In the popular movie *The Tin Men*, released in 1987, Richard Dreyfus and Danny DeVito portray aluminum siding salesmen during the early 1960s. The two competitors use every means possible to obtain an unfair advantage over each other. Like other aluminum siding salesmen, the key to success for Dreyfus and DeVito is obtaining and vigorously pursuing "leads," or indications of interest from potential customers. Leads are not only a key success factor for home siding companies but also figure prominently in many of these firms' accounting and control systems. Take the case of AMRE, Inc., a firm that for nearly two decades sold home siding and interior refurnishing products such as cabinet countertops. AMRE, short for American Remodeling, began operations in 1980 in Irving, Texas, home of the Dallas Cowboys. Within a few years, the fast-growing firm ranked as the largest company in the home siding industry, a industry historically dominated by small businesses that market their services in one metropolitan area. In 1987, AMRE went public and listed its common stock on the New York Stock Exchange. AMRE's principal operating expenses were advertising costs incurred to identify potential leads via direct mail and television commercials. Throughout the 1980s, AMRE charged a portion of its advertising costs each year to a deferred expense account. AMRE justified this accounting treatment by maintaining that these advertising costs benefited future periods. Each accounting period, AMRE divided its total advertising costs by the number of new leads generated that period. AMRE then multiplied the resulting "cost per lead" by the total number of "unset leads," that is, new leads that had not yet been pursued, to determine the amount of advertising costs to defer. The firm charged the remaining advertising costs for that period to its advertising expense account.

AMRE created a computer-based "lead bank" during the mid-1980s. When a potential customer contacted AMRE, a clerk collected and then entered information in the lead bank that could be used to develop an appropriate sales pitch for that individual. This information included variables such as age, income, home market value, and length of residency. Data for each sales presentation were also entered in the lead bank. This information allowed AMRE to evaluate each salesperson's performance by computing measures such as sales as a percentage of appointments, cancellation rate, and average dollar sales per appointment. The control functions and data provided by AMRE's computerized lead bank contributed significantly to the company's early success in the intensely competitive home siding industry.

**Accounting for "Leads" Leads to Trouble**

When AMRE went public in February 1987, the company's top officers gave optimistic revenue and profit projections to financial analysts tracking the firm. (At the time, AMRE's fiscal year ran from May 1 of one year until April 30 of the next. The company's first fiscal year as a public company fiscal 1988, ended April 30, 1988.) As the end of AMRE's first quarter as a public company approached, July 31, 1987, the net income projected for that quarter earlier in the year was clearly unattainable.

Robert Levin, an AMRE executive and major stockholder, feared that AMRE's stock price would drop sharply if the company failed to reach its forecasted earnings for the first quarter of fiscal 1988. Levin, a CPA since 1972, served as the company's
principal financial officer and held the titles of executive vice president, treasurer, and chief operating officer (COO). To inflate AMRE's net income for the first quarter of fiscal 1988, Levin instructed the company's chief accounting officer, Dennie D. Brown, to overstate the number of unset leads in AMRE's computerized lead bank.\textsuperscript{1} Brown, in turn, instructed Walter W. Richardson, the company's vice president of data processing who had served as AMRE's controller in the early 1980s, to enter fictitious unset leads in the lead bank. Entering the fictitious leads in the lead bank caused a disproportionate amount of AMRE's advertising costs for the first quarter of 1988 to be deferred rather than expensed. This accounting scam allowed AMRE to overstate its pretax income for that quarter by approximately $1 million, or by nearly 50 percent.

Once corporate executives misrepresent their firm's operating results for one accounting period, the temptation to manipulate its operating results in later periods becomes difficult to resist. In the second quarter of fiscal 1988, AMRE's executives again inflated the company's unset leads to understate the firm's advertising expenses.

During the third and fourth quarters of fiscal 1988, AMRE's actual operating results again fell far short of expectations. At this point, Levin decided to expand the scope of the accounting fraud. In addition to overstating unset leads, Levin instructed his subordinates to overstate AMRE's ending inventory for the third and fourth quarters of fiscal 1988. Richardson complied by entering fictitious inventory in AMRE's computerized inventory records and by preparing bogus inventory count sheets that were later submitted to the company's Price Waterhouse auditors.

Levin also instructed AMRE's accounting personnel to overstate the company's revenue for the third and fourth quarters of fiscal 1988. AMRE used the percentage-of-completion method to recognize revenue on unfinished installation jobs at the end of an accounting period. To overstate the revenue booked on unfinished projects at the end of fiscal 1988, AMRE grossly overstated their percentage of completion. In fact, AMRE recognized revenue at the end of fiscal 1988 on customer projects that had not been started.

