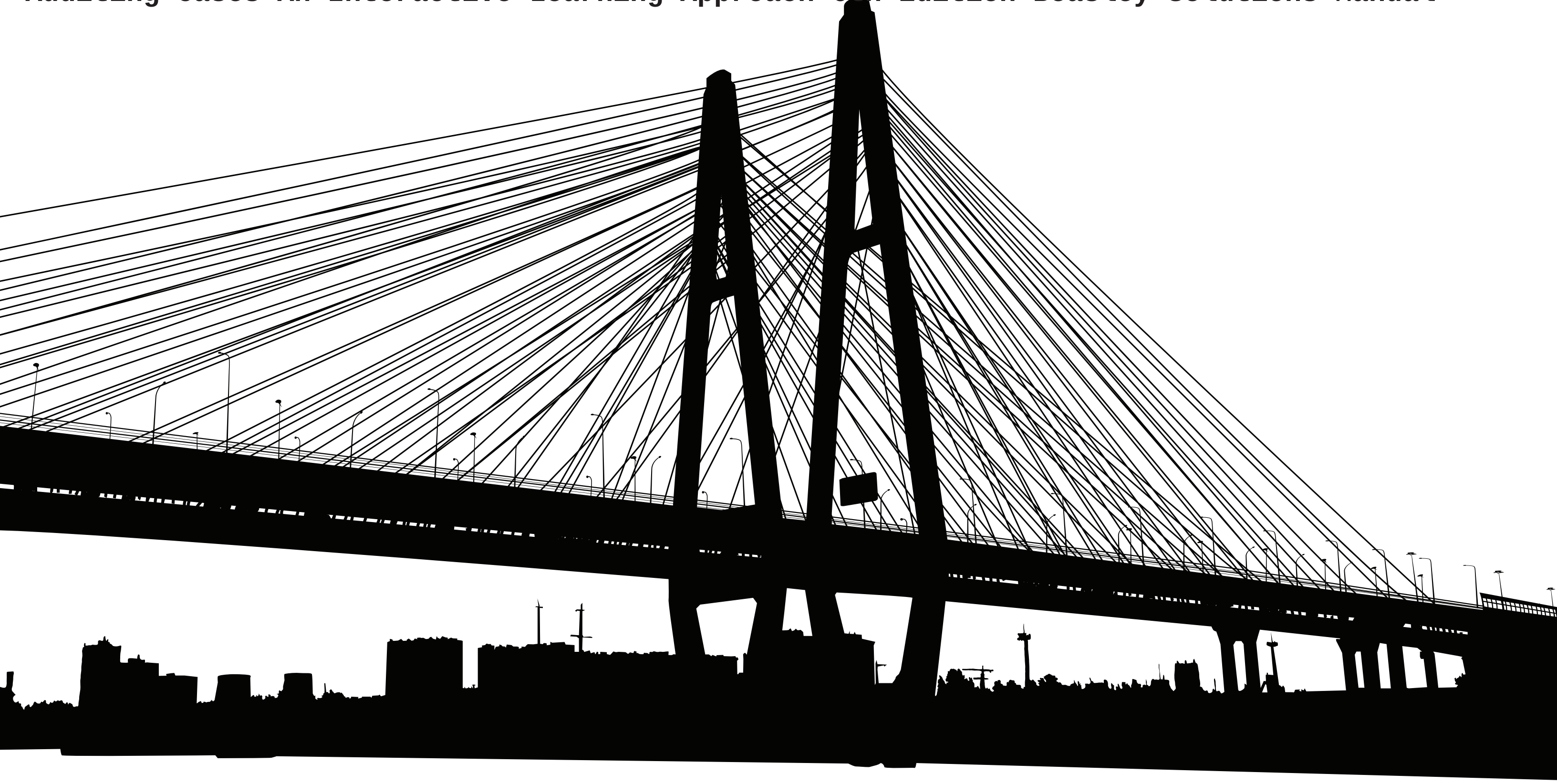

Auditing Cases

Instructor Resource Manual

SIXTH EDITION

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ACKNOWLEDGEMENTS

We would like to thank our families for their understanding and support while writing this casebook. We would also like to thank Jonathan Liljegren for his excellent work in the design and layout of this casebook as well as Karen Kirincich and Ellen Geary for their editorial support.

We are grateful to the research assistants both past and present who have helped write, revise, and review the cases in this edition. We especially thank Truman Rowley and Kyle Stubbs for their assistance with this latest edition.

PREFACE

Auditing educators continue to look for opportunities to increase their emphasis on the development of students' professional judgment, critical thinking, communication, and interpersonal relationship skills. Development of these types of skills requires a shift from passive instruction to active involvement of students in the learning process. Unfortunately, current course materials provided by many publishers are not readily adaptable to this kind of active learning environment, or they do not provide materials that address each major part of the audit process. The purpose of this casebook is to give students hands-on exposure to realistic auditing situations focusing specifically on each aspect of the audit process.

This casebook contains a collection of 49 auditing cases plus a separate learning module about professional judgment that allow the instructor to focus and deepen students' understanding in each of the major activities performed during the conduct of an audit. Cases expose students to aspects of the audit spanning from client acceptance to issuance of an audit report, with a particular focus on how professional judgment is applied throughout the audit. The cases are designed to engage the student's interest through the use of lively narrative and the introduction of engaging issues. In some cases, supporting material in the instructor notes allows the instructor to create a "surprise" or "aha!" experience for the student, creating vivid and memorable learning experiences. Many of the cases are based on actual companies, some involving financial reporting fraud. Several cases give students hands-on experience with realistic audit evidence and documentation. Each case contains a series of questions requiring student analysis, with numerous questions related to the guidance contained in authoritative auditing standards.

