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Navistar International Corporation

Cyrus McCormick revolutionized American agriculture in the mid-nineteenth century when he invented a mechanical reaper. His horse-drawn harvester would become the primary product marketed by McCormick Harvesting Machine Company. Decades later, Cyrus McCormick II merged his father’s company with three competing firms to create International Harvester Company, the nation’s largest manufacturer of agricultural equipment.

In addition to being successful businessmen, the McCormicks were pioneers in the field of management science. Each of them realized that modern management techniques were critical to a large company’s success. As an example, to help him maintain control over his rapidly growing company, Cyrus McCormick II retained an independent accounting firm to audit its financial records long before independent audits were mandated for public companies. That accounting firm was the predecessor of Deloitte, one of the Big Four firms that now dominate the public accounting profession.

By the late 1980s, International Harvester had been renamed Navistar International Corporation because the company’s principal line of business had migrated away from farming equipment and into the manufacture of trucks, school buses, and automotive engines. As the company evolved and changed over the decades, one of its most enduring relationships was with the accounting firm that Cyrus McCormick II retained in 1908. The business community was shocked in 2006 when, after 98 years, Navistar dismissed Deloitte as its independent audit firm. Even more shocking was a $500 million lawsuit subsequently filed by the company against Deloitte. Among other allegations, the lawsuit alleged that Navistar management had been duped into believing that Deloitte provided professional quality accounting and auditing services. The dramatic end to Deloitte’s relationship with Navistar caught the attention of the Public Company Accounting Oversight Board (PCAOB), resulting in that agency’s first formal investigation of a Big Four accounting firm.

New Partner … New Audit

In late 2005, Deloitte’s Navistar audit for the fiscal year ending 31 October 2005, was nearing completion when the audit engagement partner took a “mysterious medical leave” and was replaced. Navistar’s new audit engagement partner was a former Arthur Andersen partner who had joined Deloitte after a felony conviction in 2002 drove Andersen out of business. The new engagement partner was apparently shocked at the condition of Navistar’s accounting records and the work that had been done to that point on the 2005 audit. “The new lead engagement partner … began questioning almost everything that had been done or approved previously.

3. Arthur Andersen’s felony conviction was overturned in 2005 by the U.S. Supreme Court but it was not practical for the firm to resume operations at that point.
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... [and] refused to accept any of the work ... the [audit] team had already done and basically, according to Navistar, started the audit over.”

Navistar’s management team was less than happy with the sudden turn of events. The company’s executives were even more dismayed when the delay in the 2005 audit prevented Navistar from meeting the filing deadline for its annual Form 10-K with the Securities and Exchange Commission (SEC). In February 2006, Deloitte advised Navistar management that it could no longer rely on representations made by the company’s controller, which caused Navistar to replace that individual. Deloitte also asked Navistar to reassign a top executive of its large finance subsidiary, Navistar Financial Corporation, which the company did. The tense relationship between Deloitte and Navistar ended in April 2006 when the company’s audit committee dismissed Deloitte and retained KPMG as the company’s independent auditor.

Over the following 20 months, “Navistar spent more than $200 million to reaudit their 2002–2004 audits, redo and complete their 2005 audit, and reevaluate a never-ending list of material weaknesses and significant deficiencies in internal controls over financial reporting.”

Navistar hired PricewaterhouseCoopers, Ernst & Young, and two large consulting firms to overhaul its accounting and financial reporting functions. In the meantime, the New York Stock Exchange delisted Navistar’s common stock, which complicated the company’s efforts to raise needed capital. In late 2007, Navistar finally filed its 2005 Form 10-K and restated financial statements for fiscal 2003, fiscal 2004, and the first three quarters of 2005 with the SEC. The restatements reduced Navistar’s previously reported profits by nearly $680 million.

Navistar’s 2005 Form 10-K reported 15 material weaknesses in the company’s internal controls over financial reporting. Exhibit 1 provides brief summaries of those material weaknesses that were excerpted from that Form 10-K.

SEC Weighs In

The long delay in the filing of Navistar’s 2005 Form 10-K caused the SEC to investigate the company’s financial affairs. In 2010, the federal agency issued a series of enforcement and litigation releases focusing on the company and members of its management team. Despite uncovering circumstances in which financial statement amounts had been intentionally misstated, the SEC concluded that Navistar’s management did not engage in a “coordinated scheme” to misrepresent the company’s financial statements. Instead, the SEC reported that the Navistar case primarily involved a “deficient system of internal controls.”