AMRE reported a pretax income of $12.2 million in its fiscal 1988 financial statements. A subsequent investigation by the Securities and Exchange Commission (SEC) revealed that AMRE's actual pretax income for that year was less than 50 percent of the reported figure. Before AMRE filed its 1988 10-K with the SEC, Levin met with AMRE's chief executive officer and chairman of the board, Steven D. Bedowitz. At this meeting, Levin admitted to Bedowitz for the first time that illicit accounting methods had been used to overstate AMRE's reported profit for 1988. According to the SEC's investigation, Bedowitz "concurred with these efforts to improperly increase AMRE's earnings."\textsuperscript{2}

Bedowitz and Levin signed the "Letter to Shareholders" included in AMRE's 1988 annual report. That letter began with the following greeting: "We are proud to announce that fiscal 1988 was another record year for AMRE in both earnings and revenues." In a subsequent AMRE annual report, Levin recalled how he had met Bedowitz in 1981, several years before Levin accepted an executive position with AMRE. At the time, Levin worked for a building materials company that was an AMRE supplier.

We discovered that we were very much alike. We both had a lot of energy, ambition, and dreams. Our partnership was inevitable.\textsuperscript{3}

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\textsuperscript{1} The information reported in this case was drawn principally from a series of enforcement releases issued by the SEC in the early 1990s. The individuals involved in this case neither admitted nor denied the facts as represented by the SEC.


\textsuperscript{3} AMRE, Inc., 1989 Annual Report, 11.
Price Waterhouse issued an unqualified opinion on AMRE's financial statements for fiscal 1988. Nevertheless, a financial analyst for The New York Times questioned the credibility of those financial statements.4 The analyst pointed out that AMRE's use of the percentage-of-completion accounting method seemed unusual. Businesses typically use the percentage-of-completion method to recognize revenue on projects that take several months, if not years, to complete. AMRE's installation jobs required only a few days to complete. Even more troubling to the analyst was the three weeks of "unbilled revenues" that AMRE had recognized on unfinished installation jobs near the end of 1988. That figure seemed excessive since AMRE's average time to complete an installation job was one week. The analyst also questioned AMRE's advertising expense figure by pointing out that the company's deferred advertising costs had been rising rapidly. In summary, the analyst bluntly challenged the integrity of AMRE's financial statements.

To short-sellers, it looks like a classic pattern of inflating revenues and understating expenses, a pattern that often ends in a write-off. Mr. Wesselman [an AMRE spokesperson] said the company's accounting practices were proper and were periodically reviewed with outside auditors.5

**AMRE's 1989 Fiscal Year**

During fiscal 1989, AMRE's executives became increasingly concerned that their indiscretions would be discovered. In the third quarter of that year, the conspirators decided to end the accounting fraud. The executives met regularly to discuss how best to terminate the fraud without raising the suspicions of the firm's Price Waterhouse auditors and other parties. One method the executives settled on was to transfer fictitious assets in AMRE's accounting records to the firm's Decks division. That division's principal line of business was building backyard decks on residential homes. Company officials had already decided to eliminate the Decks division. By transferring approximately $3 million of fictitious assets to that division, AMRE "buried" the write-offs of those assets in the discontinued operations section of its 1989 income statement. AMRE booked these write-offs principally during the third quarter of fiscal 1989.

Company executives wrote off approximately $5 million of additional fictitious assets as losses or expenses in the fourth quarter of fiscal 1989 via adjusting entries. These write-offs and those of the previous quarter resulted in AMRE reporting a net loss of nearly $6 million for 1989. Exhibit 1 summarizes key financial data included in AMRE's 1989 annual report for the five-year period 1985–1989.

### Exhibit 1

**Key Financial Data for AMRE, Inc., 1985–1989**

<table>
<thead>
<tr>
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<th></th>
<th></th>
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<tr>
<td>Contract revenues</td>
<td>$183,885</td>
<td>$121,033</td>
<td>$72,187</td>
<td>$39,575</td>
<td>$22,451</td>
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<td>Contract costs</td>
<td>64,702</td>
<td>41,369</td>
<td>25,017</td>
<td>15,275</td>
<td>9,259</td>
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<td>Gross profit</td>
<td>119,183</td>
<td>79,664</td>
<td>47,170</td>
<td>24,300</td>
<td>13,192</td>
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<td>Operating income</td>
<td>1,602</td>
<td>9,983</td>
<td>6,153</td>
<td>1,516</td>
<td>661</td>
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<tr>
<td>Net income</td>
<td>(5,744)</td>
<td>7,298</td>
<td>2,907</td>
<td>878</td>
<td>414</td>
</tr>
<tr>
<td>Working capital</td>
<td>11,719</td>
<td>15,307</td>
<td>13,236</td>
<td>40</td>
<td>175</td>
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<tr>
<td>Total assets</td>
<td>50,399</td>
<td>34,113</td>
<td>23,527</td>
<td>7,239</td>
<td>2,471</td>
</tr>
<tr>
<td>Stockholders' equity</td>
<td>27,174</td>
<td>23,565</td>
<td>16,895</td>
<td>1,334</td>
<td>456</td>
</tr>
</tbody>
</table>

