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2.1

Your1040Return.com

Evaluating eBusiness Revenue Recognition, Information Privacy, and Electronic Evidence Issues

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

INSTRUCTIONAL OBJECTIVES

[1] To illustrate business risks for Internet-only business models.

[2] To help students develop skills related to identifying internal control responses to eBusiness risks.

[3] To highlight revenue recognition issues related to eBusiness transactions.

[4] To illustrate unique accounting issues associated with Internet web site banner advertisements.

[5] To help students identify privacy issues associated with Internet-based business models.

[6] To illustrate audit implications when transaction audit trails are solely electronic.

[7] To expose students to the benefits of cloud computing

[8] To help students recognize threats to eBusiness strategies.

KEY FACTS

- Your1040Return.com is a leading provider of online income tax preparation and filing services for individual taxpayers.
- The company was founded two years ago by Steven Chicago who realized individuals may be frustrated with the need to purchase tax preparation software upgrades each year to ensure their tax software reflects recent changes in the tax code.
- Your1040Return.com's strategy is to provide up-to-date tax preparation software that can be accessed through the Internet by individuals who pay membership fees for that access.
- In essence, Your1040Return.com's customers "rent" access to tax preparation software packages that are continually kept up-to-date with the latest tax law changes. Customers can also use Your1040Return.com's services to electronically file an already prepared paper-based tax return.
- Customers can use Your1040Return.com to file both state and federal tax returns.
- Your1040Return.com customers select from one of three service packages: Silver, Gold, or Platinum.
- Silver package customers can access electronic copies of tax forms, schedules, and publications and can enter tax return information directly onto those forms and schedules. Your1040Return.com will also file the completed return electronically to the appropriate regulatory agency.
- In addition to the Silver package services, Gold package customers have one-year access to a commercially developed and continually maintained tax preparation software package that assists customers in the preparation of their individual returns.
- Platinum package customers have access to the premium level of services, which allow customers to have multi-year access to the tax preparation software and personalized attention and real-time tax support from qualified income tax specialists.
- Revenue recognition differs for each product offered by Your1040Return.com.

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. Your1040Return.com is a fictitious company. All characters and names represented are fictitious; any similarity to existing companies or persons is purely coincidental.

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- Your1040Return.com's business is seasonal with its highest demand from early February through April 15th each year. The company experiences peaks in demand during periods surrounding extension deadlines.
- Tax payments and refunds are not funded by Your1040Return.com. Rather, tax refunds are remitted directly from the IRS or state agency to the individual. Tax payments are charged by the IRS or state agency to the individual's credit card account.
- Your1040Return.com also engages in ad swapping with a number of major Internet companies. In exchange for providing electronic advertisements on the Your1040Return.com web site, the company receives free banner ads on other web sites.
- Servers located at Your1040Return.com's offices support the tax preparation software. The servers are in facilities with physical access securities and are protected logically by firewalls and access passwords.
- The company hires several tax experts to monitor tax code changes and to help ensure the underlying tax software is accurate. The company contracts with a software design firm to develop the online tools. Two of Chicago's nephews oversee the operations of the IT platform; each has less than 5 years of relevant work experience.
- The company's CFO joined the company after three years of audit experience with a Big Four international accounting firm.
- The company does not have an official customer privacy policy. The company has been approached by marketing executives who are interested in purchasing Your1040Return.com's customer lists.
- As part of a recent line of credit arrangement with the local bank, Your1040Return.com's financial statements must now be audited.

USE OF CASE

This case assignment provides students the opportunity to recognize that while the Internet and related innovative uses of technology offer opportunities for new avenues for conducting business, there are unique risks and related accounting issues that must be considered. This case exposes students to issues associated with a relatively new eBusiness enterprise that provides tax-related services via the Internet. This case explores several issues that arise with an Internet-based business model.

First, the case highlights how the Internet provides innovative ways for businesses to deliver value added services to consumers. As a result, this case exposes students to issues different from those associated with traditional "brick and mortar" businesses. And, because the underlying service relates to tax preparation software for customers, accounting students can easily understand the main components of Your1040Return.com's service offering to consumers.