These findings do not reflect a coordinated scheme by senior management to manipulate the Company’s reported results or conduct committed with the intent of personal gain. Instead, these findings reflect misconduct that resulted in large part from a deficient system of internal controls, evidenced in part by insufficient numbers of employees with accounting training, a lack of written accounting policies and procedures, and flaws in the Company’s organizational structure.

The SEC identified several “improper accounting practices” that materially overstated Navistar’s profits in the early 2000s. The fiscal year most affected by the restatements was 2003. Navistar originally reported a net loss of $18 million for 2003; after restatement, the company reported a net loss for that year of

5. Ibid.
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1. Control Environment: As of October 31, 2005, management was unsuccessful in establishing an adequately strong consciousness regarding the consistent application of ethics across all areas of the company and the importance of internal controls over financial reporting, including adherence to GAAP.

2. Accounting Personnel: We did not have a sufficient number of accounting personnel with an appropriate level of accounting knowledge, experience and training in the application of GAAP.

3. Accounting Policies: We did not have a formalized process for monitoring, updating, disseminating, and implementing GAAP-compliant accounting policies and procedures.

4. Internal Audit: Our internal audit department was not an effective monitoring control over financial reporting.

5. Segregation of Duties: We did not maintain effective controls to ensure adequate segregation of duties.

6. Information Technology (“IT”): Our IT general controls over computer program development, computer program changes, computer operations and system user access to programs and data were ineffectively designed.

7. Journal Entries: We did not maintain effective controls over the preparation, support, review and approval of journal entries.

8. Account Reconciliations: We did not maintain effective controls over account reconciliations and financial analysis and review.

9. Period End Close: We did not maintain effective controls over the period end close process.

10. Pension Accounting: We did not maintain effective controls to accurately estimate our pension and OPEB obligations.

11. Warranty Accounting: We did not have appropriate warranty cost accounting models and methodologies in place to adequately estimate warranty accruals and we did not perform appropriate financial analyses of the warranty cost estimates on a periodic basis.

12. Income Tax Accounting: We did not have sufficient modeling tools in place or a process to validate the positive and negative evidence necessary to determine whether valuation allowances were required to reduce the carrying values of deferred tax assets.

13. Inventory Accounting: We did not maintain effective controls over our inventory accounting process.

14. Revenue Accounting: We did not maintain effective controls over the revenue accounting process.

15. Contracts and Agreements: We did not perform effective reviews of contracts and agreements, including customer agreements, supplier agreements, agreements related to variable interest entities, derivatives, debt, and leases to assess the accounting implications related to the contracts and agreements.

Source: Navistar International Corporation's 2005 Form 10-K.
$333 million. Among the largest misstatements was the company’s understate-
m ent of its reserve for warranty-related expenses on its product line of automotive
engines. The company understated that reserve by subtracting “anticipated vendor
reimbursements” from estimated warranty-related expenses each year. That
is, Navistar’s accounting staff anticipated that the company’s suppliers would
contribute to the cost of repairing or replacing automotive engines that failed due to
components purchased from those suppliers. In fact, vendor reimbursements were
not contractually required and the vendors did not offer to voluntarily make such
reimbursements.

Navistar also improperly accounted for vendor rebates that were dictated by
the volume of purchases the company made in a given period. Instead of recording
rebates strictly when they were earned, Navistar’s accountants began recording
“anticipated” rebates to be received from the company’s vendors based upon the
volume of purchases expected to be made from them in the future.

Under GAAP, a company could recognize rebates only when they were actually
earned, i.e., when the entity had substantially accomplished what was necessary to be
entitled to such rebates. Accordingly, Navistar could record the full rebate as income
in the then-current period only if no contingencies existed on its right to receive the
rebate. Conversely, the company was prohibited from booking rebates as income in
the then-current period if they were based on future business.7

Navistar also improperly deferred “start-up costs” related to a long-term contract
being negotiated with one of its major customers. In anticipation of that contract
being signed, Navistar spent nearly $60 million, including expenditures to construct
a production facility where the engines to be supplied under the contract would be
manufactured. When the other party cancelled the contract negotiations, Navistar
was forced to absorb those costs. According to the SEC, Navistar was entitled to defer
the start-up costs only if there existed an objectively verified and measured contractual
guarantee of reimbursement.8

