely because, as PCAOB standards take pains to caution auditors:

- "management is in a unique position to perpetrate fraud because of its ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding established controls that otherwise appear to be operating effectively," which "[f]raudulent financial reporting often involves";

- "[b]y its nature, management override of controls can occur in unpredictable ways";

- "[t]ypically, management and employees engaged in fraud will take steps to conceal the fraud from the auditors and others within and outside the organization," as "by withholding evidence or misrepresenting information in response to inquiries or by falsifying information";

- "material misstatements due to fraud can occur throughout the period and may involve extensive efforts to conceal how it is accomplished";

- "the auditor cannot assume that the inability to observe" some of the conditions often present in circumstances where fraud exists "means there is no risk of material misstatement due to fraud," and the extent to which each condition is "present when fraud occurs may vary"; and

- "inappropriate journal entries and adjustments might be made to other accounts" than those "associated with an identified risk of material misstatement due to fraud."

AU §§ 316.08, .09, .27, .31 ("fraud is usually concealed"), .35, .36, .48, .57, .61, .62; *see* AU § 316.04 ("the opportunities to commit fraud can be reduced significantly," but by implication still be present, even when "management and those responsible for the oversight of the financial reporting process fulfill th[eir] responsibilities").

Likewise, PCAOB auditing standards are replete with warnings that fraud can occur through collusion:

- "[m]anagement can either direct employees to perpetrate fraud or solicit their help in carrying it out";

- "controls, whether manual or automated, can be circumvented by the collusion of two or more people"; and

- "[f]raud [] may be concealed through collusion among management, employees, or third parties," in that, for example, "through collusion, false evidence that controls have been operating effectively may be presented to the auditor, or consistent misleading explanations may be given to the auditor by more than one individual within the entity."

E.g., AU §§ .08, .10, .43, 319.22; *see* AU § 316.06 ("[f]raudulent financial reporting need not be"—but by implication can be—"the result of a grand plan or conspiracy"). Koeppel's argument unconvincingly proceeds as if none of this had any implications for the importance of completeness and of audit work rigorous enough to confirm it.[32/]

[32/] Koeppel's briefing seems to assume that a "collusive fraud" (KOB 41) at Koss was unfathomable, that the possibility did not even need to be considered, much less addressed in any way in the audits, for she does not point to anything that did so, and that a material misstatement due to fraud could only have occurred at Koss through collusion if there was "a total breakdown in their control structure" (Tr. 1493). But she chose not to test internal control over critical assertions, and an understanding of how

In light of these challenges, fulfilling the responsibility under the standards "to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement" (AU § 110.02) and Koeppel's stated approach of "close[] review [of] unusual journal entries and perform[ance of] journal entry control testing" and "an added sensitivity to management's ability to override such controls" (*e.g.*, Tr. 779-81, 810, 824, 830-31; Tr. 536; Exs. J-3 at 1, 3, J-100 at 3, 6, J-200 at 3, 7; Tr. 779) were stymied at the outset by such heavy reliance as she placed on paper binders from which journal entries admittedly could have been excluded.[33/]

The first category of items cited by Koeppel as a source of assurance about completeness other than the upstream/downstream procedure is so-called journal entry control testing. As outlined by her, this "include[d] work that was performed to obtain an understanding of Koss's systems and processes" and essentially consisted of: inquiry about "the monitoring controls that existed as it related to journal entries" (meaning VP-Finance and "the active role played by Koss's CEO/CFO in reviewing [its] financial position and processes, including journal entries"); "review of access" (considering a user profile list from Koss's IT contractor) in 2006 and "our understanding that there had been no changes in the process" in 2007 and 2008; "direct observation of system access controls" and taking a "look at journal entries" in so-called walkthroughs of an individual transaction; and "testing segregation of duties" by examining handwritten

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Koss's controls were supposed to work, along with limited audit work she describes as "testing" journal entry controls, did not do enough to determine whether the journal entry population subject to fraud testing was, in fact, complete, as we discuss below. Moreover, Koeppel identified the "small size of the organization," including Koss's three-person accounting department, and the fact that "[t]he operating and financial decisions are dominated by a few individuals [at] Koss" as potential fraud concerns. *E.g.*, Exs. J-3 at 3, J-70 at 2, J-178 at 2, J-278 at 2; Exs. J-100 at 3, J-200 at 2, 3, 4; Tr. 778-81, 810-13, 829-32; *accord* Ex. R-509 at 62-63 (Audit Manager's investigative testimony).

33/ Koeppel notes that the issue about the completeness of Koss's journal entry population subject to fraud testing that was cited in the 2005 PCAOB inspection comment form was not cited in the 2005 PCAOB inspection report as resulting in an insufficiently supported audit opinion. KOB 11; Tr. 1317-18. She then suggests that she could assume from this fact that there could be no "fail[ure] to obtain sufficient competent evidential matter" as a result of a completeness problem with the journal entry testing in the 2006, 2007, and 2008 Koss audits. KOB 11. But the way in which the completeness issue was cited in the 2005 inspection report, based on the aspects and circumstances of the 2005 Koss audit that were considered and the work that was done in that inspection, does not represent a conclusion that nothing more needed to be done on completeness to support the opinions in the 2006, 2007, and 2008 Koss audits. Any finding of violation we make here regarding the three audits in question is based on the full record developed in this exhaustively litigated disciplinary proceeding.

journal entry forms compiled in binders by a member of Koss's accounting department. *E.g.*, KRB 8; KPHS 29; Tr. 825, 1142, 1147, 1300, 1306, 1311, 1451, 1493-94.

PCAOB auditing standards make clear that "because management may have the ability to override controls that otherwise appear to be operating effectively," "it is unlikely that audit risk can be reduced to an appropriately low level" through "only tests of controls"—much less merely an understanding of controls—and that, "even though controls might be implemented and operating effectively, the auditor's procedures for testing journal entries and other adjustments should include the identification and testing of specific items." AU §§ 316.51, .61. As discussed, the particular upstream/downstream testing left a clear gap in the evidence of completeness of the journal entry population, and the particular control-related procedures did not come close to filling that gap. Instead, the latter comprised a flawed effort purportedly showing there was no reason to believe false journal entries could be recorded in the first place. It was based on the same paper binders of journal entry forms used in the upstream/downstream testing; more representations from the same small accounting department viewed as possibly lacking a segregation of duties; imprecise, inconsistent, and potentially troubling understandings about company processes; an untested, one-time 2006 list of Koss IT system user profiles, not regularly reviewed by Koss and updated by the auditors through general inquiries; one-off observations; and conjecture.

To begin with, the "understanding of Koss's systems and processes" (KRB 8) that underlay the purported journal entry control testing was itself problematic. Koeppel understood that Senior Accountant and Junior Accountant posted journal entries to accounts for which the former prepared reconciliations. Koeppel also accepted VP-Finance's claim that she herself reviewed, but could not post, journal entries and that VP-Finance reviewed account reconciliations while additionally performing the bank statement reconciliations for at least 2006, having access to and authority over Koss checks, and being responsible for writing off accounts receivable. *See, e.g.,* pp. 39, 92 above. This understanding raised potential concerns of its own about segregation of duties. *See, e.g.*, Tr. 1145-47 (Koeppel); Ex. D-4 at 68-72 (Audit Manager's investigative testimony: "[i]t appears that way, yes," that VP-Finance had custody, authorization, and record keeping abilities, a concern supposedly addressed by President/CEO's review of bank reconciliations, though "I don't recall any specific evidence" of such review, only what "I took [] to mean" from what VP-Finance said); Ex. J-7 (2006 audit program: "GT notes that these individuals do prepare reconciliations of the accounts that they post entries to," a concern supposedly addressed by VP-Finance's claim that she herself "reviews all account reconciliations and the journal entries must be authorized by [her] as well"), Ex. J-9 (Koeppel's sign-off on notation).

Moreover, VP-Finance's claim about not being able to post journal entries was inconsistent with the statement in the work papers for all three audits, which each year was reviewed by Koss management, that VP-Finance and Senior Accountant "have access to create standard and non-standard journal entries." *See* pp. 34-36 above;

Exs. J-4 at 2, 3 (signed off on by Koeppel in 2006), J-101 at 2, J-201 at 2, 3 (same in 2008). Even if VP-Finance did not have direct access to post entries, she could have influenced them. This was inherent in her review role, which presumably included the ability to reject an entry and give instructions for modifying it. And nothing prevented her from being involved in the process of creating the proposed entries in the first place. In fact, a 2006 work paper stated, "GT notes that all journal entries are created on paper by…VP of Finance, and entered into the system by…Junior Accountant. [President/CEO] reviews [VP-Finance's] journal entries through review of the monthly financial statements." Ex. J-11 at 4. Audit Manager explained in the investigation that "[b]ased on certain calculations in certain areas, it was possible that [members of Koss's accounting department] were outlining what the calculations and what the entry was that should be recorded" and VP-Finance "may work on the origination and tell individuals what the entries needed to be…she had some involvement," though "the sample that we tested" did not include any journal entries drafted by her. Ex. R-509 at 139, 142-44.

Although Koeppel's expert witness conjectured that "the working papers show that [Senior Accountant] and [Junior Accountant] were appropriately experienced and familiar with Koss's operations," such that "[VP-Finance] or others at Koss would be likely unable to deceive either accountant into posting inappropriate journal entries without their awareness" (Ex. R-507 at 54-55), the expert cited a 2008 work paper stating that Senior Accountant and Junior Accountant had been employed in their current roles "for several years" (Ex. J-204). Koeppel understood at all times during the audits that both of these individuals reported to VP-Finance, who, unlike them, was a certified public accountant, had worked at Koss for a considerably longer time, was identified by Koss as among its "Officers and Senior Management," and was one of two Koss officers who signed Koss's Form 10-Ks. *See, e.g.*, Tr. 1478, 1502; Ex. J-59 at 40, 41; Exs. R-205 at 2, 5, R-396 at 1, 5. The expert addressed none of this evidence.

Nor do Koeppel or the expert take account of some key facts as to VP-Finance's claim to review all journal entries, a claim on which Koeppel heavily relied. VP-Finance worked part-time and was not at the office every day. Tr. 1495. There is no claim or evidence that an electronic approval was required to post an entry or of any bar to it being "initiated and recorded online with no physical evidence" (AU § 316.59) left behind. *See, e.g.,* Ex. R-509 at 117-18, 142. As far as the auditors knew, to the extent VP-Finance looked back at past journal entries, she used the binders, which the record indicates she did not necessarily compile and over which the auditors did not identify or test any controls. *See, e.g.*, Tr. 46, 51, 54, 334-35, 555, 827, 1473; Ex. D-4 at 45.[34/]

[34/] Koeppel's expert simply described, in hindsight, the precise fraud reported to have occurred at Koss from at least 2005 through 2009, as though it exhausts the possibilities, and assumed that collusion was "required" (Ex. R-507 at 55), as did her counsel's question to Koeppel about her belief that VP-Finance admitted in a plea agreement that "the" fraud began in 1997 (Tr. 1215). But the record, as noted, as well as documents of which we can take official notice for the limited purpose of responding

To support VP-Finance's claim to review all, and not to post any, journal entries, Koeppel relied on two elements of the so-called journal entry control testing, which are described by Koeppel as "ensuring that the specific journal entries selected for testing" under AU § 316 "were created and signed off by the appropriate personnel" and "confirming that security access controls appropriately restricted access." KRB 8. The first again involved examination of the same binders of paper journal entry forms used for the journal entry testing, prepared and maintained by Koss's accounting department, from which items admittedly could have been excluded. *E.g.*, Tr. 795, 827, 1147, 1150, 1306 (Koeppel); *see* Exs. D-4 at 84-86 ("so seeing that we had things going from both directions and no exceptions were noted, it was deemed that we had everything…their policy of the binders and then tracing them back in the other direction, finding [no] exceptions, we relied on the representations from management that they had provided everything") & R-509 at 129 ("not finding any evidence that these [binders] were incomplete, we presumed that they were complete"), 147 ("[W]e did a sample of going from the [form] binders to the system [*i.e.*, the update reports] and the system to the [form] binders to verify completeness. Absent of exceptions, we deemed the binders to be complete and concluded our testing.") (Audit Manager's investigative testimony).

Koeppel's other asserted source of support for VP-Finance's claim is Koss IT system access controls, as Koeppel understood them from audit team inquiry, walkthroughs, and a 2006 user profile list. *E.g.*, Tr. 826, 1148-49, 1306; Ex. J-73 at 1, 2; Ex. R-509 at 99-100, 101-06. But Koeppel admits that such controls, too, could not provide evidence of whether journal entries were missing from both sets of paper binders. *E.g.*, Tr. 827 (acknowledging that there were not any controls that provided evidence that all the update reports were included in the paper binders), 1149 (same).

Further on access controls, only in the first of the three audits at issue was a list of user profiles obtained from the contractor to whom Koss outsourced management of its IT system. According to an unelaborated notation reviewed by Koeppel on the 2006 audit program, "IT provided a list of all user profiles. The user profile of 'Accounting' indicates the ability to post entries to the general ledger. Per review of the listing only [Senior Accountant] and [Junior Accountant] have this user profile." Ex. J-7, Ex. J-73 at 2. As Koeppel knew, the work step on the 2006 audit program to which the notation was appended stated, "Verify the completeness and accuracy of the [user profile] list by

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with employment information they might provide, indicates that the expert's assumption is unwarranted, not least because fraud by VP-Finance beginning in 1997 predated the tenure of Senior Accountant and Junior Accountant in the accounting department. *See, e.g.*, Tr. 732, 1478, 1502; Exs. R-205 at 2, 5, R-396 at 1, 5; *see also SEC v. [VP-Finance and Senior Accountant]*, No. 10-CV-0747 (E.D. Wis.), Complaint filed Aug. 31, 2010, at 2-3 ¶¶ 8-9 (alleging VP-Finance held her position at Koss starting in 1992 but Senior Accountant did not hold her position at Koss until 2001), Senior Accountant's Answer filed Nov. 22, 2010, at 6 ¶¶ 8-9 (admitting or not denying those allegations).

comparing it to system controls." *Id.* Yet, as the notation indicated, all that done in this regard, in the words of Audit Manager's investigative testimony, was "obtain[ing]" and "look[ing] at" the list itself. *Id.* at 94-96, 101; Ex. J-9. According to that testimony, "we did not test the operating effectiveness of the[] controls" over access of Koss personnel to post journal entries and Koeppel understood this; Audit Manager did not gain an understanding of all of the user profiles that existed at the time in Koss's IT system, including whether anyone at the company had a "super user profile"; and Audit Manager could not identify any audit work performed to determine the completeness of the list or to test information the outside IT contractor used to generate the list. Ex. R-509 at 96, 100-02, 105-07, 110-13; Ex. D-4 at 53-57; *see* Tr. 535 (2007-2008 Staff/In-Charge Auditor: control effectiveness within Koss's IT system was not tested); *see also, e.g.,* AU § 319.77 (where the auditor does design tests of automated controls and, for example, identifies user review of a company report as a direct control related to an assertion, the auditor "should consider the effectiveness of the user review of the report and also the controls related to the accuracy of the information in the report"), .95 ("Inquiry alone generally will not provide sufficient evidential matter to support a conclusion about the effectiveness of design or operation of a specific control.").

Otherwise in the audits in question, there is no claim or evidence that a user access list was even obtained, much less tested. Instead, general inquiries were made of the contractor about whether the IT system had changed, and in 2008 these inquiries were directed primarily to Koss's accounting department itself. *See* pp. 41-42 above.

Moreover, there is no evidence that the one user profile list obtained in the one audit purported to cover the entire fiscal year, rather than just the point in time at which it was generated, a matter Audit Manager testified in the investigation "would be important to know" in the audit. *E.g.,* Ex. R-509 at 97, 102. Audit Manager stated that "inquiry, observation, and," again relying on the paper binders, "the lack of exceptions noted in our sample testing" were the procedures performed in 2006 to verify that access to post entries did not change over time, yet she could not identify any inquiry into, or evaluation of, changes in VP-Finance's access. *Id.* at 99-106.

Also, Koeppel knew that "no review is done of the list of authorized individuals" by Koss. Ex. J-73 at 2. This was contrary to a 2004 recommendation by the Grant Thornton IT specialists. Ex. J-2 at 15. And the two cited reasons, given by VP-Finance, for Koss not doing a review were that "the list of individuals is so small" (Ex. J-73 at 2), which had been rejected by the IT specialists as "not a control when assessing the effectiveness of segregation of duties and user access controls" (Ex. J-2 at 16), and that she claimed she "reviews each journal entry that is posted" (Ex. J-73 at 2), which again depended for corroboration on the paper binders of journal entries. Similarly, Audit Manager found it necessary to repeatedly cite the audit work on the paper binders to try to fill gaps in the access controls work, such as the lack of procedures performed to determine the completeness of the user profile list in 2006 or to verify, for example, that VP of Finance's access did not change over the year. Ex. R-509 at 98, 100-03 ("We performed journal entry testing, found [no] exceptions to our understanding, and, as such, did not perform any further verification.”), 105-06 (“Finding no exceptions, there was no need for the team to do anything further.”), 110-12 (“The testing that we did was to look at the underlying journal entries and saw no exceptions and had no reason to believe anything further….We saw that there were two individuals that had that user profile [that had the ability to post journal entries] and, through the results of our testing found [no] exceptions, did not deem it necessary to do any further testing or inquiry.”). As noted, Koss’s outside IT contractor had no involvement with the monthly binders of journal entry forms and update reports, and the audits did not identify or test any controls over the creation and maintenance of the binders. *E.g.*, Tr. 99-100, 334-35, 827, 1473; Ex. D-2 at 30 (Division expert report: chart illustrating control risks involved).

Additionally, the 2004 IT review had brought to light that there were more than 50 accessible user profiles in Koss’s IT system and only 20 users and had found that Koss “does not perform regular user access/segregation of duties reviews” and that “[a]s a result, some users may have excessive access to the Company’s financial systems.” Ex. J-1 at 5; Ex. J-2 at 12, 15-16. Koeppel also knew that management had, in effect, disregarded the IT specialists’ concern about the lack of regular review of user access for “inappropriate access rights by department managers / vice presidents.” *Id.* at 15-16. Further reducing the weight that could be placed on Koss IT controls were the specialists’ findings discussed above, known to Koeppel during the audits in question, about Koss’s outside IT contractors’ focus on functionality and poor understanding or appreciation of IT control standards, Koss’s heavy reliance on the contractors, Koss’s “probably ineffective” controls for managing user access to its software system for certain key functions, and its lack of an audit perspective in looking at internal controls. Ex. J-1 at 1; Ex. J-2 at 1, 17-18; *see* Tr. 1483-86; *see generally, e.g.,* AU § 319.40.[35/]

[35/] Koeppel argues that this case does not present the situation, posited by her as common in her experience with small companies, in which the auditor learns that key management actually “has access to information or access to systems that they have never used” and, due to “the fact that the access still exists,” reports it to the entity as “a control deficiency, or a significant deficiency.” Tr. 1301; *see* KOB 27 n.17; KPHS 22. But that ignores whether, along with the other weaknesses in the control-related work, Koeppel failed (as we find she did) under the circumstances to address the risk of such access sufficiently to place the weight she does on Koss IT controls over journal entries. *See S.W. Hatfield, CPA*, SEC Rel. No. 34-69930, 2013 WL 3339647, *2, *25 (July 3, 2013) (defect that “permeated [auditors’] problematic audit approach” was that, without sufficient attention to the particular circumstances, they “frequently relied on generalized experience from their past history with other clients to draw conclusions” about the financial statements under audit, “insist[ing] that the audit procedures they utilized in [the audits at issue] are the same procedures they have used in many other audits”).

On the subject of access controls over posting journal entries, the June or July "walkthroughs" of individual transactions in the audits did not occur at month-end, when most journal entries were assertedly entered, and added little to the foregoing. That is, the walkthroughs consisted of receiving more mere assertions from members of Koss's accounting department, taking note of a few past paper records of journal entries, and observing at the time that "A system log-on and password are necessary to access the [IT] system" (2006), that "[Senior Accountant and Junior Accountant] access the system by use of user names and passwords" (2007), and that a Koss staffer with accounts payables duties "entered her username and password to access AS 400, whereupon she did not have the authority to create and/or post journal entries" but Junior Accountant "did have such access" (2008). *See* pp. 38-39, 48 above; *see also, e.g.*, Tr. 690 (2007-2008 Staff Auditor: walkthroughs were based on inquiry, observation, and review of documentation). The fragmentary, limited information thus obtained through observation confirmed that at that particular point in time, Senior Auditor and Junior Auditor had access to post journal entries and one stray junior Koss staffer did not, but, contrary to Koeppel's characterization (*e.g.*, Tr. 826, 1493), otherwise did not "test" that any access control had been placed in operation, much less was operating effectively, over posting or review of entries by, for example, VP-Finance or President/CEO.

Koeppel additionally claims to have understood that not only VP-Finance but also President/CEO was a "monitoring control" over the journal entry process. *E.g.*, Tr. 1305, 1448-51. Although Koeppel's brief contends that President/CEO reviewed "'all'" journal entries booked each month, partially quoting a sentence from each audit's iteration of the financial reporting controls memo (KRB 8), there is no evidence that anyone read the memo to say that at the time of the audits, and whatever it stated was based on general assertions by members of Koss's accounting department, the very people on whose conduct the monitoring was supposed to be a check and balance.

The sentence actually makes the compound statement that "[President/CEO] and [VP-Finance]" review the entries, and the statement was based on representations from VP-Finance and possibly Senior Accountant. *See* Exs. J-4 at 1, 2, J-101 at 1, 2, J-201 at 2; Ex. D-4 at 45-51. Another work paper stated instead that President/CEO "reviews [VP-Finance's] journal entries through review of the monthly financial statements." Ex. J-11 at 4. Koeppel testified that she generally understood that President/CEO, who was not an accountant by training and did not profess to be a GAAP expert, reviewed journal entries only on occasion, she could not recall him ever telling her that he reviewed journal entries monthly, she did not know how he would have conducted any review of individual entries, and she was not aware of any documentation of such a review. Tr. 1448-50. This is consistent with Audit Manager's understanding, "through discussions" with the accounting department, that President/CEO "was involved in the process" and may have "go[ne] through those [same] journal entry binders" provided to the auditors, and with 2006-2008 Staff/In-Charge Auditor's belief, again through mere assertions and not any observation or documentation, that, at most, President/CEO reviewed journal entries "on a topside" basis, "through review of the financial statements or through review of supporting documentation." *See* pp. 36-37 above. This is also consistent with testimony that it "would have been hard" and "a very time-consuming process" to "go through every journal entry posted in a month or a week or a year" on a Koss computer terminal because when Koss's accounting staff "pulled up transactions" on the screen "and when you got to the detail of the journal entry, they only were able to show that transaction." Tr. 415-16 (2006-2008 Staff/In-Charge Auditor). Indeed, in response to Grant Thornton's 2004 IT review, Koss management indicated that it placed great reliance on its departmental staff: "I think it is important to note our IT is in the hands of the users. Each area is responsible for it[s] data and the accuracy of that data." Ex. J-2 at 17. All of this, along with, for example, the lack of evidence of controls over the process of creating journal entries and of compiling the binders and the lack of evidence of automated controls over the journal entry review process, meant that, as far as the auditors knew, Koss's accounting department enjoyed a significant amount of autonomy in the initiation, preparation, review, recording, and memorialization of journal entries.