Second, the structure of the three levels of product service offerings (Silver, Gold, and Platinum) provides a nice opportunity to engage students in an analysis and class discussion of the accounting implications related to revenue recognition. This analysis helps students see how operational decisions about product and service offerings create different accounting issues for each offering. In addition, the use of bartering for the ad banner transactions exposes students to a unique accounting issue for many Internet based businesses.

Third, the case illustrates basic business decisions that start-up companies must make. For example, the case highlights the practical aspects and related implications of attracting and hiring affordable employees with the necessary job skills. It also highlights the difficult realities of maintaining basic business operations with limited resources and talents, such as Your1040Return.com's limited IT system and lack of ideal data and system backups. Finally, the case illustrates trade-offs business owners must make by highlighting the ethical dilemmas associated with the potential decision to sell private customer information to external marketing agencies.

This case could be used in either an undergraduate or graduate auditing or accounting information systems course to highlight unique business risks, internal controls, and audit evidence issues associated with Internet-based businesses. The questions related to revenue recognition may be effective for use in an undergraduate intermediate accounting course.

Students can complete the case individually or in groups as an in-class or out-of-class assignment. Because the case is relatively short, students can read the case during the class period to prepare for an in-

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class discussion of several of the questions. Other questions, however, may be better suited as an out-of-class assignment (e.g., see question 1.g and 1.i) that students complete before an in-class discussion is held.

This assignment can be broken down into several sub-assignments that can be completed at various points during a quarter or semester. Students should particularly enjoy this case, given that it exposes them to broader business issues associated with Internet-based businesses.

PROFESSIONAL STANDARDS

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

AICPA ASB Standards: Relevant professional standards for this assignment include AU-C Section 315 "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," AU-C Section 330, "Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained," and AU-C Section 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures."

PCAOB Standards: AS 1101, "Audit Risk," AS 2110, "Identifying and Assessing Risks of Material Misstatement," and AS 2201, "An Audit of Internal Control over Financial Reporting That is Integrated with an Audit of Financial Statements," (Note: PCAOB Standards are relevant from an informational perspective, but are not required since Your1040Return.com is not a public company.)

QUESTIONS AND SUGGESTED SOLUTIONS

[1] ***You are an audit senior with Gooch & Brown CPA, LLP, a local accounting firm specializing in audits of information systems and financial statements. Your1040Return.com engaged your firm to perform its financial statement audit. You have been asked by the partner to perform the following tasks:***

[a] ***Why does Your1040.com need to have its financial statements audited? How might understanding the reasons for the audit of the financial statements inform the auditor about potential audit risk?***

The bank that has provided Your1040.com with a bank line of credit has requested that Your1040.com submit audited financial statements annually as part of the financing arrangement. Knowledge about the main reasons for Your1040.com to engage your firm to conduct the audit provides important insight about potential users of the audited financial statements and how they might be using the audited information to assess the creditworthiness of Your1040.com. Awareness of the reasons for the audit are also informative to the auditor's assessment of the risks of material misstatements, including the risk of fraud. Management of Your1040.com would have incentives to preserve the line of credit to help manage cash flows of their business. That incentive, if excessive, may pressure management to present financial information that portrays a favorable perception of Your1040.com's financial strength. Thus, remaining aware of that possible risk would be important to the audit of the financial statements.

[b] ***Describe to Stephen Chicago why it is important for your firm to have an understanding of Your1040Return.com's business model.***

Auditing standards require that the *a*uditor obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. A thorough understanding of the client's business model is essential for doing an adequate audit. The nature of the client's business operations and industry directly affects client business risks and the risk of material misstatements in the financial statements. The auditor uses the knowledge about these risks to determine the appropriate extent of audit evidence to be obtained through further audit procedures. Without an adequate understanding of the underlying client business models, auditors may fail to adequately identify relevant business risks. That failure will likely result in audit procedures inadequately designed to detect material misstatements in the financial statements.

