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Big Ernst and Young Settlement on Bally Fitness, Large Implications

Friday, December 18, 2009

Big Ernst and Young Settlement on Bally Fitness, Large Implications

This is the leading item on the SEC.gov website today, with the SEC charging Ernst & Young LLP and 6 current and former partners for their roles in the accounting fraud at Bally Total Fitness Holding Corporation.

The SEC's key finding: E&Y knew or should have known about Bally's fraudulent financial accounting and disclosures; and despite that, the firm issued unqualified audit opinions that Bally's 2001- 2003 financial statements were in line with US GAAP, and the audit itself was conducted in accordance with GAAS. The SEC indicates these opinions were "false and misleading". The fraud accounting includes prematurely recognizing revenue and improperly deferring costs, which overstated income and inflated stockholders' equity. The SEC claims that "E&Y did not express a qualified or adverse audit opinion, or refuse by disclaimer to express any opinion at all, but instead issued audit reports that contained unqualified opinions on Bally's 2001-2003 financial statements.", and this is indisputably incorrect.

E&Y, statutory auditor for Bally's has agreed to pay \$8.5 million to settle the SEC's charges; and each of the E&Y partners also has settled the SEC's charges against them.

The SEC sounded an very alarming note of concern. According to Robert Khuzami, Director of the SEC's Division of Enforcement. "It is deeply disconcerting that partners, even at the highest levels of E&Y, failed to fulfill their basic obligations to the investing public by not conducting proper audits. This case is a sharp reminder to outside auditors that they must carry out their duties with due diligence. The \$8.5 million settlement, one of the highest ever paid by an accounting firm, reflects the seriousness of their misconduct," said

"Ernst & Young and its partners on the Bally engagement violated their fundamental duty to function as public watchdogs, even after E&Y personnel identified Bally as one of the firm's riskiest audit clients," added Fredric D. Firestone, Associate Director in the Division of Enforcement.

The SEC also charged Bally's former CFO John W. Dwyer and former controller Theodore P. Noncek, who also agreed to settle the SEC's charges.

The SEC states that E&Y had already identified Bally as a risky audit because its managers were former E&Y audit partners who had "historically been aggressive in selecting accounting principles and determining estimates," and whose compensation plans placed "undue emphasis on reported earnings." Out of more than 10,000 audit clients in North America, E&Y identified Bally as one of E&Y's riskiest 18 accounts and as the riskiest account in the Lake Michigan Area.

The SEC indicates that the 3 E&Y partners knew or should have known that E&Y's unqualified audit opinions regarding certain Bally financial statements were materially false. In addition to agreeing to pay \$8.5 million to settle the SEC's charges, E&Y agreed to undertake measures to correct policies and practices relating to its violations, and agreed to cease and desist from violations of the securities laws.

Ernst & Young issued a statement saying, "These settlements allow us and several of our partners to put this matter behind us and resolve issues that arose more than five years ago."

Wow!

There are so many critical points in this news release.

First, there is a lot of messiness in Bally itself. The company was charged with sales fraud by the NY State AG and the SEC launched an accounting investigation in 2004. The company went into bankruptcy in August 2007, emerged from bankruptcy in October 2007 100% owned by a hedge fund, Harbinger Capital and then refilled for bankruptcy in

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December 3, 2008. Note that the sales fraud (1999 – 2004) and the bankruptcy yo-yo (2007 – 2008) were unrelated to the accounting issues

Second, the SEC appears to be taking this very seriously. Note the inherently strong language in their statement and their comments. This is not your ordinary rap on the knuckles, and the amount fined “one of the highest ever paid by an accounting firm” shows that the SEC wants to showcase this particular situation as a warning to all other accounting firms: “failed to fulfill their basic obligations”
 “sharp reminder to outside auditors”
 “seriousness of their misconduct”
 “violated their fundamental duty to function as public watchdogs”

Third, the circumstances of E&Y's involvement in Bally appear to be quite dubious. ...“its managers were former E&Y audit partners who had “historically been aggressive in selecting accounting principles and determining estimates,” and whose compensation plans placed “undue emphasis on reported earnings.””. Wait a minute, were Bally managers ex Ernst and Young partners? Which managers were they? – CEO, CFO, CAO, its not specified. Were they known to take aggressive positions within E&Y or after leaving? Were their compensation based on achieving certain EPS targets? And going around GAAP and getting the auditors' consent a way to get more bonus? So many unanswered questions.

Fourth, “E&Y agreed to undertake measures to correct policies and practices relating to its violations, and agreed to cease and desist from violations of the securities laws.” This is a large commitment on the part of E&Y to make changes in their internal procedures, and also not to ever be afool of securities laws. Look for some tough modifications on how audits are conducted by E&Y in the future with checks and counter checks to ensure that client financial statements are in conformance with GAAP and external audits are thorough, insightful and detailed to prevent sign-offs on any companies which do not comply. The SEC has specified 8 such actions that will be undertaken rather immediately by E&Y.

Finally, this is indeed a wake-up call for the Big Four firms and the accounting industry. The SEC is getting tough, and has demonstrated here that it will allow no breach of laws and investor protection, no matter how old the case and how messy the other circumstances are for the ultimate client.

This case points out the long-tail impact of a bad audit, in causing distress to accounting firms, many years after the audit has been completed. And we don't think this is the end of the affair, there are a lot of other pending accounting investigations with the SEC, Huron Consulting for example, and the outcomes for firms convicted of wrong doing are going to be high. The SEC is just emerging itself from getting a bad rap in the Madoff affair, so may be getting a little more aggressive and assertive than in previous years. Also investors would hope for drastic changes in the audit process of accounting firms, if the firms' integrity as ultimate protectors of investors' interests has to be fully and firmly re-established.

The Ernst and Young case is fully specified here: [Click here to download full SEC case on E&Y](#)

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