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5. Ibid.
The Role of AMRE's New CFO in Terminating the Accounting Fraud

In March 1989, near the end of AMRE's fourth quarter of fiscal 1989, AMRE hired Mac M. Martirossian to serve as the company's chief accounting officer. Martirossian, a CPA since 1976, had more than 10 years of public accounting experience with the Dallas office of Price Waterhouse, which performed AMRE's annual audits. In July 1989, Martirossian assumed the title of chief financial officer (CFO). Levin, who had essentially served as AMRE's CFO for several years, retained the titles of executive vice president, treasurer, and chief operating officer.

While becoming acquainted with AMRE's accounting system in his first few weeks with the firm, Martirossian discovered numerous accounting entries that lacked adequate documentation. Martirossian immediately began investigating this obvious internal control problem. No doubt, AMRE's top executives realized that the inquisitive accountant would eventually "put two and two together." So they decided to reveal the fraud to Martirossian. (Recognize that by this point the executives had already begun terminating the fraud.)

The startling confession made by his new colleagues stunned Martirossian. On April 28, 1989, just two days before the end of fiscal 1989, Martirossian called a meeting with the executives involved in the fraud. At this meeting, he insisted that the misstatements remaining in the company's accounting records be immediately corrected. If the corrections were not made, Martirossian threatened to resign.

Martirossian further stated that he would hold himself responsible for the company's financial statements for periods after fiscal 1989, but that the scheme's participants would be responsible for correcting the misstatements in the periods to which they related, and for addressing any questions [from AMRE's independent auditors and other parties] arising from the corrections.6

Bedowitz acquiesced to Martirossian's demands. Initially, the two men decided to correct AMRE's accounting records with a large prior period adjustment. In a matter of days, this plan backfired. Outside directors on AMRE's board became aware of the prior period adjustment and began questioning why it was necessary. At this point, AMRE's executives, including Martirossian, met to consider other alternatives for correcting the company's accounting records. The executives decided that the remaining errors in AMRE's accounting records would be written off against the operating results of the fourth quarter of fiscal 1989 via period-ending adjusting entries, as discussed earlier.

Shortly after the end of fiscal 1989, Martirossian attended several meetings between AMRE's top executives and representatives of Price Waterhouse. At these meetings, the large accounting adjustments made by AMRE during the fourth quarter of fiscal 1989 were discussed. According to the SEC, Martirossian sat silently while other company executives provided false explanations to Price Waterhouse regarding the large adjustments.

The efforts of his colleagues to mislead the Price Waterhouse auditors troubled Martirossian. Before Price Waterhouse completed its 1989 audit of AMRE, Martirossian arranged a confidential meeting at a local hotel with key Price Waterhouse personnel assigned to the AMRE audit. Martirossian had become well acquainted with several of these individuals during the 10 years he worked for Price Waterhouse's Dallas office.

At this meeting, Martirossian expressed a high level of anxiety regarding the audit, and he specifically stated that a portion of the adjustments "did not pass the smell test." Further, he also posed questions to the auditors that linked seemingly unrelated audit issues and events to the adjustments in an attempt to direct the auditors to the undisclosed scheme [accounting fraud].

Although he hinted strongly to the auditors that AMRE's fourth-quarter write-offs were suspicious, Martirossian never revealed the true nature or purpose of those adjustments. Price Waterhouse ultimately accepted the large fourth-quarter adjustments before issuing an unqualified opinion on AMRE's 1989 financial statements.

Following the completion of the 1989 audit, Martirossian signed a letter of representations addressed to Price Waterhouse. This letter indicated that he and other key AMRE executives were not aware of any irregularities that would materially affect the accuracy of the company's financial statements.

During fiscal 1990, Martirossian undertook an extensive effort to improve AMRE's accounting and financial reporting functions. This effort included implementing several measures to strengthen the company's internal control system. Martirossian also searched the company's accounting records for any remaining errors and reviewed the company's accounting policies to ensure that they were being properly applied.