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The auditor should understand factors such as major sources of revenue, key customers and suppliers, sources of financing, and competitors, among other matters, related to the client's core business operations. Through such an understanding, the auditor may be more likely to identify business risks arising from unique incentives and pressures or deficiencies in internal controls created by that business model structure that increase opportunities for misstatements in the financial statements. Additionally, knowledge about core business models gives auditors a better understanding of the client's business and industry to provide value-added services to those clients.

[c] ***Identify Your1040Return.com's major business risks and describe how those risks may increase the likelihood of material misstatements in Your1040Return.com's financial statements.***

Because Your1040Return.com's main business model involves the provision of software and other services accessed through the Internet, the company faces different issues from traditional "brick and mortar" businesses. Here is an overview of several business risks that Your1040Return.com faces:

- **Customer Demand.** Because the business model is solely based on services delivered through the Internet, there may be individuals who are uncomfortable using the Internet to use the online tax services. Certain customers may be reluctant to submit personal tax related financial information over the public Internet. As a result, the customer base in the online marketplace may be limited. That may put pressure on management to generate future revenues to maintain profitability goals and targets. That pressure may provide incentives for management to aggressively account for revenue and expense transactions to achieve those profitability goals. In some cases, management may select options that are not in compliance with generally accepted accounting principles.
- **Software Technical Accuracy.** One of the main selling features for Your1040Return.com is access to an up-to-date popular tax software package. There is some risk that the tax preparation software contains errors in the interpretation and application of the complicated federal and state tax codes, which in turn may cause customers to file incorrect returns. If that risk is realized, Your1040Return.com may create contingencies related to potential liabilities associated with litigation claims from customers. In addition, as information about errors in the tax software packages becomes public, customers may be reluctant to continue subscribing to the online services offered, which will lead to decreased revenues. The revenue pressure may lead to incentives to engage in aggressive accounting to maintain profitability goals.
- **Service Availability.** Because Your1040Return.com's core business is based on services delivered via the Internet, the company faces the risk that customers may not be able to access the tax preparation software if there is a failure in the Internet link to the services. Any system failures with Your1040Return.com's computer servers would prevent the company from providing services for its customers, unless reliable and quick backup access is consistently maintained. If the service access is unavailable for a significant amount of time, the company may lose customers, which would create pressures for management to maintain its profitability. In addition, the lack of access to services may create revenue recognition problems given that the company has not fulfilled its service obligations for customers who have already paid for unlimited access to the software services.
- **Inadequate Staff.** Currently, key staff positions related to system support and the accounting functions have limited experience. As Your1040Return.com's business continues to grow, the size and complexities associated with company growth may present issues that the current staff is unable to adequately handle. The lack of experience of the current staff may result in errors in judgment that lead to misstatements in the financial statements.
- **Electronic Only Evidence.** Your1040Return.com engages in all transactions electronically, with backups of that data performed daily. There is some risk that the data may be lost or temporarily not accessible, which may increase the difficulty of managing the business and creating (and auditing) accurate financial statements.

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- **Customer Privacy.** Because customers access Your1040Return.com's services to complete their individual tax returns, Your1040Return.com has access to highly sensitive personal financial and other demographic data. There is a risk that some of that information might be inadvertently given to or accessed by external parties. If that occurs, Your1040Return.com may face contingencies associated with litigation and other claims filed by customers affected that would need to be disclosed in the financial statements.