Not only did Koeppel lack enough direct, specific information about President/CEO's "active role" to place the weight she claims to have done on it as an internal control over journal entries (*see* Tr. 1221-22, 1305, 1311, 1448; *see generally* AU §§ 319.26, .36, .56), but he was also still a member of management, and so any reliance on him had to be tempered by a number of considerations. *See* AU § 316.45 n.19 ("an overall judgment about whether risk for the entity is classified as *high, medium*, or *low*" is "too broad to be useful in developing the auditor's response" to the assessment of the risks of material misstatement due to fraud). Specifically, as Koeppel knew, contributing to the inherent risk of fraud and the risks of management override of controls and lack of segregation of duties were the circumstances that "[t]he operating and financial decisions are dominated by a few individuals [at] Koss," an organization of "small size," which "preferred to put their dollars to [research] and development of products rather than internal systems," had no internal audit function, and operated in an industry with a "[h]igh degree of competition, accompanied by declining margins" and with "[p]ressure to meet expectations of analysts, creditors, and others" or revenue "targets." *See* Exs. J-3 at 2, 3, J-100 at 2, 3; Ex. J-200 at 1 ("Sales have been declining slowly over the past two years. This creates the risk that the Koss won't be able to sustain profitable bottom line."), 2, 3, 4; Exs. J-70 at 1, 2, 3, 4, J-178 at 1, 2, 3, 4, 5, J-278 at 1, 2, 3, 4; Exs. R-205 at 4, R-299 at 4, R-396 at 3; Tr. 1485-86 (Koeppel); Ex. R-509 at 62 (Audit Manager's investigative testimony).

As Koeppel also knew, contributing to the risk of fraud relating to revenue recognition was "the public company nature of Koss," that "revenues are closely focused on as a growth area" at Koss, which was "very revenue focused" and "actually posted in a public place revenues for a month and how far ahead [or] off target" it was, that President/CEO "was compensated on meeting goals and targets," and that VP-Sales "was compensated on revenues and on sales." Tr. 1274-75, 1286-87. In addition, the just-discussed findings by the firm's IT specialists further limited the reliance Koeppel could properly place on President/CEO as a control. For all of these reasons, the journal entry control-related procedures did not compensate for the serious flaw in the upstream/downstream testing used in the 2006, 2007, and 2008 Koss audits.

The remaining items Koeppel cites also did not provide any significant assurance about the completeness of the journal entry population subject to audit testing. The second item is that Koss had "a standard numbering system of which the engagement teams gained an understanding" and from which they "investigated any unexpected deviations," supposedly "provid[ing] additional comfort that they were dealing with a complete population of journal entries." KRB 7. But Koeppel acknowledges that "Koss's numbering system for its journal entries was not sequential" and that "gaps in sequential numbering" themselves "could not, therefore, identify missing journal entries." *Id.; see* Tr. 1322-23. So all the auditors' "[r]eview of the numbering of journal entries" and consideration of Koss's "use of consistent numbers for standard entries" (KPHS 30) could have accomplished was to identify internal inconsistencies in the numbering of the set of entries presented to the auditors.

This said nothing about whether entries were missing outside of that group: standard entries above, not below, the highest number represented in the binders in the range of 100 potential journal entry numbers per category, and nonstandard entries (which bore both a number and an indeterminate range of letters) above, not below, the respective bare journal entry number or combination of respective numbers and letters represented in the binders. By Koeppel's own description, there was no "use of consistent numbers" for nonstandard entries. The "standard numbering" audit work left an obvious blind spot for journal entries that may have been the most unusual and the most likely to exhibit characteristics of inappropriate entries, and this work therefore did not provide meaningful "additional comfort" about the completeness of the journal entry binders. *See, e.g.*, Exs. D-4 at 82-83 & Ex. R-509 at 94 (Audit Manager testified in the investigation about the importance of "looking for things that are unusual in nature and nonstandard" and of having a complete population to test because "you can't evaluate what's not there"); *see generally, e.g.,* AU § 316.61 (identifying characteristics that fraudulent journal entries often have and also noting that "[n]onstandard entries," such as "entries used to record nonrecurring transactions," "might not be subject to the same level of internal control" as "[s]tandard journal entries used on a recurring basis").

It is not clear how the third item cited by Koeppel is any more or better evidence of completeness of the journal entry binders than the second item. Simply making the point, as Koeppel does, that Koss printed update reports on multiple pages attached to each other by perforated edges ignores consistent testimony by her and multiple other audit team members that, while this might describe the pages of an individual update report, the update reports were separate from one another, journal entries could be entered at any time of the month, and journal entries could be entered singly or in batches, thereby generating separate update reports at different times. Tr. 770-71, 788-89 (Koeppel); Tr. 52-53, 90, 412-13, 417 (2006-2008 Staff/In-Charge Auditor); Tr. 555-57, 705-06 (2007-2008 Staff Auditor); Ex. R-509 at 118-20, 129 (Audit Manager's investigative testimony). Thus, merely because the pages of each update report that was given to the auditors by a member of Koss's accounting department may have been attached to each other by perforated edges said nothing about whether any number of other reports of single or multiple entries were omitted from the binders.

The fourth item urged by Koeppel is that Koss's outside IT contractor (criticized in the 2004 IT review) and accounting department members stated generally that "Koss's IT system generated an Update Report each time a journal entry was posted to Koss's general ledger," which she claims "provided additional support that the Update Reports represented a complete population of journal entries that had been entered to the general ledger." KRB 9. The only corroboration for these assertions was the other items Koeppel cites and, again, the upstream/downstream procedure. *E.g.*, Tr. 826-28, 1141-42. So the assertions lack detail and support. But more importantly, even assuming the contractor's depiction of Koss's computer system was correct, this does not mean all update reports that were printed were included in the binders, which was entirely the province of Koss's accounting department and over which process no controls were identified giving evidence of completeness. *E.g.*, Tr. 99-100, 334-35, 827.

The fifth and last of the items Koeppel cites consists of mere assertions by Koss's management and accounting department to the effect that they were not aware of any fraud at the company and that management had made available all "[f]inancial records and related data" and there were "no material transactions that have not been properly recorded in the accounting records underlying the financial statements" (*see* pp. 48-49 above). In light of the detailed evaluation we have just made of the audit work in the journal entry area of the 2006, 2007, and 2008 audits, Koeppel's reliance on these representations can only be viewed as treating them as "a substitute for the application of those auditing procedures necessary to afford a reasonable basis" for an audit opinion, in violation of AU § 333.02. Her extensive, excessive reliance on highly general and largely or entirely uncorroborated management representations likewise violated the bedrock principles that the auditor "neither assumes that management is dishonest nor assumes unquestioned honesty" and "should not be satisfied with less than persuasive evidence because of a belief that management is honest" (AU § 230.09); that the auditor "should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity" (AU § 316.13); and that "[i]n designing audit procedures to obtain competent evidential matter, [the auditor] should recognize the possibility that the financial statements may not be fairly presented..." (AU § 326.25).

After thus canvassing the audit work in the journal entry area, Koeppel appears to contend that this was the only way she "could have complied with AU § 316.61 under the circumstances." KOB 40. The apparent basis for such a claim is her view that the only alternative raised by the Division was accessing Koss's electronic general ledger through a Koss computer terminal, which she argues would have been "mediated in at least two respects" ("first, by the software and commands that were used to make particular journal entries appear on the computer monitor" and "second, by [Senior Accountant's] participation in the process") and been no better than the paper binders, and her view that the cited firm journal entry training materials "did not identify an alternative method that could have been used at Koss." KOB 15-16 n.10, 22-23 & n.14, 40; KPHS 31-32, 70. According to Koeppel, she was simply "rely[ing] on the firm's guidance," through "consult[ing] with several senior partners" about the PCAOB inspection comment on the 2005 Koss audit, "concerning how to address completeness of the journal entry population at Koss." KOB 15, 23 n.14, 40; Tr. 1451-55.

There is no merit to these arguments. At the hearing, Koeppel acknowledged that it was she who was ultimately responsible for conducting the Koss audits in accordance with PCAOB standards. Tr. 1438. It was Koeppel who decided not to pursue the discussion with the Grant Thornton partners beyond the general idea of "upstream/downstream testing" and who never asked anyone outside of the audit teams to review the remedial work on the 2005 audit or the different "upstream/downstream testing" used in 2006, 2007, and 2008 before authorizing issuance of the audit reports for those years, because she "did not see a need to elevate that to somebody outside of the engagement team." Tr. 766-71, 1452-55, 1491-92. Nor did Koeppel even engage with Audit Manager about the particular methods Audit Manager chose to use for the upstream/downstream testing in the various Koss audits. Tr. 768-71, 1491-92.

Koeppel also made no effort to secure the assistance of a professional with specialized IT skills or apply computer-assisted techniques to try to obtain a complete population of journal entries for fraud testing or to help access Koss's electronic general ledger by computer terminal to test entries. *See, e.g.*, Tr. 1324. Koeppel knew that, as Audit Manager testified in the investigation, no alternative procedures were performed to test the completeness of the journal entries in the binders by, for example, reconciling the beginning and ending balance for any general ledger account using the update reports for the fiscal year. *See, e.g.*, Tr. 1334-35; Exs. D-4 at 127 & R-509 at 127-28, 179. And Koeppel chose not to test internal controls. Tr. 1254-57, 1336, 1473.[36/]

[36/] *See generally* AU §§ 319.04 ("the auditor needs to be satisfied that performing only substantive tests would be effective in restricting detection risk to an acceptable level"; "[w]hen evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form, the auditor's ability to obtain the desired assurance only from substantive tests would significantly diminish"), .65, .66 ("the auditor may determine that it is not practical or possible to restrict detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions"), .67 ("[i]n determining whether assessing control risk at the maximum level or at a lower level would be an effective approach for specific assertions, the auditor should consider," among other things, "[t]he nature of the available evidential matter, including audit evidence that is available only in electronic form"), .68 ("In circumstances where a significant amount of information supporting one or more financial statement

Furthermore, PCAOB standards stress that "[t]he auditor's response to the assessment of the risks of material misstatement due to fraud involves the application of professional skepticism in gathering and evaluating audit evidence" and that examples of application of professional skepticism in response to the risks of material misstatement due to fraud are "designing additional or different auditing procedures to obtain more reliable evidence in support of specified financial statement account balances, classes of transactions, and related assertions" and "obtaining additional corroboration of management's explanations or representations concerning material matters, such as through third-party confirmation, the use of a specialist, analytical procedures, examination of documentation from independent sources, or inquiries of others within or outside the entity." AU § 316.46; *see* AU § 316.02 ("the auditor's response to the risks of material misstatement due to fraud involves the application of professional skepticism when gathering and evaluating audit evidence"), .13 ("Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud."), .16 (recognition of "the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating evidence throughout the audit" should lead auditors "to thoroughly probe the issues, acquire additional evidence as necessary, and consult with other team members, and, if appropriate, experts in the firm"). The auditor "should be thorough in his or her search for evidential matter and unbiased in its evaluation." AU § 326.25. The difficulty and expense that may be involved in testing a particular item "is not in itself a valid basis for omitting the test." AU § 326.24.

PCAOB standards require the auditor "to assess the risks of material misstatement due to fraud throughout the audit and to evaluate at the completion of the audit whether the accumulated results of the auditing procedures and other observations affect the assessment." *See* AU § 316.02. The auditor's responses to address specifically identified risks of material misstatement due to fraud "may include changing the nature, timing, and extent of auditing procedures in the following ways:

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assertions is electronically initiated, recorded, processed, or reported, the auditor may determine that it is not possible to design effective substantive tests that by themselves would provide sufficient evidence that the assertions are not materially misstated. For such assertions, significant audit evidence may be available only in electronic form. In such cases, its competence and sufficiency as evidential matter usually depend on the effectiveness of controls over its accuracy and completeness."), 326.14 ("In entities where significant information is transmitted, processed, maintained, or accessed electronically, the auditor may determine that it is not practical or possible to reduce detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions.…In such circumstances, the auditor should perform tests of controls to gather evidential matter to use in assessing control risk[] or consider the effect on his or her report (see paragraph .25 of this section).").

The *nature* of auditing procedures performed may need to be changed to obtain evidence that is more reliable or to obtain additional corroborative information….The *timing* of substantive tests may need to be modified." For example, the auditor "might conclude that substantive testing should be performed at or near the end of the reporting period to best address an identified risk of material misstatement due to fraud (see section 313, Substantive Tests Prior to the Balance Sheet Date). That is, the auditor might conclude that, given the risks of intentional misstatement or manipulation, tests to extend audit conclusions from an interim date to the period-end reporting date would not be effective." AU § 316.52. An option might be "[r]equesting that inventories be counted at the end of the reporting period or on a date closer to period end to minimize the risk of manipulation of balances in the period between the date of completion of the count and the end of the reporting period." AU § 316.53; *see* AU §§ 316.54 (if an identified risk of material misstatement due to fraud affects inventory quantities, "it may be appropriate for inventory counts to be conducted at or near the end of the reporting period to minimize the risk of inappropriate manipulation during the period between the count and the end of the reporting period"), 319.82 (to increase the assurance from substantive tests, the auditor may "[c]hange the nature of substantive tests from a less effective to a more effective procedure, such as using tests directed toward independent parties outside the entity rather than tests directed toward parties or documentation within the entity," "[c]hange the timing of substantive tests, such as performing them at year end rather than at an interim date," and "[c]hange the extent of substantive tests, such as using a larger sample size").

The standards further provide that "[i]f the auditor is precluded from performing procedures he or she considers necessary in the circumstances with respect to a matter that is material to the financial statements, even though management has given representations concerning the matter, there is a limitation on the scope of the audit, and the auditor should qualify his or her opinion or disclaim an opinion." AU § 333.14. To the extent the auditor "remains in substantial doubt about any assertion of material significance, he or she must refrain from forming an opinion" until she had "obtained sufficient competent evidential matter to remove such substantial doubt" or "express a qualified opinion or a disclaimer of opinion." AU § 326.25; *see* AU § 319.28 ("Concerns about the nature and extent of an entity's records may cause the auditor to conclude that it is unlikely that sufficient competent evidential matter will be available to support an opinion on the financial statements."). The auditor may even "conclude that it would not be practicable to design auditing procedures that sufficiently address the risks of material misstatement due to fraud," in which case "withdrawal from the engagement with communication to the appropriate parties may be an appropriate course of action." AU § 316.49; *see* AU § 316.78 ("consideration of the risks or material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to the audit committee or others with equivalent authority and responsibility"). We reject any notion that Koeppel had no choice but to accept the inadequate journal entry testing without doing anything more.[37/]

Finally, Koeppel advances the unavailing procedural argument that the initial decision "misapplied the burden of proof" in the journal entry area because it noted that the part of AU § 316.61 with which it found noncompliance uses the word "should" ("the auditor's procedures should include selecting from the general ledger journal entries to be tested and examining support for those items") and that PCAOB Rule 3101(a)(2) states that "should" in the Board's auditing standards "indicates responsibilities that are presumptively mandatory." KOB 40 (citing I.D. 32, 36); KRB 5-6, 9. Presumptively mandatory, in turn, means that failure to discharge that responsibility "is a violation of the relevant standard and Rule 3100" unless the auditor "demonstrates that, in the circumstances, compliance with" that responsibility "was not necessary to achieve the objectives of the standard" and that "alternative actions he or she followed in the circumstances were sufficient to achieve [its] objectives." Rule 3101(a)(2).

Even if Koeppel's parsing of language in the initial decision did support her claim of error, it is the Board's decision, on *de novo* review, that governs. *See, e.g., Kabani & Co.*, SEC Rel. No. 34-80201, 2017 WL 947229, *8 n.7 (Mar. 10, 2017) (if further review

[37/] At oral argument, Koeppel's counsel also broadly argued that because, in his view, "throughout those three years" the "test work that was done" on pertinent Koss financial statement accounts hit by the journal entries "didn't raise any issues with respect to any of those journal entries" and "did not identify any journal entries on the other side that raised any questions," this supports the journal entry testing. ArgTr. 63, 64, 67-68. That vague, general claim was a frequent refrain in Audit Manager's investigative testimony (Exs. D-4 at 86 & R-509 at 127-28, 131-34, 179) and was made at the hearing by 2006-2008 Staff/In-Charge Auditor (Tr. 82-83, 107-08). But, as noted, AU § 316.61 requires a particular focus on the fraud risk of management override of controls. Indeed, AU § 316.42 specifically provides that "the auditor should address that risk (see paragraph .57) apart from any conclusions regarding the existence of more specifically identifiable risks." Furthermore, identified risks of material misstatement due to fraud are not interchangeable with identified inherent risks generally (*see, e.g.,* AU § 316.34) and may be "related to specific financial-statement account balances or classes of transactions and related assertions" or they may "relate more pervasively to the financial statements as a whole" (AU § 316.38). In addition, "audit procedures that are effective for detecting an error may be ineffective for detecting fraud." AU § 316.12; *see, e.g.*, AU § 316.31 ("Because fraud is usually concealed, material misstatements due to fraud are difficult to detect."). Ordinary substantive testing of financial statement accounts cannot simply be assumed to be comparable to proper fraud testing of journal entries, and, in particular, does not address a completeness problem with the latter when, as discussed in later sections, the account testing is itself characterized by inadequate audit work on the completeness of the entity information on which it rested.

is sought in a PCAOB disciplinary proceeding, it is "only the Board's decision on appeal" that the SEC reviews); *Richard G. Cody*, SEC Rel. No. 34-64565, 2011 WL 2098202, *19 (May 27, 2011) (alleged error in earlier stage of administrative proceeding does not taint a later decision based on *de novo* review in the matter if there is no evidence that such error factored into that decision and sufficient evidence supports the decision), *aff'd*, 693 F.3d 251 (1st Cir. 2012); *mPhase Technologies, Inc.*, SEC Rel. No. 34-74187, 2015 WL 412910, *8 (Feb. 2, 2015) (same); *Robert Tretiak*, SEC Rel. No. 34-47534, 2003 WL 1339182, *10 (Mar. 19, 2003) (same); *Frank J. Custable*, SEC Rel. No. 34-33324, 1993 WL 522322, *6 (Dec. 10, 1993) (same); *Stephen Russell Boadt*, SEC Rel. No. 34-32905, 1993 WL 365355, *2 (Sept. 15, 1993) (same, citing *Dillon Sec., Inc.*, SEC Rel. No. 34-31573, 1992 WL 383783, *7 n.29 (Dec. 8, 1992) (collecting cases)). Suffice to say, our *de novo* review of the record includes consideration of any evidence offered by the parties about whether, in the circumstances, compliance with AU § 316.61, and any other presumptively mandatory responsibility at issue, was not necessary to achieve the objectives of the standard and whether alternative actions followed in the circumstances were sufficient to achieve its objectives. In this, as in other regards, the Division bears the burden of proving by a preponderance of the evidence that Koeppel engaged in an act or practice, or omitted to act, in violation of PCAOB rules and auditing standards, as charged in this proceeding. PCAOB Rule 5204(a).[38/]

Accordingly, we find that Koeppel violated AU §§ 110 and 316.61 and also failed under AU § 230 to exercise due professional care, including professional skepticism, with respect to the journal entry testing.

[38/] For the record, it is apparent from the initial decision that the hearing officer did not engage in "an improper shifting of the burden of proof from the Division to the Respondent." KOB 40. Rather, the initial decision applied PCAOB rules and auditing standards in a manner that at times correctly identified what those rules and standards required of the audit work but at other times mischaracterized the charges in a way that either imposed extra elements on the Division that it did not need to prove (*see, e.g.*, DOB 26) or relieved the burden of full compliance with particular auditing standards (*see, e.g.,* I.D. 48 (incorrectly stating that "unlike the journal entry testing discussed above, PCAOB auditing standards do not expressly provide that the auditor 'should' perform a reconciliation or any other specific procedure to obtain evidence that an Interim A/R Aging Report is complete and accurate," ignoring, for example, the decision's own quotation two pages earlier of AU § 350.24 in resolving the pertinent AU § 326 charge). Koeppel is thus simply trying to leverage those instances in which the initial decision erred in this regard into an argument that when the initial decision correctly applied the rules and standards it "misapplied the burden of proof" (KOB 39).

3. The revenue-related accounts

a. Net sales

In the net sales area of the 2006, 2007, and 2008 Koss audits, Koeppel relied on analytical procedures as "substantive test[s] to obtain evidential matter about particular assertions related to account balances or classes of transactions" (AU § 329.04.b; *see* AU § 329.09-.22). *See* p. 50 above. Koeppel has indicated broad, contemporaneous familiarity with the analytical procedures performed, specifically signed off on enough of the work papers to show that she knew the approach being taken to the procedures, and approved the larger audit approach of which they were a part. *See id.* For multiple reasons, the procedures did not provide the necessary level of assurance about the occurrence and valuation of Koss's net sales, and in relying on them to form her audit conclusions and authorize issuance of the unqualified opinions without performing necessary further work, she violated AU §§ 150, 230, 326, and 329.

The auditor "obtains assurance from analytical procedures based upon the consistency of the recorded amounts with expectations developed from data derived from other sources." AU § 329.16. Such data can include "[f]inancial information for comparable prior period(s) giving consideration to known changes." AU § 329.05. The precision of the expectation depends in part on the "consideration of factors that significantly affect the amounts being audited." AU § 329.17. Expectations developed in analytical procedures used as substantive tests "should be precise enough to provide the desired level of assurance that differences that may be potential material misstatements, individually or when aggregated with other misstatements, would be identified for the auditor to investigate." AU § 329.17. Expectations "developed at a detailed level generally have a greater chance of detecting misstatements of a given amount than do broad comparisons." AU § 329.19; *see* AU § 316.56 ("the use of substantive analytical procedures, such as the development by the auditor of an expected dollar amount at a high level of precision, to be compared with a recorded amount, may be effective in certain circumstances" in response to a risk of material misstatement due to fraud relating to misappropriation of assets); note 42 below.

Furthermore, the reliability of the data used to develop the expectations "should be appropriate for the desired level of assurance from the analytical procedure." AU § 329.16. AU § 329.16 provides that "[b]efore using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information." AU § 329.16 further provides that the auditor "should assess the reliability of the data by considering the source of the data and the conditions under which it was gathered, as well as other knowledge the auditor may have about the data." And AU § 329.16 identifies a number of factors that "influence the auditor's consideration of the reliability of data for purposes of achieving audit objectives": (1) "Whether the data was obtained from independent sources outside the entity or from sources within the entity"; (2) "Whether sources within the entity were independent of those who are responsible for the amount being audited"; (3) "Whether the data was developed under a reliable system with adequate controls"; (4) "Whether the data was subjected to audit testing in the current or prior year"; and (5) "Whether the expectations were developed using data from a variety of sources." In delineating several presumptions "about the validity of evidential matter in auditing" that may "have some usefulness," AU § 326.21 echoes that the first and third points listed in AU § 329.16 can each provide greater assurance about the reliability of accounting data and financial statements, and adds, "The independent auditor's direct personal knowledge, obtained through physical examination, observation, computation, and inspection, is more persuasive than information obtained indirectly."