NEW TO THE SIXTH EDITION

The sixth edition contains exciting new content that we believe will significantly enhance student understanding of the audit process. For example, this new edition includes:

- A new **Learning Module on Professional Judgment** that exposes students to a professional judgment framework and outlines a framework of good judgment as well as a number of judgment tendencies and traps that can introduce bias into the judgment process. Because professional judgments are required throughout the entire audit process, from client acceptance to report issuance, we included an Introduction to Professional Judgment as an upfront learning module rather than as an individual case. We encourage students to complete this learning module early in their auditing course to expose them to the fundamentals of professional judgment, which they can use as they complete the required professional judgment questions in many of the cases in this edition.
- New questions in many of the cases throughout the sixth edition to help students see the importance of professional judgment in auditing. These questions are separately identified as *"Professional Judgment Questions"* and they challenge students to understand the critical elements of an effective audit judgment process. A number of these questions raise student awareness of potential judgment tendencies and traps that may lead to biased judgments if not appropriately considered. The materials also help students to understand steps that can be taken to mitigate potential biases.
- A new case, **9.7 RedPack Beer Company**, that exposes students to the challenges of auditing accounting estimates, specifically the allowance for bad debts, at a hypothetical brewery. Students are provided the aged accounts receivable trial balance and other

accounts receivable balance information including a transcript of the auditor's interview of the company's credit manager about accounts included in the aging schedule. Students use this information, along with the company's policy and procedures related to the allowance for bad debts, to evaluate the reasonableness of management's recorded estimate. Students are also asked to develop their own estimate and to propose any necessary audit adjustments.

- Updates to reflect new auditing standards issued by the AICPA's Auditing Standards Board including the recently clarified auditing standards (AU-C) up through SAS No. 128, *Using the Work of Internal Auditors*, and the PCAOB's Auditing Standards (up through AS No. 18, *Related Parties*). When relevant, questions expose students to new guidance contained in recently issued auditing standards.
- New questions that introduce students to recent topical issues and their impact to the audit process, such as: COSO's 2013 updated *Internal Control – Integrated Framework*, the impact of cloud computing on IT controls, and recently issued accounting standards. Cases based on events at real companies have been updated to reflect recent developments in the profession.
- Restructured questions in many cases to change the nature of the topics addressed and to expose students to different issues from those examined in prior editions. Many cases also have reordered questions. Dates in the hypothetical cases have been set in calendar year 2015 with audit procedures performed on the 2014 fiscal year information and/or interim procedures performed on the 2015 fiscal year information. When appropriate, we have changed underlying data in the hypothetical cases so that the cases differ from prior editions. All of these changes reduce the potential benefit of students seeking our solutions from prior editions of the casebook. Further, students who inappropriately access and use solutions to prior editions are more likely to be detected by the instructor.

APROPRIATE FOR BOTH UNDERGRADUATE AND GRADUATE AUDITING COURSES

The cases included in this book are suitable for both undergraduate and graduate students. At the undergraduate level, the cases provide students with active learning experiences that reinforce key audit concepts addressed by the instructor and textbook. At the graduate level, the cases provide students with active learning experiences that expand the depth of their audit knowledge. Use of the casebook will provide students with opportunities to develop a much richer understanding of the essential underlying issues involved in auditing, while at the same time developing critical thinking, communication, and interpersonal relationship skills.

The casebook provides a wide variety of cases to facilitate different learning and teaching styles. For example, several of the cases can be used either as in-class exercises or out-of-class assignments. The instructor resource manual accompanying the casebook clearly illustrates the different instructional approaches available for each case (e.g., examples of cooperative/active learning activities and/or out-of-class individual or group assignments) and efficiently prepares the instructor for leading interactive discussions. To access this manual, log on to *www.pearsonhighered.com/beasley6e*.

We are pleased to provide this updated sixth edition and hope that the professional skills of your students will be enhanced through completion of cases contained within this edition.

INTRODUCTION

Professional Judgment

Understanding and Developing Professional Judgment in Auditing and Accounting

Mark S. Beasley · Frank A. Buckless · Steven M. Glover · Douglas F. Prawitt

INSTRUCTIONAL OBJECTIVES

[1] To help students understand that the changing nature of the accounting profession increasingly requires professionals to use professional judgment (e.g., fair value measurements and principles-based standards).

[2] To help students gain an understanding of a good judgment process and practice using it in an accounting context.

[3] To help students identify, recognize and mitigate common judgment traps and tendencies.

[4] To help students gain an understanding of professional skepticism by exploring judgment frames.

BACKGROUND

KPMG LLP, one of the four largest international public accounting firms, launched an initiative in 2009 to enhance the professional judgment and professional skepticism of its people and teams. KPMG collaborated with two professors at Brigham Young University, Professors Steve Glover and Doug Prawitt, to emphasize these skills in its training. The result of this effort is refreshed professional judgment content throughout KPMG's audit training curriculum for all levels of audit professionals.

KPMG took the additional step of sharing and leveraging its professional judgment training content to create, again in collaboration with Brigham Young University Professors Glover and Prawitt, a monograph to help students accelerate the development of their professional judgment while still in college. The monograph is titled Elevating Professional Judgment in Auditing and Accounting: The KPMG Professional Judgment Framework. That monograph is available free of charge for college students and professors on KPMG's University Connection site. (You can find the monograph at http://www.kpmguniversityconnection.com). It is only available in electronic form because it comes as a pdf, with live internet links and audio files embedded. In addition, there are video files and an instructor's manual available separately to professors who register on KPMG University Connection.

This Professional Judgment Module is adapted from the KPMG Elevating Professional Judgment in Auditing and Accounting monograph. It covers some of the topics that are discussed and illustrated in more depth in the monograph. This module can be used as an overview for the monograph and as a brief introduction to professional judgment for those who do not have space in

The case was prepared by Mark S. Beasley, Ph.D. and Frank A. Buckless, Ph.D. of North Carolina State University and Steven M. Glover, Ph.D. and Douglas F. Prawitt, Ph.D. of Brigham Young University, as a basis for class discussion. It is not intended to illustrate either effective or ineffective handling of an administrative situation.

the curriculum to assign the full monograph.