[d] ***Indicate what Your1040Return.com should do to improve its internal control?***

Below are suggestions designed to strengthen Your1040Return.com's internal controls:

- **Revenue Recognition Controls.** Your1040Return.com should evaluate the adequacy of internal controls surrounding its revenue recognition. Currently, Your1040Return.com recognizes revenue differently for the three levels of service. For the Platinum service, revenue for the first year of service is recognized completely at the point the customer requests the service. Revenue recognition is not spread across the year of service and is not contingent on the filing of a return. However, revenue for the Gold service is treated differently. A portion of the revenue is recognized when service is activated with the remainder not recognized until the customer files the return. Management needs to evaluate internal controls over revenue recognition to ensure that the treatment is consistent with generally accepted accounting principles for all levels of service (For further information regarding revenue recognition see solution to question 1.g).
- **Backup and Contingency Controls.** Your1040Return.com's ability to generate revenues is dependent on the availability of customer access through the Internet to Your1040Return.com's servers and databases. The company needs to evaluate the adequacy of the backup and contingency controls in the event there is a server failure. Backup files should be made frequently (at least daily) and stored off site in secure environments. Alternative servers fully loaded with software and necessary backup data files should be available so that service can be provided in the event of a system failure. These backup and contingency controls should be regularly tested.
- **Privacy Controls.** Because Your1040Return.com has access to highly sensitive customer financial and other demographic information, Your1040Return.com should develop a formal customer privacy policy that identifies how private customer information is maintained and protected. Without a formal policy, sensitive information may be inadvertently released, which may expose Your1040Return.com to significant liabilities. In addition, the company should ensure that policies related to security controls (i.e., firewalls and passwords) are continually evaluated for adequacy.
- **Controls Over Advertising Arrangements.** Because contracts associated with banner advertising can often contain complex revenue provisions (i.e., ad revenues can often be a function of the number of hits to the banner ads and the extent of subsequent drill downs on the advertiser's web site), Your1040Return.com needs to develop controls to ensure the company correctly understands and accounts for revenue transactions generated from offering banner advertisements.

[e] ***Explain what audit implications arise if you decide that the controls over electronic records at Your1040Return.com are inadequate to ensure that records have not been altered?***

Given that all transactions are documented solely in electronic form, there is no alternative paper trail to serve as evidence supporting financial statement transactions and accounts. If the auditor is unable to determine that electronic records have not been altered, there may be no reliable evidence for the auditor to examine when evaluating the fair presentation of account balances and transactions. In certain cases, the lack of reliable electronic or other alternative evidence may cause the auditor to conclude that the entity is un-auditable (see AU-C 500, "Evidential Matter"). In that case, the auditor may be unable to accept the audit engagement or may have to withdraw at a later date. Thus, Your1040Return.com's management needs to establish effective internal controls to ensure that adequate evidence is maintained to support accounts and transactions in the financial statements.

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[f] ***Steven Chicago has indicated that he is exploring upgrades to the company's IT systems. Your audit partner would like you to explore whether cloud computing is an option that your firm might recommend for consideration by Steven. Perform research to explain what cloud computing is and why it might offer benefits to Your1040.com.***

COSO's thought paper, *Enterprise Risk Management for Cloud Computing*, defines cloud computing as "a computing resource deployment and procurement model that enables an organization to obtain its computing resources and applications from any location via an Internet connection." Depending on a particular cloud solution, all or parts of the organization's hardware, software, and data might reside on servers in data centers managed by the cloud service provider. One of the most significant benefits of this cloud solution for Your1040.com is the fact that the hardware supporting the tax return preparation software and related data storage would be managed by a third-party IT service provider that is in the business of maintaining and securing IT platforms. Thus, the level of infrastructure support and security surrounding Your1040.com's systems would most likely be significantly strengthened. Additionally, given Your1040.com's business model is seasonal, the cloud option most likely would provide Your1040.com the ability to scale up operations during peak times and then scale down operations in off-peak times. The cloud option would also be more likely to support any significant growth in Your1040.com's business, given the scalability options of cloud-based IT solutions.

[g] ***Authoritative literature provides guidelines for proper revenue recognition policies for transactions such as those discussed in the case. Analyze Your1040Return.com's revenue recognition policies for the three package services. Provide appropriate citations to authoritative literature.***

As summarized in the case materials, Your1040Return.com recognizes revenues differently for each of the three service packages.