Relevant to the desired level of assurance, the parties disagree about the role of the net sales analytical procedures in the audits. The Division stresses that Koeppel "intended to use the analytical procedures" as "substantive testing to support the occurrence and valuation of Koss's net sales," yet, in the Division's view, those procedures "were not substantive tests in compliance with AU § 329.09-.21," capable of providing the necessary evidential matter, due to insufficiently precise expectations and inadequate support for the reliability of the underlying information. *E.g.*, DOB 6, 17 n.69, 28, 30, 32-33; DRB 23-25; DPet. 2 & n.3, 4, 5, 8, 9; DPHS 73, 76-78; *see, e.g.*, OIP 13-14 ¶¶ 41-43. Before us, the Division does not seem to challenge the initial decision's point that, consistent with the "transaction cycle" approach to the audits described by Koeppel (*see, e.g.*, Tr. 1363), accounts receivable testing "constitute[d] evidential matter relevant to Koss's net sales assertions" (I.D. 60). *See* DRB 24. As the initial decision explained, quoting a Koeppel expert, "'Audit procedures using a cycle approach recognize that confirmation of accounts receivable provides evidence not only that the receivable exists, but also that the sale occurred.'" I.D. 59; *see* Tr. 877 (Koeppel). But the Division defends the initial decision's conclusion that, even so, the analytical procedures were "the principal substantive tests of Koss's net sales assertions" (I.D. 60). *E.g.*, DRB 22-23.

Koeppel, for her part, claims that "tests of details performed on accounts receivable constituted the principal audit procedures supporting the valuation and occurrence of net sales" and, in particular, describes "the tests to confirm accounts receivable" as "the other substantive procedures performed to test net sales," in addition to the analytical procedures. *See, e.g.,* KRB 10 & n.3, KPHS 33, 71-72; *see also, e.g., id.* at 73, 75; KOB 44, 45; Ex. R-507 at 75 (Koeppel expert report, describing "[t]he confirmation procedures performed with respect to invoices outstanding in accounts receivable as of April 30 of each year" as "especially important" source of evidential matter for Koss's net sales); Tr. 2070 (Koeppel expert: "the accounts receivable confirmations were the primary test").[39/]

The initial decision found that "the work papers do not indicate that the A/R testing was intended to be the principal testing of Koss's net sales." I.D. 60 (emphasis in original); *see, e.g.*, Exs. J-123 at 3, J-220 at 45 (2007, 2008 accounts receivable sample testing work papers, stating simply for "Conclusion" that "Based on the above testing, GT notes AR is fairly stated at 4/30/07" or "Based on above testing, GT concludes that A/R is fairly stated at 4/30/08"); Exs. J-16 at 3, J-110 at 2, J-210 at 1 (2006-2008 revenue audit programs, which include but do not address the respective weight of the confirmation procedure). For documentation in support of her claim, Koeppel points only to Grant Thornton audit manuals stating generally that the "transaction cycle" approach "permit[s] us to account for the interrelationships among audit procedures and assertions for income and expense accounts and corresponding elements of the balance sheet." *E.g.*, Ex. J-60 at 13, cited by KOB 44-45.

Even if we assume that, in Koeppel's judgment, the principal substantive test in each audit of Koss's net sales was the accounts receivable testing, we nonetheless conclude that the analytical procedures were important tests of Koss's net sales. As the initial decision noted, "Koeppel does not contend that the A/R procedures by themselves provided 'sufficient competent evidential matter' as to Koss's net sales assertions." I.D. 59-60. Indeed, at one point, a Koeppel expert witness indicated in his report that "test of details in the form of accounts receivable confirmations" and "analytical procedures for testing revenue-related accounts" were, in combination, "[t]he principal audit procedures for the revenue cycle." Ex. R-507 at 61. Grant Thornton audit manuals for the relevant period explained that the "B" strategy, which Koeppel testified was applied in the revenue and inventory areas of the audits, "emphasizes analytical procedures on income statement accounts and tests of details for balance sheet accounts," even as it "requires analytical procedures to be augmented with tests of details." *See* p. 15 above. As she testified, under that strategy, "We focused on tests of details of the balance sheet and analytics as it relates to the income statement." Tr. 1353; *see, e.g.,* Tr. 1263 (Koeppel stated that firm's proprietary software automatically designed procedures tailored to the B approach, "provid[ing] a summary of procedures that focus on test of details for the balance sheet and a variety of analytics addressing the income statement"); Tr. 689 (2007-2008 Senior Auditor understood that the strategy required testing of critical assertions in the income statement by substantive analytical procedures). Accordingly, no detailed lists of Koss's gross sales or contrarevenue items

[39/] Although "the testing of co-op allowances was one of the pieces of audit evidence relied upon to support the valuation of revenues" (Ans. 31 ¶ 74), Koeppel does not identify those procedures as being as significant a part of the net sales audit work as the analytical procedures. *See, e.g.*, KRB 10 & n.3. In fact, the sales allowance procedures did not test the underlying recorded sales transactions themselves and, as we discuss later, were deficient under PCAOB auditing standards.

(those subtracted from gross revenue to arrive at net revenue) were obtained for testing in the Koss audits. *See, e.g.,* Tr. 964-65, 1013-14, 1081-83; pp. 50, 56 above.

The limitations of the accounts receivable testing reinforce the importance of the analytical procedures. The number of confirmations to send was based on the accounts receivable balance, not the amount of the annual sales. See Exs. J-30 at 1, J-124 at 1-2, J-220 at 1-2. In each audit, the population of receivables from which a sample was selected for confirmation testing—approximately $9.3 million in 2006, $6.8 million in 2007, and $4.7 million in 2008, respectively—included only receivables remaining on Koss's balance sheet as unpaid as of the interim date of April 30. Consequently, of the total gross sales Koss recorded for the fiscal year—approximately $55.3 million for 2006, $50.4 million for 2007, and $52.3 million for 2008—only a small fraction (about 16.8%, 13.5%, and 9%, respectively) had a chance of being selected for the confirmation testing. *See* p. 64 above; *see also* DRB 24 (referencing Division expert witness's illustration of the limited scope of the confirmation testing, based on using Koss's gross accounts receivable at fiscal year end as a proxy for the size of the population from which the sample for the testing was drawn at interim and dividing by Koss's fiscal year net sales, to arrive at 16% for 2006, 19% for 2007, 24% for 2008).

Although Koeppel claims the Division "cannot seek to reargue th[is] point here" because the hearing officer "expressly rejected" it and the Division "did not seek review of that finding" (KRB 10 n.3), she is incorrect. The Division's position is that the accounts receivable confirmation procedures, even if correctly performed, provided "little or no" support for the occurrence and valuation of the "over three quarters of Koss's net sales" not subject to those procedures. DRB 24; DPHS 43. Koeppel mischaracterizes that argument as instead the blanket contention that those procedures "could not provide support for the occurrence and valuation of Koss's net sales" at all, and mischaracterizes the initial decision as having "expressly rejected" the argument that "the confirmation testing 'related to only a fraction of Koss's net sales,'" simply because the initial decision stated that, to some extent, this testing "constituted evidential matter relevant to Koss's net sales assertion" (KRB 10 n.3).[40/]

40/ A Koeppel expert witness had purported to take issue with the Division's point, asserting that accounts receivable confirmation testing "applies not only for the sales that are uncollected" as of the date selected for the testing but "for sales for the entire [fiscal-year] period" up to that date. Ex. R-507 at 89-90; *see* Tr. 1899-1901, 2078-79. But her expert's argument was not that the confirmations tested any sales other than those represented in accounts receivable at the time, but rather that any other sales recorded by that point in the fiscal year would be covered by other testing of other accounts than sales or receivables: "Thus, accounts receivable confirmations test not only for sales around [the date selected for testing] but for sales recorded at any time that still remain in accounts receivable [as of that date]. To the extent sales no longer remain in accounts receivable, they have either been collected or moved to other accounts that are subject to other audit testing." Ex. R-507 at 91; *see* Tr. 1901-02

Moreover, because the confirmation testing was performed as of an April 30 interim date, none of Koss's May and June sales transactions, totaling between some $8 million and $9 million in each of the three fiscal years, was covered by that testing. *See* Exs. J-31 at 1, 2, J-125 at 1, 2; Ex. J-18 at 1; Exs. J-25 at 1, J-118 at 1, J-214 at 1; Ex. J-213 at 1-2. And the 2006 and 2007 accounts receivable rollforwards, which were meant to cover the remaining period, included no or little direct detail testing of sales activity in May and June, depending instead on the comparison of the overall accounts receivable balance, representing millions of dollars of offsetting items, from an April 30 trial balance report, adjusted using subledger reports of May and June activity, with a June 30 trial balance report. *See* pp. 66-69 above; *see also, e.g.*, Ex. R-509 at 156-62, 170-73 (Audit Manager's investigative testimony). To the extent, as Koeppel theorizes, the 2008 audit relied in part on the analytical procedures to compensate for the lack of any accounts receivable rollforward that year, that would only heighten the importance of those procedures in that audit. *See, e.g.*, Tr. 1365; KOB 50; KRB 13. And although

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("your satisfaction with the remaining accounts receivable provides assurance not only to the sales that make up those accounts receivable, but all sales throughout the year, simply because once they put it in accounts receivable, to get it out, you're—you're testing for that in various ways"). The expert thus did not contest the limited scope of the confirmation testing itself, even if properly performed, as a test of Koss's net sales.

In addition, that expert's rudimentary discussion of "other audit testing" that would apply where Koss had "put [an item] in accounts receivable" and "got it out" did not address the rigor and importance of that other testing relative to the desired level of assurance from the net sales analytical procedures, much less address that sales can be misstated without making any entry in accounts receivable, that fraudulent entries can balance without having any logical, realistic relationship to one another, and that a fraud can be spread out over multiple income statement or balance sheet accounts at the same time. The expert gave the cash account as an example of a relevant other account that would have been tested. But, unlike revenue, cash was not designated as a "critical cycle" in the Koss audits; no walk-through was performed with respect to it; it was not subject to any of Grant Thornton's "three main [audit] strategies," including the "B" strategy applied to Koss's "critical assertions" in the revenue area, but only to the "D" strategy, which consisted of "less extensive substantive audit procedures" and "concentrate[d] on techniques such as inquiry and analytical procedures to identify items that warrant detailed examination"; and the audits "did not tailor[] in specific procedures" related to VP-Finance having custody, authorization, and recordkeeping responsibilities for cash. Exs. J-15 at 1, J-109 at 1, J-209 at 1; Exs. J-60 at 21, J-139 at 24-25, J-269 at 20; Tr. 1136-40, 1476 (Koeppel); Ex. R-509 at 60-61 (Audit Manager's investigative testimony). For example, no testing was done of the exercise of check-signing authority by Koss's accounting department or whether or how its reconciliations of the cash account to the general ledger were reviewed by President/CEO, on whose oversight Koeppel testified she generally placed great reliance. *See, e.g.*, Tr. 1197, 1219-23, 1305, 1311, 1448-51; Exs. D-4 at 63-64, 67, 69-72 & R-509 at 58-61, 80.

each audit also included cut-off testing around the April 30 and June 30 dates of a total of about a dozen product shipments identified on Koss system-generated reports and the scanning of other such reports for large or unusual items in the last week or month of June, no procedures were applied to any of those reports to evaluate their reliability and the work was not significant enough in scale or scope to contribute sufficient additional audit evidence about the sales not subject to the confirmation testing. *See, e.g.,* pp. 50, 56-57, 65-68 above; *see also* Ex. D-2 at 64-65 (report of Division expert).

Furthermore, as Koeppel recognized, more was necessary to address Koss's net valuation of sales than audit work on Koss's gross sales. Tr. 964, 1014, 1082. Yet, as she knew, no effort was made in the accounts receivable testing in any of the audits to, for example, confirm with customers the terms or amounts of any sales allowances they might have received from Koss. Tr. 1404-05; *see* Ex. R-509 at 174-78 (Audit Manager's investigative testimony). And the 2006, 2007, and 2008 work papers for the confirmation procedure document only a combined total of a few instances in which the auditors reviewed a debit memo (a sales allowance claim) and around a dozen instances in which alternative audit procedures used when a receivable was not confirmed involved matching the unconfirmed amount to a credit memo (a sales allowance granted by Koss), in the case of one customer identifying the type of allowance ("coop allowance") and in a number of cases noting that the credit memo was issued after the confirmation date. Exs. J-30 at 1-2, J-123 at 1-8, J-220 at 44-46.

Finally and separately, the discussion thus far about net sales assumes that the audit work on accounts receivable was adequate under PCAOB standards even to test accounts receivable. As we find in the later section, that was not the case.

Despite the level of assurance indicated by the importance of the net sales analytical procedures in the audits, those procedures were, as the initial decision found (I.D. 62-63), characterized by "vaguely expressed expectations of changes" from prior period financial information that reflected a lack of detailed consideration of known changes to that information and "provided little assistance" in "identifying potential misstatements for further investigation." *See* pp. 52-53 above. Koeppel does not deny the vagueness of the expectations, instead making the argument, which we have rejected, that they did not need to be any more specific under the circumstances.

Additionally, two analytical procedures, to which Koeppel devoted substantial attention in each of the audits and which were intended to be more precise than other trend analyses (*see* pp. 53-55 above), provided less than the necessary level of assurance due to insufficient audit work to determine the reliability of the information used in the procedures. Specifically, the procedures compared current and prior-year annual and monthly sales amounts that Koss recorded by product line, using reports generated by Koss's IT system. As she explained, "breaking [the sales data] down by more than just account level" and "mov[ing] from looking at it on account basis to quarterly, also looking at it on a monthly basis" was undertaken in the Koss audits "[b[ecause disaggregation is more precise." Tr. 1382. In developing expectations, "[m]onthly amounts will generally be more effective than annual amounts and comparisons by line of business usually will be more effective than company-wide comparisons." AU § 329.19; *see* AU §§ 316.30 (results of analytical procedures that "use data aggregated at a high level," typical at audit planning stage, "provide only a broad initial indication about whether a material mistatement of the financial statements may exist"), .52 (extent of audit procedures applied "should reflect the assessment of the risks of material misstatement due to fraud…performing analytical procedures at a more detailed level may be appropriate"), .53 (example of modification of substantive audit testing in response to identified risks of material misstatement due to fraud is "[p]erforming substantive analytical procedures using disaggregated data," such as "comparing gross profit or operating margins by location, line of business, or month to auditor-developed expectations"), .54 (potential response to fraud risk involving revenue recognition is "[p]erforming substantive analytical procedures relating to revenue using disaggregated data, for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods"). But the reliability of the disaggregated amounts matters to achieving the purpose of using disaggregated data in the first place. *E.g.*, Tr. 987-88, 1067-68 (Koeppel: consistency of the product line groupings was a fundamental question that needed to be asked when performing such a variance analysis, though she was not specifically aware of it having been asked during the audits). Otherwise, the auditor is simply making mathematical comparisons from one report to another of categories of disembodied numbers not necessarily tied to the entity's underlying accounting records.

At the hearing, Koeppel stated she understood during the Koss audits that Koss's management used a consistent methodology to allocate sales to the various accounts shown on the reports used in the audit testing. According to Koeppel, she "understood during each audit that the customer master file," a Koss IT system database, "assigns a customer to a particular sales category" and further understood, based on the walk-throughs of individual revenue-related transactions, that Koss had put controls in place that limited the authority and access of Koss personnel to change customer masterfiles. Tr. 1295 (observation was made in walkthrough, Ex. R-300 at 19, that Junior Accountant had update access and Senior Accountant had read-only access); *see* Tr. 362-63 (2006-2008 Staff/In-Charge Auditor); Exs. J-6 at 1, J-203 at 1 (2006 and 2008 Revenue Procedures Memorandum, reviewed by Koeppel, asserting, based on inquiry of Koss's accounting department, that customer masterfile was maintained by Junior Accountant, that any changes to it were reviewed by Senior Accountant, and that "the system will only allow authorized users to make changes to the masterfile" and "[a]ccess is limited by the use of user ID's and passwords"). A work paper from the 2006 audit described a journal entry as having been "done to record sales each month among the sales categories," and Koeppel acknowledged testifying in the investigation that this meant that the sales involved were allocated to the various sales categories by manual journal entry posted by Koss's accounting department. Ex. J-11 at 5; Tr. 957-

61. She insisted at the hearing, however, that during the audits "my understanding was it [the allocation] was done by the system," not generated by manual journal entries. *Id.*

Even if Koeppel had this understanding, she testified the approach applied by her in the Koss audits did not include any specific testing of whether sales were, in fact, consistently allocated among the product line accounts or between the periods of the year. Tr. 961-65, 987-90, 1010-13, 1066-68, 1080-83; *see* Tr. 220-21 (2006-2008 Staff/In-Charge Auditor). For example, the auditors did not obtain, much less examine, any detail listings of the transactions in those accounts. Tr. 962, 965, 1082-83; Tr. 150-52, 196. Koeppel's audit approach focused on comparing the same reports from one year to the next (*e.g.*, KPHS 80), not on whether, for example, as referenced by AU § 329.16, the reports were developed under a reliable system with adequate controls or whether the reports themselves were subjected to audit testing in the current or prior year. *See, e.g.,* Tr. 1336 ("We audit the output of the system, rather than the system itself."), 1473 ("we did not perform detailed tests of controls over IT") (Koeppel); KPHS 21 ("the Division's characterization of the 'obtain evidence' requirement [in AU § 319.65, as to the completeness and accuracy of entity system-generated data] as a 'testing' requirement misstates what is required"). No audit procedures were applied to the reports to support the completeness and accuracy of any of the current- or prior-year disaggregated amounts. *See* pp. 54-55 above. Testing the total amount of sales in auditing the financial statements thus did not include testing the disaggregated sales amounts, which was supposed to contribute to the testing of the total sales amounts.[41/]

For these reasons, the analytical procedures used to test the occurrence and valuation of Koss's net sales did not provide the necessary level of assurance.[42/]

[41/] Koeppel argues that prior year amounts that were used to establish the expectations for use in these two analytical procedures "had been subjected to audit testing," which is a factor under AU § 329.16 that influences the auditor's consideration of data reliability, and argues that, under AU § 329.16, the auditor "needs to address the reliability of the data used to develop the expectation," whereas "[t]he recorded amount is tested through the analytical procedure itself." KPHS 26-27. But this argument is unavailing. By her own account of the approach she and her audit assistants took to the Koss audits, presented as longstanding and fundamental and borne out on the record of the audit work, no additional procedures had been performed in the prior year than were undertaken in the current year with respect to the reliability of the reports used in these two analytical procedures. *See, e.g.*, Tr. 932-33, 1092, 1100-01, 1107-09, 1187-88, 1339-40, 1409-11, 1498; Ex. R-507 at 14 (Koeppel expert report).

[42/] Koeppel has asserted that the analytical procedures included in the audit work papers must be "considered as a whole." KPHS 75. But she fails to explain how, under the circumstances, any other of the analytics compensated for the serious weaknesses in the multiple analytical procedures on which the initial decision focused and which we have just discussed. It would not necessarily preclude the other analytics from taking

Koeppel's reliance on the above procedures in the 2006, 2007, and 2008 audits, in forming and authorizing the issuance of unqualified audit opinions, without having directed anyone else to perform, and without herself performing necessary additional audit work, violated AU §§ 150, 230, 326, and 329.16 & .17.[43/]

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on added significance that, overall, most of the analytics were trend analyses, and, except for the returns reserve testing, the rest were ratio analyses. But the Division's expert did note, for example, that generally "'ratio and trend analyses are relatively imprecise and should be performed at a disaggregated level when higher levels of assurance are desired.'" Ex. D-2 at 51, quoting *AICPA Audit Guide: Analytical Procedures* ¶¶ 2.13 (2001) and citing AU §§ 329.19 and 150.06 ("The auditor should be aware of and consider interpretive publications applicable to his or her audit. If the auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance.").

Most of the analytical procedures were not disaggregated. *E.g.*, Ex. D-4 at 119, 125 (Audit Manager's investigative testimony: "When it came to the ratio analyses and looking at the [trends] and the revenue ratios, those are done at the consolidated level" and constituted "[t]he majority of our analytics"; it was only secondarily, "[w]hen we got to looking at just the income statement and looking at line item variation analysis," that the procedures ceased to be "done at the consolidated level."). In response to the Division's expert, Koeppel does not specify how any particular, distinguishing characteristics of any of the other analytical procedures would have neutralized the flaws in the analytical procedures that form the basis for the violations we find here, nor does she identify any audit work applied to Koss IT-system-generated reports used in that testing that would do so. Some analytical procedures applied to inventory, not revenue, and Koeppel does not contest the Division expert's point that some of the revenue-related procedures provided little or no support for net sales. *See* p. 51 above (citing Ex. D-2 at 61). According to Koeppel's own expert, more than half of the analytical procedures in the record were prepared for quarterly reviews and "were never intended to meet the criteria for analytical procedures performed in annual audits under AU § 329." Ex. R-507 at 91. The inadequate audit response to the risk of management override of controls, discussed above, casts further doubt on the overall utility of the analytical procedures for purposes of her arguments here. *See* AU § 329.10 (override "might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements" and "might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions"). This problem is only compounded where, as here, it occurs over multiple years and "many of the expectations used in [the] analytical procedures are derived, at least initially, from prior year balances" (Ex. R-507 at 77).

43/ With regard to the revenue-related analytical procedures, the OIP additionally charged failure to sufficiently investigate and evaluate significant unexpected

b. Special sales allowances

It is undisputed that Koeppel depended in part on the audit testing of Koss's so-called special sales allowances to assess the valuation of Koss's net sales. *See* pp. 11-12, 57 above. It is also undisputed that these sales allowances materially reduced the sales reported on Koss's income statement and materially contributed to the liabilities reported on Koss's balance sheet for fiscal years 2006, 2007, and 2008. Audit work on Koss's special sales allowances was therefore necessary to address the risk of material misstatement of Koss's financial statements for each of those years, including the risk,

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differences between recorded amounts and the auditor's expectations, in violation of AU § 329.21, or to document such efforts under AS No. 3, ¶¶ 5-6. *E.g.*, OIP 13 ¶¶ 41-42. As to those charges, the initial decision found that the Division had proven only certain audit documentation failings. Specifically, the decision determined that in instances "in which the analytical procedures work papers indicate that a current-year amount differed from the [expectation of the] corresponding prior-year amount by more than the tolerable error amount established for the audit," the documentation of the "assessments that led [the auditors] to conclude that some amounts that exceeded tolerable error did not require evaluation as significant unexpected differences" was lacking under AU § 329.22. I.D. 63-64. But the hearing officer was prepared to accept, based on testimony of the 2006-2008 Staff/In-Charge Auditor, that "tolerable error was used only as a starting point in determining whether a difference was both significant and unexpected, requiring further evaluation in accordance with AU 329.21," and that, in any instance in which the auditors expected current-year amounts to remain unchanged from the prior year but encountered "differences that they concluded were both significant and unexpected," they "evaluated [such] differences," even if this was not documented. I.D. 64. And further on AU § 329.21, the decision, citing various work papers, found that the Division had not proven that there was a failure to "properly corroborate management explanations for unexpected differences." I.D. 64-66.

