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Auditors' Duty to Respond to "Red Flags" Indicative of Overvaluation of Inventory: A Case Study of Sanchez v. Deloitte & Touche

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ABSTRACT: This is a legal case study of *Sanchez v. Deloitte & Touche*. It covers: (a) legal elements of a securities fraud claim; (b) the effect of the Private Securities Litigation Reform Act upon the pleading of an auditor's complicity in securities fraud; (c) how SEC Rule 10b-5 affects auditors; (d) potential red flags pertaining to an audit client's deficient inventory control system;
(e) the failure of a client's internal controls to detect a gross overvaluation of inventory; (f) the failure of an auditor to ensure that the client's inventory is valued at the lower of cost or market, as required under General Accepted Accounting Principles; (g) the court's decision as to whether the auditor in this case was liable for complicity in securities fraud, the court's legal justification for the decision, and the impact of the red flags on the court's decision.

KEYWORDS: Auditor, Duty, Securities Fraud, Red Flags, Inventory, Overvaluation

I. GENERAL PROBLEM

The problem in this article is to study the legal case of *Sanchez v. Deloitte & Touche* and to focus on: red flags indicative of overvaluation of inventory, how an auditor's opinions on the financial statements and the client's internal controls impact a securities fraud case, the legal elements required to prove that an auditor is complicit in securities fraud, and whether the auditor in this case was complicit.

II. REVIEW OF THE LITERATURE: "RED FLAGS" INDICATIVE OF ILLEGAL OR UNETHICAL ACTIVITY OF A BUSINESS FIRM

Jaba (2012) investigated the risk of fraud in reference to the fraud triangle factors and financial indicators that the literature often refers to as "red flags;" the study showed that a business firm's risk of fraud is primarily influenced by its degree of financial leverage. Stanistic (2013) studied red flags indicative of financial trouble in the banking sector of Serbia; he emphasized the importance of auditor independence and external audits as a means of providing confidence to stakeholders in those banks. Amaechi (2013) explored the use of financial ratios to detect fraud in the Nigerian banking system; regression analysis showed that 16 of 29 financial ratios tested were statistically significant indicators of fraud in the financial statements of banks. Varma (2013) demonstrated how to use an Excel sheet to perform Benford distribution statistical tests as an effective tool for locating red flags in suspected data pertaining to business firms in a supply-chain network. Abdullatif (2013) explored how CPA firms in Jordan modify their audit plan whenever red flags indicate a greater risk of fraud in audit clients; the most important fraud risk factors were the attributes of the client's management and their attitude towards the audit. Kassem (2014) proposed a framework for external auditors to help them properly assess and respond to red flags associated with asset misappropriation, a type of fraud which has received less attention in the literature. Using questionnaire data, Bazrafshan (2016) compared perceptions of fraud risk factors between auditors and university students; he found that both groups believe the most important red flags indicative of fraud are degree of dependence of managers' salaries on operating results of the firm, and management's lack of supervision over subordinates in implementation of internal controls. Grenier (2017) provided evidence that, under common audit conditions, an auditor's degree of industry specialization inhibits some aspects of his professional skepticism; his study finds that audit firm efforts to promote professional skepticism are more effective for specialists as non-specialists are skeptical regardless of these efforts. Pazarskis (2017) researched 12 Greek firms that committed financial statement fraud during 2008-2015 and used 12 other, non-fraudulent firms as a control sample; he developed a model using financial ratios than can be used to analyze financial statements for fraud, with an accuracy rate exceeding 90 percent. Del Magro (2017) studied red flags that can be used to assess a business firm's fraud risk; in a sample consisting of 51 internal auditors working in credit unions in Brazil, he found that they attributed greater importance to red flags relating to operational activities and internal control procedures. Varma (2017) explored how Enterprise Resource Planning systems can be used to detect fraud relating to a business firm's vendors, red flags pertinent to vendor fraud and types of vendor fraud; the article emphasized giving greater attention to ensuring that potential fraudsters do not get access to the firm's vendor master file. Huang (2017) identified financial statement fraud detection factors using the fraud triangle risk elements; the most important dimension was shown to be "pressure/incentive" and the least one was "attitude/rationalization," and the top 5 determinants of pressure/incentive were poor performance, the need for external financing, financial distress, insufficient board oversight, and degree of competition or market saturation. Utami (2020) investigated red flags indicative of fraud in 14 Indonesian banks; the results showed that internal controls and organizational culture had a significant positive effect on early detection of fraud. Safta (2020) looked at the manipulation of financial statements as a significant red flag indicative of potential fraud; using data from 62 Romanian business firms, the researcher found that 84% of the firms in the study manipulated their financial statements, with the greatest amount of manipulation occurring in the fields of tourism, construction, trade and transport. Brazel (2021) found that when managers identify red flags in the financial statements under their review, they have greater concern over earnings quality; when red flags are present, managers are more likely to report those both to their CEO and to the external auditor. In a legal case study, Blythe (2021, KPMG case) explored whether "red flags" ignored by the auditor, coupled with the auditor's violation of Generally Accepted Auditing Standards, were sufficient grounds to deny the auditor's motion to dismiss the securities fraud case against him; the court answered this question in the affirmative, but only if the red flags were significant, and the court held the red flags were insufficient in that case. In another legal case study involving alleged securities fraud, Blythe (2021, Aegean Marine case) noted that the court had found 13 red flags which should have alerted the auditor to the possibility of the client's fraud, that the auditor had exhibited "willful blindness" in not responding to those red flags, and the auditor's motion to dismiss the case was denied.