The KPMG Professional Judgment Framework, from which this module is adapted with permission from KPMG, LLP, was awarded the 2013 American Accounting Association/Deloitte Wildman Award. The Wildman award, first presented in 1979, recognizes a work that the judges view as "the most significant contribution to the advancement of the practice of public accountancy" published within the most recent 5-years.

USE OF CASE

The Professional Judgment Introduction is a summary of the KPMG monograph titled, Elevating Professional Judgment in Auditing and Accounting: The KPMG Professional Judgment Framework. The full version of the monograph and accompanying instructor's guide can be found at http://www.kpmguniversityconnection.com. Both the student version and the instructor's guide contain additional links and resources that would be beneficial to students' learning.

This section of the casebook introduces students to the components of a good judgment process. The introduction also discusses traps and biases that can threaten good judgment and suggests common-sense ways to mitigate the effects of those threats.

This section is recommended for use in undergraduate or graduate auditing and accounting courses to introduce students to fundamental judgment concepts. It can be utilized in a variety of ways, depending on the amount of in-class time that is available. For example, all of the reading and work could be assigned outside of class; or the cases found at the end of this section could be used for creating an in-class discussion.

Additionally, as discussed in the preface, we have added various questions to many of the cases that involve exercising the skills discussed and developed in this section. These question questions will allow students to apply what they have learned in this section to a variety of circumstances similar to those that they will experience in their professional careers. Students will need to have read this introduction in order to fully benefit from those questions.

PROFESSIONAL STANDARDS

PCAOB standards are referenced by standard number. Relevant professional standards for this assignment are:

PCAOB Standards: AU Section 230, "Due Professional Care in the Performance of Work"

QUESTIONS AND SUGGESTED SOLUTIONS

[1] ***Identify and describe two common judgment traps***

Rush to Solve and Judgment Triggers. Rush to solve occurs when professionals want to "get to a solution" quickly and as a result tend to skip the first step of the judgment process, which involves identifying the problem or issue to be solved and specifying the objectives to be achieved. Likewise, decision triggers, which are often alternatives masquerading as a problem definition, tend to push the decision maker to fail to consider the problem definition and problem objectives. Skipping this first step of the judgment process usually artificially limits the size of the set of potential alternatives. This is important because a decision can only be as good as the best alternative identified.

[2] ***How can considering multiple judgment frames enhance an auditor's professional skepticism? Explain and give an example.***

Evaluating issues and objectives from different frames can help auditors to understand a variety of different perspectives. Considering multiple frames can bring additional insights or ways to understand a situation. It can also open up a variety of additional alternatives that might not have been considered otherwise. For example, suppose that a client's revenues have increased more than any other company in the industry and that the client attributes its success to a new marketing strategy. The auditor should understand the client's explanation and then apply professional skepticism by considering other possibilities, such as an error in revenue recognition or even financial statement fraud. Considering financial results from that perspective will help the engagement team identify evidence that could help to either identify or rule out the possibility of error or fraud.

[3] ***What is the first step in avoiding traps or reducing bias? Briefly explain why this first step is so important.***

Awareness of potential traps and conditions that lead to bias is the most important factor—it is a necessary first step before any other efforts to mitigate bias can be implemented.

[4] ***Identify and briefly describe three potential ways to mitigate the effects of biases.***

Actively questioning our assumptions, which might include considering potentially disconfirming evidence or seeking more complete information, is a key approach in mitigating all of the judgment biases. Consulting with others can go a long way toward mitigating the effects of the availability tendency. Getting an outside view on a going-concern uncertainty assessment can help keep the auditor's judgment from being too optimistic, or pessimistic, given recent, salient experiences. In other judgment and decision tasks, a helpful approach is to ask others to gather and evaluate information without revealing our preference. (We do not want to reveal our preference because it may affect their judgment just like it may affect our own.) Finally, we can also take steps to objectively evaluate the pros and cons for each alternative. In mitigating bias related to the anchoring tendency, it can be helpful to seek out and explicitly consider alternative anchors.

DISCUSSION CASES

[1] ***An audit engagement team is planning for the upcoming audit of a client who recently underwent a significant restructuring of its debt. The restructuring was necessary as economic conditions hampered the client's ability to make scheduled re-payments of its debt obligations. The restructured debt agreements included new debt covenants. In auditing the debt obligation in the prior year (before the restructuring), the team established materiality specific to the financial statement debt account (account level materiality) at a lower amount than overall financial statement materiality. In planning the audit for the current year, the team plans to use a similar materiality level. While such a conclusion might be appropriate, what judgment trap(s) might the team fall into and which step(s) in the judgment process are most likely affected?***

The team needs to understand the terms of the debt restructuring. If the covenants in the new debt agreements require the company to maintain certain financial ratios (for example, ratio of assets to liabilities greater than 1.5 to 1), the appropriate account level materiality threshold may be lower than the threshold used in the prior year when the debt agreement in place only required the client to meet certain non-financial debt covenants. The traps that the team may have fallen into include both a rush to solve and a judgment trigger in that they may have considered only the same approach or alternative as was used in the prior year, even though conditions have changed in important ways. The step in the judgment process most affected in this scenario is Step 2, "Consider Alternatives."

[2] ***A client is determining its accounting treatment for new types of long-term contracts. Consider the differences in outcome for the two scenarios below regarding the approach the client and***

auditor took. How does framing relate to the two different scenarios?

Scenario A: The client entered into a large number of long-term sales contracts and recorded revenue using an approach they determined was the preferred approach, with no consultation or discussion with the audit engagement team. The engagement team conducted revenue recognition testing to ensure that the client correctly followed the chosen approach. The engagement team noted that the client consistently and accurately applied the approach and determined that the audit testing supported the amount of revenue reported by the client.