The SEC sanctioned several of Navistar’s top executives despite ruling that the
company’s misrepresented financial statements were not due to a coordinated scheme.
Those executives included Daniel Ustian, Navistar’s chairman of the board and chief
executive officer (CEO), and Robert Lannert, the company’s chief financial officer
(CFO). In addition to agreeing to “cease and desist” from future violations of federal
securities laws, Ustian and Lannert forfeited more than $1 million in bonuses they
had each received due to Navistar’s inflated earnings. The SEC did not fine Navistar
because the firm had implemented a wide range of measures to remedy its serious
accounting and internal control problems. Those measures included hiring 50 addi-
tional accountants, a new chief accounting officer, a new vice president of internal
audit, and a new chief information officer.

Navistar’s sloppy accounting practices triggered the filing of a class-action lawsuit
against the company by investors who had purchased the company’s common stock
during the time periods when its financial statements were misrepresented. Navistar
settled that lawsuit in 2011 by agreeing to pay the plaintiffs $13 million. Deloitte had
previously been dismissed as a defendant in that case by a federal judge who ruled
that there was an insufficient basis for the allegations filed against the accounting
firm by the plaintiffs’ attorneys. Deloitte would not be so fortunate when it came to
the PCAOB’s investigation of its Navistar audits.

7. Ibid.
8. Ibid.
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Deloitte vs. The Feds

In June 2005, the SEC, which oversees the PCAOB's operations, inadvertently revealed that the PCAOB was investigating Deloitte's 2003 audit of Navistar. The PCAOB had notified the SEC of that investigation the prior month in a document that was not intended to be released to the public. An SEC spokesperson admitted his agency had accidentally included that document with other documents routinely made available to the public. The spokesperson apologized for the error and indicated that steps were being taken to improve the SEC's administrative procedures. The release of the PCAOB document was newsworthy because it signaled the PCAOB's first formal investigation of a Big Four accounting firm.

Prior to the SEC's inadvertent disclosure of the PCAOB's Deloitte investigation, there was already considerable tension between the SEC and Deloitte. In April 2005, the SEC had fined Deloitte $50 million for its audits of the fraudulent financial statements of Adelphia Communications, a large telecommunications company that collapsed into bankruptcy in 2002. That fine was easily the largest ever levied against a Big Four firm by the SEC.

Shortly after the SEC announced the $50 million fine, James Quigley, Deloitte's CEO, issued a press release that infuriated SEC officials. In the press release, Quigley noted that, "Among our most significant challenges is the early detection of fraud, particularly when the client, its management, and others collude specifically to deceive a company's auditors." An SEC spokesperson responded harshly to Quigley's statement. "Deloitte was not deceived in this case. The findings in the order show that the relevant information was right in front of their eyes. Deloitte just didn't do its job, plain and simple. They didn't miss red flags. They pulled the flag over their head and claimed they couldn't see."10

The SEC also suggested that Quigley's press release violated the terms of the agreement the agency had reached with Deloitte in settling the Adelphia case. Under the terms of that agreement, Deloitte was not required to "admit" to the SEC's findings, nor was it allowed to "deny" those findings. Deloitte subsequently rescinded Quigley's press release and issued another that eliminated some, but not all, of the statements that had offended the SEC.11

A few weeks after the brouhaha involving Deloitte and the SEC, the PCAOB began investigating the accounting firm's 2003 audit of Navistar. The PCAOB's investigation of that audit was in addition to the agency's mandated annual inspections of Deloitte. The Sarbanes-Oxley Act of 2002 requires accounting firms that audit companies with securities traded on U.S. stock exchanges to register with the PCAOB. Accounting firms that audit more than 100 SEC registrants are inspected annually by the PCAOB; accounting firms that audit fewer than 100 SEC registrants are inspected every three years.