Missing from the literature is a study of a recent legal case pertaining to an auditor's duty to recognize red flags indicative of deficient inventory control, and legal elements required to plead a case of an auditor's complicity in securities fraud. This study will fill that gap and will enrich the literature.

III. SPECIFIC OBJECTIVES

The objectives of this article are to analyze the legal case of *Sanchez v. Deloitte & Touche* and to: (a) explain the elements of a case of securities fraud pursuant to the Securities and Exchange Act of 1934, and tell how the auditor in this case allegedly violated that statute; (b) describe the effect of the Private Securities Litigation Reform Act on a plaintiff's pleading of a securities fraud claim, and tell how that statute affects the plaintiff's pleadings in this legal case; (c) explain SEC Rule 10b-5 and tell how the auditor in this case allegedly violated Rule 10b-5;

(d) describe the potential red flags pertaining to the audit client's deficient inventory control system; (e) indicate the failure of the client's internal controls to detect a gross overvaluation of inventory; (f) illustrate the failure of the auditor to ensure that the client's inventory was valued at the lower of cost or market, as required under General Accepted Accounting Principles; and (g) explain the court's decision as to whether the auditor in this case was liable for complicity in securities fraud, the court's legal justification for the decision, and the impact of the red flags indicative of inventory overvaluation on the court's decision.

IV. RESEARCH METHOD: A CASE STUDY OF *SANCHEZ v. DELOITTE & TOUCHE*

A. Facts of the Case

Crocs, Inc. (Crocs) is a U.S. corporation located in the State of Colorado. The company is a shoe manufacturer that was founded in 2002. In the beginning, it sold only one product, in six different colors. The shoe was successful and the firm grew rapidly. By 2006, it had expanded its product line to include a variety of footwear, apparel, accessories, and sports equipment. Its products were sold in 11,000 domestic retail stores and 8,000 retail stores in foreign countries. It also managed manufacturing plants, or contracted with third-party manufacturers, all over the world; the majority of its footwear was manufactured by a Chinese company (Crocs case, p. 711).

Despite its expansion, Crocs continued to use archaic, error-prone Excel spreadsheets to track inventory and forecast sales, instead of adopting modern inventory control software which provides real-time, continuously-updated information on a firm's inventory. Additionally, the same barcode was assigned to multiple products, and there no written company procedures or a formal operations manual (Crocs case, p. 712).

This primitive system created numerous problems with the company's inventory. Because its inventory data was often incorrect, Crocs would often order inventory in bulk quantities and styles, much of which it would not sell. Some of the style/color/size combinations that the company manufactured had a low probability of being sold; for example, thousands of pairs of size 13 women's shoes in unusual colors had been ordered and gathered dust on the shelves. Simultaneously, Crocs often ran short of its best-selling shoes, and could not keep up with the demand for those models. Also, filling orders from retail stores was difficult because no one had reliable data on inventory, and the inventory would often be far away from the retail store that ordered it; as a result, Crocs often sent the wrong orders to retailers. The company also ordered its Chinese manufacturing plant to continue producing as many as 1.5 million shoes a week in order to combat counterfeit Crocs shoes that were being sold on the black market. Often, the Chinese manufacturing plant produced lower-quality shoes, resulting in an increase in returns (Crocs case, p. 712).

Because of the absence of an effective inventory control system, Crocs' inventory increased four-fold from August to December, 2006, and increased the same amount again in 2007 through the end of the third quarter, and then again in the fourth quarter of 2007 and the first quarter of 2008. Crocs' managers were aware of the out-of-control, skyrocketing inventory; they discussed the matter in internal communications. Although management recognized that demand for the shoes was decreasing, it believed that demand would rebound, and therefore the company continued its high production level despite the substantial inventory increase. The company's primitive information technology and inventory control were brought to management's attention; in September, 2007, shortly after joining the firm, the head of information technology sent the Chief Financial Officer a critical report detailing flaws in the data management system (Crocs case, p. 712).