Scenario B: Before entering into long-term contracts with customers, the client reached out to the audit engagement team to discuss the client's preferred approach for recognizing revenue. The team researched authoritative accounting standards and considered the client's preferred alternative. The team also considered other possible approaches and consulted with other engagement teams with experience in accounting for long-term contracts. Based on this process, the engagement team determined that although the client's preferred approach had merit, another alternative was more consistent with accounting principles for revenue recognition. The client carefully reconsidered the situation and ultimately decided to use the alternative suggested by the engagement team to recognize revenue associated with the long-term contracts they entered into.

In Scenario A, the auditor appears to have adopted the client's frame without considering alternatives. While the client's accounting treatment may have been correct, the auditor did not apply sufficient professional skepticism. In Scenario B, the auditor took time to understand the client's frame and then also challenged that frame by researching and considering alternative perspectives. Considering more than one frame is the "stuff" of professional skepticism. In Scenario B, rigorous application of professional skepticism led the engagement team to recommend a different revenue recognition accounting treatment.

[3] ***For each of the two audit situations below, determine which judgment shortcut or tendency is most prevalent and briefly describe the likely consequences of using the shortcut.***

[a] ***A staff auditor is testing accounts payable balances. The auditor observes an unexpected fluctuation in the account balance compared to the prior year. The client happens to be walking by, so the auditor asks the client about the fluctuation. The client provides a plausible and reasonable explanation. In considering other possible causes for the fluctuation, the client's explanation seems to be the most likely, so the staff auditor documents it as evidence supporting the fluctuation. Later, it is determined that other facts encountered during the audit do not support the client's explanation.***

It appears the staff auditor was influenced by the availability tendency in considering the client's available and plausible explanation as most likely. The staff auditor may also have been vulnerable to the confirmation tendency. In this scenario, the availability and confirmation tendencies led to shallow thinking, insufficient professional skepticism, lack of corroborating evidence, and weak documentation. Some of the ramifications for the audit could include weak documentation—no corroboration of the client's explanation, and lack of evidence of professional skepticism.

[b] ***A client has provided the audit engagement team an estimate of the inventory valuation reserve. The client used a method for calculating the reserve that had been used in prior years. To audit the reserve, the engagement team obtained and reviewed the client's calculation. However, the team noted that the client's calculation did not reflect a significant decline in customer demand for an older product line that was losing popularity relative to the newer products. The engagement team suggested that the client adjust the reserve upward. The client argued that the current reserve amount was adequate but indicated***

that a small increase in the reserve would be acceptable. The engagement team reviewed the client's proposal, and ultimately accepted the inventory account as fairly stated in view of the increase to the reserve. However, within a few months after the financial statements and audit report were issued, it became apparent that the reserve was insufficient as significant inventory write-downs were recorded for obsolete inventory that was discarded at scrap value.

While it appears that the team initially fell prey to the confirmation tendency in auditing to the client's reported value, the team did recognize the need to increase the reserve for the drop in market demand. Thus, the tendency that ultimately led to biased judgment in this scenario likely is the anchoring tendency. The auditor accepted an insufficient adjustment to the reserve because the client's initial estimate served as an anchor. The bias impacted Steps 3 and 4 of the judgment process, and led to a biased reserve estimate.

[4] ***For each of the two audit situations below, determine which judgment tendency (or tendencies) is (or are) most prevalent and what the auditor could do to reduce bias.***

[a] ***A client contacts the audit partner regarding the likely fee for the upcoming audit. The engagement team is in the early stages of planning interim and final fieldwork including making personnel assignments and estimating required audit hours. In the prior year the total hours for the audit were 900 hours. The engagement partner tells the client's CFO that, because the engagement team is returning and is very familiar with the client, the level of audit effort should be only slightly greater than that of the prior year, even though the client has acquired a new subsidiary and has begun manufacturing a new product line.***

The audit partner may anchor on the prior year's budgeted hours, and she may adjust insufficiently away from that starting point. Once aware of this possibility, the partner may want to explicitly consider other possible anchors, such as the effect on budgeted hours on other similar engagements of changes such as an acquisition or new product line that occurred during the year.

The audit partner also is likely to be overconfident in her estimate that the team will need only a slightly greater number of hours to complete the audit given the changes at the client. Awareness that overconfidence is a common tendency (and one that tends to worsen with experience) is key to mitigating the effects. Once aware, the partner may want to defer her response until her team has had a chance to scope the work required to address the changes. She may also want to reflect on whether she has underestimated budgeted hours in the past in similar situations.

[a] ***An audit manager is tasked with approaching the client to discuss the possible need for write-downs on level 2 fair-valued assets. To her surprise, the client has already prepared a detailed schedule examining the assets in question and has modeled fair value using three different valuation approaches. Based on these analyses, the client has proposed a relatively small write-down. The analysis appears to be well thought-out and carefully performed. The audit manager checks the numbers in each valuation model and finds that there are no mathematical errors. The manager concludes that the client's proposed write-down is adequate.***

While checking the accuracy of mathematical calculations is an important audit step, the audit manager is likely falling prey to the confirmation tendency. The client's analyses may very well be carefully performed and adequate, but focusing on an existing analysis and simply checking for mathematical errors leaves open the possibility that the client's analyses leave out important considerations in valuing the assets. The auditor should actively seek more complete information, consider alternatives, or make the opposing case. The auditor should question the client's position with an appropriate degree of professional skepticism.

SECTION 1

Client Acceptance

CASES INCLUDED IN THIS SECTION

CASE 1.1

Ocean Manufacturing, Inc.