PCAOB inspections are intended to "identify and address weaknesses and deficiencies related to how a firm conducts audits." The PCAOB identifies two types

11. In late 2007, a Deloitte audit partner would become the first individual barred by the PCAOB from being associated with an accounting firm approved by the agency to audit SEC registrants. That individual, James Lazlo, had supervised an audit of the San Diego-based Ligand Pharmaceuticals. The joint SEC-PCAOB investigation of Deloitte's Ligand audit also resulted in Deloitte being publicly censured and fined $1 million. See Case 71, "Ligand Pharmaceuticals."
of such weaknesses and deficiencies: those on specific audits reviewed by PCAOB inspectors and those that involve more pervasive "matters related to the firm's quality control system." Deficiencies on specific audit engagements are included in the publicly available inspection reports issued by the PCAOB for individual accounting firms, although the disclosures do not reveal the identities of the given audit clients. The more critical quality control deficiencies are excluded, at least initially, from PCAOB inspection reports released to the public. If a firm does not properly resolve or remediate quality control deficiencies observed by PCAOB inspectors within 12 months of the date that an inspection report is released, the PCAOB may subsequently disclose those quality control matters to the public.

In May 2008, the PCAOB released its 2007 inspection report for Deloitte. In that report, the PCAOB revealed that the inspection team had visited Deloitte's national headquarters and 18 of the firm's approximately 70 practice offices in the United States. The inspection team identified audit deficiencies on nine of the 61 Deloitte audits that it reviewed. It was widely believed that one of those clients was Navistar given the SEC's inadvertent disclosure that the PCAOB was investigating the 2003 Navistar audit.

As dictated by the PCAOB's policies, the 2007 inspection report did not reference any quality control deficiencies or defects in Deloitte's audit process. The inspection report included the following statement regarding any such item: "Any defects in, or criticisms of, the Firm's quality control system are discussed in the nonpublic portion of this report and will remain nonpublic unless the Firm fails to address them to the Board's satisfaction within 12 months of the date of this report."

Navistar Audit Partners Sanctioned by PCAOB

In November 2008, the PCAOB released its first public statement regarding the ongoing investigation of the 2003 Navistar audit. The agency reported that it had fined Christopher Anderson, an audit partner in Deloitte's Chicago office, $25,000 and suspended him from being associated with a PCAOB-registered accounting firm for one year. This was the first fine ever imposed on an individual by the PCAOB. Anderson had supervised the 2003 audit of Navistar Financial Corporation (NFC), Navistar's finance subsidiary. NFC's 2003 financial statements were included in Navistar's consolidated financial statements for that year.

Among other charges, the PCAOB reported that Anderson had accepted a decision made by a member of the Navistar audit engagement team, presumably the Navistar audit engagement partner, to increase the planning materiality threshold for NFC by 50 percent during the final few days of the 2003 Navistar and NFC audits. According to the PCAOB, Anderson "believed that the original threshold remained appropriate and understood that the increased threshold would make it easier to treat known misstatements as immaterial." The "known misstatements" referred to by the PCAOB involved errors discovered in NFC's accounting records shortly before the completion of the 2003 audit.

13. Ibid.
14. Ibid.
15. Because NFC issued debt securities that were publicly traded, it filed an annual Form 10-K with the SEC in addition to the annual Form 10-K filed by its parent, Navistar.
Following the announcement of the PCAOB sanctions, a Deloitte spokesperson reported that Anderson was still with the firm "with responsibilities consistent with the settlement [with the PCAOB]." A PCAOB official refused to comment on why Deloitte was not sanctioned at the same time that the penalties were handed down against Anderson. "We do not comment on considerations involved in whether to charge firms or persons other than named respondents. The Board's order only finds violations relating to Mr. Anderson," When asked to comment on the same issue, a former PCAOB official provided a more elaborate response. "The firm tends to be the subject of disciplinary action when there is a failure of oversight or supervision. Where a particular partner simply makes an error but the firm was not negligent, only the party may get named in the proceeding." Less than one year after sanctioning Anderson, the PCAOB issued a second enforcement release focusing on Deloitte's 2003 Navistar and NFC audits. This second release centered on Thomas Linden, the Deloitte partner who had supervised the 1997–2003 Navistar audits. In that role, Linden effectively served as Anderson's supervisor during the 2003 audit. Linden was fined $75,000 by the PCAOB and received a two-year suspension. Published reports indicated that at the time the PCAOB sanctioned Linden in August 2009 he was no longer associated with Deloitte.

On 1 December 2003, Linden participated in a meeting with Navistar's audit committee in which the company's 2003 operating results were discussed. The audit committee was reviewing those results in anticipation of releasing them the next day in a telephone conference call to securities analysts who tracked the company's common stock. During the 1 December meeting, Linden "informed the Audit Committee at that time that Deloitte had substantially completed its audit and expected to issue an unqualified report." The following day, the preaudit operating results, which were "on the top side" of the previous earnings guidance provided by Navistar's management, were communicated to the company's securities analysts.