The Division's petition for review did not address the initial decision's resolution of these audit documentation issues under AU § 329.22, which applies "[w]hen an analytical procedure is used as the principal substantive test of a significant financial statement assertion," instead of under AS No. 3, which is not limited to a "principal substantive test." Nor, as Koeppel correctly notes (KRB 11 n.4), did the Division's petition address the initial decision's dismissal of the AU § 329.21 charges, partly on the basis of undocumented audit procedures asserted in hearing testimony. Rather, the petition cryptically claimed, "As Koeppel did not assert at the Hearing that additional undocumented audit procedures were performed during the Koss Audits, the A.S. No. 3 charges are not at issue." DPet. 2 n.3. Having otherwise found it unnecessary to decide whether the analytical procedures were the principal substantive test of net sales, and the Division having abandoned the AS No. 3 charges, we set aside, without considering, the hearing officer's findings of audit documentation deficiencies.

acknowledged by Koeppel, of material misstatement due to fraud relating to revenue recognition. For example, understatement of the allowances would overstate Koss's revenue and understate its liabilities. The auditor's objective is to obtain sufficient competent evidential matter to provide a reasonable basis for forming an opinion regarding the financial statements under audit (AU §§ 150, 326), and where, as here, the auditor performs only substantive tests, using information provided by the entity's information system, and does not test internal controls, "the auditor should obtain evidence about the accuracy and completeness of the information" (AU § 319.65).

Those tasks were made more difficult in the Koss audits by the lack of formal contracts or agreements in place that documented the terms of Koss's sales allowance program. Koeppel identified this in 2006 and 2007 as a control deficiency, which she believed did not allow the company, in the normal course of its functions, to prevent or detect misstatements on a timely basis, and in 2008 as a significant control deficiency, which she believed created a potential for a misstatement of Koss's financial statements that could be material. *See, e.g.*, Tr. 1121-27; Exs. J-39 at 2, J-132 at 2, J-239 at 7, 9. She "highlight[ed]" that this deficiency, as to a "judgmental accrual when we could not tie to third-party support or a contract," was "an area of concern and potential risk in [Koss's] financial reporting process." Tr. 1401-03. Referring to "the severity of this issue," audit work papers reviewed by Koeppel stressed "the limited amount of information provided to us (i.e. no support for percentage or fixed allowances" other than management's representation—that, as Koeppel described it, "this was a complete and accurate and reasonable accrual at the end of the period" (Tr. 1403)—"to determine reasonableness and adequacy of the accrual." Ex. J-226 at 1, 3; Ex. J-227 at 1, 4. The auditors also noted VP-Finance's claim that "most customers in [Koss's sales allowance] program are long-time customers which have proven reliable in the past, therefore [there is] no risk" (Ex. R-393 at 2; *see* Ex. R-295 at 2) and reasoned that Koss "has had the sales allowance program in place for a number of years with the same customers who participate, year over year" so "management is very knowledgeable of the allowances given and would likely be able to detect a material misstatement in the financial statements" (Ex. R-482 at 723). But that did not alter Koeppel's recommendation that Koss enter into signed agreements with its customers in the sales allowance program "so that these discounts are stated and accrued for correctly" (Exs. J-39 at 4, J-132 at 3) or Koeppel's findings that Koss did "not have proper documentation to support the discounts given and the related accrual" (Ex. J-239 at 7) and, at most, suggested that management might be in a position to record correct figures for the special sales allowances, not that it was actually doing so.[44/]

44/ Contrary to rhetoric in Koeppel's briefing (KPHS 43, 89), Koeppel is not being "faulted for having properly identified the lack of written contracts" as a deficiency or significant deficiency in Koss's controls but rather for not effectively addressing the implications of the lack of written contracts for the audit work that needed to be performed on Koss's special sales allowances under PCAOB auditing standards.

Under such circumstances, the importance was apparent of the auditor being "thorough in his or her search for evidential matter and unbiased in its evaluation" (AU § 326.25). PCAOB auditing standards make clear that the difficulty and expense that may be involved in testing a particular item "is not in itself a valid basis for omitting the test" (AU § 326.24); that management representations "are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit" (AU § 333.02); and that "[i]f the auditor is precluded from performing procedures he or she considers necessary in the circumstances with respect to a matter that is material to the financial statements, even though management has given representations concerning the matter, there is a limitation on the scope of the audit, and the auditor should qualify his or her opinion or disclaim an opinion" (AU § 333.14). Yet, as Koeppel knew, despite the clear need to test whether Koss's recorded fiscal year-end balances included all of the customers entitled to special sales allowances and all of the amounts to which they were entitled, the audit work attended to what Koss recorded while doing little, if anything, to test whether items that should have been recorded were, in fact, recorded.

As discussed in detail above (pp. 57-63), the special sales allowance work central to the parties' arguments about each audit consisted of the following. First, audit procedures were performed using a Koss report that purported to show customer balances of special sales allowances at the end of the prior fiscal year, the customers' monthly special sales allowance activity in the current fiscal year, and the customers' allowance balances at the end of the current fiscal year. Namely, the auditors performed "some clerical tests" (Tr. 1404) on the mathematical accuracy of that allowance schedule; reconciled the total June 30 balance outstanding on that schedule with a June 30 Koss trial balance report; recomputed two months of four customers' percentage-based allowances shown on the allowance schedule using a Koss sales report and comparing those percentages to the allowance schedule from the prior fiscal year, which, under Koeppel's approach to the Koss audits, had similarly been tied to a June 30 Koss trial balance; tied one customer's fixed allowance shown on the schedule to a written contract in the 2006 audit and to a credit memo in the 2008 audit; and tied four to ten allowance claims shown on the allowance schedule, each from a different customer, to credit memos in each audit.

Second, the auditors "reviewed" a Koss list of credit memos issued in the fourth quarter of the current fiscal year. In the 2006 and 2007 audits, that procedure consisted of comparing the total balance of the items on the list to the balance of unsettled special sales allowances at June 30 on a Koss trial balance report and tracing ten to twelve items on the list to underlying credit memos. In the 2008 audit, the procedure consisted of scanning the list for large or unusual credits along with asking VP-Finance whether there were write-offs or significant credit memos issued after June 30.

Third, the auditors "reviewed" a Koss list of credit memos issued subsequent to the end of the fiscal year under audit but before issuance of Koss's financial statements. This meant scanning the list for significant or unusual items and additionally in 2006 comparing a $5,900 special sales allowance item and a $9,963.14 other item on that list to an underlying credit memo for each item. Additionally, in each of the three audits, the auditors compared the total balance of unsettled special sales allowances at June 30 of the current and prior fiscal year, as shown on a Koss trial balance report.[45/]

No other audit procedures than those summarized above were applied to the Koss reports used in the substantive testing of Koss's special sales allowances. For example, due to the lack of audit work on the reliability of the Koss monthly sales reports used by the auditors to recompute, for certain customers for certain months, the special sales allowances shown on Koss's allowance schedule, that procedure provided little, if any, evidence about the schedule's reliability. Koeppel's own briefing describes the "[s]ubsequent reviews of credit memos" as going to "the accuracy of the Allowance Schedules and the accrual," not to completeness. KPHS 90. Tying the balance of a Koss IT system-generated detail report used in the special sales allowance testing to a Koss trial balance did not address whether items might have been omitted from both reports, even apart from other limitations to which that procedure was subject here, as discussed in depth in the next section. *See, e.g.*, Tr. 1404 (discussing tie-out of total balance on Koss's allowance schedule to a Koss trial balance and "perform[ing] some clerical tests" on the schedule as providing "a reasonable basis to determine that the [schedule] was accurate," with no mention of completeness).

We find that Koeppel, in relying on this audit work, known to her, on Koss's special sales allowances to form her audit conclusions and authorize issuance of the unqualified opinions on Koss's 2006, 2007, and 2008 financial statements, without having directed that necessary further audit work be done, violated AU §§ 150, 326, and 319.65 by not performing the necessary further audit work herself.

45/ There is no indication in the record that the 2006 or 2007 so-called field work or post-field-work credit memo reviews, or the 2006, 2007, or 2008 audits more generally, identified what the Division's expert described, based on the Koss-prepared sales allowance schedules in the work papers, as "a pattern of exceptionally high credit memos during the two months after" June 30 of 2005, 2006, and 2007. *See* Ex. D-2 at 62, 67-68, 116 ($437,158 in discount and rebate claims in August 2005 alone, nearly $300,000 more than next highest month, out of $1,406,916 total for fiscal year 2006; $662,587 in such claims in August 2006, over $550,000 more than next highest month, out of $1,086,548 for the year; $670,773 in such claims in July 2007, nearly $400,000 more than next highest month, out of $1,703,489 million for that fiscal year); Exs. J-42, J-135, J-228 (Koss sales allowance schedules for fiscal years 2006, 2007, 2008).

c. Accounts receivable

There are several aspects to the charges against Koeppel in the accounts receivable area. First, with respect to the accounts receivable testing as of the April 30 interim date in each audit in question, the Division argues that Koeppel relied on a Koss IT system-generated report as the basis for selecting the sample of receivables to be used for the confirmation testing without sufficient audit evidence of the completeness of that report. Second, the Division argues that Koeppel relied on May-June remaining period testing in each audit that, as a result of the confirmation testing not being adequately grounded in Koss's accounting records, was not tied to the interim period testing and so did not cover the remaining period in a way that provided a reasonable basis for extending to the balance sheet date the audit conclusions from the tests of details at the interim date. Third, the Division argues that Koeppel relied on a so-called rollforward procedure in the 2006 and 2007 audits to cover the remaining period that was also inadequate because it consisted of comparing subledger and trial balance reports generated by Koss's IT system with each other, without sufficient evidence of the completeness of those reports. Fourth, the Division argues that Koeppel relied in the 2008 audit on audit work that made no reference to the performance of any rollforward and that alternative procedures she has cited were inadequate to cover the remaining period. We find that Koeppel, in relying on the challenged interim testing in 2006-2008 and remaining period testing in 2006 and 2007 to form her audit conclusions and authorize issuance of the unqualified opinions, without directing her audit assistants to perform necessary further audit work, violated AU §§ 150, 230, and 326 and AU §§ 313.08 and 319.65, respectively, by not herself performing the necessary further work.

Confirmation of accounts receivable is typically an important audit test. *See, e.g., S.W. Hatfield, CPA*, SEC Rel. No. 34-69930, 2013 WL 3339647, *14, *22 (July 3, 2013). Subject to certain exceptions not relevant here, "there is a presumption that the auditor will request the confirmation of accounts receivable during an audit." AU § 330.34. There is no dispute that the confirmation testing was the principal substantive test of accounts receivable in the 2006, 2007, and 2008 Koss audits and no claim that the other substantive tests of details or the analytical procedures were sufficient to reduce audit risk to an acceptably low level for the applicable assertions. *See* Tr. 1353, 1357 (Koeppel); KOB 44; *see also, e.g.*, Tr. 887-89, 893, 919, 937 (Koeppel testified she understood that AU § 313 applied to the accounts receivable audit testing, which used confirmation procedures at interim); AU § 313 (standard addresses "applying principal substantive tests to the details of balance-sheet accounts at interim dates").

In each audit, Koeppel knew that confirmation testing was performed on Koss's accounts receivable at the interim date of April 30 and she treated an April 30 AR Aging Report generated by Koss's IT system and provided by its accounting department as capturing the entire population of its accounts receivable at April 30 for purposes of selecting a sample of receivables for the confirmation testing. There is no dispute that either these reports should have been reconciled to Koss's general ledger, which admittedly was not done in any of the three audits, or other audit evidence should have been obtained as to the reports' completeness and accuracy. *See, e.g.*, I.D. 45, 47, 50; Tr. 908-09, 1361 (Koeppel); Tr. 445-46 (2007-2008 Staff/In-Charge Auditor).

The auditor's substantive procedures "must include reconciling the financial statements to the accounting records" (AU § 326.19), and substantive tests designed to cover the period between the interim date and the balance sheet date "ordinarily should include [] comparison of information at the balance-sheet date with the comparable information at the interim date to identify amounts that appear unusual and investigation of any such amounts" (AU § 313.08(a)). Use of reports for interim date audit testing that do not reflect the company's actual financial condition at that time would defeat those requirements by allowing an undetected, untested gap to exist between the interim date audit testing and the company's true interim date financial information, the remaining period audit testing that is premised on the interim audit work, and the financial statements. Moreover, completeness of the reports was critical to the efficacy of the confirmation testing. This is because that testing depended on audit sampling of an overall accounts receivable population and "[s]ample items should be selected in such a way that the sample can be expected to be representative of the population," which means "all items in the population should have an opportunity to be selected" (AU § 350.24). *See, e.g.*, Tr. 881-83 (Koeppel); Tr. 885 (agreeing that Grant Thornton's audit methodology at the time reasonably provided that, as an item erroneously excluded from a population to be sampled cannot be selected for testing, supplementary procedures should be performed to support that the sample population is complete); Exs. J-60 at 160, J-139 at 269, J-269 at 273 (2006-2008 firm manuals, stating that an example of such a procedure would be "footing the population and agreeing it to the general ledger"); Tr. 403 (2006-2008 Staff/In-Charge Auditor: acknowledging that receiving confirmations back from customers does not necessarily indicate that all items that should have appeared on the AR Aging Report were there). As a Grant Thornton training program Koeppel attended in January 2007 stressed, "Don't waste time on an incomplete file! Would you select A/R confirmations sample or Inventory price test sample items before you tied out your detail to the ending balance? No, you wouldn't." Ex. J-130 at 20; *see* Tr. 796-802 (Koeppel); Ex. J-306 at 1.

Although Koeppel does not dispute that in the audits in question the interim date AR Aging Reports used for the accounts receivable confirmation testing were not tied to any other Koss reports, she appears to claim that she could reasonably have thought each was, in fact, reconciled to a trial balance report. *See* Tr. 1361 (stating she did not believe she was aware at the time of the audits of the lack of a reconciliation). Koeppel does not specify the grounds for her supposed belief, and, based on a thorough review of the record, we find that the preponderance of the evidence is to the contrary of her claim to have had a reasonable basis for that belief.

In this regard, Koeppel has described herself as a "highly engaged" and "thoroughly engaged" auditor, an "active participant in the audits." KPHS 2, 5-6. The other Koss audit team members who appeared at the hearing described Koeppel as "very involved" and "actively involved" in the audits (Tr. 181, 184-85), a "very, very hands-on partner" (Tr. 530) and an "extremely detailed" and "very thorough" reviewer of the audit work (Tr. 531, 686). Koeppel testified that confirmation of accounts receivable was "an area I would focus on" in the audits. Tr. 1353. Indeed, she contends that the confirmation procedure was the primary audit test used to obtain evidential matter about not only Koss's accounts receivable but its revenue generally, which, in her view, was one of the two "critical transaction cycles" in the audits and subject to a potential fraud risk, as well as the potential risks of management override of internal controls and lack of segregation of duties. *See, e.g.*, Tr. 830-32, 872-74, 1021, 1353, 1356, 1387; Exs. J-3 at 1, 3, J-100 at 3, 4, 6, J-200 at 3, 4, 7; Tr. 779; KOB 44; KPHS 72.

Considered in this context, Koeppel knew that in each audit certain items were excluded from Koss's April 30 AR Aging Report for purposes of confirmation testing and that in 2007 and 2008 that report was modified before a sample was even selected for confirmation. At the hearing, an audit team member who was involved in that work cited the modifications as a complicating factor that was partly responsible for the lack of any attempt to perform an interim-date reconciliation. Tr. 446 (2007-2008 Staff/In-Charge Auditor). Koeppel further knew that there could be a large difference, and swing in the relationship, between the total population of April 30 receivables used for confirmation testing and the April 30 trial balance used as the starting point for the rollforward. *See* Exs. J-30 at 1, 6 & J-31 at 1, 5 (former exceeded latter by $1,486,784 in 2006), Exs. J-123 at 2, 12 & J-125 at 1, 10 (former fell short of latter by $13,415 in 2007). And, in the audits, she was aware of large swings between the size of the receivables population at April 30 of the current year used for confirmation testing, on the one hand, and Koss's accounts receivable balance at June 30 of the prior fiscal year and/or the trial balance at June 30 of the current fiscal year, just two months after the interim testing date, on the other hand: $9,290,117 compared to $9,227,938 and $7,750,762; $6,821,607 compared to $7,750,762 and $8,749,662; and $4,693,212 compared to $8,749,662 and approximately $11,000,000, respectively. *See* Ex. J-20 at 1, 4; Ex. J-30 at 1, 6; Ex. J-114 at 1, 7; Ex. J-123 at 2, 12; Ex. J-220 at 1, 48; Ex. J-268 at 26. All of this would have drawn attention to an interim reconciliation, if one had been done.

Moreover, Koeppel testified that Grant Thornton's proprietary software used in the Koss audits to generate audit programs with firm-suggested procedures did not include an audit work step for reconciling accounts receivable subledger reports to the general ledger as of an interim date but only as of fiscal year end, that she did not tailor the Koss audit programs to include such a step, and that she would have been aware, through approval of the program, if any audit assistant had done so. Tr. 1362, 1437; *see* Exs. J-16 at 1, J-110 at 3, J-210 at 2 (work step in revenue audit program, under heading "Year End" and/or to which fiscal year-end reconciliation attached: "Test the footings of subsidiary ledgers (accounts, notes and installments receivable) and agree the total with the general ledger control."). Indeed, as she recognized, and as the firm's audit manuals state, the "'B' approach" of those audit programs was not specific to a low-inherent-risk-high-control-risk audit, in which internal controls might not be tested and other methods might need to be used to determine the reliability of system-generated reports, but also applied to a high-inherent-risk-low-control-risk-audit, in which, to assess control risk at low, controls would necessarily be tested and so other means might not be needed to determine the reliability of the reports. Tr. 1439-44.

At the hearing, Koeppel seemed to state it was her view during the audits that reconciliation of Koss's AR Aging Report only at fiscal year end was sufficient, under the firm's methodology, as applied by her in those audits: "our methodology addresses the need to test reports for completeness and accuracy, that that's embedded in the tests that we do and the fact that you…tied reports back to the general ledger or the trial balance, that you footed them. Those are all tests of completeness that are embedded into our methodology. And we talked about that in training, we talked about that the steps were designed to incorporate those into our work, and so that I didn't feel it was necessary, on this engagement or any other engagement, to tailor in a whole bunch of more steps" to address the reliability of Koss's reports. Tr. 1498. Koeppel takes that very position in this litigation: "most importantly, the same management-prepared report from which accounts receivables were selected at interim for confirmation (the AR Aging Report) was tied each year without exception to the general ledger [trial balance report] at year-end…[t]he fact that the same report as of year-end reconciled without exception to the general ledger provided the auditors with evidence of the completeness and accuracy of the AR Aging Reports used at interim." KPHS 37-38. This position aligns with the testimony of another Koss audit team member, expressed as reflecting a collective view, that "we didn't feel it was necessary" to do an interim reconciliation. Tr. 435, 445-46, 524-25 (2007-2008 Staff/In-Charge Auditor).

Consistent with the foregoing, in selecting work papers to review, Koeppel made a point of reviewing in the 2006 and 2007 audits a work paper titled "AR Reconciliation" and in the 2008 audit at least a notation on the audit program attaching an "AR Lead and Reconciliation" work paper. Exs. J-32 at 1, 5, J-126 at 1, 7, J-221 at 5. Containing no reference to any interim-date reconciliation, those work papers tied Koss's fiscal year-end AR Aging Report to a Koss fiscal year-end trial balance report. There was a difference between the June 30 "Balance per Aging" and the June 30 "Balance per G/L" (balance per trial balance report) of $964,975.55, $1,232,560.35, and $701,679.97, in 2006, 2007, and 2008, respectively, involving additions and subtractions that, in absolute amount, totaled $1,087,356.01, 1,278,181.13, and $934,767.81, respectively. *Id.* (identifying reconciling items of "I/C Balances" ("intercompany AR" among Koss related entities), "Cash in transit," "Reclass of AR credit balance" ("GT recomputed the credit balances per the AR aging"), and "Reclass of Office Depot Rec." ("not truly a receivable until the consigned inventory is sold…Office Depot sends Koss a monthly report showing what sold so Koss knows what to recognize as revenue")).

Additionally, Koeppel specifically signed off on work papers that identified the balance of the April 30 accounts receivable population used for the confirmation testing but that marked that balance only with a tick mark stating that it had been tied to Koss's April 30 AR Aging Report. Exs. J-30 at 4-5, 6 (2006), J-123 at 2, 10-12 (2007), J-220 at 1, 47, 48 (2008). The standard "beta" tick mark used in the Koss audits to signify that a balance had been tied to a trial balance report (*see e.g.*, Tr. 1457-58 (Koeppel)) was absent, the work paper contained no such reconciliation, and no other procedures were documented to determine the reliability of the April 30 AR Aging Report. If any audit work on a interim-date reconciliation had been performed for 2008, that work paper (Ex. J-220) would have been the place to find it, according to the notation Koeppel reviewed on the 2008 audit program. *See* Ex. J-221 at 5.

Koeppel also reviewed the work paper for the procedure performed in the 2006 and 2007 audits to "roll forward" the interim accounts receivable balance to the balance sheet date. The work paper showed that the starting point for that procedure was the "Balance Per 4/30/[2006 or 2007] G/L," a trial balance. But the work paper contained no reconciliation to the April 30 AR Aging Report, whereas it specifically cross-referenced the tie-out of the June 30 trial balance, the end point of the procedure, to the June 30 AR Aging Report. *See* Exs. J-31 at 1, 5, J-125 at 1, 10. Koeppel could not have come across any interim date reconciliation elsewhere in the work papers, as none existed.

Incidentally, even if Koeppel had believed that an interim-date reconciliation was performed as part of the accounts receivable audit work, the most she claims would have been done would have been to tie Koss's April 30 AR Aging Report to a Koss April 30 trial balance report, as was done with the fiscal year-end reports. *See, e.g.*, KPHS 37-38 & n.18, 83, 84 n.24. Yet, as she knew, neither Koss's IT system nor the operating effectiveness of Koss's internal controls was tested in the audits. She thus lacked the information that such testing could have provided about the extent to which Koss's information system may have been susceptible to errors or oversights in the entry of data into the general ledger and whether the system contained defects that could cause or enable it to wrongly capture, summarize, or report general ledger data.[46/]

[46/] *See, e.g.,* Ex. J-30 at 2 (2006 confirmation work paper reviewed by Koeppel: "GT had selected a deduction on the customer's account that was paid back, however, it was misapplied to the wrong invoice. As such the amount remained on the customer's account until the proper research was performed."); Ex. J-123 at 2-6 (2007 confirmation work paper, reviewed by Koeppel, identified two cases in which "payment [of invoice] was received into Koss's bank account" before April 30 but, per discussion with Senior Accountant, "A/R wasn't reduced" ("via entry to a Cash-in-transit Account which offsets [the general] A/R Acct"), and cash was not increased, until after April 30, when "a manual journal entry was made" to that effect); Ex. J-127 at 2, 5, 10 (2007 inventory rollforward work paper, reviewed by Koeppel: "[Per discussion with VP of Finance], [an] account was mistakenly omitted from the total [June 2007 inventory balance]" and also "GT notes [a] discrepancy" between May 2007 scrap balance in rollforward and in Koss scrap report, as to both of which the auditors did no further work because the amounts were below tolerable error); Ex. J-49 at 1 (Koss data entry staff "enters the [inventory]

Koeppel also knew that Koss's trial balance reports were printed at a particular point in time. And she knew, among other things, that they could not be reprinted as of that date at a later time for comparison purposes due to asserted IT system limitations; would not reflect the general ledger data for the relevant period if journal entries affecting that data were subsequently posted directly to the general ledger; and would not reflect the company's true financial condition at the time the report was generated if false journal entries had previously been posted directly to the general ledger, if false journal entries had previously been posted to a subledger and transferred to the general ledger, or if correct subledger data was excluded from system reports, as by system flaw or manipulation of the timing or content of the transfer of data from subledger to general ledger, none of which was effectively addressed in the audit work.