The New Client Acceptance Decision

Mark S. Beasley · Frank A. Buckless · Steven M. Glover · Douglas F. Prawitt

INSTRUCTIONAL OBJECTIVES

[1] To help students understand the process of considering a new prospective audit client and the factors that auditors commonly consider in making the acceptance decision.

[2] To give students experience in computing and interpreting preliminary analytical procedures commonly used in obtaining an understanding of a prospective client during the client acceptance decision process.

[3] To raise issues relating to auditor independence in the context of client acceptance, both in terms of financial interests and the provision of non-audit services.

[4] To illustrate the subjective and sometimes difficult nature of the judgments involved in the client acceptance decision, and to give students the opportunity to justify a recommendation on client acceptance in the presence of both significant positive and negative factors.

[5] To help students understand how information gathered in the client acceptance process can help the auditor in planning the audit if the client is accepted.

KEY FACTS

- The student takes on the role of a newly promoted audit manager recently given the task of considering factors and making a recommendation with respect to the acceptance of a new prospective client. The request to consider the engagement was received two weeks past the client's fiscal year-end.
- The accounting firm, Barnes and Fischer, LLP, is a medium sized national firm with over 6,000 professionals on the payroll. The firm mainly provides auditing and tax services, but has been trying with some success to build the information systems consulting side of the business over the past few years. Most of the clients in the local office that is considering the acceptance of Ocean Manufacturing, Inc. are in the healthcare services industry.
- The prospective client, Ocean Manufacturing, is a medium-sized manufacturer of small home appliances, and is planning an initial public offering (IPO) in the next two years. The company has recently decided to terminate its relationship with its current auditor. The partner is intrigued with the idea of having a client in the home appliance industry. She believes the engagement may present an excellent opportunity for Barnes and Fischer to enter a new market.
- The case gives brief background information on the home appliances industry and Ocean's business environment, management team, selected financial statement accounts, and internal controls. Summary information is also provided on the predecessor auditor, independence issues, and client background checks. Ocean's financial statements are also included, together with some industry ratios.
- Ocean's management reluctantly gives Barnes and Fischer permission to contact the predecessor

The case was prepared by Mark S. Beasley, Ph.D. and Frank A. Buckless, Ph.D. of North Carolina State University and Steven M. Glover, Ph.D. and Douglas F. Prawitt, Ph.D. of Brigham Young University, as a basis for class discussion. Ocean Manufacturing is a fictitious company. All characters and names represented are fictitious; any similarity to existing companies or persons is purely coincidental.

auditor. The engagement partner at the predecessor firm indicates he had problems dealing with Ocean's new IT system and management's tendency to become aggressive with financial reporting issues (year-end accruals and revenue recognition) to meet creditor requirements for relatively favorable interest rates. He also indicates there had been some disagreement over the proposed audit fee.

- Two independence issues are raised for research or discussion. These involve consulting services and an immaterial indirect financial interest by a partner in another office.
- Ocean has recently implemented a new IT system, and the transition has not gone smoothly. As a result, some audit trails have not been successfully maintained. Risk of material misstatement is high in 1) inventory tracking and cost accumulation, 2) receivables billing and aging, 3) payroll deductions, 4) payable balances, and 5) balance sheet account classifications.
- There has been significant management turnover in the past year. A client background check reveals that the V.P. of finance was charged with illegal gambling five years ago, raising a management integrity issue.

USE OF CASE

This case is designed to expose students to a client acceptance decision that includes consideration of both significant positive and negative client acceptance issues. The case has been designed to present a non-trivial acceptance decision, making class discussion more rich and interesting. The case is intended to go beyond the standard textbook treatment of the client acceptance decision by illustrating the subjective nature of the process and stimulating discussion of the issues affecting this important decision. The case can be used in either an introductory or an advanced financial statement auditing course. The case is short enough to be used as a stimulating in-class learning exercise, but involved enough to be used as an out-of-class written assignment, including computation of preliminary analytical procedures and preparation of recommendation and pre-planning memos.

If the case is to be used for an in-class discussion, we recommend having students read the case as an out-of-class reading assignment prior to the in-class discussion. A useful cooperative learning technique to use for the in-class discussion is "Roundtable." The basic process for the Roundtable activity is to have students meet in small groups to state aloud and write down on a single sheet of paper ideas for each question. Once all students have had an opportunity to state their ideas and arrive at a group consensus, the instructor can randomly call on individual students to share their group's answers with the class. The class time allocated to the group discussion can be shortened by assigning groups responsibility for different case questions. Randomly calling on individual students to share their group's answers with the class helps to ensure that all students take responsibility for learning the material.

If the case is going to be used as an out-of-class writing assignment, we recommend discussing the case requirements with the students prior to having them complete the assignment. A useful cooperative learning technique to use for the out-of-class writing assignment is "peer editing." With this approach students first meet in pairs to develop an outline for each memo. Once the outlines are developed, one student individually drafts the recommendations memo while the other student drafts the pre-planning memo based on the outlines. When the drafts are completed, students exchange draft responses and prepare written suggestions on the grammar, organization, and accuracy of the composition. Students then meet to discuss revisions for each draft. Finally, students revise their responses based on the suggestions provided. To ensure the process is followed, students should attach their final drafts to the outlines and critiqued drafts. The out-of-class activity can be reviewed by having student pairs compare their answers with another student pair. Students can then be selected to share their answers with the whole class. Again, randomly selecting students to share their answers with the class helps to maintain individual student accountability for the learning task.

PROFESSIONAL STANDARDS

References to AU-C sections have been updated to reflect the new codification of ASB clarity standards. PCAOB standards are referenced by standard number. Relevant professional standards for this assignment are:

AICPA ASB Standards: AU-C 210, "Terms of Engagement," AU-C 300, "Planning an Audit," AU-C 510, "Opening Balances --Initial Audit Engagements, Including Reaudit Engagements," ET Section 101 "Independence," ET Section 301, "Confidential Client Information," and QC Section 10, "A Firm's System of Quality Control."