Linden expected Navistar to file its 2003 Form 10-K, including Deloitte's audit report, with the SEC on 18 December, one week before Christmas, which was the company's standard practice. Two days prior to that date, on the evening of 16 December, Christopher Anderson told Linden of $20 million of errors in NFC's accounts that his subordinates had uncovered, errors that had materially overstated NFC's assets, revenues, and earnings. That figure was also material to the consolidated operating results of Navistar.

18. Ibid.
19. Ibid.
20. This quote and the remaining quotes in this case, unless indicated otherwise, were taken from the following source: Public Company Accounting Oversight Board, "Order Making Findings and Imposing Sanctions, In the Matter of Thomas J. Linden, CPA, Respondent," 11 August 2009.
21. For fiscal 2003, Navistar reported a net loss of $18 million. However, the company reported a $77 million profit for the fourth quarter of 2003. For the previous three quarters of 2003, the company had reported a net income (loss) of ($50 million), ($14 million), and $19 million, respectively. Apparently, company management was intent on not reducing the impressive preaudit earnings for the fourth quarter in order to signal to investors that the company was in the midst of a significant turnaround. For fiscal 2002, the company had reported a net loss of $536 million. Although the $20 million in errors were material to NFC's financial statements, the PCAOB was most concerned by how the treatment of the NFC errors impacted Navistar's consolidated financial statements.
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Executives of both Navistar and NFC were informed of the $20 million of errors. “Because NFC’s financial results were consolidated into NIC’s [Navistar’s] financial statements, correction of the overstatement created the prospect that NIC would have to revise its previously announced earnings.” According to the PCAOB, Linden was aware that Navistar’s executives had a “certain level of anxiety” concerning the errors and that they “would prefer not to revise its [Navistar’s] announced earnings.”

Over the following two days, NFC made a series of accounting adjustments to “neutralize” most of the errors discovered by the NFC audit team. For example, the company recomputed the gains that it had previously recorded on certain securitization transactions during 2003. The increased gain on those transactions, which were recorded with Linden’s knowledge, “canceled out” approximately $7.2 million of the $20 million in errors discovered by the NFC auditors.

After the “neutralizing” adjustments were made, only $4.5 million in overstatements due to the discovered errors remained. NFC’s accounting staff chose to defer the write-off of that amount until the first quarter of 2004. Linden was aware that NFC made the decision to postpone that write-off “without identifying a sufficient basis under GAAP” to do so.

On the morning of 17 December, Linden “initiated, and the NFC engagement partner [Anderson] adopted” a 50 percent increase in the “planning materiality threshold” for the 2003 NFC audit. Anderson had used a planning materiality threshold of 5 percent of NFC’s pretax income during each of the four years that he had supervised the NFC audit. Linden increased that threshold to 7.5 percent of NFC’s pretax income. The increase in the materiality threshold allowed the Deloitte auditors to accept NFC’s decision not to record a year-end adjustment for the postponed $4.5 million write-off. That is, the increase in the materiality threshold made the $4.5 million error “presumptively immaterial” under Deloitte’s policies and procedures. Absent the increase in the materiality threshold, the $4.5 million error would have been “presumptively material.”

In addition to increasing NFC’s materiality threshold, Linden prepared an audit workpaper justifying that change. “[Linden] authored, with the assistance of the NFC engagement team, an NFC audit workpaper that inaccurately characterized the reasons for and circumstances surrounding the increase.”

More Pushback from the PCAOB

In October 2011, the PCAOB surprised the public accounting profession by releasing “Part II” of its 2007 inspection report for Deloitte. Part II of that report included the discussion of quality control deficiencies the PCAOB had identified during its 2007 inspection of Deloitte but not included in the version of that report made available to the public. This was the first instance in which the PCAOB had released information from Part II of an inspection report for a Big Four accounting firm. The decision to release that information was made because Deloitte allegedly had not properly addressed the issues raised in that section of the report in the 12 months following its release. Exhibit 2 includes statements excerpted from Part II of the 2007 inspection report.

The most pervasive cause for concern that the PCAOB raised in Part II of the 2007 inspection report revolved around Deloitte’s internal “culture.” In particular, the PCAOB questioned whether the rank-and-file employees of that firm had “embraced” the need to change how they performed audits.