Notwithstanding the significant inventory issues during this period, Crocs valued its inventory at historical cost. In retrospect, of course, it should have applied the "lower of cost or market" rule and written down the value of the inventory, but it did not. During 2006 and 2007, Crocs' auditor was Deloitte & Touche (Deloitte). Apparently, Deloitte saw nothing amiss and issued unqualified audit opinions in both years; those audited financial statements were attached to the 10-K Reports filed with the Securities and Exchange Commission (SEC). In 2006, Deloitte expressed a disclaimer regarding the effectiveness of Crocs' internal controls; in 2007, however, Deloitte issued an unqualified opinion regarding the effectiveness of the internal controls (Crocs case, pp. 712-713).

Beginning in late 2007, Crocs began to publicly disclose its inventory issues. For example, on Ocrober 31, 2007, the company partially revealed its inventory build-up, causing its stock price to drop 36% in a single day. On April 14, 2008, Crocs announced that its inventory had increased between 5 and 10% in the past three months, resulting in a 45% plunge in the stock price. Finally, in November 2008, Crocs wrote down the value of its inventory by over $70 million.
The value of the company's stock plummeted and the Crocs stockholders incurred huge losses (Crocs case, p. 713).

In 2011, the Crocs stockholders filed a class action securities fraud lawsuit against Crocs, several officers of Crocs, and Crocs' auditor, Deloitte. The lawsuit alleged that the officers had violated the Securities Exchange Act (Exchange Act) s 10(b) by misrepresenting the inventory valuation in the firm's 2006 and 2007 financial statements; the lawsuit also alleged the officers had violated SEC Rule 10b-5 by filing audited financial statements with the SEC in those years, with knowledge that the inventory value in those financial statements was grossly inaccurate. The lawsuit alleged that the auditor, Deloitte, had also violated the Exchange Act and Rule 10b-5. The suit alleged that various company reports had fraudulently represented the value of the inventory and the adequacy of its internal controls over financial reporting and that Deloitte knew well before 2008 that the majority of Crocs' inventory was unsalable or unsuitable and could not be sold at cost. Accordingly, plaintiffs alleged Deloitte had committed securities fraud when it issued unqualified audit opinions on the financial statements in 2007 and 2008, and when it issued an unqualified opinion on the effectiveness of the internal controls in 2008. The district court dismissed the complaint for failure to state a claim, and plaintiffs appealed. The Tenth Circuit Court of Appeals affirmed the district court's dismissal of plaintiffs' complaint. The court held that the securities fraud allegations in plaintiffs' complaint lacked the particularity required under the Financial Securities Litigation Reform Act: (1) the general statement that Deloitte's personnel were regularly present at the company and had access to its confidential documents was insufficient to show the auditor was reckless, absent specific allegations identifying documents that would have alerted the auditor to inventory tracking problems at Crocs; and (2) the general statement that Crocs had an inefficient data management system was insufficient to show the auditor was reckless, because this was not an obvious red flag from which the auditor could have known the inventory was overvalued (Crocs case, p. 711).

B. Pursuant to the Securities Exchange Act of 1934, What Are the Legal Elements of a Securities Fraud Case?

In the aftermath of the stock market crash of 1929 and the Great Depression which followed, two federal U.S. statutes were enacted pertinent to regulation of the sale of securities (stocks and bonds) on stock exchanges: the Securities Act of 1933 and the Securities Exchange Act of 1934 (Exchange Act). The 1933 statute regulated initial public offerings of securities. The 1934 statute regulated public offerings of securities following the initial offering, and it also created the Securities and Exchange Commission (SEC), the federal agency charged with enforcement of the 1933 and 1934 statutes. These two statutes are inapplicable to private corporations, i.e., those corporations whose securities are not traded on a public exchange.

Under Section 18a of the Exchange Act, in order to plead a case of securities fraud, a plaintiff is required to state that: defendant made a materially false or misleading statement; the statement was contained in a document filed pursuant to the Exchange Act or any rule or regulation thereunder; plaintiff relied on the false statement; and plaintiff thereby incurred a loss.

In the present case, plaintiffs sued the auditor, alleging that Deloitte had committed securities fraud by: (a) making false statements in its audit report; (b) filing the audit report with the SEC; (c) the audit report was read by plaintiffs; (d) plaintiffs relied on the false statements in the audit report by purchasing the Crocs stock; and (e) plaintiffs thereby incurred a financial loss. The false statements allegedly made by Deloitte are contained in the audited financial statements (Crocs case, p. 718).