PCAOB Standards: AS9, "Audit Planning."

QUESTIONS AND SUGGESTED SOLUTIONS

NOTE: The underlying facts, numbers, and suggested solutions have changed in the 6th edition to address the availability of solutions of prior editions for sale on the internet.

[1] ***The client acceptance process can be quite complex. Identify five procedures an auditor should perform in determining whether to accept a client. Which of these five are required by auditing standards?***

There are many activities that are reasonable for an auditor to perform in making the client acceptance decision. Thus, students' answers will vary greatly. Relevant standards (see prior listing) require that the audit firm establish quality control procedures to determine whether a client should be accepted. The audit firm also must determine its independence with respect to the prospective client, evaluate its ability to adequately service the prospective client, evaluate the integrity of management, and attempt to communicate with the predecessor auditor after obtaining permission from the prospective client to discuss confidential matters. Once these steps are taken the client and auditor must come to an agreement on various issues such as the nature and limitations of the specific services to be rendered, the expected cooperation of client personnel, the anticipated audit start and end dates, and an estimated audit fee. Below are some of the more common and important activities (those activities that are ***specifically*** required by relevant standards begin with an asterisk):

a) Obtain and review client financial information such as annual reports and income tax returns.
b) *Evaluate the integrity of client management.
c) *Communicate with the predecessor auditor after receiving permission from the client. Topics discussed should include management integrity and any disagreements about accounting or auditing issues.
d) *Determine the independence of your firm with respect to the client.
e) Inquire of third parties about the client (banks, attorneys, credit agencies, etc.).
f) *Take various steps to obtain an understanding of the client and its industry (e.g., on-site tour, reviewing industry publications), and determine if your firm has or can reasonably expect to obtain the technical skills and industry knowledge needed to perform the audit properly.
g) Consider whether the client has any unusual or special circumstances that will require special attention by your firm. Also consider whether issues such as litigation or going-concern problems exist for the client.
h) Perform preliminary analytical procedures to obtain an understanding of the prospective client and its industry.

i) Evaluate the opportunities and business risks posed by the client to your auditing firm.

j) Obtain an agreement from management that it acknowledges and understands its responsibility for selecting the appropriate financial reporting framework, establishing and maintaining internal control, and providing access and information to the auditor.

k) Determine whether the client is using an acceptable accounting framework.

l) Determine if management is going to impose a limitation on the scope of the auditor's work.

[2] ***What nonfinancial matters should be considered before accepting Ocean as a client? How important are these issues to the client acceptance decision? Why?***

Relevant non-financial matters include the following:

a) Recent management turnover. This matter may or may not pose a potential problem to the audit, but may be a sign of other problems that should be investigated. The controller is very new and has little relevant experience, which may make audit work slower and more difficult.
b) High auditor turnover rate. This should be a red flag to the auditors. The auditors should look into why Ocean has employed so many different auditors in so few years.
c) Complicated new computer system. The complicated system poses a couple of problems for the auditors. First, the auditors may have difficulty getting the information they need from the system, and a question arises regarding auditability due to the loss of conventional audit trails during parts of 2014. Second, inadequate controls over the new system may increase the amount of substantive testing required.
d) Client hesitant to allow new auditor to speak with previous auditor. Anytime a client is hesitant or unwilling to allow new auditors to communicate with the previous auditor, a red flag should be raised in the mind of the successor auditor, and a careful examination of the issue, including consideration of management integrity, should ensue.
e) Illegal gambling incident. This is a matter of concern because it raises the management integrity issue. What the V.P. of finance did was definitely wrong, but the impact on the overall integrity of management is a matter of judgment. This issue can be debated among the students. Some will come down on one side saying that if a key member of management is dishonest in one thing, he is likely to be dishonest in others. Other students will argue that the incident has little to do with the business and its management, especially since there are no other known incidents. At a minimum, this incident creates an opportunity to raise and discuss the central role of management integrity in the client acceptance decision.
f) Initial public offering. Ocean has plans to go public and aggressively expand into the national market. If successful, these plans will make Ocean a more attractive client for Barnes and Fischer, but they also serve to increase the auditor's business risk (increased reliance on the statements, increased litigation risk, etc.) and should be considered.
g) Management's aggressiveness. There are some indications in the case that management is willing to manipulate the financial statements via year-end accruals and revenue recognition to achieve relatively low interest rates from creditors. This raises a potential management integrity issue, and should be heavily weighted in view of the fact that the upcoming IPO may give management even greater incentive to manipulate the financial statements.
h) Relationship with predecessor auditor. This issue is left intentionally debatable in the case, but is certainly a concern that should be raised. The relationship with the predecessor auditor has been negative, and this is cause for concern. On the other hand, the poor relations may be present because the auditor did not have a sound understanding

of Ocean's business and was not competent in helping Ocean with its new IT system. Personality issues can also play a role. Further, the apparent differences over the current year's audit fee should be a concern to Barnes and Fischer from a business perspective.

i) Students should also raise *positive* non-financial issues, such as the opportunity to expand into a new industry and the opportunity to provide significant consulting services relating to Ocean's new IT system as well as to Ocean's internal controls. The company has a relatively long and stable history in the small appliances industry. Further, Ocean is well positioned in the small appliances market. With its plans for going public and expanding nationally, the company may become an even larger and more attractive client. Some students will think the case represents a clear non-acceptance situation due to the negative factors listed above. The instructor can provide some perspective by pointing out that no prospective client comes without some concerns and problems. Ocean certainly presents some issues and concerns, but would likely be accepted by most auditing firms. (Two different partners from major firms commented in presenting this case to graduate auditing courses that the level of risk presented by Ocean Mfg. was fairly typical of many of the firm's clients. In our experience, most students indicate that they would not accept Ocean Mfg. as a client. This case provides an opportunity for students to better understand the subjective issues and risks that auditors face in practice.).