22. The original planning materiality threshold was approximately $4.1 million; the revised threshold was approximately $6.1 million.
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1. The engagement reviews provide cause for concern that the Firm’s system of quality control may not do enough to assure that the firm performs appropriate procedures to audit significant accounting estimates, including evaluating management’s assumptions and testing the data supporting the estimates.

2. The engagement reviews provide cause for concern about the effectiveness of the Firm’s quality controls with respect to the audit procedures performed on income tax balances.

3. The engagement reviews provide cause for concern about the effectiveness of the Firm’s quality controls with respect to the use of specialists.

4. The inspection results provide cause for concern that the Firm’s system of quality control may not do enough to assure that accounting and auditing issues are evaluated with the objectivity that is contemplated in the auditing standards.

5. The Firm’s apparent failure to appropriately challenge management’s representations occurred in numerous areas, including when the Firm evaluated management’s estimates, considered the valuation of investment securities, performed alternative procedures in connection with confirmations, and tested income tax accounts and disclosures.

6. The engagement reviews provide cause for concern that the Firm’s quality controls may not result in appropriate and effective consultations when necessary. Further, the Firm’s policy on consultations appears to be deficient in that it lacks a mechanism reasonably designed to provide that significant, complex matters are raised to the appropriate level in the hierarchy in order to ensure a sufficient level of rigor in the analysis.

7. Deloitte Touche Tohmatsu (DIT) uses its global internal inspection program to assess and monitor the quality of the audit work of its member firms. However, the specific results of the inspections of member firms or practice offices are not disseminated to the Firm’s partners. Accordingly, the global inspection program does not routinely provide a U.S. engagement partner with a basis for assessing a foreign office’s qualifications and familiarity with U.S. GAAP, PCAOB standards, and SEC reporting requirements.


These deficiencies may result, in part, from a Firm culture that allows, or tolerates, audit approaches that do not consistently emphasize the need for an appropriate level of critical analysis and collection of objective evidence, and that rely largely on management representations. While it appears that the Firm has instituted positive changes to its audit practice over the years of PCAOB inspections, and that the Firm’s senior leadership has accepted the need to do so, some questions remain about whether the Firm’s audit personnel have embraced the concept that change in audit performance is necessary in order to achieve compliance with PCAOB standards.

Before the 2007 inspection report was released in May 2008 to the public, Deloitte was given an opportunity to respond to a draft of that report. Deloitte wrote two letters to the PCAOB in response to the report: one letter addressing the audit deficiencies identified by the PCAOB on specific engagements that were reviewed (Part I) and a second letter responding to the observed defects in Deloitte’s quality controls (Part II). Deloitte was aware that the letter written in response to Part II of the report

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would not be made publicly available unless the PCAOB subsequently released that section to the public.

In its letter addressing Part II of the inspection report, Deloitte strenuously objected to the PCAOB’s suggestion that the firm’s culture needed to change. “We believe that such a broad statement by the Board mischaracterizes our audit approach and our practices. Further, we strongly take exception to the observation that our culture or system of quality control allows or tolerates such audit approaches. … We do not believe that the inspection results support such a broad statement by the Board and such statement should not be included in the final report.”24

Deloitte also objected to many of the issues identified in Exhibit 2. Deloitte’s most ardent complaints revolved around the broad-brush statements made by the PCAOB that were based on “limited instances” observed by the inspection team. Deloitte also suggested that the PCAOB was improperly “second-guessing” the judgments of highly skilled professionals. “Professional judgments of reasonable and highly competent people may differ as to the nature and extent of necessary auditing procedures, conclusions reached and required documentation. We believe that reasonable judgments should not be second guessed.”25

Following the PCAOB’s release of Part II of the 2007 Deloitte inspection report, Deloitte’s CEO once again defended his firm’s audit practices. At the same time, though, he admitted that his firm was aware of the need to continually improve the quality of its professional services. “We have complete confidence in our professionals and the quality of our audits, and agree that there were and always will be areas where we can improve.”26

Navistar Sues Deloitte

In August 2011, two months prior to the PCAOB’s release of Part II of Deloitte’s 2007 inspection report, Navistar filed a $500 million lawsuit against its former audit firm.27 Among the company’s harshest allegations against Deloitte was that the auditing services were seriously flawed due to the inadequate training of its professional staff.28 In the 134-page complaint filed against Deloitte, Navistar’s attorneys also suggested that Deloitte had been much more than Navistar’s independent audit firm. In fact, the attorneys alleged that Deloitte had been so deeply involved in the company’s accounting and financial reporting function that the firm was a “de facto adjunct to Navistar’s accounting department.”