The Division is therefore correct that under these circumstances "[a]greeing the account balance on an information system-generated report to a balance appearing on the information system-generated trial balance does not provide evidence of the completeness or accuracy of the report (i.e., whether the auditor is auditing the right numbers), only that two system-generated reports reflect the same account balances. They could both be complete, be incomplete, or even reflect the same balances (through adjustments or otherwise), even though the transactions they each include are different." DPHS 70. Assertions at the hearing by Koss audit team members that they considered trial balance reports to be equivalent to the general ledger (*see* KPHS 24 n.10, 84 n.24) do not mean that, without more audit work, those reports could be treated that way in the audits in question. And citations by Koeppel to general propositions in "professional literature that a trial balance is essentially a snapshot of the balances of each account in the general ledger" (*id.*) only highlight the problem in those audits that the information in Koss's system-generated reports might have been altered through journal entries not necessarily provided to the auditors, even if those reports otherwise would have correctly captured, summarized, and presented the general ledger data.

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receipt including order number, quantity and part number information into the system to update perpetual inventory once the goods have completed an initial inspection – note that this does not update the g/l. Once a week the accounting department reconciles differences b/w the g/l and inventory systems (usually clerical errors)….The VP of Finance reviews a listing of unmatched receipts on a monthly basis."); Ex. J-221 at 3 (2008 reconciliation of June 30 AR Aging Report to June 30 trial balance: "GT notes amount relates to a return that the Company was made aware of very close to YE, that did not get posted to the aging….As amount is below TE ($220,000) GT will PFW and accept as reasonable."); Ex. R-398 at 4 (VP-Operations "noted that on a weekly basis, she reviews the inventory file in the AS400 for such parts as those with no cost, negative costs, and negative qualities"). There is no evidence in the record of any consideration in the audits of possible systemic implications of any of these instances.

In particular, comparing the balance reflected on April 30 AR Aging Reports, after adjusting for certain reconciling items, to the accounts receivable balance reflected on April 30 trial balance reports would not identify, for example, certain omissions from the subledger detail reports used in the procedure that could contribute to an overstatement of Koss's trial balance. Specifically, the procedure would not identify the omission from those detail reports of certain genuine items that reduce the accounts receivable balance, combined with, in equal amount, the omission from those reports of false items that increase the balance and/or the direct inflation of the trial balance through posting false sales to the general ledger or including so-called "intercompany" sales between related Koss entities, which do not belong in Koss's financial statements. In that example, some items that would reduce the accounts receivable balance and would not be part of the sample selected in the audits for confirmation, such as credit memos and cash in transit (cash received but not yet applied to a particular receivable), could be omitted from subledger detail provided to the auditors. The resulting inflation of the balance derived from the AR Aging Report used in the audit testing could mask an inflation of the accounts receivable trial balance attributable to false sales omitted from the AR Aging Report or to a combination of such omissions, false sales posted directly to the general ledger, and miscategorized or disguised intercompany sales.[47/]

Despite the lack of a reconciliation of the April 30 AR Aging Report to the general ledger, Koeppel argues that "appropriate evidence of the completeness and accuracy of the Interim A/R Aging Reports" was obtained because (1) "[t]he same standard reports from which accounts receivable were selected at interim were tied without exception to the general ledger at year-end in each of the Relevant Audits" and (2) "[t]he year-end A/R Aging Reports were also subjected to a variety of tests of details that included tracing the items on the reports to source documents." KOB 49; *see* KRB 12 ("it was reasonable to place 'reliance on the system' that generated A/R Aging Reports by tying the year-end A/R Aging Reports to the general ledger and performing other procedures on those reports, including tracing individual items back to source documents").

The initial decision correctly rejected the first of these contentions: "Even assuming that the engagement teams could have utilized the year-end reconciliations—which they did not have when they selected receivables for confirmation from the Interim A/R Aging Reports—to draw conclusions about the completeness and accuracy of the Interim A/R Aging Reports, there is no evidence in the work papers, or testimony from any engagement team member, that they did so," and "the fact that a year-end report can be reconciled to the general ledger does not, by itself, establish that an

[47/] The alternative audit procedures used in the 2006, 2007, and 2008 audits when a selected receivable was not confirmed by the customer involved matching certain of those receivables to subsequent cash receipts and certain others to credit memos, but the work papers identify only some of those payments as having been received, and only a few of those credit memos as having been issued, during the confirmation period. *See* Exs. J-30 at 1-2, J-123 at 1-8, J-220 at 44-46, all reviewed by Koeppel.

interim report could also be so reconciled—the report might have been incomplete or inaccurate at the interim date, but corrected by year-end." I.D. 49 & n.22. Koeppel's argument also ignores the possibility that, through management override of controls, the interim report could have been manipulated so that it did not reflect the general ledger or the general ledger itself could have been manipulated through false journal entries. She understood that the auditors were limited in their ability to test Koss's journal entries for fraud by their preferred method, knew that they instead depended on what Koss's small accounting department represented were binders of paper copies of journal entries posted and compiled by that same department, was specifically put on notice by the 2005 PCAOB inspection, as well as Grant Thornton training, about the issue of completeness of the population of journal entries selected for testing, and, as we have found, violated PCAOB auditing standards regarding that testing. Additionally, she knew the limited nature of the rollforward testing, discussed below, which was meant to extend the conclusions formed at the interim date to the balance sheet date.

Similarly, Koeppel's second contention cites tests of details to which "the year-end A/R Aging Reports" were subjected, not any procedures applied to the interim AR Aging Reports. The audit tests she does cite are shipping cut-off testing in 2006, 2007, and 2008 and an assessment in 2006 and 2008 of whether receivables were being properly aged. KOB 49; KPHS 38 n.19. But the six invoices each year subject to that cut-off testing represented what audit team members acknowledge was a very small or miniscule amount of the receivables on Koss's AR Aging Report at any given time, limited to those immediately before and after the end of the period, and the 10 or so invoices selected from the June 30 AR Aging Report for the audit work on aging in 2006 and in 2008 represented only 1.6% and 1% of the respective year's report balance. *See* pp. 65-66 above. Not only did the small scale of this testing limit any support it provided for the reliability of Koss reports, but also the nature of the testing led Koeppel and other audit team members themselves to describe it as "supporting the reports' accuracy" rather than completeness. *See* KPHS 38 n.19; Tr. 401-03, 713-14.

We therefore conclude that in the 2006, 2007, and 2008 audits, Koss's April 30 AR Aging Report was not reconciled to Koss's general ledger, sufficient evidence of the completeness of the report was not obtained by other means, and Koeppel knew the facts necessary to these conclusions. Consequently, the interim date audit testing was not adequately grounded in Koss's accounting records, sufficient competent evidential matter was not obtained to support the existence of Koss's accounts receivable, in violation of AU §§ 150, 230, and 326, and the interim date testing was not linked to the rollforward procedures performed in the 2006 and 2007 audits, making it impossible for the rollforwards to supply a reasonable basis for extending to the balance sheet date the audit conclusions from the interim work, in violation of AU § 313.08. Further, even if the accounts receivable balance used for the interim testing had been reconciled to the accounts receivable balance used to commence the rollforward, the remaining period testing was independently deficient, as discussed next.

Where, as here, the auditor performs only substantive tests, using information provided by the entity's information system, and does not test internal controls, "the auditor should obtain evidence about the accuracy and completeness of the information." AU § 319.65. Applying principal substantive tests to the details of an asset or liability account, such as accounts receivable, at an interim date rather than the balance sheet date potentially increases the risk that the auditor will not detect misstatements that might exist at the latter date. *See* AU § 313.03. Under PCAOB auditing standards, substantive tests need to be designed to control that potential increased audit risk and should cover the remaining period in such a way that the assurance from those tests and the substantive tests applied to the details of the balance as of an interim date, and any audit assurance provided from the assessed level of control risk, achieve the audit objectives at the balance sheet date. AU §§ 313.03, .08. In the audit work on the existence of Koss's accounts receivable, control risk was assessed at the maximum, and only substantive tests were performed, so audit assurance was not provided from the assessed level of control risk.

In the 2006 and 2007 Koss audits, the only audit procedure identified as designed to cover the remaining period was the so-called rollforward. *See, e.g.*, Ex. J-125 at 3; KPHS 38, 84. The procedure played an important role. *See, e.g.*, Ex. D-4 at 90-92 (Audit Manager's investigative testimony). A notation on the revenue audit program for the 2006 Koss audit attached the work paper for the rollforward and indicated that it was an alternative audit procedure for fiscal year receivable accounts not confirmed, and the rollforward work paper concluded, "Per the testing of the AR roll forward, AR appears to be properly stated as of year-end." Ex. J-16 at 3; J-31 at 2. The revenue audit program for the 2007 Koss audit specifically referred to "the roll forward period," bore a notation referring to "review of the roll forward activity," and included as an attachment the rollforward work paper, which explained, "As A/R was confirmed as of 4/30/07, GT will test activity between the confirmation date and year-end to further validate the year-end A/R balance." Ex. J-110 at 3-4; Ex. J-125 at 3, 6.

The rollforward took Koss's April 30 receivable "Balance per GL," which in the Koss audits meant a trial balance, added to it Koss's May and June sales and credit balances and subtracted from it Koss's May and June cash receipts and Koss's inventory still on consignment at a retailer at the end of June ("Office Depot Reclass"), made a further modification of the receivable balance for May and June cash in transit, and then compared the resulting receivable balance with a Koss June 30 trial balance report. *See* pp. 66-69 above. Thus, the beginning and ending accounts receivable balances used in the rollforward were trial balances, and the May and June activity data came from subledger detail reports, mainly Koss's monthly AR Distribution Register, all generated by Koss's IT system and provided by its accounting department.

In Koeppel's view, "[t]he successful performance of the rollforward procedures themselves demonstrated the accuracy of the data used in them" and "serve[d] as evidence that the reports used in the rollforwards were accurate and complete." KPHS

39, 84. She reasons, "If an entry had been posted to the general ledger and omitted from the subledger A/R Distribution Register, the rollforward procedure would not have been able to reconcile the interim general ledger balance with the closing general ledger balance." *Id.* The initial decision agreed (I.D. 53), simply declaring it is "the net number that is being tested at year-end" and "as a practical matter the fact that the roll forward reconciles provides additional evidence as to the accuracy of the individual categories" of transactional data summed in the procedure. But Koeppel's argument assumes from the mere mathematical agreement of balances or sums of balances of various reports that the transactions listed or purportedly reflected in the reports were valid or recorded correctly and that all of the transactions that occurred were recorded and reflected.

For one thing, Koeppel's argument depends on Koss IT system-generated reports for the "general ledger balance." After the reports used in the rollforward were generated, however, a journal entry affecting the accounts receivable balance for the relevant period could be posted directly to the general ledger, either as an initial matter or to reverse parts of a previously posted revenue-neutral journal entry involving multiple accounts or categories of items in one account, all in the absence of proper testing of journal entries in the Koss audits.

Koeppel did observe in testimony that "[t]ypically, [a trial balance report, generated from the general ledger] is the document that is then tied to the consolidating workbook [*i.e.*, another general ledger report]," which "is what supports the Ks and Qs the company files" (Tr. 1457), suggesting an unbroken chain in each audit of tying a trial balance report to a general ledger report more closely resembling the financial statements and finally to the financial statements themselves. But this does not address the risk of error or oversight in the entry of data into the general ledger over the relevant period or of a systemic flaw affecting all of the reports' depiction of the general ledger data. Nor does it address whether the transfer of data from Koss subledgers to its general ledger could be manipulated in relation to the generation of the general ledger reports or items could be omitted from the subledger detail reports used to "roll forward" the interim trial balances to June 30, quite apart from the possibility that detail reports could contain false items that escaped detection by the ordinary audit tests. If, for example, false sales (and related receivables) posted directly to the general ledger and a corresponding amount of true items that reduce accounts receivable were both omitted from subledger reports, those reports would agree to a general ledger accounts receivable trial balance that was a composite of the false sales and all other items, additive and subtractive, contributing to that overall account balance.[48/]

[48/] The reconciliation in each audit of the June 30 AR Aging Report to the June 30 accounts receivable trial balance was susceptible to the same potential problems. Moreover, misstatement due to error or fraud is even less likely to be detected by a reconciliation procedure if the auditor does not check that the balance totals listed on the detail report correctly reflect the line items on that report. According to a notation reviewed by Koeppel under a work step on the revenue audit program for the 2008

Koeppel's emphasis on tying IT system-generated general ledger reports and subledger detail reports to one another and to each other obscures that this does not constitute direct, detail testing of any report entry or reconciling item. Without sufficient support for the reliability of that data, the reconciliation becomes an all but meaningless exercise. To illustrate, tying out one general ledger report to another can involve large reconciling items. *See, e.g.*, Ex. R-277 at 2 (tie-out to a consolidating workbook). The offsetting, reconciling items flowing through the accounts receivable rollforward purportedly totaled May-June sales of $8,294,738.81 in 2006 and $8,524,441 in 2007; May-June cash receipts of $8,869,117.88 in 2006 and $6,534,796 in 2007; May-June gross cash in transit of $776,339.99 in 2006 and $412,361 in 2007; May-June credit balances of $61,190 in 2006 and $22,810 in 2007; and $240,530.08 in inventory on consignment at a retailer as of June 30 in 2006 and $57,029 in 2007. In 2006, no audit procedures were applied to the subledger detail reports that were the source of these items to determine their reliability. In the 2007 audit, ten cash receipts each from May and June, totaling $180,498.93, were traced to underlying documents and to the respective month's AR Distribution Register; ten invoices each from May and June, totaling $255,278.65, were traced to underlying documents and to Koss daily subledger reports called Invoice Summary Registers; and those reports' daily total invoice balances were traced to the AR Distribution Registers. But none of this small-scale tracing of items from system-generated reports provided by Koss's accounting department addressed items that might have been omitted. This created an important opening for misstatement due to error or fraud in a major area of the audit.

There is no indication in the record that the accounts receivable rollforward was performed in the 2008 Koss audit, and Koeppel concedes that it was not performed. Tr. 1365; *see* Tr. 446-47 (2007-2008 Staff/In-Charge Auditor). The auditors have provided no explanation for the absence of the procedure that year, in light of its use in 2006 and 2007 and the use in 2006, 2007, and 2008 of a rollforward in another major audit area that was principally tested at April 30, inventory. Koeppel testified that "inherent" in her approach in the Koss audits was that "doing a roll forward" was part of what "gave us comfort that the system was working appropriately" and that Koss reports were reliable. Tr. 1092, 1186-88. And the work papers for 2008 do not denominate any other audit procedure or set of procedures as a substitute for the accounts receivable rollforward. Koeppel testified that she did not believe she had communicated to any member of the

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audit, "As the 6/30/08 AR Aging is in paper format, GT footed and extended select customers w/o/e"—not all customers' items listed on the report. Ex. J-210 at 2; Ex J-221 at 5. In 2007, the corresponding notation and the cross-referenced work paper, both reviewed by Koeppel, did not state one way or the other whether the auditors tested the footings of the AR Aging Report, as called for by the work step. Ex. J-110 at 3; Ex. J-126. For 2006, the corresponding notation asserted, "GT footed the AR aging and notes that the aging footed correctly," without elaboration or any mention of this in the cross-referenced work paper, which Koeppel reviewed. Ex. J-16 at 1; Ex. J-32.

Koss audit teams that too many procedures were performed in 2006 or 2007 on accounts receivable activity recorded in the remaining period. Tr. 894, 914. She further testified that "I can't say if I was aware or not" at the time of the 2008 audit that the rollforward was omitted, that "I don't recall," and that "I don't believe I was." Tr. 937-38, 1365. Either she knew the rollforward was not done in 2008 or she believed, given her assertedly active role in planning the audits, prior approval and review of the procedure, and consistent approach to the issue of the completeness of system-generated reports used for substantive testing, that, as far as that issue was concerned, the rollforward was performed in 2008 in the same manner as in 2006 and 2007. Either way, more audit work needed to be done, Koeppel did not direct that it be done, and she did not perform it herself, which could be a factual basis for finding she violated AU § 313.08.[49/]

49/ Koeppel has claimed in briefing in this case that "it appears" that she "delegated responsibility for review of the year-end 2008 accounts receivable work to [Audit Manager]." KPHS 40, 85. The brief bases this claim on inference from two work papers (Ex. J-221 ("AR Lead and Reconciliation") and Ex. R-426 at 4-6 ("Reserve for Doubtful Accounts")) that bear only Audit Manager's initials in the "Reviewed By" column. As to the first, work papers in the record permit a comparison to the counterpart document in the 2006 and 2007 audits, which bore both Koeppel's and Audit Manager's initials in that column. *Compare* Ex. J-221 at 5 (2008) *with* Ex. J-32 at 5 (2006) and Ex. J-126 at 7 (2007). The brief also notes that "[b]y the time of the 2008 audit," Audit Manager "already had four years of experience auditing Koss's financial statements, and was being promoted to partner." KPHS 10. But the particular Koss audit work papers on which Koeppel signed off varied from year to year, not following any pattern of increased reliance on Audit Manager, even as to remaining period testing. *Compare, e.g.*, Ex. J-222 *with* Ex. J-33. Her review of work papers was not limited to those on which she signed off. *See, e.g.,* Tr. 752-53, 835-37, 1064-65, 1072-75, 1101, 1131-32. And even if she did "delegate portions" of the "supervision of the audit to other firm personnel" (AU § 311.02; *see* KOB 7, 32; KPHS 6, 9, 54), that would not mean that she lacked any understanding or expectation, coming out of the prior audits and planning of the 2008 audit, about use of an accounts receivable rollforward in 2008 or that she delegated all responsibility for review of the work on Koss's year-end 2008 accounts receivable, part of one of the two "significant transaction cycles with critical assertions" in the audit. For example, Koeppel reviewed the notation on the 2008 revenue audit program that made various representations in response to the work step "[t]est the footings of subsidiary ledgers (accounts…receivable) and agree to the general ledger control" and that cross-referenced the year-end accounts receivable reconciliation. *See* Ex. J-221 at 5. She included the work paper containing that reconciliation (Ex. J-221) on an exhibit she prepared for the litigation (Ex. R-510 at 3) that she described on her list of admitted exhibits as "Partial List of Workpapers Reviewed by Ms. Koeppel During the Audits" (R.D. 79). And only her initials appear as reviewer of a notation on the audit program documenting "GT['s] review[]" of "the 'Month to Date – Commissions' report" for "unusual or significant items" that "need further investigation" (Ex. J-219), a procedure she claims helped "provide[] a reasonable basis to extend the conclusions from the

Koeppel insists that no more work than was done was necessary in any of the three audits on Koss's remaining period accounts receivable to comply with AU §§ 319.65 or 313.08. She argues that in each audit—in 2006 and 2007 along with an accounts receivable rollforward and in 2008 as an alternative to it—a combination of "tests of details on accounts receivable and analytical procedures on receivables and sales," performed at fiscal year end, "provided a reasonable basis to extend the conclusions from the interim procedures to the remaining period and the year-end balance" and, together with the interim procedures, "was the basis for [her] professional judgment that reasonable assurance had been attained with respect to Koss's accounts receivable." KOB 50; KRB 13; KPHS 40-41, 85-86. In briefing, she identifies in this regard a set of from eight to ten procedures each year. The eight 2008 procedures she cites had all been performed in one or both of the prior audits when a rollforward was also done. *See* Ex. R-507 at 72 & n.320.

Overall, Koeppel cites five procedures as having been performed in each of the audits: (1) shipping cut-off testing (Exs. J-28, J-120, J-249); (2) a scan of a Koss IT system-generated subledger detail report for sales recorded in June (Exs. J-29, J-122, J-219); (3) a comparison of revenue totals for each of the three months of the fourth quarter with those figures from the prior fiscal year (Exs. J-18, J-115, J-213); (4) a calculation, and a comparison with the prior year, of five fiscal year-end "Short Term Liquidity Ratios," one of which ("Days Sales in Receivables") included accounts receivable (Exs. J-19, J-112, J-245); and (5) a calculation of various ratios of receivables to assets, net worth, and sales, as well as the ratio of sales allowances to sales, as of fiscal year end, and a comparison to those ratios from the prior year (Exs. J-20, J-113, J-212). Her other work paper citations may be categorized as follows: (6) a 2006 and 2007 procedure calculating, as of fiscal year end, the ratio of the reserve for doubtful accounts to accounts receivable, of bad debt expense to sales, and of average accounts receivable to daily sales (similar to the days sales in receivables calculation in the fourth procedure, except dividing accounts receivable by a calculation of gross sales, instead of net sales, divided by 365 days), and comparing these ratios to the prior fiscal year-end ratios (Exs. J-21, J-114); (7) a 2006 and 2008 procedure that tested the aging of ten or twelve items on Koss's June 30 AR Aging Report by comparing them to the underlying invoices (Exs. R-227, R-426 at 4-5); (8) a 2007 procedure that compared Koss net sales totals for each quarter of the current to the prior fiscal year (Ex. J-116); (9) a 2007 procedure that listed October, November, and December 2006 Koss sales by product line and compared them to those figures for 2005 (Ex. J-141); (10) a 2007 and 2008 fourth-quarter export sales territory work paper (Exs. J-146, J-231); and (11) the 2008 reconciliation of the AR Aging Report to a trial balance at June 30 (Ex. J-221).

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interim procedures to the remaining period and the year-end balance" for Koss's accounts receivable (KOB 50; KRB 13; KPHS 41).

Although Koeppel, relying on her expert, asserts generically that such of these procedures as were performed in each audit "should be considered in their totality" or "cumulative effect" and that "viewing them in that light, they were sufficient" for purposes of her argument (KRB 13; KPHS 40, 41, 86), we agree with the hearing officer that the expert "failed to explain in any reasonable manner" how that was so (I.D. 54). The audit documentation does not indicate that any of these procedures to which Koeppel now points were "substantive tests to cover the remaining period" (AU § 313.03). None of them provided any tie to, or even cross-referenced, the interim period testing performed. Linking the cited procedures to the interim testing would be part of determining whether the procedures "provide a reasonable basis for extending to the balance sheet date the audit conclusions from the tests of details at the interim date" (*id.*). None included a "comparison of information concerning the balance at the balance-sheet date with the comparable information at the interim date to identify amounts that appear unusual and investigation of any such amounts" (AU § 313.08(a)). *See, e.g.*, Tr. 2036-51 (Koeppel's expert conceded this as to all four of those procedures about which he was specifically cross-examined, Ex. J-212, Ex. J-213, Ex. J-221, Ex. R-426). A purported remaining period procedure that did not isolate data from the May-June period or limit any interim period data that was included in the procedure to data tied to and necessarily supported by the interim testing could include data that was inconsistent with the data tested at interim—for example, a June 30 balance could include interim period activity different from that provided for audit testing at interim—and thereby skew any conclusions about Koss's remaining period activity that might be drawn from the procedure. And as in the audits more broadly, adequate audit work was not performed to determine the reliability of the Koss IT system-generated data used in the procedures. The cited procedures did not achieve compliance with AU §§ 313.08 or 319.65 in any of the Koss audits.