The Fraud Is Disclosed Publicly

In 1990, the SEC revealed that it was investigating AMRE's financial statements for the previous few years. The New York Times article in late 1988 that challenged AMRE's financial data prompted that investigation. In early 1991, AMRE formed a special committee consisting of three outside members of its board to scrutinize the company's financial affairs. Following the report of this committee, AMRE publicly revealed that its financial statements for each year 1987 through 1990, but principally 1988 and 1989, contained material errors. AMRE restated its financial statements for each of those years. From early 1992 through mid-1994, the SEC issued several enforcement releases disclosing the results of its lengthy investigation of AMRE's accounting fraud.

Each of the AMRE executives who actively participated in the fraud, including Bedowitz, Levin, Brown, and Richardson, agreed to an SEC consent order. The executives neither admitted nor denied their alleged roles in the fraud but pledged not to violate federal securities laws in the future. Levin and Brown also forfeited proceeds they had received from the sale of AMRE stock while the fraud was in progress. This feature of the agreement required Brown to pay approximately $16,000 to the federal government. Levin paid nearly $1.8 million to the federal government, including a $500,000 fine for violating the provisions of the Insider Trading Sanctions Act.

In November 1991, The Wall Street Journal reported that Bedowitz, Levin, and AMRE, Inc., had reached an agreement to settle a large class action lawsuit filed by AMRE's stockholders. This agreement required the two former AMRE executives to contribute approximately $8.8 million to a settlement pool. AMRE, Inc., contributed another $5.9 million to that pool.

Martirossian reached an agreement with the SEC similar to the agreement made by the federal agency with the other AMRE executives. However, the federal agency

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7. Ibid.
8. AMRE's financial condition continued to deteriorate during the mid-1990s. In 1997, the company ceased operations and filed for involuntary bankruptcy.
issued a separate enforcement release describing Martirossian’s role in the fraud. The SEC criticized Martirossian for not insisting that proper measures be taken to correct AMRE’s accounting records and for not disclosing the fraud to Price Waterhouse.

Martirossian’s nonparticipation in the original fraudulent scheme cannot justify his actions in turning a blind eye to the methods utilized by AMRE to correct the material misstatements. . . . Although he expressed concern and posed questions to AMRE’s auditors in an attempt to expose the existence of the scheme to them, Martirossian’s effort to discharge his duty to make accurate and complete disclosure to AMRE’s auditors was ineffectual and misleading because he failed to provide the auditors all of the information he possessed.  

SEC Investigates Price Waterhouse’s 1988 and 1989 AMRE Audits

After the SEC finished dealing with AMRE’s executives, the federal agency turned its attention to the company’s independent audit firm, Price Waterhouse. The SEC focused on the conduct of two members of the AMRE audit engagement team, Edward J. Smith and Joel E. Reed. Smith served as AMRE’s audit engagement partner, while Reed was a senior audit manager assigned to the AMRE audits.

Among the SEC’s complaints lodged against Price Waterhouse was that the audit firm failed to properly test AMRE’s deferred advertising expenses. Recall that AMRE computed the advertising costs to be deferred for a given accounting period by multiplying the “cost per lead” for that period by the number of “unset leads” at the end of the period. One method AMRE used to inflate its reported profits was to create fictitious unset leads. Staff auditors of Price Waterhouse assigned to the AMRE engagement verified the cost-per-lead computation during the 1988 audit. However, the staff auditors failed to adequately test the number of unset leads reported by AMRE at the end of fiscal 1988. The auditors simply compared the number of unset leads on two client-prepared schedules.

The audit of the unset leads deferral was flawed because no procedures were performed to verify the integrity of the reports on which the audit relied. In fact, the reports were not supported by underlying data. Although the number of unset leads supposedly had increased during the year by over 200% (from 10,438 to 31,580), the audit relied on AMRE’s summary reports.  

Price Waterhouse’s audit planning memorandum for the 1988 AMRE audit indicated that EDP audit procedures would be used to test the integrity of AMRE’s lead bank. AMRE executives involved in the accounting fraud feared that these procedures would result in detection of the fictitious leads in the lead bank. These executives persuaded Smith and Reed to bypass the EDP tests.

AMRE also inflated its reported profits by overstating year-end inventory. During fiscal 1988, AMRE’s inventory increased by 213 percent, while sales increased 68 percent and inventory purchases increased 66 percent. The 1988 AMRE audit planning memorandum identified the large increase in inventory as a key risk factor. The audit planning memorandum also pointed out that AMRE did not use a perpetual inventory system, meaning that the year-end inventory quantities would be determined by a physical count.

