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UNITED STATES OF AMERICA
Before the
OFFICE OF THRIFT SUPERVISION

In the Matter of:

Re: 90-3033

YERKES & MICHELS,
JOHN D. CARROLL,
LOUIS H. MICHELS,
MICHAEL BALDASSARO, AND
RANDY HOFFMAN

Dated: December 11, 1990

The Former Audit Firm, Partners
and Senior Auditor of
First Federal Savings and Loan
Association of Independence,
Independence, Kansas

CONSENT ORDER

Pursuant to the provisions of Part 313 of the Rules and Regulations of the Office of Thrift Supervision, 12 C.F.R. §513 et seq. (1990) ("OTS Regulations") (successor, for some purposes, to the Federal Home Loan Bank Board ("FHLBB")), the Office of Thrift Supervision ("OTS") has the authority to suspend or permanently revoke the privilege of any person or entity to practice before it. Yerkes & Michels ("Y&M") is a partnership of certified public accountants located in Independence, Kansas. Y&M was engaged by First Federal Savings and Loan Association of Independence, Independence, Kansas ("First FS&LA") to perform an independent audit of its financial statements for the years ended September

30, 1988 and 1989, and to issue opinions on those financial statements. Y&M knew, or should have known, that those financial statements and opinions would be provided to the OTS pursuant to Section 563.17-1 of the FHLBB Regulations, 12 C.F.R. § 563.17-1 (1988 and 1989), renumbered in pertinent part as Section 563.170 of the OTS Regulations, 12 C.F.R. § 563.170 (1990). Y&M performed such audits and issued unqualified opinions on said financial statements which were provided to the OTS pursuant to Section 563.170 of the OTS Regulations, 12 C.F.R. § 563.170 (1990). Thus, in connection with its audits of First FS&LA's 1988 and 1989 financial statements, Y&M was practicing before the OTS as that term is used in Section 513.2(e)(2) of the OTS Regulations, 12 C.F.R. § 513.2(e)(2) (1990).

Y&M reported that in its opinion First FS&LA's financial statements for the fiscal years ended September 30, 1988 and 1989, were presented in accordance with generally accepted accounting principles ("GAAP") and that the audits of these financial statements were conducted in accordance with generally accepted auditing standards ("GAAS"). The engagement partner for these audits was John D. Carroll. Randy Hoffman was assigned by Y&M as one of the "Senior Auditors" responsible for the field work on these audits.

For reasons hereinafter set forth, the OTS has concluded that the audits of First FS&LA's 1988 and 1989 financial statements were not performed or prepared in accordance with GAAS or the applicable OTS Rules and Regulations.

Yerkes & Michels, John D. Carroll, Louis H. Michels, Michael Baldassaro and Randy Hoffman, by their execution of the attached Stipulation and Consent Agreements, without admitting or denying any of the statements, conclusions or terms herein, have stipulated and consented to the entry of this Order by the OTS. Their execution of these Stipulation and Consent Agreements is for the sole purpose of resolving the issues in these proceedings. These individuals, without trial, presentation of any evidence, or findings of fact pursuant to an administrative judicial hearing, have consented to the terms of the Stipulation and Consent Agreements. The OTS has determined that it is appropriate and in the best interest of the public to execute the attached Stipulation and Consent Agreements. This Order and the attached Stipulation and Consent Agreements are issued solely to settle this proceeding, and are not the result of factual findings.

I. BACKGROUND

First FS&LA is a federally-chartered savings and loan association with its principal place of business in Independence, Kansas. First FS&LA engaged the accounting firm of Y&M to perform the annual audits of First FS&LA's financial statements for the fiscal years ended September 30, 1988 and 1989, in accordance with GAAS. Y&M was subsequently engaged to perform the annual audit of First FS&LA's financial statements for the fiscal year ended September 30, 1990, also in accordance with GAAS.

Under GAAS and OTS regulations, Y&M and the engagement partner were required to ensure that the audits of First FS&LA:

- ° were performed by persons having adequate technical training and proficiency as an auditor, including adequate knowledge of the savings and loan industry;
- ° were adequately planned and assistants properly supervised;
- ° obtained sufficient competent evidential matter to afford a reasonable basis for an opinion regarding the financial statements;
- ° resulted in reasonably adequate informative disclosures in the financial statements;
- ° were performed with an attitude of professional skepticism; and
- ° were performed by qualified public accountants who were in fact independent.