One procedure Koeppel cites (the second) involved only a scan of purported June sales on a Koss IT system-generated report to which no audit procedures were applied. This work did not involve any other procedures to test Koss's June accounts receivable activity or any examination of the May activity.

Three of the cited procedures (numbers one, seven, and eleven) were applied to Koss's June 30 AR Aging Report. As previously discussed, the first procedure, shipping cut-off testing, was limited to a small number and amount of transactions, immediately around period ends, and, as explained by a Koss audit team member, was performed to obtain evidence that sales were booked in the right period rather than to obtain evidence of the existence of accounts receivable. *See* pp. 65-66, 152 above; Tr. 710-12 (2007-2008 Staff Auditor) (citing Ex. J-120). The risk of incorrect items did not just exist at period ends. Indeed, the inspection comment form on the 2005 Koss audit had identified the issue of "[t]esting of journal entries throughout the period" (Ex. D-1 at 1), not just at a period end, and Koeppel has stated she took the comment "very seriously" (KOB 22, KPHS 69) and was mindful of it throughout the later Koss audits she led (Tr. 813-14, 1325). *See* R.D. 118 at 43 (oral argument); Ex. D-4 at 80-81 (Audit Manager's investigative testimony).[50] The seventh procedure, which tested the aging of about a dozen items on a Koss June 30 AR Aging Report by tracing them to invoices the work papers do not indicate were confirmed with customers, provided very limited evidence of the existence of Koss's accounts receivable and was not focused on the remaining period. *See* pp. 66, 152 above. The eleventh procedure reconciled the total accounts receivable balance on a June 30 Koss AR Aging Report with that on a June 30 Koss trial balance report, which, as we just discussed, simply tied one Koss IT system-generated report to another at fiscal year end, without any effective link to the interim period testing or any focus on or particular testing of remaining period activity.

Koeppel's remaining seven citations are to analytical procedures, which she viewed as having even less weight, especially analytical procedures on sales, than tests of details in the work on accounts receivable in the Koss audits. *See, e.g.*, KPHS 72 ("substantive tests of details on balance sheet accounts" were "the principal source of evidence for all of Koss's revenue cycle accounts"); KPet. 8 ("accounts receivable testing served as the principal substantive test" to support "the valuation and occurrence of accounts receivable on the balance sheet"). Each analytical procedure relied for its expectations on Koss IT system-generated data from the prior fiscal year, when no more audit work had been performed than in the current fiscal year with respect to the reliability of such data. *See, e.g.,* p. 139 n.41 above. The "expected effectiveness and efficiency of an analytical procedure in identifying potential misstatements" depends in part on "the availability and reliability of the data used to develop the expectation." AU § 329.11. And because management override of controls, which the flawed journal entry testing and the otherwise flawed substantive testing failed to properly address, could "allow[] adjustments outside of the normal period-end financial reporting process to have been made to the financial statements" that "might have resulted in artificial change to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions," "substantive analytical procedures alone are not well suited to detecting fraud." AU § 329.10.

Three of the analytical procedures cited by Koeppel (numbers four, five, and six) included accounts receivable in calculating one to several fiscal year-end ratios that are compared to the prior year ratios. Any evidence these procedures might have provided about remaining period accounts receivable activity was diluted by their lack of any

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[50] *See generally, e.g.*, AU §§ 316.52 ("because an intentional misstatement," involving, for example, inappropriate revenue recognition, "may have been initiated in an interim period, the auditor might elect to apply substantive tests to transactions occurring earlier in or throughout the reporting period"), .58 ("[m]aterial misstatements of financial statements due to fraud often involve the manipulation of the financial reporting process" by "recording inappropriate or unauthorized journal entires throughout the year or at period end"), .62 (material misstatements due to fraud "can occur throughout the period and may involve extensive efforts to conceal how it is accomplished").

effective link to the interim period testing, their use of fiscal year-end accounts receivable balances, their consideration of accounts receivable only as one factor in a ratio, and their failure to support the reliability of Koss system-generated data used in the procedures. The ninth procedure addressed the second quarter of 2007, not the remaining period. The three remaining cited procedures (numbers three, eight, and ten) concerned themselves with Koss fourth quarter gross or net sales figures. The limited value of the export sales territory procedure (number ten) was discussed in detail above. *See* p. 55 n.16. The other two procedures involved consideration of trends in Koss fourth quarter sales figures but made no reference to its April 30 or June 30 accounts receivable balances, lacked any effective link to the interim period testing, and used Koss IT system-generated data without supporting the reliability of that data.

Accordingly, we further find that in the 2006 and 2007 audits, Koeppel violated AU §§ 313.08 and 319.65 with regard to Koss's remaining period accounts receivable, even without considering her violations of PCAOB auditing standards with regard to Koss's interim period accounts receivable. Although there is a basis in the record for finding that Koeppel violated AU § 313.08 with respect to the remaining period audit work on accounts receivable in the 2008 audit, the OIP did not charge in the alternative that either she knew the rollforward was not done in 2008 or she believed that the rollforward was performed in 2008 in the same manner as the procedure was performed in 2006 and 2007 (*see* OIP ¶ 52), and the Division did not prove the former by a preponderance of the evidence. Consequently, we do not find any violation by Koeppel arising from the lack of an accounts receivable rollforward in the 2008 audit.

4. The inventory account

The charges against Koeppel in the inventory area concern the remaining period work in the 2006, 2007, and 2008 Koss audits. As with accounts receivable, existence of inventory was tested in each audit by applying principal substantive tests to the details of that asset account at the interim date of April 30. In that circumstance, "[s]ubstantive tests should be designed to cover the remaining period" in a way "that will provide a reasonable basis for extending to the balance-sheet date the audit conclusions from the tests of details at the interim date." AU §§ 313.03, .08. And, as noted, where, as here, the auditor performs only substantive tests, using information provided by the entity's information system, "the auditor should obtain evidence about the accuracy and completeness of the information" (AU § 319.65) and, having not "test[ed] the design and operating effectiveness of controls over financial information used in" substantive analytical procedures, "the auditor should," "[b]efore using the results obtained from substantive analytical procedures," "perform other procedures to support the completeness and accuracy of the underlying information" (AU § 329.16).

The Division argues that Koeppel violated these PCAOB auditing standards because audit procedures were not performed on the Koss IT system-generated reports that were used in the substantive testing of the remaining period activity in Koss's inventory account to determine the reports' accuracy and/or completeness, as Koeppel understood when she relied on that testing in forming and authorizing issuance of the 2006, 2007, and 2008 audit opinions. *E.g.*, DOB 6, 17, 34-35. Specifically, the Division contends that sufficient audit work was not performed in the 2006 audit on either the accuracy or completeness, or in the 2007 and 2008 audits the completeness, of the main report, or the completeness and accuracy of the other Koss reports, used in the substantive testing of the remaining period inventory activity to support the existence of inventory at June 30. DOB 13, 16-17 & n.70; DRB 11 & n.53; DPHS 48-51, 79-82.

Koeppel has contended that in each audit "[t]he substantive inventory procedures performed at interim, combined with the inventory rollforward and analytical procedures, provided ample evidence supporting [her] professional judgment that reasonable assurance had been obtained with respect to Koss's inventory" and that she "reasonably relied on that work in signing off on the issuance of the audit opinion." KPHS 41, 42-43. In particular, claiming to have been "very involved" in planning the Koss audits and "personally involved" in "reviewing the audit documentation" overall (*e.g.*, Tr. 727, 1237), she has argued that "[i]n order to extend the results of the substantive testing performed on inventory as of the interim date to the year-end, the auditors in each of the audits planned to perform and did perform various Remaining Period procedures." KPHS 86. Koeppel has described those procedures as: (1) so-called inventory rollforwards; (2) analytical procedures on the rollforwards; (3) certain testing in the 2007 and 2008 audits of a sample of items on the main report used in both the rollforward and the related analytical procedures; (4) inventory ratio analyses with respect to Koss's June 30 inventory balance; and (5) cut-off testing of inventory receipts as of June 30. KOB 18; KPHS 42 (citing Ex. R-507 at 96 (expert report)), 86. We have previously discussed in detail those procedures, all of which depended on Koss IT system-generated reports. *See* pp. 69-73 above.

As noted above, a cover page to the Koss inventory audit program in 2006, 2007, and 2008 stated that an inventory observation—the principal substantive audit test of the details of Koss's inventory account—would "be made prior to year end." Exs. J-54 at 1, J-153 at 1, J-250 at 1; *see* Tr. 369 (2006-2008 Staff/In-Charge Auditor), 1176-77 (Koeppel). The procedure identified in the 2006 Koss audit work papers as designed to cover Koss's remaining period inventory activity was the "Inventory Roll Forward." The procedures identified as designed to do so in the 2007 and 2008 audits were the rollforward; the tracing of a sample of items on the main Koss report used in the rollforward to source documents or to another Koss report (referred to by the work papers as "Rollforward Testing"); and analytical procedures comparing the totals of each component of Koss's inventory account activity in April and May of the current and prior fiscal years, based on the same Koss reports ("Inventory Roll Forward Analysis").

As with the accounts receivable rollforward, the beginning and ending account balances used in the inventory rollforward were trial balances. The remaining period inventory activity data came from Koss IT system-generated subledger detail reports and from trial balances of some half-dozen Koss inventory subaccounts. The main detail report used in the inventory rollforward was the monthly Detail Invoice Accounting Listing. The offsetting, reconciling items that flowed through the inventory rollforward for which that report provided the data totaled purported additions of May-June purchases for 2006, 2007, and 2008, of $3.6 million, $4.4 million, and $4.2 million, respectively; additions of May-June "labor added to inventory" for those years of $124,354, $29,859, and $63,337, respectively; subtractions of May-June cost of sales of $3.6 million, $3.7 million, and $3.9 million, respectively; and several other categories of generally smaller items. Two other Koss subledger detail reports contributed data to the rollforwards for those years for May-June returns (additions of $159,132, $127,104, $139,693, respectively) and May-June scrap from returns (subtractions of $47,773, $47,603, $73,685, respectively). Koss trial balance reports contributed data for those years used to calculate the inclusion of net May-June prepaid inventory of +$337,167, -$316,454, and -$365,890, respectively, and the inclusion of net May-June inventory in transit of -$329,073, -$583,225, and +$617,220, respectively, as well as May-June data for several other miscellaneous items. Exs. J-33 at 1-7, J-127 at 1-6, 9, J-222 at 1-5, 8.

In the inventory area, the rollforward itself in 2006 and the rollforward and two associated procedures in 2007 and 2008 played an important role in the Koss audits. In the 2006 audit, the rollforward was the only other work paper referenced on the inventory audit program together with the interim period inventory observation testing work papers. *See* Ex. J-33 at 8; Ex. J-54 at 4. According to the audit documentation, "Per the inventory rollforward, the amounts appear to be properly stated." Ex. J-33 at 5. In both the 2007 and 2008 Koss audits, the inventory audit program categorized certain tasks as "Year End" and, within that section, specifically referred to "the roll forward period." To one of those work steps was attached the work paper containing the rollforward and the rollforward testing (Exs. J-127 at 10, J-222 at 9; Exs. J-153 at 5, J-250 at 6) and to another was attached the rollforward analysis (Exs. J-128 at 6, J-223 at 7). For both 2007 and 2008, the rollforward testing work paper explained the role of the procedure: "As physical inventory count was taken prior to year-end on 4/30/[07 or 08], GT will test activity between count date and year-end to further validate the year-end inventory balance." Exs. J-127 at 7, J-222 at 6. The conclusion drawn from that procedure in 2007 was, "Per review of the above testing, GT notes receipts [and all shipments] are properly recorded as of 6/30/07" (Ex. J-127 at 7, 8) and in 2008 was, "Based on the above, it appears that inventory receipts [and shipments] have been properly accounted for in May and June 2008" (Ex. J-222 at 6, 7). The conclusion drawn from the rollforward in 2008 was, "Based on the above, it appears that inventory-related activity has been appropriately accounted for in May [and June] 2008." *Id.* at 2.

Yet, in 2006 no audit procedures were applied to the Koss IT system-generated reports used in the inventory rollforward to determine their reliability. In the 2007 and 2008 audits, ten inventory receipts and ten inventory shipments each from May and June were traced from the Detail Inventory Accounting Listing to underlying documents or to another Koss system-generated report. But none of this tracing of a small number of entries on one of the reports used in the rollforward addressed items that might have been omitted from that report, as audit team members acknowledged at the hearing. *See* pp. 71-72, 161-63 above; Tr. 1099-1100 (Koeppel claims this tested accuracy of the report before adding, without explanation, that it was also "designed to be a completeness test"). Nor did it provide evidence about the reliability of the other reports on which the rollforward depended.

As in the accounts receivable area, Koeppel claims that the reliability of the reports was determined "through the roll forward process" itself. Tr. 1092. We reject that argument here for the same reasons we rejected it there. And the rollforward analytical procedures compared only one month of remaining period inventory activity with the year before (May), did not, for example, compare the two months of the period with each other or with any prior period in the fiscal year, and the auditors relied for their expectations on prior-year Koss IT system-generated data, when no more audit work had been performed than in the current year on the reliability of the data. *See, e.g.,* p. 139 n.41 above. The lack of audit work on the reliability of Koss IT system-generated reports appropriate to the role they played in the designated remaining period audit testing constituted a fundamental inadequacy in all of that testing that created an important opening for misstatement due to error or fraud in a major area of the audit.[51/]

It is no answer to this deficiency for Koeppel to cite the inventory receipts cut-off testing and analytical procedures that included inventory in calculating two fiscal year-end ratios and comparing them to the prior year ratios. Any evidence the ratio analyses might have provided about remaining period inventory activity was limited by their consideration, due to the nature of the procedure, of inventory only as one factor in a ratio, their significantly different June 30 inventory balances from those used in the rollforward procedures, their use of fiscal year-end inventory balances, and their failure to support the reliability of Koss IT system-generated data on which they depended. The cut-off testing, performed using an inventory listing by invoice that apparently was used in the interim testing, was limited to a small number and amount of transactions, immediately around April 30 and June 30, only six of which each year were within the remaining period. Indeed, a Koss audit team member testified that similar shipping cut-off testing was performed to obtain evidence that items were booked in the right period rather than relied on as evidence of the existence of the fiscal year-end account balance. *See* p. 158 above. This is consistent with the stated conclusion from the 2007 and 2008 cut-off testing that "inventory cutoff controls were in place and operating effectively" at period end (*see* Ex. J-121 at 2, 4; Ex. J-217 at 1, 3), though the use of the language of controls testing in the work paper runs afoul of the undisputed fact that

51/ The procedure documented on the 2007 and 2008 inventory audit programs of "Scan the entries in the general ledger inventory control account during the rollforward period for unusual activity" was subject to the same flaw, for it consisted of "review" of the Detail Inventory Accounting Listings for May and June. Exs. J-153 at 5, J-250 at 6.

there was no audit testing of the operating effectiveness of controls over critical assertions for the audit period (*see, e.g.*, Tr. 1025, 1287, 1468 (Koeppel)). And as to the Koss IT system-generated reports used in that other cut-off testing, Koeppel and others described the testing as "supporting the reports' accuracy" rather than completeness. *See* KPHS 38 n.19; Tr. 401-03, 713-14.

Moreover, there was no effective link between the analytical procedures that Koeppel cites as covering Koss's remaining period inventory activity and the interim period inventory testing. If the interim testing had been tied to Koss's general ledger at April 30,[52/] such a link might have been established by audit procedures and evidence showing that the Koss June 30 inventory account balance reports, to which the Koss Inventory Listing used in the interim testing apparently was tied at June 30 and from which the ratio and rollforward analyses drew their data, reliably reflected Koss's general ledger and underlying accounting records. But, as we have discussed at length above, the auditors relied on Koss IT system-generated reports in substantive audit testing in the pertinent areas without applying the necessary audit procedures and obtaining the necessary evidence to determine their reliability for the audit purposes they served. *See, e.g.,* Tr. 703-04, 713-14 (2007-2008 Staff Auditor acknowledges limitations of tying to report or tying reports used in substantive testing to trial balance as evidence of reliability).[53/] Additionally, in tying the Inventory Listing to the June 30 trial balance, the auditors did not check that the total balance and each of the subtotals stated on the Listing was in fact the sum of all the the individual items on that report or subsection, further undercutting the efficacy of the reconciliation. *See* p. 71 above.

For the foregoing reasons, we find that in the 2006, 2007, and 2008 Koss audits, Koeppel relied on audit work, known to her, that was inadequate on Koss's remaining period inventory activity to form and authorize the issuance of unqualified opinions on its financial statements for those fiscal years, without having directed that necessary further audit work be done. She therefore violated AU §§ 313.08, 319.65, and 329.16.

52/ The Division developed evidence at the hearing that this was not done. *See* pp. 70-71 above. As a Grant Thornton training program Koeppel attended in January 2007 noted, "Don't waste time on an incomplete file! Would you select A/R confirmations sample or Inventory price test sample items before you tied out your detail to the ending balance? No, you wouldn't." Ex. J-130 at 20; *see* Tr. 796-802 (Koeppel); Ex. J-306 at 1. But Koeppel was not charged with violations regarding the interim period inventory audit work, nor has the Division argued that the violations with which she was charged concerning the remaining period audit work stemmed in part from flawed interim work.

53/ All but the first point made above about the ratio analysis also apply to a trend analysis performed in each audit that compared the current and prior fiscal year-end inventory balances. *See* Exs. J-47, J-147 at 3-4 (reviewed by Koeppel), J-234 (same).

VI.

Sarbanes-Oxley Act Section 105(c)(4) authorizes the Board to impose "such disciplinary or remedial sanctions as it determines appropriate," subject to certain limitations, on registered public accounting firms or associated persons of such firms if the Board "finds, based on all of the facts and circumstances," that the firm or person has violated PCAOB rules and auditing standards. 15 U.S.C. 7215(c)(4). With respect to a proceeding against an associated person, such as here, Section 105(c)(5) specifies that a suspension, bar, or limitation on the activities or functions of such person, as well as a certain range of civil money penalties "for each violation" (above $110,000 and not more than $800,000 for the period of the Koss audits in question), "shall only apply" to "intentional or knowing conduct, including reckless conduct, that results in violation of the applicable statutory, regulatory, or professional standard" or to "repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard." 15 U.S.C. 7215(c)(5); 17 C.F.R. 201.1001, Table 1.[54/]

[54/] The Commission has stated that "the knowledge, recklessness, and negligence standards" in Section 105(c)(5) "are similar to the standards for Commission discipline of accountants under Rule 102(e) of [its] Rules of Practice (now also codified in [Securities] Exchange Act Section 4C by Sarbanes-Oxley)" and that accordingly the Commission's "interpretations of the Rule 102(e) standards inform [its] analysis under Sarbanes-Oxley Section 105(c)(5)." *Gately & Assocs., LLC*, SEC Rel. No. 34-62656, 2010 WL 3071900, *11 (Aug. 5, 2010); *see Hatfield*, 2013 WL 3339647, *23 n.141. Nevertheless, despite certain similarities in these standards, Rule 102(e) contains not only the language "repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards," which is similar to Section 105(c)(5), but also the language "that indicate[s] a lack of competence to practice before the Commission" (17 C.F.R. 201.102(e)(1)(iv)(B)(2)), which nowhere appears in Section 105(c)(5). *See Gately*, 2010 WL 3071900, *11 n.31. That additional language is considered a separate element in a Rule 102(e) proceeding. *See Dearlove*, 2008 WL 281105, *28 ("We must now determine whether Dearlove's conduct, though only negligent, nonetheless demonstrates a lack of competence to practice before the Commission."); *John J. Aesoph*, SEC Rel. No. 34-78490, 2016 WL 4176930, *16 (Aug. 5, 2016) ("We must 'make a specific finding that the conduct indicates a lack of competence' because 'two isolated violations of applicable professional standards…may not pose a threat to the Commission's processes'") (citation omitted), *appeal filed*, No. 16-3830 (8th Cir. Oct 3, 2016). Koeppel cites no support in the statute for her assertion that the imposition of certain sanctions under Section 105(c)(5) "requires proof of intentional misconduct or repeated acts of negligent conduct demonstrating a lack of competence to practice public accounting" (KOB 1) or for her suggestion that sanctions may be imposed only for "'incompetence or a lack of integrity'" (KOB 19, 37 (quoting phrase in initial decision)). Furthermore, by contrast to Section 602 and Rule 102(e), which require more in an SEC proceeding for improper professional conduct by an accountant than one instance of ordinary negligence,

Negligence on the part of the auditor is "the failure to exercise reasonable care." *See Dearlove,* 2008 WL 281105, *31. Negligence is a standard that is "objective, measured by the degree of the departure from professional standards rather than the intent of the accountant." *See Kevin Hall, CPA*, SEC Rel. No. 34-61162, 2009 WL 4809215, *7 (Dec. 14, 2009); *see also Dearlove v. SEC*, 573 F.3d 801, 805 (D.C. Cir. 2009) ("an objective inquiry whether [the auditor's] conduct was unreasonable in the specific factual circumstances at issue"); *McNeeley*, 2012 WL 6457291, *15. PCAOB auditing standards provide the standard of care for assessing the auditor's conduct. *Hatfield*, 2013 WL 3339647, *21.

As discussed in depth above, Koeppel was responsible for complying with PCAOB auditing standards in the performance of the 2006, 2007, and 2008 Koss audits and, in the ways we have found, she failed to do so. Proceeding to a sanctions analysis, the next step would be to consider—by reference to Section 105(c)(5)'s categories of either "intentional or knowing conduct, including reckless conduct" (subsection A) or "negligent conduct" (subsection B)—the "degree[] of deviation" by her from PCAOB standards in the three audits. *See Dearlove*, 573 F.3d at 805; *accord Hall*, 2009 WL 4809215, *7 ("degree of the departure" from applicable standards). Then, for negligent conduct, we would consider whether there were repeated instances of such conduct, each resulting in a violation of applicable standards.

Based on the nature, frequency, and extent of Koeppel's violations, we conclude that her conduct constituted repeated instances of negligence, each of which resulted in a violation of PCAOB standards. We now turn to determining appropriate sanctions.

A. Koeppel Engaged in Repeated Instances of Negligent Conduct, Each Resulting in a Violation of Applicable PCAOB Standards.