11. This and all subsequent quotations were taken from the Securities and Exchange Commission, Accounting and Auditing Enforcement Release No. 554, 26 April 1994.
Price Waterhouse's initial audit plan for 1988 called for the observation of the client's physical inventory counts at 11 of 26 inventory sites. The previous year, Price Waterhouse had visited nine of 22 inventory sites during the physical counts. Client management complained that the increase in the number of inventory sites to be observed by Price Waterhouse would materially increase the cost of the 1988 audit. AMRE's executives convinced Price Waterhouse to allow AMRE accounting personnel to monitor the physical counts at three of the inventory sites that the auditors had selected for observation. According to the SEC's investigation, AMRE management inflated the year-end inventory of each of the 18 inventory sites not observed at year-end by Price Waterhouse. These inventory sites included the three sites where AMRE accounting personnel observed the physical counts. In total, AMRE overstated its 1988 year-end inventory by $1.4 million.

During the third and fourth quarters of fiscal 1989, AMRE began writing off its fictitious assets. Recall that AMRE's executives concealed several million dollars of such write-offs in the losses booked for the discontinued Decks division. The Price Waterhouse auditors reviewed the large losses stemming from the elimination of AMRE's Decks division during fiscal 1989. However, according to the SEC, the Price Waterhouse auditors accepted the client's explanations for these losses without applying any "meaningful audit procedures" to them.

While writing off fictitious assets during the fourth quarter of 1989, AMRE purged 17,000 bogus unset leads from the computerized lead bank. The average cost of these leads was $108.33, meaning that the total loss related to their write-off exceeded $1.8 million. A Price Waterhouse staff auditor asked an AMRE accountant why the large number of unset leads was being dropped from the lead bank. The accountant responded that the unset leads had been improperly recorded due to an "accounting control weakness." In the audit workpapers, the staff auditor concluded, based on the AMRE accountant's statement, that this "weakness" was an "isolated incident" that did not require further investigation. Smith and Reed concurred with the staff auditor's assessment and did not require any further audit procedures to be applied to the large adjustment.

The SEC also questioned Price Waterhouse's review of the quarterly financial data included in AMRE's 1989 10-K registration statement. Near the end of the 1989 audit, Smith recommended that AMRE disclose in the 10-K the large period-ending accounting adjustments that were largely responsible for the company's net loss for fiscal 1989. AMRE's executives refused. After reconsidering the matter, Smith noted in the audit workpapers that the fourth quarter adjustments did not need to be disclosed separately.

Smith concluded that the adjustments did not require disclosure because "the quarterly data is not part of the financial statements and the disclosure is informative only. ... The magnitude of the adjustments is not sufficient to cause us to require them to do it [that is, disclose the adjustments]."

A key factor that reportedly influenced Smith and Reed's decisions to accept AMRE's questionable accounting treatments was their familiarity with Martirosian, a former colleague of theirs in the Dallas office of Price Waterhouse. According to the SEC, Smith and Reed "relied improperly on his [Martirossian's] unverified representations based upon their prior experience with him and his reputation for integrity within Price Waterhouse."

In an enforcement release issued in April 1994, the SEC concluded that Smith and Reed had failed to comply with generally accepted auditing standards during the 1988 and 1989 AMRE audits. As a result, the SEC prohibited Smith and Reed from being assigned to audits of SEC registrants for nine months.
Questions

1. Define the terms ethics and professional ethics. Using the following scale, evaluate the conduct of each individual involved in this case.

   -100 .......................... 0 .......................... 100
   Highly                      Highly
   Unethical                   Ethical

2. Do you believe that the individuals who behaved unethically in this case were appropriately punished? Defend your answer.

3. Identify the alternative courses of action available to Martirossian when he became aware of the accounting fraud at AMRE. Assume the role of Martirossian. Which of these alternatives would you have chosen? Why?

4. Was AMRE's practice of deferring a portion of its advertising costs in an asset account appropriate? Defend your answer.

5. What key red flags, or audit risk factors, were present during the 1988 and 1989 AMRE audits? Did Price Waterhouse appropriately consider these factors in planning those audits? Why or why not?

6. Was Price Waterhouse justified during the 1988 audit in agreeing to allow client personnel to observe the physical counts at certain inventory sites? To what extent should an audit client be allowed to influence key audit planning decisions?

7. SAS No. 31, "Evidential Matter," identifies five management assertions that underlie a set of financial statements. Which of these assertions should have been of most concern to Price Waterhouse regarding the large period-ending adjustments AMRE recorded during the fourth quarter of fiscal 1989?

8. What responsibility do auditors have for quarterly financial information reported in the footnotes to a client's audited financial statements?