In 1975, Carlos Cordova and several other investors founded Capital National Bank (CNB) in Bronx, New York. Cordova was appointed the bank's chief executive officer and chairman of the board. Over the next several years, the bank opened five branch offices in the New York City metropolitan area. CNB catered primarily to the banking needs of Hispanic-American and immigrant communities in New York City. In 1986, Cordova and the other owners of CNB formed CapitalBanc Corporation, a publicly owned bank holding company registered with the Securities and Exchange Commission (SEC). Throughout its entire existence, the principal operating entity controlled by CapitalBanc was CNB. Cordova assumed the titles of president, chief executive officer, and chairman of the board of CapitalBanc when it was created.

In the fall of 1987, CapitalBanc retained Arthur Andersen & Co. as its independent audit firm. Andersen's first engagement for CapitalBanc was to audit the bank holding company's consolidated financial statements for the fiscal year ending December 31, 1987. Thomas Curtin, an Arthur Andersen partner since 1979, was the engagement partner for the 1987 CapitalBanc audit. Curtin delegated the responsibility for much of the audit planning to James Lukenda, an audit manager with Arthur Andersen since 1983. Lukenda also supervised the staff auditors assigned to the CapitalBanc engagement.

On December 29, 1987, several Arthur Andersen staff auditors accompanied members of CNB's internal audit staff to the bank's 177th Street Branch. The Arthur Andersen auditors intended to observe and participate in a surprise count of the branch's cash funds by the internal auditors. Related audit objectives were to test CNB's compliance with certain control procedures and to evaluate the competence of the bank's internal audit staff.

1 The facts of this case were drawn from the 1987 annual report of CapitalBanc Corporation and the following source: Securities and Exchange Commission, Accounting and Auditing Enforcement Release No 458, 28 June 1993
The accounting personnel at each CNB branch maintained a “vault general ledger proof sheet” that reconciled the amount of cash on hand at the branch to the balance of the branch’s general ledger cash account. During the surprise cash count at the 177th Street Branch, the Arthur Andersen auditors discovered a $2.7 million reconciling item listed on the branch’s proof sheet. That amount equaled 61 percent of the branch’s general ledger cash balance and 45 percent of the branch’s total cash funds that were supposed to be available on the date of the surprise count. When the staff auditors asked to count the $2.7 million of cash represented by the reconciling item, they were told that Cordova had segregated those funds in a locked cabinet within the bank’s main vault. According to bank personnel, three keys were required to unlock the cabinet. Cordova, who was out of the country at the time, maintained custody of one of those keys.

Stymied temporarily, one of the staff auditors telephoned Lukenda. The staff auditor relayed to Lukenda the information regarding the $2.7 million of segregated cash. After considering the matter and discussing it with Curtin, Lukenda informed the staff auditor that the cash could be counted upon Cordova’s return. Lukenda also reportedly told the staff auditor that it would not be necessary to place audit seals on the doors of the cabinet or to secure it in any other way given the three-key security system used by the branch. Following the telephone conversation with Lukenda, the staff auditor informed bank personnel that Arthur Andersen auditors would count the cash on the date Cordova returned from his trip.

CNB’s practice of segregating a large amount of cash in a facility that was not readily accessible was clearly not a normal banking procedure. In a subsequent investigation, the SEC commented on this practice.

It is an unusual circumstance for a substantial portion of a bank’s cash to be inaccessible for an extended period of time. It is also unusual for a substantial portion of a bank’s assets not to be invested and earning interest for an extended period of time.2

In early January 1988, an employee of the 177th Street Branch informed Arthur Andersen that Cordova would return to the branch on January 14. On that date, the Arthur Andersen staff auditors arrived at the branch to complete their count of the branch’s cash funds. The locked cabinet in the main vault was opened in the presence of the staff auditors. The auditors then proceeded to count the $2.7 million that had not been counted on December 29, 1987. All of the cash was present. None of the other cash funds of the 177th Street Branch or other CNB branches was counted by the Arthur Andersen auditors on January 14, 1988.

After counting the cash in the locked cabinet, the staff auditors asked Cordova why those funds were kept segregated in the locked cabinet. Cordova replied that a customer had previously cashed a large certificate of deposit and insisted on having the funds available on demand at all times. According to Cordova, the customer intended to use the funds to buy foreign currencies when market conditions became favorable. The volatility of the foreign currency market dictated that the customer have access to the funds on a daily basis.

Near the completion of the 1987 Capital Banc audit, Lukenda reviewed the workpaper that documented Cordova’s explanation for the $2.7 million of

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segregated cash. Lukenda then discussed that explanation with Curtin. After considering the matter, Curtin instructed Lukenda to have the staff auditors confirm that there was an offsetting liability to the given customer in CNB’s accounting records equal to the amount of the segregated funds. The staff auditors obtained the documentation for this liability directly from CNB personnel. This information was not confirmed with the customer or independently verified by the auditors in any other way. The staff auditors also did not obtain documentation confirming that the customer in question had cashed a large certificate of deposit. Finally, the staff auditors did not obtain any evidence to corroborate Cordova’s assertion regarding the customer’s planned use of the funds.

Following the completion of the CapitalBanc audit in March 1988, Arthur Andersen issued an unqualified opinion on the firm’s 1987 financial statements. Those financial statements reported a net income of $701,000, total cash funds of $14.1 million, and total assets of $143.2 million. The audited financial statements were included in the 1987 10-K registration statement that CapitalBanc filed with the SEC.

EPILOGUE

In July 1990, the Office of the Comptroller of the Currency declared CapitalBanc Corporation insolvent and placed it under the control of the Federal Deposit Insurance Corporation (FDIC). The following year, Banco Popular de Puerto Rico purchased the assets of CNB from the FDIC.

In late 1991, Carlos Cordova pleaded guilty to three counts of bank fraud and conspiracy to commit bank fraud. Two of Cordova’s associates pleaded guilty to similar charges. Earlier in 1991, Cordova had agreed to an order issued by the SEC that permanently banned him from serving as an officer or director of a public company. A federal investigation of CNB’s financial affairs revealed that Cordova misappropriated at least $400,000 of the $2.7 million allegedly stored in the locked cabinet in the 177th Street Branch’s main vault. Cordova, with the help of his subordinates, had intentionally concealed this shortage from the Arthur Andersen auditors during the 1987 audit. Cordova had secretly returned to the 177th Street Branch on January 9, 1988, and placed cash obtained from other CNB branches in the locked cabinet. As a result, Arthur Andersen’s count of the cash in the locked cabinet on January 14, 1988, failed to uncover Cordova’s embezzlement.

The description of the three-key security system relayed to the Arthur Andersen auditors by employees of the 177th Street Branch was a hoax. The facility...
which they each reside or their principal office is located and they must each become a
member of or be associated with a member firm of the SEC Practice Section of the
AICPA's Division for CPA Firms as long as they practice before the Commission.3

QUESTIONS

1. In auditing cash, which of the five management assertions identified by SAS
   No. 31, "Evidential Matter," is of primary concern to the auditor? Why?
2. Identify audit procedures that should be applied to cash funds maintained by
   a client on its business premises.
3. What mistakes or oversights, if any, were made by Arthur Andersen personnel
during the audit procedures applied to the cash funds of the 177th Street Branch?
   Explain.

3. Ibid.