Deloitte provided Navistar with much more than audit services. Deloitte also acted as Navistar’s business consultant and accountant. For example, Navistar retained Deloitte to advise it on how to structure its business transactions to obtain accounting treatment under Generally Accepted Accounting Principles (GAAP). … Deloitte advised and directed Navistar in the accounting treatments Navistar employed for numerous complex accounting issues apart from its audits of Navistar’s financial statements, functioning as a de facto adjunct to Navistar’s accounting department … Deloitte even had a role in selecting Navistar’s most senior accounting personnel by directly interviewing applicants.”29

24. Ibid.
25. Ibid.
27. The specific civil charges filed against Deloitte in the complaint included fraud, fraudulent concealment, negligent misrepresentation, professional malpractice, breach of contract, and breach of fiduciary duty.
29. McKenna, “Navistar Sues Deloitte.”
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Many parties within the profession came to the defense of Deloitte when the Navistar lawsuit was reported. One widely quoted observer of the profession pointed out that Navistar's lawsuit against Deloitte ignored two important features of the auditor-client relationship: (1) a company's financial statements are ultimately the responsibility of senior management; (2) a public company's audit committee has a "responsibility to certify the independence of the auditor every year and to change or reduce the services they perform, or fire them, if their independence and objectivity becomes compromised."30

The most visceral reaction to the lawsuit within the profession was, not surprisingly, from Deloitte itself. Deloitte representatives vigorously defended their firm in the business press. A Deloitte spokesperson told Accounting Today that Navistar's lawsuit was "cynical and baseless attempt to shift responsibility for the wrongdoing of Navistar's own management."31 The spokesperson added that, "Several members of Navistar's past or present management team were sanctioned by the SEC for the very matters alleged in the complaint. This claim is without merit and we will defend ourselves vigorously."32

EPILOGUE

In June 2008, Navistar's common stock regained its listing on the New York Stock Exchange, signaling to many observers that the company had recovered from the embarrassing accounting scandal that had tarnished its reputation. Over the next several years, the company posted impressive profits, culminating in a record net income of $1.7 billion for fiscal 2011. Bad news returned in August 2012 when the SEC launched another investigation of the company's accounting records. The announcement of that investigation caused the company's stock price to drop sharply. Less than four weeks later, Navistar's board of directors fired Daniel Ustian as the company's CEO and chairman of the board. In December 2012, the company reported a massive $3 billion loss. Over the next several months, unhappy investors filed several class-action lawsuits against Navistar charging the company and its management team with issuing misleading financial reports.

As Navistar's troubles mounted, the company quietly announced in its Form 10-Q for the first quarter of 2013 that it had settled the lawsuit filed against Deloitte in 2011. Neither Navistar nor Deloitte publicly commented on the financial aspects, if any, of that settlement.

In October 2013, the PCAOB announced that it was fining Deloitte $2 million for permitting Christopher Anderson to perform audit services during the time that he was serving his one-year suspension. According to published reports, in anticipation of his suspension, Anderson had resigned as a Deloitte partner and accepted a salaried position as a director with the firm. In that role, Anderson had interacted with, and provided advice on auditing matters to, three different Deloitte audit engagement teams.33

The PCAOB has continued to vigorously pursue its legislative mandate to strengthen the independent audit function for SEC registrants. The agency made mandatory audit firm rotation the hottest topic within the public accounting profession when it issued a concept release in August 2011 to solicit input from the public on ways to strengthen auditor independence. One of the measures mentioned prominently by the PCAOB was limiting the tenure of public

30. Ibid.
32. Ibid.
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company auditors to a discrete number of years. James Doty, the chairman of the PCAOB, raised this possibility while discussing the problems posed by long-term auditor-client relationships.