Koeppel was repeatedly negligent in leading the 2006, 2007, and 2008 Koss audits. Despite the importance of Koss's journal entries, net sales, special sales allowances, accounts receivable, and inventory to those audits, despite her years of auditing experience, despite her knowledge of the facts pertinent to the violations, and despite circumstances that called her attention to some of the very issues in this case, she failed time and time again to take proper account of (1) the limitations of the audit work and evidence, (2) countervailing information, and (3) the interrelationship of weaknesses in the work, as these matters related to the very foundation for the testing in these areas—data reliability and a basic element of an important substantive test of net sales. In these areas, the audits were characterized by acceptance of precisely

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Section 105(c)(4) authorizes the Board to sanction an auditor "based on a single instance of negligent conduct." *See PCAOB Proposed Rules Relating to Investigations and Adjudications*, SEC Rel. No. 34-49454, 2004 WL 555401, *14 (Mar. 19, 2004).

what the company and, in particular, its small accounting department, told the auditors about its systems and processes and precisely what it gave them to test and by satisfaction with multiplying procedures performed on a potentially incomplete data set.

Koeppel was the auditor with final responsibility for the audits and authorized the issuance of audit reports expressing unqualified opinions on Koss's financial statements for those fiscal years. She claimed to act on the understanding that "I have ultimate responsibility for the opinion that is issued on those financial statements," including determining whether or not an opinion can be issued, and "have the obligation to make sure that the audit is planned and performed properly, using my engagement team, and that the workpapers support the opinion that we render." Tr. 1156-57; *see* Tr. 1167-68 ("I am responsible, again, based on the work done by my team and reviewed, that the work is complete and has been executed as planned, and that all the necessary work steps are done prior to the release of the audit"). This is consistent with our discussion of her responsibilities in Section V(A) above. She was an experienced auditor who began her career in 1986 with a large national audit firm, joined Grant Thornton in 2002, led the audit practice at that firm's Milwaukee office for the next six years, and served as the office's managing partner from April 2008 to April 2011. As discussed, Koeppel knew the facts about the audit work and evidence pertinent to our findings of violations.

The audit work led by Koeppel on Koss's journal entries purportedly responded to the fraud risk of management override of internal controls, which required specific attention in each audit. Work papers reviewed by her in the audits recognized the need for "an added sensitivity to management's ability to override" any controls "the entity has in place to address the identified fraud risk factors"; the need to address possible "lack of segregation of duties" in Koss's small accounting department, which could give "rise to fraudulent financial reporting"; the need to "closely review unusual journal entries and perform journal entry control testing"; and the need to "substantively test journal entries throughout the period and thoroughly review journal entries posted around year-end." Koeppel agrees with the Division that to achieve the objectives of testing specific entries for fraud under AU § 316, a complete journal entry population is necessary.

Yet in all three of those audits Koeppel failed to notice or address a fundamental flaw in the testing of Koss's journal entries. For the identification and testing of specific journal entries, Koeppel relied on the paper binders prepared and maintained by Koss's accounting department from which items admittedly could have been excluded. She did so knowing that this was not "the preferred method to get the information" and that the auditors could not "identify numbers that were missing," which would have been a "nice" alternative "way to get comfort" about completeness, because Koss's journal entries were not "numbered sequentially." Koeppel has conceded that the so-called upstream/downstream method she accepted instead in those audits to test completeness would not identify any journal entry missing from both sets of binders and that no work step in the audit programs specifically addressed that issue.

There was no good reason for Koeppel's failure. A PCAOB inspection comment on the 2005 Koss audit and 2006 and 2007 Grant Thornton audit training courses specifically called her attention to the issue of the completeness of the journal entry population subject to fraud testing. She has admitted to attending and agreeing with that firm training, has stated that she took the inspection comment "very seriously," and has confirmed that she had the comment in mind in the 2006 Koss audit, which was in progress at the time of the comment, and in the 2007 and 2008 Koss audits. Such "obvious reminder[s]" of the requirements of professional standards made Koeppel's "failure to comply all the more glaring." *McNeeley*, 2012 WL 6457291, *16. Moreover, at the time of the inspection comment, the firm's regional professional standards partner discussed with Koeppel the general concept of "upstream/downstream" testing, which Koeppel believed could be performed in "multiple ways." But, despite this need for and availability of guidance, this focus on the issue as important, and the existence of specific complicating factors at Koss, Koeppel "did not see a need to elevate" to "somebody outside of the engagement team" how that rough idea might specifically be applied, or "the variety of procedures that we could use," to determine completeness under the particular circumstances of the Koss audits, and she neither provided input into nor learned why Audit Manager chose the particular "upstream/downstream" procedure used in the 2006-2008 Koss audits. Koeppel's passive approach in this respect underscores the unreasonableness of her conduct on the facts of this case.

The excuse Koeppel offers for not noticing or addressing the flaw in the journal entry testing is inadequate. She argues, mostly in highly general, indirect fashion, that completeness was addressed not only by the upstream/downstream procedure but also by a combination of other audit work. The other work she cites consists of journal entry control-related procedures, an assessment that the inherent risk of fraud at Koss was low, an understanding that a so-called update report was generated by Koss's IT system whenever a journal entry was posted to Koss's general ledger, an examination of the numbering of journal entries in the binders and of physical characteristics of update reports in the binders, and obtaining general representations from Koss personnel that they were not aware of any fraud at the company. According to Koeppel, that other audit work made the difference in "provid[ing] a reasonable basis" for her "judgment that sufficient evidence supported the completeness of the journal entry population." *E.g.*, KPHS 67-68. What this amounts to is Koeppel using a potentially incomplete set of paper records as the validation for mere assertions about company processes and for spotty information about company IT access controls, from which, along with the apparent internal consistency of the set of records and more untested, general representations, she then, in circular manner, leapt to the conclusion that the set of paper records was complete. Examination of the particulars of that work for sanctions purposes only confirms that Koeppel's conduct was negligent.

What Koeppel claims as her chief other source of support for completeness is that Koss had "effective controls over its journal entry processes," a "strong control environment," and a "well-controlled process." *E.g.*, Tr. 1311, 1328, 1493-94; KPHS 68.

By this, she means that, in her view, the duties in Koss's accounting department were appropriately segregated, related IT system access controls on who could post journal entries were in place, and VP-Finance and President/CEO functioned as "monitoring controls." Tr. 826, 828-29, 1141-44, 1147-49, 1305-06, 1311, 1451, 1493-94.

Koeppel's attempt to explain why she believed the audit work on these internal control-related matters showed that the binders were complete is vague, oblique, and insubstantial. Namely, she contends that "[t]he auditors understood and confirmed through testing that controls were in place over the journal entry processes which prevented any individual from single-handedly posting improper journal entries." KPHS 67; *see* Tr. 1306. In the first place, this claim misconceives the issue here as whether "improper journal entries were [] being made" by a particular method ("singlehandedly posting"), based on consideration of identified fraud risk factors (*e.g.*, KOB 42). Rather, the issue is whether a complete population of journal entries was obtained for fraud testing to address the more general risk of management override of controls, which can occur in unpredictable ways. Moreover, Koeppel depends decisively on generalizations based on the very binders whose completeness was at issue, takes an exaggerated view of the purported "testing" of Koss journal entry controls, relies excessively on mere "understanding" of how its processes were supposed to work, and glosses over serious weaknesses in that understanding as well as negative information. The resulting shortfall in the reality of the evidence, compared to her characterization of the evidence, about how the controls actually operated causes her claim to fail on her own terms, as it does her justification for focusing solely on "single-handed[]" posting of improper journal entries and paying no discernible attention to the possibility of collusion—that collusion would "represent[] a total breakdown in [Koss's] control structure" (Tr. 1493).

Specifically, by Koeppel's own account, the auditors' testing of segregation of duties in Koss's accounting department played a key role in the audits. But the examination of department-provided paper records of journal entries for who created and signed off on them did not mean that those were the only entries actually recorded or that they reflected the only way in which journal entries came to be recorded at Koss.

Apart from that, what Koeppel refers to as "testing" of Koss journal entry access controls consisted of nothing more than the following. First, the audit team obtained from Koss's outside IT contractor a list of Koss user profiles in 2006, read it, and accepted VP-Finance's explanation for why, contrary to a 2004 recommendation by the Grant Thornton IT specialists and inconsistent with a work step in the audit program, no review of the list was performed by Koss. Part of that explanation had been rejected by the specialists as "not a control when assessing the effectiveness of segregation of duties and user access controls," and the other part of it left the auditors again to rely on the paper binders. Second, the audit teams made general inquiries in the 2007 and 2008 audits of Koss's IT contractor and increasingly only of Koss's accounting department about any changes, again dependent for validation on the binders. *E.g.*, Tr.

1300. And third, the audit teams obtained fragmentary, limited information about journal entry access controls through observation in the one-time "walkthrough" in each audit.

The so-called testing of access controls was far less substantial than suggested by Koeppel. For example, there is no claim or evidence that the auditors did any other "testing" of whether access of Koss personnel to post journal entries changed over time; performed any procedure to determine the time period covered by or the completeness of the 2006 user profile list or to test information the IT contractor used to generate the list, despite a direction in the audit program to "[v]erify the completeness and accuracy of the list by comparing it to the system settings"; or gained an understanding of all user profiles in Koss's IT system, much less tested the operating effectiveness for any of the audit periods of any IT controls over access to post journal entries. No controls over the creation or maintenance of the journal entry binders were even identified in the audits. Negative information in Grant Thornton's 2004 IT review further diminished the already slight value of the access control work as a source of evidence that the binders were complete. Specifically, the firm's IT specialists found that, by all appearances: Koss's lack of regular user access/segregation of duties reviews created a risk of inappropriate access rights and excessive access to its financial systems, a matter management seemed to disregard and the auditors never identified any response to; Koss's IT contractor focused on functionality with little understanding or appreciation of IT control standards; Koss relied completely on the contractor and shared that focus; and Koss's controls for managing user access to a key software system were probably ineffective.

The last of the journal entry control-related audit work that Koeppel cites as evidence of completeness of the binders was her "understanding" that VP-Finance and President/CEO acted as "monitoring controls." But the auditors' understanding that VP-Finance reviewed all journal entries was part of the segregation of duties work, which, as pertinent to this point, consisted merely of obtaining assertions from accounting department personnel and examining those journal entries they offered up as a complete set. Even ignoring the possibility of collusion and assuming unfailing review of all journal entries by VP-Finance, she was a certified public accountant, unlike her subordinates, had worked at Koss longer, was identified by Koss as an officer and senior manager, was one of two Koss officers who signed its Form 10-Ks, and so, for all the auditors knew, she could have played a dominant role in the creation or revision of journal entries presented to her by subordinates. This would have been inconsistent with heavy reliance on her as a "monitoring control." And again, she worked part-time, and there is no indication electronic approval was needed to submit a journal entry.

The auditors' understanding of any role President/CEO might have played in monitoring journal entries was vague and untested, lacking in direct information, documentary support, and basic, critical details, such as how he would have reviewed any individual journal entries—for all the auditors knew, by using the same paper binders they used. A review of financial statements was not, in fact, the same as a review of the myriad journal entries that contributed to the total balances. The heavy reliance placed by Koeppel on President/CEO (and VP-Finance, for that matter), a member of management, as a control in this context is even less justifiable for numerous reasons. Among other things, a number of identified fraud risk factors in the audits counseled against such reliance; journal entry fraud testing is meant to address the risk of management override of controls; and management itself commented in response to the 2004 IT review that "our IT is in the hands of the users," that "[e]ach area is responsible for it[s] data and the accuracy of that data," and that the apparent functioning of an accounting process as "a well oiled machine" determines the appropriateness of IT governance and controls related to that process, which was in line with the IT contractor's focus but contrary to the audit firm's IT specialists' view.

Koeppel also claims to have relied on "the low assessed risk of fraud," referring to a component of the inherent risk assessment in each audit (*see* Exs. J-70 at 3, J-178 at 3, J-278 at 3; Exs. J-71 at 1, 2, 4, J-179 at 1, 2, 4, J-279 at 1, 2, 4), to establish the adequacy of the evidence of completeness of the binders. She suggests, as with her separate argument about Koss's supposedly "well-controlled environment," that, because of the low assessed inherent risk of fraud, items would not have been omitted from the binders in the first place and so not much audit effort was necessary to determine completeness. *See, e.g.*, Tr. 1493 (when asked if risk of items missing from both binders occurred to her during the audits, Koeppel responded, "I've searched my brain a lot. You know, I have to say no."). But in so arguing, Koeppel fails to account for the impact of the weakness of the so-called journal entry control-related audit work, especially in light of the negative information in Grant Thornton's 2004 IT review; for the particular fraud risks and risk factors identified in the audits; and for the difference between identified fraud risks and the risk of management override of controls. *See* pp. 91-110, 113-26 above. Her argument about the low assessed inherent risk of fraud proceeds as if that were the only determinant of the risk of material misstatement due to fraud, as though her view about Koss's "well-controlled environment" took control risk entirely out of the equation. In fact, inherent risk and control risk are both components of the risk of material misstatement, and merely because inherent risk of fraud was assessed as low did not mean that the risk of material misstatement due to fraud was low. As summarized immediately above, the journal entry control-related work was far less substantial than Koeppel portrays it and was undercut by the negative information in the 2004 IT review. There is no evidence that the extent of support for completeness she claims to have drawn from the low inherent fraud risk assessment can compensate for her wrongly inflated view of the value of the journal entry control-related work and the lack of response to the IT review information. Even as to the inherent fraud risk component itself, an assessment of low risk did not mean no risk. Further, "[b]ecause fraud is usually concealed, material misstatements due to fraud are difficult to detect" (AU § 316.31), and the response to identified fraud risks, which is required in any audit (*e.g.,* AU § 316.02), is not the same as the response to the more amorphous risk of management override of controls. *See, e.g.*, AU § 316.42. We see no evidence or argument about anything particular in the response to identified fraud risks in the Koss audits that provided an extra measure of effectiveness capable of reducing the otherwise necessary response to the risk of management override.

Koeppel otherwise claims to have relied, for evidence the binders were complete, on sources that contributed little or no further support under the circumstances. First, she cites unverified assertions that an update report was invariably generated whenever a journal entry was recorded. The assertions were obtained from Koss's outside IT contractor—whose knowledge and appreciation of IT control standards were criticized by the Grant Thornton IT specialists—and from members of Koss's small, significantly autonomous accounting department—whose representations and journal entry binders were used by the auditors in each audit as virtually the only evidence about the operation of internal controls over the journal entry process. The contractor's assertions did not give Koeppel any visibility into whether an update report, even if printed without fail or interference, made it from the printer into the binders provided to the auditors.

Second, any "additional comfort" that Koeppel was "dealing with a complete population of journal entries" that might have come from "gain[ing] an understanding" of Koss's "standard numbering system" and "investigat[ing] any unexpected deviations" (KRB 7) was minimal. As she knew, "consistent numbers" were used only for "standard entries" and investigating "gaps in sequential numbering" in the items in the binders was not an effective method of "identify[ing] missing journal entries" because "Koss's numbering system for its journal entries was not sequential." KRB 7; KPHS 30; Tr. 1322-23. Firm training she attended during the relevant period specifically pointed out that a client-prepared "list of journal entries" "would probably not include [any] fraudulent entries" and "[c]opies of fraudulent journal entries would likely not be in [a] binder" of "'paper copies of journal entries maintained by the [client].'" Ex. J-130 at 20-22.

Similarly, even if the pages of individual, multi-page update reports that were provided to the auditors in the binders were connected by perforated edges, that did nothing to prevent one or more individuals from excluding other update reports, which were separately printed, from the binders as part of a fraud, which, of course, is usually concealed (*see, e.g.*, AU §§ 316.09, .31, .62). Yet in this regard Koeppel was content simply to note the absence of signs that "pages had been ripped out" (KOB 17) or "ripped apart" (KRB 6). Lastly, mere general representations by management and staff at Koss that they were not aware of any fraud at the company could not fill the large holes remaining in the evidence of completeness in each of the Koss audits at issue.

For all of the foregoing reasons, Koeppel did not have a reasonable basis for concluding that the journal entry population subject to fraud testing in the Koss audits was complete. Her violations in the journal entry area were negligent.

We reach the same conclusion about Koeppel's violations with respect to Koss's revenue and inventory. She understood that Koss's recorded revenue and inventory presented a reasonable possibility of material misstatement and that they called for "additional attention" and "heav[y]" "focus" in the audits. In this regard, of the three revenue-related areas charged and in which we have found violations, net sales was by far the largest line item on Koss's income statement, special sales allowances was by far the largest component of Koss's reported accrued liabilities, and accounts receivable was one of the two largest assets on Koss's balance sheet. Inventory, the other charged area in which we have found violations, was the other largest reported asset.

At the outset, we note that Koeppel failed to recognize the implications of the flawed journal entry testing for the data reliability work and related substantive testing in these last four areas. Journal entries recorded in Koss's IT system could affect the content of its IT system-generated reports and alter the data, contemporaneously or after the fact, for the period reflected in the single-point-in-time printouts. But due to the inadequate audit work on completeness of the journal entry population, the auditors would not have necessarily received and effectively tested those entries for fraud, calling the reports into doubt. As an example, this, in turn, complicates the auditor's consideration, for purposes of applying principal substantive tests to the details of an asset or liability account as of an interim date rather than as of the balance sheet date, of whether "the [entity's] accounting system will provide information concerning the balances at the balance-sheet date and the transactions in the remaining period that is sufficient to permit investigation" of "(a) significant unusual transactions or entries (including those at or near year-end), (b) other causes of significant fluctuations, or expected fluctuations that did not occur, and (c) changes in the composition of the account balances," such that "evidential matter related to" these matters would be "sufficient for purposes of controlling audit risk." AU § 313.07; *see* AU § 313.05 ("if the auditor assesses control risk at the maximum during the remaining period, he should consider whether the effectiveness of certain of the substantive tests to cover that period will be impaired"). Furthermore, the "expected effectiveness and efficiency of an analytical procedure in identifying potential misstatements" depends in part on "the availability and reliability of the data used to develop the expectation." AU § 329.11. Management override of controls, which the journal entry testing in the Koss audits did not properly address, could "allow[] adjustments outside of the normal period-end financial reporting process to have been made to the financial statements" that "might have resulted in artificial change to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions." AU § 329.10.

With regard to the net sales analytical procedures, the record shows that in each audit analytical procedures were clearly important tests of Koss's net sales. The expectation is a fundamental element of the procedure. Yet, Koeppel countenanced expectations of differences from prior-year sales amounts that were stated in such a vague manner they did not capture identified changed circumstances with any meaningful level of precision and did not enable the auditors to identify differences that might be potential material misstatements. *See* pp. 51-53, 132-40 above.

With regard to the reliability of Koss IT system-generated data used in the substantive audit testing of net sales, special sales allowances, accounts receivable, and inventory, Koeppel decided not to test the operating effectiveness of Koss's internal control in those areas for any of the audit periods in question. According to Koeppel, PCAOB auditing standards "do not require an auditor who is not relying on internal controls to perform such tests of controls." KOB 27. This is not always true. *See, e.g.,* AU § 319.03 & .66 (circumstances may exist in which "it is not practical or possible to restrict detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions"), .65 ("the auditor needs to be satisfied that performing only substantive tests would be effective in restricting detection risk to an acceptable level"). But assuming for purposes of this case that it is true here, a reasonable auditor must come to terms with the implications of that lack of testing.

Koeppel did not. She purported to do so through what Audit Manager called "a highly substantive audit to validate the balances and assertions." *See* Tr. 1254, 1336 ("We audit the output of the system, rather than the system itself.") (Koeppel); Ex. D-4 at 35 & Ex. R-509 at 182 (Audit Manager's investigative testimony). But integral to substantive audit testing is the reliability of the internal company information used in that testing. A Grant Thornton training program Koeppel attended in January 2007 stressed, "Don't waste time on an incomplete file! Would you select A/R confirmations sample or Inventory price test sample items before you tied out your detail to the ending balance? No, you wouldn't." Ex. J-130 at 20; *see* Tr. 796-802 (Koeppel); Ex. J-306 at 1. Although Koeppel claims that "[t]he record is clear that substantial evidential matter was obtained [in each Koss audit] about the accuracy and completeness of the information produced by Koss's IT system which [she] believed provided a reasonable basis for her professional judgments regarding the issues criticized in the OIP" (KPHS 22), what is clear from the record is that her analysis of this issue was riddled with flaws.

For most of that claimed "substantial evidential matter," Koeppel fell back on audit planning activities. First, in effect, she treated an understanding of internal control as though it were testing of internal control. Koeppel was adamant in testimony that, based on the "good evidence" and "audit support related to that a system is operating effectively" that was provided by understanding Koss's controls over "critical cycles [and] financial reporting, which includes IT and governance," she "could certainly come to the conclusion" that those controls "were designed and operating effectively," that Koss "had an internal control process" over IT that "was designed and operating effectively," and that its IT system could reasonably be relied upon in the the audits. Tr. 1292-94, 1297-99, 1466-73. So uncritical was she in accepting reports generated from Koss's IT system at face value, based on understanding rather than testing of controls, that when asked at the hearing if the auditors at any point went behind Koss's IT system to look at what the reports were actually drawing from, she said that "we didn't think to do that, again, because they were system-generated reports." Tr. 1488.

As discussed, that understanding cannot bear the weight Koeppel places on it as evidence of data reliability. The understanding was built on a 2004 Grant Thornton IT "review," without taking proper account of its limitations and negative information; mere representations by Koss personnel; Koss's use of a "reputable" computer system that assertedly had not been "extensively" altered; the administration (though not the use) of Koss's IT system by an outside consultant who was the only person "authorized" to implement system changes and who, along with Koss's controls related to managing program changes and user access, had been criticized by the audit firm's IT specialists; the supposed use for business purposes of Koss reports provided to serve a distinct audit purpose; and stray, incomplete observations in a walk-through of certain system access controls and automated features of an "integrated" accounting system that appeared to be in place at Koss at one point in time, which at best scratched the surface of issues such as data entry error, system error, and management override of controls. It was unwarranted and unreasonable for Koeppel to assume that this understanding of how Koss's internal controls were supposed to work for the period covered by each audit meant that the controls actually operated that way.

The second aspect of audit planning that Koeppel has tried to use to support her conclusion about the reliability of Koss IT system-generated information is the assessment of low inherent risk in each of the audits. Not being in a position from the audit work to identify or determine how Koss's internal control operated over the audit period, Koeppel had to take control risk seriously in determining the nature, timing, and extent of audit procedures. As she knew, the "'B' approach" of the audit programs, which equally applied to a low-inherent-risk-high-control-risk audit and a high-inherent-risk-low-control-risk-audit, was not tailored to specific issues of the reliability of client IT system-generated data posed by the former type of audit. *See, e.g.*, Tr. 1439-44. She "didn't feel it was necessary" in the Koss audits "to tailor in a whole bunch of more steps" than "the steps" the audit program already was "designed to incorporate [] into our work" to address the reliability of Koss's reports. Tr. 1498. Moreover, there is no evidence that the audit programs, as produced by the audit firm's software, specifically reflected certain Koss system limitations and internal control information, discussed above, that mattered to the audits. Indeed, Koeppel identified a control deficiency of escalating seriousness to her in the revenue area. Yet in every discussion of the reliability of Koss system-generated data, she cavalierly disregards control risk, focusing only on low inherent risk, never on the combination of low inherent risk and high control risk. And, as noted above, even her narrow focus on inherent risk and overstatement cannot explain why so little, if any, audit work was done on completeness of the data.