The importance of the items listed above in the proper completion of an audit in compliance with GAAS and the OTS Rules and Regulations cannot be overemphasized. For example, the requirement for an auditor to have adequate technical training, including adequate knowledge of the savings and loan industry, is critical because the accounting principles and regulations are very specialized, and transactions undertaken by savings associations can be extremely complex.

II. The 1988 and 1989 Audits of First FS&LA, as Issued By Yerkes & Michels, Were Not Prepared By "Qualified Public Accountants"

Section 563.170(a)(2) of the OTS Regulations, 12 C.F.R. §563.170(a)(2) (1990), requires each savings association to be audited once in each calendar year by qualified public accountants in the manner prescribed by the OTS rules, regulations and policy statements. Section 571.2(c)(2)(i) of the OTS Regulations, 12 C.F.R. 571.2(c)(2)(i) (1990), defines a "qualified public accountant" as "a person who is a certified public accountant or licensed public accountant, certified or licensed by a regulatory authority of a State or other political subdivision of the United States and who is in good standing as such under the laws of the State or other political subdivision of the United States in which is located the home office of the savings association that is to be audited".

Y&M expended a total of 664 man-hours and 772 man-hours on the 1988 and 1989 audits, respectively. Although Mr. Carroll, a certified public accountant ("CPA"), was designated as the "accountant-in-charge", he charged only fifty-three (53) and fifty-one (51) hours to the 1988 and 1989 audits, respectively, and he was seldom on-site to provide oversight and supervision to the audit process. Less than twelve percent (12%) of the hours expended on the 1988 audit, and less than twenty percent (20%) of the hours expended on the 1989 audit, were logged by CPAs of Y&M. Neither of the Senior Auditors assigned by Y&M to the 1988 or 1989

audits held the designation of CPA, and one of the Senior Auditors did not possess a college degree. In addition, approximately fifty percent (50%) of the total man-hours expended on the 1988 and 1989 audits were logged by representatives of Y&M who did not possess college degrees.

The OTS has, therefore, concluded that Y&M and Mr. Carroll failed to conduct the 1988 and 1989 audits of First FS&LA in accordance with the applicable OTS Rules and Regulations because the audits were not staffed nor performed by qualified public accountants.

III. The 1988 and 1989 Audits Were Not Performed In Accordance With Generally Accepted Auditing Standards

Statements of Auditing Standards ("SAS") are pronouncements on auditing matters issued by the Auditing Standards Board, the senior technical body designated by the American Institute of Certified Public Accountants ("AICPA") to issue such pronouncements. SAS are considered interpretations of GAAS and any departure from these standards require proper justification.

GAAS includes the General Standards, the Standards of Field Work and the Standards of Reporting. These three standards are interrelated and interdependent and, in many instances, lack of compliance with one standard may also result in a lack of compliance with another. These standards are presented in the AICPA's "Professional Standards," Volume 1. This codification of auditing standards is divided into sections, hereinafter referred to as AU Standards, Section ____.

A. Training and Proficiency of the Independent Auditor

The first General Standard of Auditing states that "[t]he audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor". AU Standards, Section 210. Paragraph .02 of Section 210 notes that regardless of an individual's capabilities in business or finance, ". . . he cannot meet the requirements of the auditing standards without proper education and experience in the field of auditing". Paragraph .03 further notes that "[t]he independent auditor must undergo training adequate to meet the requirements of a professional." AU Standards, Section 210.

As noted above, the Senior Auditors assigned by Y&M to the 1988 and 1989 audits of First FS&LA were not CPAs; one of the Senior Auditors did not possess a college degree; and, approximately fifty percent (50%) of the field work was performed by Y&M staff who did not possess college degrees. In addition, during the past three years, only nine hours of continuing professional education related to financial institutions has been completed by Y&M partners and staff.

General expertise and experience in auditing is not adequate to perform a competent audit of an insured depository institution. Specialized industry audits, such as savings association audits, require very specialized expertise that cannot be developed instantly by merely utilizing an industry audit guide. Consequently, a thorough understanding of an entity's business and the industry in which it operates is essential. The OTS is of the

opinion that such an understanding can only be gained through proper continuing professional training and appropriate experience.

Based upon the foregoing, the OTS has concluded that Y&M and Mr. Carroll failed to ensure, as required by AU Standards, Section 210, that the audits of First FS&LA's 1988 and 1989 financial statements were prepared and performed by personnel with the requisite credentials, education, experience and training sufficient to audit a federally insured depository institution.