The PCAOB's efforts to address these problems through inspections and enforcement are ongoing. But considering the disturbing lack of skepticism we continue to see, and because of the fundamental importance of independence to the performance of quality audit work, the Board is prepared to consider all possible methods of addressing the problem of audit quality—including whether mandatory audit firm rotation would help address the inherent conflict created because the auditor is paid by the client.15

Although PCAOB officials never referred to Deloitte's 99-year tenure as Navistar's auditor or the allegedly "cozy" relationship that developed between the two organizations over that time, many parties believed that relationship was a key factor that prompted the agency's interest in mandatory audit firm rotation.16

In March 2012, Chairman Doty was asked to testify before the U.S. House Subcommittee on Capital Markets and Government Sponsored Enterprises. The principal topic that the subcommittee wanted to pursue with Doty was the issue of mandatory audit firm rotation. The opening remarks made by U.S. Representative Scott Garrett set the tone for the hearing. "I do think it is important to remind the PCAOB that it is not a policy-making entity; Congress and this committee are the policy makers. The PCAOB's job is to regulate and oversee the accounting profession. I am very concerned about some of the recent activist proposals put forth by the PCAOB."16

Representative Garrett and other members of the subcommittee then grilled Doty on why mandatory audit firm rotation was the major agenda item being pursued by his agency. At one point, Representative Garrett challenged Doty to provide "data" other than "anecdotal" circumstances to demonstrate that lengthy tenure between auditors and clients impairs auditors' independence. Doty could not provide such data but noted that the lack of auditor skepticism in such situations "recurs in our findings over the years. It is not an isolated issue."37

Instead of mandatory audit firm rotation, members of the congressional subcommittee suggested that other strategies for strengthening auditor independence might be less costly and more fruitful to consider. One such recommendation was that the percentage of revenue that a PCAOB-registered accounting firm could receive from any one client.

In 2013, the U.S. Congress once more took up the topic of mandatory audit firm rotation. On 19 June 2013, the U.S. House Financial Services Committee voted unanimously to approve a bill that would prohibit mandatory audit firm rotation for SEC registrants. In commenting on that bill, U.S. Representative Jeb Hensarling, the chairman of the congressional committee, observed that, "It is boards of directors, management and shareholders who should ultimately make the decision about which accounting firms should audit a company's financial statements—not the PCAOB."38 Three weeks later, on 8 July 2013, the U.S. House of Representatives voted 321 to 62 in favor of the bill and sent it to the U.S. Senate for its consideration.

35. The record for the longest auditor-client relationship involving a Big Four accounting firm and a public company belongs to Deloitte and Procter & Gamble. That relationship began in 1890.
37. Ibid.
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Questions

1. Identify the advantages and disadvantages of mandatory audit firm rotation. What, if any, auditor rotation rules are in effect in the United States?

2. What is the formal definition of a “material weakness” in internal control? How do material weaknesses in internal control differ from “significant deficiencies” in internal control? Identify the three material weaknesses in Exhibit 1 that you believe were most critical. Defend your choices. Can an organization’s internal controls be so inadequate that it is not possible for the entity to be audited? Defend your answer.

3. Is it appropriate for an audit firm “to function as a de facto adjunct” to a client’s accounting department? Why or why not? Which party or parties were primarily responsible for Deloitte being dismissed as Navistar’s independent auditor in April 2006? Defend your answer.

4. Define what is meant by the phrase “planning materiality threshold”? What factors should be considered in establishing such thresholds? Are there any conditions under which it is appropriate for auditors to change a planning materiality threshold after the given audit has begun?

5. This case includes the following quote from a former PCAOB official: “The [audit] firm tends to be the subject of disciplinary action when there is a failure of oversight or supervision. Where a particular partner simply makes an error but the firm was not negligent, only the party may get named in the proceeding.” Do you believe that Deloitte, in addition to Linden and Anderson, should have been sanctioned by the PCAOB in connection with the 2003 Navistar audit? Justify your answer.

6. What professional standards require accounting firms to develop quality controls for their audit practices? What key issues should such quality controls address? In commenting on Deloitte’s quality controls, the PCAOB referred to the “culture” of that firm. What are the key factors or conditions that influence the “culture” within an accounting firm’s audit practice?

7. Do you believe that the PCAOB overstepped its regulatory role and responsibilities by beginning a dialogue regarding the possible need for mandatory audit firm rotation? Why or why not? Do you agree with U.S. Representative Garrett that the PCAOB is not a policy-making body? Explain.

8. Deloitte maintained that it was not appropriate for PCAOB inspection teams to “second-guess” the “reasonable judgments” of skilled professionals. Do you agree? Defend your answer.