In the late 1970s, William Nashwinter accepted a position as a salesman with Doughtie's Foods, Inc., a publicly owned food products company headquartered in Portsmouth, Virginia.1 The ambitious young salesman impressed his superiors with his hard work and dedication and was soon promoted to general manager of the Gravins Division of Doughtie's, a promotion that nearly doubled his salary. The Gravins Division was essentially a large warehouse that wholesaled frozen-food products to retail outlets on the East Coast.

Nashwinter quickly discovered that managing a large wholesale operation was much more complicated and stressful than working a sales route. Within a short time after accepting the promotion, Nashwinter found himself being maligned by corporate headquarters for his division's poor performance. After several rounds of scathing criticism for failing to meet what he perceived to be unrealistic profit goals, Nashwinter decided to take matters into his own hands. The young manager began fabricating fictitious inventory on his monthly performance reports to headquarters. By inflating his monthly inventory balance, Nashwinter lowered his division's cost of goods sold and thus increased its gross profit.

Several years later, Nashwinter insisted that he had never intended to continue his scheme indefinitely. Instead, he saw his actions simply as a solution to a short-term problem: “I always had in the back of my mind that the division would make enough legitimate profit one day to justify the fake numbers.”2 Unfortunately for Nashwinter, his division's actual operating results continued to be disappointing. With each passing year, Nashwinter had to fabricate larger amounts of fictitious inventory to reach his profit goals. Finally, in 1982, Nashwinter admitted to a superior that he had been filing false inventory reports to corporate headquarters for several years. Doughtie's management immediately fired Nashwinter and retained Price Waterhouse to determine the magnitude of the inventory errors in Gravins' accounting records and their impact on the company's consolidated financial statements. Price Waterhouse's study revealed that Nashwinter's scheme had overstated Doughtie's 1980 consolidated net income by 15 percent, while the company's 1981 net income had been overstated by 39 percent.3

Nashwinter used simple methods to misrepresent his division's inventory. In 1980, he inflated Gravins' inventory by including three pages of fictitious inventory items in the count sheets that summarized the results of the division's annual physical inventory. Nashwinter also changed the unit of measure of many inventory items. Rather than reporting 15 single boxes of a given product, for example, Nashwinter changed the inventory sheet so that it reported 15 cases of the product. In 1981, after Doughtie's acquired a computerized inventory system, Nashwinter simply input fictitious inventory items into his division's computerized inventory ledger.

In 1980 and 1981, the CPA firm of Goodman & Company audited Doughtie's. Thomas Wilson of Goodman & Company served as the audit manager on the 1980 audit and as the audit engagement partner the next year, after having been promoted to partner. In both years, Frank Pollard was the audit supervisor assigned to the Doughtie's engagement. Following the disclosure of Nashwinter's scheme to the Securities and Exchange Commission (SEC) by Doughtie's executives, the federal agency began investigating the 1980 and 1981 audits of the food distribution company. The SEC subsequently criticized Wilson and Pollard for their roles in those audits, particularly for their failure to rigorously audit Doughtie's inventory account.

The SEC maintained that Doughtie's inventory should have been considered a high-risk account and thus subject to a higher-than-normal degree of scrutiny by Wilson and Pollard during the 1980 and 1981 audits. First, inventory was the largest line item on the Doughtie's balance sheet, accounting for approximately 40 percent of the company's total assets. Second, Wilson and Pollard were aware of several weaknesses in Doughtie's internal controls for inventory, particularly within the Gravins Division. These weaknesses increased the likelihood of inventory errors. Finally, the SEC noted that Gravins' inventory increased rapidly during 1980 and 1981. The federal agency maintained that Wilson and Pollard should have considered the audit implications of this high growth rate and the closely related implications of the division's abnormally low inventory turnover.

The SEC also criticized Wilson and Pollard for failing to pursue problems that they or their subordinates uncovered during the 1980 and 1981 audits of Gravins' inventory. Following the completion of the physical inventory for Gravins in 1980, Nashwinter forwarded the three fictitious inventory count sheets to Wilson and Pollard. Nashwinter claimed that the Goodman & Company auditors had overlooked the three count sheets. After briefly reviewing these count sheets, Wilson and Pollard added the items on them to Gravins' inventory. Following the division's 1981 physical inventory, the audit senior on the Doughtie's engagement could not reconcile the quantities for numerous items listed on the inventory count sheets with the quantities shown on the computer printout that summarized the details of Gravins' year-end inventory balance. The senior notified Wilson of the problem and wrote Nashwinter a memo asking for an explanation. Wilson failed to follow up on the problem, and Nashwinter never responded to the memo. In his review of the senior's workpapers, Pollard either did not notice the numerous differences between the count sheets and the computer listing of Gravins' inventory or chose not to investigate those differences.

Nashwinter's testimony to the SEC was not complimentary of Goodman & Company's annual audits. Nashwinter testified that he often made up excuses to account for missing or misplaced inventory and that the auditors apparently never double-checked his explanations. He also testified that the auditors were lax when it came time to test count inventory items in Gravins' blast freezer: “A lot of times the auditors didn't want to stay in the freezer. It was too cold.”4

EPILOGUE

For their roles in the Doughtie's case, the SEC required Wilson and Pollard to complete several professional education courses. The SEC also required that selected audits supervised by the two men in the future be subjected to peer reviews to determine that the appropriate audit procedures had been performed. Goodman & Company was not sanctioned by the SEC, since Wilson and Pollard had failed to comply with the firm's quality control standards. In 1983, Doughtie's dismissed Goodman & Company and retained Price Waterhouse as its audit firm.

To settle the charges filed against him by the SEC, William Nashwinter signed a consent decree in which he neither admitted nor denied the charges but agreed not to violate federal securities laws in the future. At last report, Nashwinter still worked in the food distribution industry.5

**QUESTIONS**

1. In 1981, Gravins' inventory turnover was approximately one-half that of comparable divisions within the firm. How should this fact have affected the planning for the 1981 audit of Doughtie's? What audit procedures should Wilson and Pollard have performed to investigate Gravins' unusually low inventory turnover rate?
2. Nashwinter was under considerable pressure to improve his division's operating results. Discuss how this fact, if known to the auditors of Doughtie's, should have affected their assessment of audit risk for this client.