[3] ***Using Ocean's financial information, calculate relevant preliminary analytical procedures to obtain a better understanding of the prospective client and to determine how Ocean is doing financially. Compare Ocean's ratios to the industry ratios provided. Identify any major differences and briefly list any concerns that arise from this analysis.***

The following are various ratios computed from Ocean's financial statements. This question is intentionally vague so that students will have to refer to their auditing textbook for guidance on the types of analytical procedures useful for gaining an understanding of the client. The instructor can make the assignment more specific by requiring specific ratios to be computed. The instructor could also require preparation of horizontal and vertical analyses on the financial statements.

Several interesting trends should be noted in the ratios. Return ratios are improving, as is inventory turnover (which is poor relative to the industry), but accounts receivable turnover, while relatively good, is deteriorating.

	Formulas	2014	2013	2012
ROE	NI/Equity	10.02%	7.11%	6.29%
ROA	NI/Total Assets	5.09%	3.77%	3.39%
Asset to equity	Assets/Equity	1.97	1.88	1.85
Accounts Receivable Turnover	Sales/End AR	12.52	13.11	14.02
Average Collection Period	365/AR Turnover	29.16	27.85	26.03
Inventory Turnover	COGS/End Inv.	6.50	4.51	3.48
Days in Inventory	365/Inv. Turnover	56.13	80.89	104.99
Debt Ratio	Liabilities/Asset	0.49	0.47	0.46
Debt to Equity	Liabilities/Equity	0.97	0.88	0.85
Times interest earned	EBIT/Interest Expen.	4.98	4.24	6.24
Current ratio	Cur. Asset/Cur. Liab.	1.85	1.92	1.69
Profit Margin (on operating income)	EBIT/Sales	5.6%	6.0%	4.7%

Industry Ratios for Comparison:

	2014	2013
ROE	20.33%	26.22%
ROA	6.62%	8.10%
Asset to equity	3.30	2.82
Accounts Receivable Turnover	7.49	6.96
Average Collection Period	41.25	44.35
Inventory Turnover	8.09	6.90
Days in Inventory	38.16	43.86
Debt to Equity	2.38	1.90
Times interest earned	1.62	2.37
Current ratio	1.29	1.44
Profit Margin (on operating income)	10.58%	10.82%

Major Differences to be noted:

a) Ocean has a low return on equity relative to the industry.
b) Ocean has a low return on assets relative to the industry.
c) Ocean's accounts receivable turnover is high relative to the industry.
d) Ocean's inventory turnover is low relative to the industry.
e) Ocean's profit margin is low relative to the industry.

[4] [a] ***Ocean wants Barnes and Fischer to aid in developing and improving its IT system. What are the advantages and disadvantages of having the same CPA firm provide both auditing and consulting services? Given current auditor independence rules, will Barnes and Fischer be able to help Ocean with its IT system and still provide a financial statement audit? Support your conclusion with appropriate citations to authoritative standards if your instructor indicates that you should do so.***

The issue of providing both systems consulting and auditing services to the same client has been a topic of considerable debate in the profession. Some parties argue that providing both consulting and auditing services to the same client may impair auditor objectivity. On the other hand, many in the profession argue that a great deal of efficiency is gained by the same firm providing both kinds of services because the firm can leverage the auditor's deep understanding of the client and its information system in providing additional services. For public companies, which are subject to the Sarbanes-Oxley Act of 2002, the auditor is not permitted to provide certain types of consulting services for clients. Financial information systems design and implementation is not an approved consulting service under Sarbanes-Oxley. Until it executes its planned initial public offering, Ocean is a privately-held company and is thus subject to AICPA independence requirements. The AICPA Code of Professional Conduct indicates that systems implementation is an acceptable nonattest service to provide to audit clients under certain conditions. For example, while a CPA firm may assist an audit client in implementing a computer software package, it may not "design" the financial information system by creating or changing the computer source code underlying the system. Students typically have strong views on this issue. Some argue that objectivity would likely be impaired, and others argue that the objectivity issue can be dealt with and that the efficiencies gained outweigh the potential costs.

[b] ***As indicated in the case, one of the partners in another office has invested in a venture capital fund that owns shares of Ocean common stock. Would this situation constitute a violation of independence according to the AICPA Code of Professional Conduct? Why or why not?***

According to Rule 101 of the AICPA *Code of Professional Conduct*, materiality is not to be considered in the case of a direct financial interest—no direct financial interests on the part of the auditor are tolerated. However, if the financial interest is indirect, as in the case of a mutual fund or venture capital fund investment, materiality is considered. It is fairly clear from the case that the partner's indirect financial interest is immaterial and thus does not constitute a violation of Rule 101. The instructor may wish to point out that no individual who is on the engagement team, who is a partner or manager not on the attest engagement team but who provides nonattest services to that client, who is a partner who works in the same office as the attest engagement's lead partner, or who is a position to influence the engagement, can hold a *direct* financial interest in the client. However, even the partner in charge of the Ocean audit *would* be permitted to hold an immaterial *indirect* financial interest in Ocean.

[5] [a] ***Prepare a memo to the partner making a recommendation as to whether Barnes and Fischer should or should not accept Ocean Manufacturing, Inc. as an audit client. Carefully justify your position in light of the information in the case. Include consideration of reasons both for and against acceptance and be sure to address both financial and nonfinancial issues to justify your recommendation.***

The memo should be professional in appearance and in substance, and should be well written. The memo should include the points brought out in the preceding questions, which are designed to help prepare the students to make reasoned and informed recommendations. The memo should also include a clear recommendation as to whether the client should be accepted. There is no right or wrong recommendation as long as a student demonstrates she weighed the issues and made a reasonable decision based on the information provided. However, in our experience, students tend to be much more negative about the prospect of accepting Ocean as an audit client than are auditing professionals. Most of our students tend to reject Ocean as a client; audit partners visiting our classrooms, especially those partners from non-big 4 firms, often indicate that Ocean is similar to many of their own clients. Students tend to want an ideal client; audit professionals have to make a living in the real world, which includes dealing with clients that have some issues and that present some risks. Emphasize that the client acceptance decision is a very subjective one that is ultimately determined by professional judgment.