Otherwise, Koeppel relies for evidence of completeness on her basic audit approach, which, according to her, "incorporates into" and "embeds" in "our testing various tests of reports" used in the substantive audit procedures, namely "tying back to a supporting document or doing a roll forward or tying to the general ledger [by way of a trial balance report] or tying to a subledger [report]." Tr. 1186-88, 1340, 1348-49, 1457-62. But she knew or should have known that, as explained in depth above, the mere mathematical agreement of balances or sums of balances of various reports does not necessarily mean that the transactions listed or purportedly reflected in the reports were valid or recorded correctly and that all of the transactions that occurred were recorded and reflected. In emphasizing tying IT system-generated general ledger reports and subledger detail reports to one another and to each other, Koeppel overlooks that this is not direct, detail testing of any report entry or reconciling item, and without sufficient support for the reliability of the data, the reconciliation becomes an all but meaningless exercise. The nature and small scale of what audit work was done to tie Koss reports to underlying source documents did not come close to compensating for these problems, as discussed in detail above. *See, e.g.*, pp. 89-91, 146-52 above.

For the foregoing reasons, Koeppel did not have a reasonable basis for her conclusions that the expectations were sufficiently precise for the net sales analytical procedures in which a significant difference from the recorded amount was expected. Likewise unreasonable were her conclusions that sufficient competent evidential matter had been obtained about the completeness of Koss's IT system-generated reports used in the pertinent substantive audit testing of Koss's net sales, special sales allowances, accounts receivable, and inventory to support the audit opinion she developed or to cover the remaining period in a way that provided appropriate audit assurance at the balance sheet date. Her conduct in all of these respects was negligent.

Having found that Koeppel's conduct in violating PCAOB auditing standards in the 2006, 2007, and 2008 Koss audits was negligent, we consider whether that misconduct consisted of repeated instances of negligence, each resulting in a violation. Whether an auditor's negligent conduct involves "repeated instances" of such conduct, "each resulting in a violation," is a question that arises not only in our application of Section 105(c)(5), but also in connection with Commission consideration, under Rule 102(e) of the Commission's Rules of Practice or Sarbanes-Oxley Act Section 602, of whether there are grounds to deny persons licensed to practice as accountants the privilege of appearing or practicing before the Commission. 15 U.S.C. 78d-3(b)(2)(B); Rule 102(e)(1)(iv)(B)(2). The Commission's consideration of the question is instructive. In interpreting Rule 102(e), the Commission has expressly defined "repeated" to mean, simply, "more than once." *Amendment to Rule 102(e)*, 1998 WL 729201, *9. As explained in the SEC's adopting release, "repeated instances" of negligence can encompass "as few as two separate instances of unreasonable conduct occurring within one audit, or separate instances of unreasonable conduct within different audits." *Id.* "By contrast," the release explained, "a single error that results in an issuer's financial statements being misstated in more than one place would not, by itself, constitute" repeated instances of negligent conduct. *Id.* *See also Hall*, 2009 WL 4809215, *7 (whether there are "repeated instances" of negligence depends on number of distinct instances of conduct, not on number of affected accounts); *accord Aesoph*, 2016 WL 4176930, *15 n.73; *see generally Dearlove*, 2008 WL 281105, *30 (finding repeated instances of at least unreasonable conduct by auditor).

Koeppel's negligence extended to three audit years, five distinct areas in each audit (journal entries and four financial statement accounts), and multiple types of violations within audit areas. Her violations involve, for example, inadequate support for the reliability of Koss data used in the substantive audit testing and other deficiencies in respective audit procedures on one of the accounts, deficient audit work on both interim and remaining period financial data for another account, and various failures over multiple accounts to perform certain presumptively mandatory procedures, to exercise due care, including professional skepticism, and to obtain sufficient competent evidential matter. By no stretch of the imagination can this conduct be viewed as a "single error" that "results in an issuer's financial statements being misstated in more than one place." Rather, it is repeated instances of negligence many times over. Thus, Koeppel is subject to the sanctions specified by Section 105(c)(5).

B. Koeppel's Violations Call for the Imposition of Strong Sanctions, Which in This Unusual Case Is Accomplished by Our Imposition of a Limitation on Her Activities and a Censure.

In determining the sanctions that are appropriate for Koeppel's violations, we consider the nature, seriousness, and circumstances of the violations and any potentially aggravating or mitigating factors supported by the record, to carry out our statutory responsibility to protect investors' interests and further the public interest in the preparation of informative, accurate, and independent issuer audit reports. *See* Sarbanes-Oxley Act Section 101(a), 15 U.S.C. 7211(a); *see also* Section 101(c)(5), 15 U.S.C. 7211(c)(5) (in identifying duties of Board, referring to objective "to promote high professional standards among, and improve the quality of audit services offered by, registered public accounting firms and associated persons thereof" or "otherwise to carry out this Act, in order to protect investors, or to further the public interest"); *Hatfield*, 2013 WL 3339647, *26 ("'[T]he appropriate sanction depends upon the facts and circumstances of each particular case and cannot be determined precisely by comparison with actions taken in other proceedings.'") (citation omitted). In making this determination, the Board also draws guidance from the grounds on which the Sarbanes-Oxley Act authorizes the Commission to disturb Board sanctions: a finding, with "due regard for the public interest and the protection of investors," that the sanction "is not necessary or appropriate in furtherance of this Act or the securities laws" or "is excessive, oppressive, inadequate, or otherwise not appropriate to the finding or the basis on which the sanction was imposed." Section 107(c)(3), 15 U.S.C. 7217(c)(3).

Koeppel's non-compliance with the above-identified PCAOB auditing standards in the 2006, 2007, and 2008 Koss audits, affecting five major audit areas in each of three audit years, was pervasive and protracted. As such, it reflected a deep-seated inability or unwillingness by Koeppel to understand and carry out her auditing responsibilities, despite her attempt to suggest otherwise at the hearing (*see* Tr. 1156-57, 1167-68; *see also* I.D. 7 (referring to her testimony, divorced from proper analysis of her conduct), cited by KOB 36). The failures in one audit year compounded the failures in the next, as shown, for example, by Koeppel's heavy reliance on prior year recorded numbers as the expectations for the net sales analytical procedures. As the SEC has noted, "'the existence of a violation raises an inference that it will be repeated.'" *Hatfield*, 2013 WL 3339647, *25 (quoting *Geiger v. SEC*, 363 F.3d 481, 489 (D.C. Cir. 2004)). Koeppel committed the violations despite having, by the time of the audits, spent about 20 years in public accounting (*see, e.g.,* Tr. 1203), auditing issuers since 1986, which should have equipped her to comply with the standards at issue. She has shown no recognition of the wrongful nature of her conduct, and the record provides no assurance that she would respond differently if faced with similar circumstances in a future issuer audit. Koeppel unequivocally testified that she wanted to resume auditing issuers. Tr. 1208; *see* KRB 45 & n.22 (asserting she is "not unfit to continue auditing" and should not be subjected to a "career-ending bar from public accounting").[55/]

[55/] On December 2, 2015, while this matter was pending, the SEC issued an order instituting and settling proceedings against Koeppel based on charges that in other issuer audits she engaged in improper professional conduct under SEC Rule of Practice 102(e). *See Melissa K. Koeppel, CPA*, SEC Rel. No. 34-76537, 2015 WL 7755467 (Dec. 2, 2015). That settlement relates to her conduct while serving as engagement partner for two Grant Thornton issuer clients other than Koss. Specifically, without admitting or denying the Commission's findings, Koeppel consented to the entry of an order finding that, during the 2009 and 2010 year-end audits of one company and the 2009 third-quarter review and 2009 year-end audit of another company, she violated multiple PCAOB auditing standards by, among other things, failing to properly plan the audits, exercise due care and professional skepticism, obtain sufficient evidence, and properly supervise audit assistants. The Commission concluded that Koeppel's conduct "involved repeated instances of unreasonable conduct, each resulting in violations of PCAOB standards and indicating a lack of competence, and also satisfies the standard of highly unreasonable conduct resulting in violations of PCAOB standards in circumstances in which heightened scrutiny was warranted." She was ordered to pay a $10,000 civil penalty and was denied the privilege of appearing or practicing before the SEC as an accountant with leave to apply for reinstatement after five years. The settled order stated that "Koeppel, age 54, is a [CPA] licensed to practice in Wisconsin," that "[s]ince 2012, Koeppel has been employed by Grant Thornton as a managing director, outside the audit-services practice," and that any application for reinstatement by her "must satisfy the Commission that," among other things, she "has resolved all disciplinary issues with the PCAOB, and has complied with all terms and conditions of any sanctions imposed by the PCAOB (other than reinstatement by the Commission)." The order is no legal impediment to our determining appropriate sanctions to address the particular misconduct in the present case. *See, e.g., Thomas C. Trauger*, CPA, SEC Rel. No. 34-51259, 2005 WL 464862, *1 & n.5 (Feb. 25, 2005); *Hunter Adams*, SEC Rel. No. 34-52144, 2005 WL 1963483, *3 & n.6 (July 28, 2005); *cf. Perpetual Secs., Inc.*, SEC Rel. No. 34-56613, 2007 WL 2892696, *12 & n.68 (Oct. 4, 2007).

The auditor "is not an insurer and his or her report does not constitute a guarantee," but the audit report "is based on the concept of obtaining reasonable assurance," through the exercise of due professional care and the related observance of standards of field work, including obtaining and evaluating sufficient competent evidential matter, that "the financial statements are free of material misstatement, whether caused by error or fraud." *E.g.*, AU §§ 230.02, .10, .11, .13, 326.02, .22, .25. The investing public relies heavily on auditors to fulfill their professional duties in auditing public companies to help assure corporate compliance with federal securities law and disclosure of accurate and reliable financial information. *McNeeley,* 2012 WL 6457291, *12; *see, e.g.*, *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984); *McCurdy v. SEC*, 396 F.3d 1258, 1261 (D.C. Cir. 2005); *Marrie v. SEC*, 374 F.3d 1196, 1200-01 (D.C. Cir. 2004); *Touche Ross & Co. v. SEC*, 609 F.2d 570, 580-81 (2d Cir. 1979); *Dearlove*, 2008 WL 281105, *30. An issuer audit thus stands as a vital line of defense against incorrect, unreliable financial information that can harm the markets and investors, such as resulted from the fraud at Koss that was ongoing throughout the three audits and led to so large a restatement. The audit cannot serve its purpose when it falls as short as the audits were proven to have done here of the rigorous, objective evidence gathering and analysis required by PCAOB standards.

Relying extensively on the initial decision, Koeppel opposes sanctions by arguing that: (1) she cannot be found to have committed violations based on her own conduct, which was favorably "attested to" by "those [other audit] team members [who] testified," but only by attributing or imputing conduct of "junior members of the engagement teams" to her through some uncharged or invalid means; (2) "extensive work [was] done on the Relevant Audits" with "professionalism and competence [by] the engagement team members"; (3) the Division is merely "second-guessing" her "professional judgments" after discovery of the fraud at Koss, and any departures from PCAOB standards were "mistakes" or "pure errors of judgment" that do not rise to the level of negligence; (4) she has "rightfully defended the reasonableness of her judgments and actions" in this case; (5) "[a]ny finding of violation of PCAOB standards would have a very severe impact on [her], personally and professionally," and that she "has already been penalized," in that she "is no longer performing audits," "no longer manages Grant Thornton's Wisconsin practice," and "has lost her position as a Grant Thornton partner [and moved to a managing director role], significantly impacting her financially," as "the principal wage earner [in her family], with college-aged children"; and (6) at most, an appropriate sanction "would be limited to censure and/or supplemental professional education." KOB 3 n.2, 35-39; KRB 44-45; Tr. 1209-10, 1427-28.

Koeppel's reliance on the initial decision is misplaced. The decision declared that it would "briefly address the facts and considerations that would bear upon the Board's sanctions determination" if the Board were to review the decision. I.D. 85. Yet the initial decision's subsequent sanctions discussion (I.D. 85-88) derived from the same faulty premise as Koeppel's first contention above, which concerns not sanctions but the basis for liability in this case and which we have thoroughly rejected in Section

V(A). The decision also purported to refute a Division argument "that the Board has authority to impose disciplinary sanctions on Koeppel even if her own conduct did not amount to negligence" (I.D. 87-88), which is irrelevant to our resolution of this case, in which we have found repeated instances of negligent conduct by Koeppel. As to a short, separate, earlier section of the initial decision ("Conclusions Regarding the Work of the Engagement Teams," I.D. 73-75), certain favorable statements there about the audit work, which Koeppel cites for her second contention above, are mere summary, general assertions not reconciled with the hearing officer's own findings of violations and not grounded in the record or proper analysis, set forth herein. Nor is it any more of an answer to the Board's analysis of the audit work to say that junior members of the engagement teams involved in the performance of the failed work vouch for that work and for Koeppel's attentiveness to it. *See, e.g., McNeeley*, 2012 WL 6457291, *17.

Contrary to Koeppel's third contention, her departures from PCAOB standards that we have discussed in depth in this final decision went well beyond merely making "mistakes" or "pure errors of judgment." They constituted repeated instances of negligence. References cited by Koeppel in the auditing standards to professional judgment simply reflect the unremarkable fact that decisions about procedures to be performed in an audit depend on engagement-specific facts that an auditor learns during the audit process and require the exercise of informed judgment about how to respond to such information as it becomes available. *See, e.g.*, AU § 326.13. This detracts in no way from the fact that "an auditor must exercise, not [her] 'inclination,' but [her] 'professional judgment' and that judgment must be 'guided by sound' auditing principles, among which are a 'thorough…search for evidential matter, AU § 326.23, and an 'attitude that includes a questioning mind and a critical assessment of audit evidence,' AU § 230.07." *McCurdy*, 396 F.3d at 1263. And there is no basis for suggesting that the Board is somehow unable or unwilling to distinguish the evidence bearing on conduct during the audits from after-the-fact developments. Our extensive analysis of the audit work clearly reflects that the "gravamen of the charge against" Koeppel "is not her failure to uncover the fraud itself, but her failure to adhere to [applicable auditing standards] during [each] audit." *McNeeley*, 2012 WL 6457291, *12.

Regarding Koeppel's fourth contention, no one disputes that a respondent in an auditor disciplinary proceeding "has the right to present a vigorous defense." *Id.* at *18. And this decision reflects the time and care we have devoted to analyzing and addressing in detail her many and fact-intensive arguments. But it is also appropriate to take account of the fact that those arguments provide no inkling of any recognition that her conduct was deficient in the serious ways we have concluded are demonstrated in the record. We are therefore left with no reason to believe that, absent appropriate sanctions, Koeppel will not repeat such lax conduct, which is a relevant consideration.[56/]

56/ *Gately*, 2010 WL 3071900, *14, *16; *see, e.g., Aesoph*, 2016 WL 4176930, *17; *S.W. Hatfield, CPA*, SEC Rel. No. 34-73763, 2014 WL 6850921, *10 (Dec. 5, 2014); *Michael C. Pattison, CPA*, SEC Rel. No. 34-67900, 2012 WL 4320146, *10 (Sept. 20, Koeppel's fifth contention concentrates exclusively on the potential impact of sanctions on her well-being, without consideration of the implications of her misconduct for the public interest and the protection of investors. Collateral consequences to a respondent do not outweigh the need to "protect the interests of investors and further the public interest" by, among other things, investigating, adjudicating, and sanctioning conduct that threatens those interests. *See* 15 U.S.C. 7211(a), 7211(c)(5); *see also, e.g., McNeeley*, 2012 WL 6457291, *19; *Gary N. Kornman*, SEC Rel. No. 34-59403, 2009 WL 367635, *9 (Feb. 13, 2009) ("'[f]inancial loss to a wrongdoer as a result of his wrongdoing' does not mitigate the gravity of his conduct") (quoting *Robert L. Wallace*, SEC Rel. No. 34-40654, 1998 WL 778608, *5 (Nov. 10, 1998)), *aff'd*, 592 F.3d 173 (D.C. Cir. 2010); *Ashton Noshir Gowadia*, SEC Rel. No. 34-40410, 1998 WL 564575, *4 (Sept. 8, 1998); *Hunter v. SEC*, 879 F. Supp. 494, 501 (E.D. Pa. 1995) (there is no general right "not to be injured in one's reputation or business prospects" by the fact of investigative or disciplinary actions that are authorized by Congress) (citing cases).

Addressing the specific conduct here, we determine that Koeppel poses too great a risk to investors to be in a position to continue auditing public companies until appropriate sanctions provide a reason to believe she can and would do so in compliance with PCAOB standards. We recognize this is not a case in which "virtually no audit procedures" were performed in an audit. *See, e.g., John L. Van Horn*, SEC Rel. No. 209, 1988 WL 1705575 (Nov. 1, 1988) (settled order) (permanently barring auditor from appearing or practicing before SEC for violations of applicable standards in three audits). Nor is this a case the Division contends is rife with obvious warning signs of material misstatement or involves an overall high risk of material misstatement for any financial statement assertion at issue. *See, e.g., Mark E. Laccetti, CPA*, PCAOB File No. 105-2009-007 at 62-63 (Jan. 26, 2015) (barring auditor, with leave to petition to associate after two years, and imposing $85,000 civil penalty for violations in one audit), *aff'd*, SEC Rel. No. 34-78764, 2016 WL 4582401 (Sept. 2, 2016), *appeal filed on other grounds*, *Laccetti v. SEC*, No. 16-1368 (D.C. Cir. Oct. 31, 2016). And this is not a case that in some respects shares both of those types of features. *See, e.g., Hatfield*, 2013 WL 3339647 (sustaining imposition of permanent associational bar for violations in three audits); *Gale Moore, CPA*, PCAOB File No. 105-2012-004 (Aug. 23, 2016) (for misconduct in one audit, barring auditor from association with a registered public accounting firm, with proviso that she may petition to associate after two years and that

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2012); *see also Horning v. SEC*, 570 F.3d 337, 346 (D.C. Cir. 2009); *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90, 100 (2d Cir. 1978); *Rita J. McConville*, SEC Rel. No. 34-51950, 2005 SEC LEXIS 1538 at *60 (June 30, 2005), *aff'd*, 465 F.3d 780 (7th Cir. 2006); *ZPR Inv. Mgmt Inc.*, SEC Rel. No. 40-4249, 2015 WL 6575683, *29 (Oct. 30, 2015) (failure to recognize the wrongfulness of conduct "is relevant to our consideration of the public interest and demonstrates a risk of future violations") (collecting cases), *aff'd in relevant part*, 861 F.3d 1239, 1255 (11th Cir. 2017).

weight will be given in considering such petition to completion by her of 50 hours of professional education, and restricting her activities for two additional years).

Rather, the salient feature of this case is audit work that lacked the rigor and effectiveness necessary to have reliably identified red flags in the first place. This is a serious failure in its own right that calls for strong sanctions, especially when widely repeated in three audits. Without a proper foundation for audit testing, such as adequate audit work to determine the completeness of a set of items being tested, simply multiplying procedures applied to those items can be meaningless. That was a major, fundamental flaw in all three audits, with which Koeppel's sixth contention fails to come to terms.

We determine that, at this stage, it suffices, to protect against Koeppel's demonstrated capacity for the negligence at issue in this case and to encourage compliance by her and others with their responsibilities under PCAOB auditing standards in the future, to limit Koeppel's activities by restricting her, until after two years, in any audit with respect to an issuer, from serving as an engagement partner or engagement quality reviewer; from performing audit procedures or otherwise assisting an engagement partner in fulfilling his or her planning or supervisory responsibilities; from performing engagement quality review procedures or otherwise assisting an engagement quality reviewer in fulfilling his or her responsibilities in an engagement quality review; from consulting on issues arising in the audit; and from exercising authority either to sign a registered public accounting firm's name to an audit report for an issuer or to consent to an issuer's use of a previously issued audit report. This sanction is well situated within the range of measures imposed in other adjudicated auditing cases, such as those just discussed and *Dearlove*. *See Dearlove,* 2008 SEC LEXIS 223, *111 & n.120 (noting actions taken in litigated Rule 102(e) auditor cases, from denial of the privilege of appearing or practicing before the SEC with leave to seek reinstatement after one to five years to permanent denial and denying auditor that privilege with leave to seek reinstatement after four years for misconduct in one audit).

We also censure Koeppel. A censure additionally serves to '"notif[y] the public of [her] past misconduct' even after the terms of the other sanctions have been fulfilled." *Moore*, PCAOB File No. 105-2012-004 at 51 (quoting *Salvatore F. Sodano*, SEC Rel. No. 34-59141, 2008 WL 5328801, *3 (Dec. 22, 2008)); *see, e.g., Philip L. Spartis*, SEC Rel. No. 34-64489, 2011 WL 1825026, *13 (Dec. 1, 2010) (censures "alert the public, including other [regulatory authorities], of the unacceptability of [the actor's] conduct").

These sanctions will impress upon Koeppel the seriousness of her violations and her auditing responsibilities. In imposing these specific sanctions under these unique circumstances, the Board is mindful of the time that has passed since the conduct at issue and the commencement of this proceeding, as well as the likely impact of the supervening impositions ordered by the SEC. The sanctions protect investors and further the public interest, and none of Koeppel's arguments, and none of the circumstances presented by this case, suggest that they are excessive or oppressive.

VII.

As set forth above, we have found that the Division proved by a preponderance of the evidence charges in the OIP that Koeppel violated PCAOB rules and auditing standards, and we have determined appropriate sanctions under the circumstances for those violations.

An appropriate order will issue.[57/]

By the Board (Board Member Harris not participating)

[57/] We have considered all of the parties' contentions regarding the issues addressed in this opinion and we have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of Melissa K. Koeppel, CPA, Respondent	PCAOB File No. 105-2011-007 **ORDER IMPOSING SANCTIONS** December 29, 2017

On the basis of the Board's opinion issued this day it is

ORDERED that Melissa K. Koeppel may not, until after two (2) years from the effective date of this order, in any audit with respect to an issuer, serve as an engagement partner (as that term is defined in PCAOB Auditing Standard 1201) or engagement quality reviewer (as that term is used in PCAOB Auditing Standard 1220); perform audit procedures or otherwise assist an engagement partner in fulfilling his or her planning or supervisory responsibilities; perform engagement quality review procedures or otherwise assist an engagement quality reviewer in fulfilling his or her responsibilities in an engagement quality review; consult on issues arising in the audit; or exercise authority either to sign a registered public accounting firm's name to an audit report for an issuer or to consent to an issuer's use of a previously issued audit report.

And it is further

ORDERED that Melissa K. Koeppel is censured.

Effective Date of Sanctions: If Respondent does not file an application for review by the Securities and Exchange Commission (Commission) and the Commission does not order review of the sanction on its own motion, the effective date of the sanction shall be the later of the expiration of the time period for filing an application for Commission review or the expiration of the time period for the Commission to order review. If Respondent files an application for review by the Commission or the Commission orders review of the sanction, the effective date of the sanction shall be the date the Commission lifts the stay imposed by Section 105(e) of the Sarbanes-Oxley Act of 2002.

By the Board (Board Member Harris not participating)

Phoebe W. Brown

Phoebe W. Brown
Secretary

December 29, 2017