B. Independence of the Auditor

The second General Standard of Auditing requires that "[i]n all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor and auditors". AU Standards, Section 220. This standard was not met by Y&M or Mr. Hoffman, as fully discussed in Part IV., below.

C. Due Care in the Performance of the Audit

The third General Standard of Auditing states that "[d]ue professional care is to be exercised in the performance of the audit and the preparation of the report". AU Standards, Section 230.

In August 1990, the District Director for the OTS-Topeka District rejected First FS&LA's financial statements for the year ended September 30, 1989, due to several deficiencies, including

non-conformance with PA-7a and GAAS. Among other things, Y&M's auditors' opinion did not conform to GAAS and the financial statements did not include adequate disclosures pertaining to certain significant accounting policies; the market values of investment securities; the components of the loan portfolio; the reporting of loans in process as a component of loans receivables; the reporting of accounting policies affecting the recognition of interest on loans, deferred loan origination fees and commitment fees; the composition of savings accounts by interest rate; and, outstanding commitments for funding of loans.

The OTS, therefore, has concluded that the 1989 audit prepared by Y&M, under the supervision of the engagement partner, Mr. Carroll, was not prepared or performed with due professional care. Accordingly, the audit did not comply with Section 230 of the AU Standards.

D. Planning and Supervision of the Audit

The first Standard of Field Work states that "[t]he work is to be adequately planned and assistants, if any, are to be properly supervised". AU Standards, Section 310. In accordance with this standard, the auditor must develop an overall strategy that defines the scope of an audit. As such, he must determine the nature, extent and timing of audit procedures based on the

size and complexity of the entity he audits. Furthermore, the level of supervision of an audit is dictated by many factors including, the complexity of the entity's operations and the qualifications of the staff assigned to the audit. AU Standards, Section 311.

The OTS has concluded that Y&M's audits of First FS&LA's financial statements for fiscal years 1988 and 1989 were not adequately planned because Y&M and Mr. Carroll did not, among other things, identify areas that may have a high level of risk exposure; perform any analytical review of First FS&LA's operations; adequately evaluate First FS&LA's systems of internal accounting and operating controls; or, staff the examination with qualified personnel. The OTS has further concluded that Y&M and Mr. Carroll did not adequately supervise the preparation of the 1988 and 1989 audits of First FS&LA. The total hours expended by Mr. Carroll on the 1988 and 1989 audits, including supervision of Y&M staff, accounted for only seven percent (7%) and nine percent (9%), respectively, of the total hours logged by Y&M personnel. Given the nature of First FS&LA's operations as a federally insured depository institution and the questionable qualifications of the staff assigned to these audits, Y&M's and Mr. Carroll's supervision of the field work on the 1988 and 1989 audits was deficient and did not comply with Section 310 of the AU Standards.

E. Evidential Matter Required in the Performance of an Audit

The third Standard of Field Work requires "[s]ufficient competent evidential matter to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit". AU Standards, Section 326.

Y&M's audit procedures for the 1989 audit were primarily intended to verify the existence of pertinent loan documents, to confirm individual loan and savings account balances, and to tie general ledger balances to subsidiary records. Mr. Carroll did not perform, nor did he direct other staff from Y&M to perform, adequate independent evaluations of, among other things, the collectibility of loans or the adequacy of valuation allowances. Y&M and Mr. Carroll were prepared to issue an unqualified opinion of First FS&LA's financial statements for fiscal year 1989 that did not include \$2.3 million of specific and general valuation allowances identified by the OTS in its examination of the institution. Without the OTS's input, Y&M would have issued an unqualified opinion on clearly erroneous financial statements because Y&M's procedures were not adequate to identify the inadequacies of First FS&LA's valuation allowances.

The OTS has, therefore, concluded that Y&M's audit procedures were clerical in nature and did not evaluate the collectibility and recoverability of assets, and were contrary to the AU Standards, Section 326. Y&M and Mr. Carroll did not undertake adequate independent inspections, observations, inquiries or confirmations to support its opinion on First FS&LA's financial statements for the fiscal year 1989.