C. What is the Effect of the Private Securities Litigation Reform Act (PSLRA) on a Plaintiff's Pleading of a Securities Fraud Claim?

The PSLRA, a federal securities statute enacted in 1995, was designed to prevent unwarranted or frivolous lawsuits from being filed, which can be expensive, time-consuming and can reduce the efficiency of the legal system. The PSLRA requires a plaintiff to state with particularity the circumstances constituting defendant's fraud or mistake. Conclusory allegations are insufficient. Plaintiffs must comply with stringent pleading requirements, *to wit*: they must allege specific fraudulent statements made by defendant, that the statements were made recklessly or intentionally, and that they relied upon the false statements and thereby incurred a financial loss because of the fraud. Before the PSLRA was enacted, plaintiffs could reasonably file a lawsuit simply because the price of a security had changed significantly (Chen, 2020).

In this case, plaintiffs did not comply with the stringent pleading requirements of the PSLRA because plaintiffs did not state with specificity how Deloitte had failed to properly perform its audits of Crocs. In their complaint, plaintiffs failed to identify the documents that allegedly alerted the auditors to inventory tracking problems at Crocs, and they failed to identify the supposedly-obvious red flags that allegedly indicated to Deloitte that the inventory was overvalued (Crocs case, pp. 721-723).

D. What Is the Significance of SEC Rule 10b-5 In This Case?

SEC Rule 10b-5 broadly prohibits publicly-traded corporations' fraudulent and deceptive practices and untrue statements or omissions of material facts in connection with the purchase or sale of any security. Unlike Section 18 of the Exchange Act, this provision applies to any information released to the public by the issuing corporation, including press releases and annual and quarterly reports to stockholders. In this case, SEC Rule 10b-5 was allegedly violated in 2007 and 2008 when Crocs filed inaccurate financial statements with the SEC (Crocs case, p. 718).

E. According To Plaintiffs' Complaint, What Were the "Red Flags?"

The red flags were Crocs' flawed data management system and inventory reporting, including use of error-prone Microsoft Excel spreadsheets to monitor its inventory, the lack of formal written operating procedures or accounting processes, the rapid increase in Crocs' inventory, and the existence of several risk factors, such as the company's rapid growth and expansion into foreign countries. Plaintiffs alleged that some of these issues were obvious; for example, the data management system problem was so apparent that the head of Crocs' information technology department identified it within months of being hired (Crocs case, pp. 714-715).

F. May a Legal Inference of Recklessness of an Auditor Be Justified if the Auditor Was Aware of, But Ignored, Red Flags Indicative of the Client's Misconduct?

Yes. Where warning signs are so irregular as to put an auditor on notice for fraud, a court may infer that the danger of misleading buyers or sellers of the client's securities is so obvious that the auditor must have been aware of it. Such an inference may be warranted where an auditor's auditing and accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious (Crocs case, pp. 721-722).

G. On the Other Hand, May a Legal Inference of an Auditor Be Justified if the Auditor Was Unaware of the Red Flags?
No. An inference of recklessness may be justified where the defendant was aware of, but failed to investigate, certain red flags that plainly indicated misconduct of the client's officers or directors. However, the mere fact that an auditor missed what a plaintiff labels obvious warning signs gives little support by itself to the conclusion that an auditor was reckless, or willfully blind. This is because an unseen red flag cannot be heeded (Crocs case, pp. 722-723).

H. Why Are Crocs' Internal Controls, Or Lack Thereof, Significant In This Case?
Deloitte issued unqualified audit opinions on Crocs' financial statements in both 2006 and 2007. In the 2006 audit, Deloitte considered internal control over financial reporting only as a basis for designing audit procedures to be used in its financial statement audit; Deloitte did not express an opinion on the effectiveness of the internal controls, so it issued a disclaimer that it had evaluated the internal controls. However, in 2007, Deloitte did evaluate the internal controls and expressed an unqualified opinion on the effectiveness of the controls over financial reporting (Crocs case, p. 713).

In November 2008, less than one year after issuing unqualified opinions on both the financial statements and the internal controls, Crocs was forced to write down the value of its inventory by more than $70 million. Obviously, the internal controls that Deloitte had touted in 2007 were woefully deficient (Crocs case, p. 713).