[b] ***Prepare a separate memo to the partner briefly listing and discussing the five or six most important factors or risk areas that will likely affect how the audit is conducted if the Ocean engagement is accepted. Be sure to indicate specific ways in which the audit firm should tailor its approach based on the factors you identify.***

This pre-planning memo should include many of the same issues considered in the acceptance decision. However, this memo should then consider the implications of these issues for how the audit will be conducted assuming the client is accepted. The case discusses many issues that would have potentially important implications for conducting the audit. Some of the more important implications are listed below.

a) As a result of Ocean's recent IT implementation, some audit trails have not been successfully maintained. The auditor will need to determine how to gain comfort on the items for which traditional audit trails were not maintained. Depending on the nature of the items, the auditor may be able to gather evidence by backing in to the missing periods using the data from before and after the breakdown of the trails. Additionally, analytical procedures to test for reasonableness may become more important due to the audit trail breakdowns.

b) Also as a result of Ocean's recent IT implementation, risk of material misstatement is high in inventory tracking and cost accumulation, receivables billing and aging, payroll deductions, payable balances, and balance sheet account classifications. Substantive procedures with relatively large sample sizes will likely play an important role in these areas, with particular emphasis on tests of details of balances.

c) Internal controls appear to be lacking. Thus, the auditor will likely have to rely heavily on substantive procedures. This will in turn have implications for staffing budgets and the cost of the audit.

d) Accounts Receivable turnover, while good, is deteriorating. This suggests that the auditor may want to pay special attention to the valuation of receivables.

e) Inventory turnover, while still poor relative to the industry, has improved rather dramatically over the past three years. This could be due to more effective inventory management, but may also be due to misstatements in the inventory account. This suggests the auditor may want to emphasize the completeness, valuation, and accuracy objectives for inventory. Since the client is a manufacturer with relatively large inventory balances, the audit of inventory will be a major focus of the audit.

f) Ocean's profit margin percentage and return on equity are low relative to the industry. The auditor should identify and corroborate a viable explanation. These factors are likely related to Ocean's cost structure or the competitiveness of Ocean's region or product set. However, the issue is worth investigating as these ratios may be seen as red flags for fraud risk.

g) The predecessor auditor indicated that Ocean's management tended to become aggressive in the treatment of accruals and revenue recognition toward the year-end. This is clearly an area where the auditors will want to focus a great deal of attention, increasing the extent of cut-off tests, reasonableness of accruals, etc. Frequent material fourth-quarter adjustments are also considered a red flag for fraud, so the audit program should probably take into account a heightened risk of fraud, in accordance with auditing standards.

h) Since the successor auditor will take on the audit subsequent to year-end, some cut-off and inventory issues arise. For ending inventory in particular, the successor will either have to rely on the work of the predecessor auditor (if the predecessor observed the client's ending inventory procedures) or gain comfort by "backing into" the ending inventory balance via alternative procedures, such as roll-backs and tests of transactions.

PROFESSIONAL JUDGMENT QUESTIONS

It is recommended that students read the Professional Judgment Introduction found at the beginning of the book prior to responding to the following questions.

[6] [a] ***How might the confirmation tendency affect your client acceptance decision?***

Answers may vary. However, students should demonstrate an understanding that due to the confirmation bias, the auditor likely will tend to seek and place emphasis on evidence that supports his or her beliefs about Ocean. The confirmation bias is the tendency for decision makers to seek for and put more weight on information that is consistent with their initial beliefs or preferences.

[b] ***How might the overconfidence tendency come into play in your client acceptance decision?***

Again, answers may vary. However, students should demonstrate an understanding that due to the overconfidence tendency, Barnes and Fischer, LLP may overestimate the firm's ability to take on this client in an industry that the firm has little experience in. The overconfidence tendency is the tendency for decision makers to overestimate their own abilities to perform tasks or to make accurate diagnoses, estimates, or other judgments and decisions.

[c] ***How might an auditor mitigate the possible effects of the confirmation and overconfidence tendencies in a client acceptance situation?***

There is no single "best approach" auditors can use to mitigate the effects of the confirmation and overconfidence tendencies. The first step is always awareness--there is no hope of mitigating biases if the auditor is not aware of these tendencies. With awareness, common sense approaches might be available to help guard against possible bias. Regardless of the method identified, students should demonstrate an understanding of the effects of these tendencies and suggest reasonable, commonsense approaches for mitigating the possible negative effects. For example, to mitigate the effects of the confirmation tendency, the auditor might refer to a robust checklist of important considerations for client acceptance. By performing a complete evaluation of the prospective client, the auditor will be required to consider information that does not confirm the auditor's initial belief or opinion. Also, the auditor responsible for making the acceptance decision could consider seeking a second opinion from another auditor about the prospective client and could even ask that second auditor to play the role of "devil's advocate" and make the case for the negative factors. To mitigate the effects of the overconfidence tendency, Barnes and Fischer could get input from another auditor with experience and expertise in Ocean's industry in order to better identify the firm's gap in skills in taking on the new client. The firm could explicitly consider factors that could result in undetected misstatements and the impact of possible lawsuits. The firm could also consider specific factors that might result in budget over-runs in estimating the hours that would be needed to complete the audit of the client. One way to do this is to identify what has gone wrong in the past and consider the likelihood that similar things might go wrong with the prospective client.

SECTION 2

Understanding the Client's Business and Assessing Risk

CASES INCLUDED IN THIS SECTION