F. Professional Skepticism in the Audit Process

Proper professional skepticism also is necessary to properly complete an audit. AU Standards, Section 316.16-21. Accepting management's representations, both verbal and written, without adequate and reasonable support and analysis can contribute to an inaccurate representation of the financial condition of the financial institution. This is particularly true where a literal application of GAAP can result in misleading financial statements. GAAS provides that transactions and other events should be accounted for and presented in accordance with their substance and financial reality and not merely with their legal form. AU Standards, Sections 334.02, 411.07, 411.09 and 411.10. As previously noted, Y&M and Mr. Carroll, without undertaking any independent review of loan valuations and collectibility, were prepared to issue an unqualified opinion of First FS&LA's financial statements for fiscal year 1989 that did not include \$2.3 million of specific and general valuation allowances identified by the OTS in its examination of the institution.

In the savings and loan industry, a substantial portion of the lending is supported by collateral, particularly real estate. First FS&LA is no exception. An independent auditor must understand the appraisal process and critically evaluate the ability of the loan to be serviced and repaid from the collateral or other sources that the borrower may have. The GAAS requirement to maintain an attitude of professional skepticism is essential when using appraisals as a determinant for the necessity or adequacy of a loan loss allowance.

During the audit of First FS&LA's 1989 financial statements, Y&M and Mr. Carroll failed to undertake any critical review of the valuation or collectibility of real estate loans. No analysis whatsoever was undertaken to review the qualifications of First FS&LA's appraisers, obtain confirmation letters from appraisers of their independence, check appraisal assumptions such as capitalization and lease-up rates for consistency and reasonableness, review appraisals to determine whether they met regulatory standards, or otherwise critically evaluate the values assigned to real estate loans. In summary, Y&M and Mr. Carroll simply failed to exercise proper professional skepticism.

The OTS is of the opinion that professional skepticism provides the cornerstone of an independent audit. Without proper professional skepticism by an auditor, an audit's results are neither reliable nor meaningful.

G. Overall Conclusions Regarding Noncompliance With GAAS

The OTS has concluded that Y&M's audits of First FS&LA's 1988 and 1989 financial statements were not conducted in accordance with GAAS because Y&M and Mr. Carroll did not possess, and did not provide, adequate technical training and proficiency in the performance and preparation of the audits; did not exercise due care in the performance of the audits; did not adequately plan and supervise the audits; did not perform adequate audit procedures; did not apply the appropriate professional skepticism to the audit process; and, were not independent of First FS&LA.

IV. Yerkes & Michels and Randy Hoffman Lacked Independence to Perform the 1988 and 1989 Audits of First FS&LA

Section 571.2 of the OTS Regulations, 12 C.F.R. § 571.2 (1990), sets forth the "...criteria for determining that an auditor or an audit is satisfactory to the Office". Among other requirements, Section 571.2(c)(3)(ii) of the OTS Regulations, 12 C.F.R. § 571.2 (c)(3)(ii) (1990), states that "[t]o be acceptable, an audit must be made by a qualified public accountant or internal auditor who is in fact independent". This regulation further provides that a public accountant is not considered independent if he has loans from the institution other than loans secured by his principal residence, savings accounts, or consumer loans used for personal, family or household purposes. Further, subsection (c)(3)(ii)(F) of this regulation provides that a public accountant

is not considered independent if he has ". . .any interest, direct or indirect, financial or otherwise, in any real property owned by, or securing any loan made by, the savings association . . . except as provided in paragraph (c)(3)(ii)(D)".

Section 571.2(c)(3)(iv) of the OTS Regulations, 12 C.F.R. § 571.2(c)(3)(iv) (1990), states that "[t]he requirements as to independence are applicable to those members or employees of a firm of public accountants who, in any way, are in a position to influence or control the conduct of an audit of a savings association or to influence or control the presentation of facts and other information in the report of such audit." In addition, Section 571.2(c)(3)(v) notes that "[i]t is the responsibility of the public accountant or internal auditor to disclose [the independence issue] to the District Director. . . and to have resolved any question as to independence before proceeding with the audit".

As noted above, the second General Standard of Auditing requires the auditor to be independent of the client. AU Standards, Section 220. Paragraph .03 of section 220 notes that in order for an auditor ". . . to be recognized as independent, he must be free from any obligation to or interest in the client. . ." (emphasis added) This standard further states that "[i]ndependent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence." The independence standards are further supplemented by the AICPA Code of Professional Conduct. Article IV of this Code states that "[a] member in public practice should

be independent in fact and appearance when providing auditing and other attestation services." Paragraph .01 of Article IV further notes that "[i]ndependence precludes relationships that may appear to impair a member's objectivity in rendering attestation services."