I. Pursuant to Generally Accepted Accounting Principles (GAAP), Was Crocs Justified in Writing Down the Value of its Inventory?
Yes. The general rule under GAAP is that inventory should be valued at the lower of cost or market. In this case, Crocs' inventory market value had fallen far below its cost. Crocs was not only justified—but compelled—by GAAP to write down the value of the inventory by $70 million (Crocs case, p. 713).

J. In a Securities Fraud Claim Against an Auditor, How Can the Scienter Element Be Proven?
In this appeal to the U.S. Court of Appeals, plaintiffs challenge the district court's dismissal of their securities fraud claim against Deloitte. They argue that the complaint adequately states the false statements made by Deloitte in the 2006 and 2006 10-K Reports filed with the SEC, and that those false statements support a strong inference of scienter against the auditor (Crocs case, pp. 718-719).

The Court of Appeals held that plaintiffs had failed to comply with the stringent pleading standard for scienter imposed by the PSLRA. In this case, scienter pertains to whether Deloitte made the false statements in the 10-K Reports with intent to defraud investors, or with conscious disregard of a risk that stockholders would be misled. The scienter element of a securities fraud claim may be satisfied by allegations of either intent or recklessness: (1) Intentional conduct may be easily identified because it includes deliberate illegal acts or omissions; (2) Recklessness requires an auditor to have knowledge of a fact that is so material that the auditor must have been aware of both its materiality and that its non-disclosure would likely mislead investors in the client's securities; recklessness involves conscious misconduct, and negligence or even gross negligence fall below the high bar for liability imposed by the PSLRA (Crocs case, pp. 718-719).

K. As a Result of the Red Flags Which Deloitte Either Knew About or Should Have Known About, Was Deloitte Complicit in Securities Fraud?
No. Without allegations the auditor had actual awareness of any fraud, missed red flags at most supports an inference of gross negligence; as stated above, even gross negligence is insufficient to show the requisite degree of scienter in a securities fraud case. An unseen red flag cannot be heeded. In this case, the sole alleged basis for Deloitte's knowledge of the red flags is that Deloitte's employees were regularly present at Crocs and had access to Crocs' confidential internal corporate, financial, operating and business information. However, these generalized allegations that the auditor had access to the client's business records are "insufficiently concrete" to prove that the auditor was aware of any red flags, or that the auditor's failure to see the red flags constituted willful blindness; compare this case to the Aegean Marine case, where the court held that the auditor had exhibited "willful blindness" in its failure to see the 13 red flags indicative of managerial fraud (Crocs case, pp. 720-721; and Aegean Marine case).

L. What Was the Final Outcome in This Case?
The Crocs stockholders' lawsuit against auditor Deloitte was dismissed (Crocs case, p. 711).

V. CONCLUSIONS AND IMPLICATIONS FOR AUDITORS
A. The elements of a securities fraud case pursuant to the Exchange Act are: a materially false statement of defendant contained in a document filed with the SEC; the false statement was relied upon by plaintiff; and this caused plaintiff's financial loss.

B. The Private Securities Litigation Reform Act requires a plaintiff to comply with stringent pleading requirements and he must allege: specific fraudulent statements made by defendant; the statements were made recklessly or intentionally; and plaintiff justifiably relied upon the statements, thereby incurring a financial loss.

C. SEC Rule 10b-5 requires publicly-traded corporations to be honest and forthright in information they disseminate to the public. This rule is broader than Section 18 of the Exchange Act and applies not only to statements filed with the SEC, but also to press releases and quarterly and annual reports issued to stockholders.

D. Potential red flags pertaining to a client's deficient inventory control system include: lack of formal written operating procedures or accounting methods pertinent to inventory, a rapid increase in the value of inventory on the client's books, use of Excel spreadsheets to monitor and forecast inventory instead of adoption of a real-time, continuously updated inventory management system, and the presence of additional risk due to rapid growth and expansion into foreign countries.

E. An auditor's evaluation of the effectiveness of internal controls should include the ability of those controls to indicate potential inventory control problems.

F. An auditor should ensure that the client is adhering to Generally Accepted Accounting Principles. In this case, the client failed to apply the "lower of cost or market" rule in the 2006 and 2007 financial statements, but the auditor disregarded this matter and issued unqualified audit opinions in both years.

G. In order to hold an auditor complicit with management in a securities fraud case, a legal inference of recklessness of the auditor may be justified if the auditor was aware of, but ignored, red flags indicative of the client's misconduct.

H. On the other hand, a legal inference that the auditor was reckless is not justified if the auditor was unaware of the red flags.

I. In this case, there is insufficient evidence that the auditor, Deloitte, was aware of the red flags. An unseen red flag cannot be heeded. Accordingly, the securities fraud lawsuit against Deloitte was dismissed.

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