While the AICPA interpretation of the independence requirement does not consider secured loans made under "normal lending procedures, terms, and requirements" as an indicator of lack of independence, the interpretation further states that "[r]elated prohibitions that may be more restrictive are prescribed by certain state and federal agencies having regulatory authority over such financial institutions". As such, the more restrictive OTS independence requirements prevail.

As of September 30, 1988, First FS&LA had extended approximately \$561,000 in loans to Mr. Hoffman, or entities in which he held a significant ownership interest (the "Hoffman loans"). As previously noted, Mr. Hoffman was one of Y&M's Senior Auditors on the 1988 and 1989 audits. As of September 30, 1989, the Hoffman loans outstanding at First FS&LA had increased to \$592,000. In addition, loans to four other Y&M partners and staff members totaled approximately \$200,000. The Hoffman loans included a \$39,000 mortgage on Mr. Hoffman's principal residence. The remaining \$553,000 of loans at September 30, 1989, were for commercial purposes, secured by rental properties principally located in Independence, Kansas. When the Hoffman loans are aggregated pursuant to the OTS's loans-to-one-borrower regulation, 12 C.F.R. §563.9-3 (1988 and 1989), it is revealed that Mr.

Hoffman was, at the time of the 1988 and 1989 audits, one of the ten largest borrowers of First FS&LA. In the OTS's opinion, based on the regulatory requirements concerning independence, and the independence requirements of GAAS, neither Mr. Hoffman nor Y&M were independent with respect to First FS&LA for the years ended September 30, 1988 and 1989. Furthermore, neither Mr. Hoffman nor Y&M attempted to resolve this independence problem with the District Director.

Order

NOW, THEREFORE, IT IS HEREBY ORDERED AS FOLLOWS:

1. Yerkes & Michels is permanently suspended from practice before the OTS from and after the date of this Order. No officer, director, employee or partner of Yerkes & Michels shall, directly or indirectly, prepare or participate in the preparation of any statement, opinion, financial statement, audit report, or other document or report for, or on behalf of, any savings association, savings and loan holding company, or wholly or partly owned subsidiary of any savings association or savings and loan holding company (hereinafter collectively referred to as "savings association").

2. John D. Carroll is permanently suspended from practice before the OTS from and after the date of this Order. Mr. Carroll shall not, directly or indirectly, prepare or participate in the preparation of any statement, opinion, financial statement, audit report, or other document or report for, or on behalf of, any savings association.

3. Louis H. Michels is permanently suspended from practice before the OTS from and after the date of this Order. Mr. Michels shall not, directly or indirectly, prepare or participate in the preparation of any statement, opinion, financial statement, audit

report, or other document or report for, or on behalf of, any savings association.

4. Michael Baldassaro is permanently suspended from practice before the OTS from and after the date of this Order. Mr. Baldassaro shall not, directly or indirectly, prepare or participate in the preparation of any statement, opinion, financial statement, audit report, or other document or report for, or on behalf of, any savings association.

5. Randy Hoffman is permanently suspended from practice before the OTS from and after the date of this Order. Mr. Hoffman shall not, directly or indirectly, prepare or participate in the preparation of any statement, opinion, financial statement, audit report, or other document or report for, or on behalf of, any savings association.

6. For purposes of this Order, unless otherwise noted, the phrase "savings association" is defined in accordance with 12 U.S.C. §1813(b)(1). The phrase "insured depository institution" is defined to include savings associations, commercial banks, credit unions and other similar entities that hold federally insured deposits. The word "practice" is defined in accordance with Section 513.2(e) of the OTS Regulations, 12 C.F.R. 513.2(e) (1990).

7. All technical words or terms used in this Order, for which meanings are not specified or otherwise provided for by the provisions of this Order, shall, insofar as applicable, have meanings as defined in Chapter V of Title 12 of the Code of Federal Regulations or as such definition is amended after the execution of this Order, and any such technical words or terms used in this Order and undefined in said Code of Federal Regulations, shall have meanings that accord with their best custom and usage in the savings and loan industry.

8. The terms and provisions of this Order shall be binding upon, and inure to the benefit of, the parties hereto and their successors in interest.

9. This Order shall remain in effect until modified or terminated by the OTS.

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Timothy Ryan, Director