Your1040Return.com's Revenue Recognition Policies

For the Silver package, customers pay for access to tax forms, schedules, and publications. And, Silver package customers can submit tax forms electronically. Access is only allowed for one year. Your 1040.com recognizes revenue on the Silver package when the customer submits the tax return to the IRS or state agency.

Gold package customers can access the tax preparation software to complete and submit the return. Access is allowed for one year. Your1040Return.com recognizes a portion of the revenue when the customer accesses the tax software package for the first time. Your1040Return.com recognizes the remaining portion of the revenues when the customer submits the return.

Platinum package customers pay to access the tax software on a multi-year contract basis. Customers can access the tax software package year round to update their tax information and they can receive personalized attention and real-time tax support from qualified income tax specialists. Your1040Return.com recognizes revenues for each year immediately after the customer selects the Platinum service.

At a minimum, Your1040Return.com needs to evaluate their revenue recognition policies to ensure they are applying revenue recognition criteria correctly and consistently across all three products. In addition, Your1040Return.com needs to evaluate implications of their cancellation policy to determine whether they need to record an accrual for the cancellation expense.

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Guidance Relevant to Revenue Recognition

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) recently completed a joint project to develop a common revenue standard for U.S. GAAP and IFRS to improve revenue recognition practices and to remove inconsistencies and weaknesses in revenue requirements. The updated guidance is contained in the Accounting Standards Codification as Topic 606, "Revenue from Contracts with Customers." In order to record revenue transactions, ASC 606, "Revenue from Contracts with Customers," describes the core principle for revenue recognition as follows: "...the entity should recognize revenue to depict the transfer of promised goods or services to customers in the amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services." To achieve that core principle, ASC 606 notes that the entity should apply the following steps:

Step 1: Identify the contract(s) with a customer.
Step 2: Identify the performance obligations in the contract.
Step 3: Determine the transaction price.
Step 4: Allocate the transaction price to the performance obligations in the contract.
Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

For Your1040Return.com, all three packages (Silver, Gold, and Platinum) grant customers access to the web site for a contracted period of time. For the Silver and Gold memberships, customers have access for a full year. For the Platinum service, customers contract for multiple year service. Because the services allow customers access for a period of time, one may argue that Your1040Return.com should recognize revenues for the Silver and Gold services evenly over the 12-month contractual period. For the Platinum service, revenues should be spread evenly over the number of months contracted in the multi-year package selected.

While all of the revenues for the Silver package and a portion of the revenues for the Gold package are not recognized until the customer files the tax return, one could argue that Your1040Return.com is prematurely recording a portion of the revenue. Even though the tax return has been filed by the customer, both the Silver and Gold packages allow customers access to the web site information to file amendments to their already filed returns. Thus, Your1040Return.com promises access to services beyond the tax return filing date. As a result, Your1040Return.com has an obligation to its customers for the entire one-year period. Thus, revenues are not fully realized until the 12 months expire.

Your1040Return.com's revenue recognition policy appears most aggressive for the Platinum package. Fees for each year's service are recognized as revenue immediately after the customer selects the Platinum option. Because the customer is paying for access to the software and tax specialists for an entire year, revenues from the Platinum service should be earned proportionately over the entire contract period. Thus, Your1040Return.com should modify its revenue recognition policy for the Platinum service to ensure that it is not prematurely recording revenues.

Your1040Return.com needs to evaluate the extent that customers have cancelled previously paid for services during the contract period, as allowed by its cancellation policy. Management needs to perform this evaluation to provide a basis for developing an estimate for the cancellation expense and related liability that should be recorded to reflect this cancellation expense in the financial statements. Your1040Return.com should also determine whether the cancellation policy should be modified to clearly communicate cancellation options for customers during the contract period.

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[h] ***Explain how you can obtain evidence that ad swapping actually occurred between the Your1040Return.com and Amazon.com? Describe accounting issues that arise when Internet-based companies swap ad services and identify relevant authoritative literature.***

Your1040Return.com and Amazon should have entered into formal contracts regarding the exchange of advertising services on each company's web sites. The auditor would want to obtain copies of the contracts for the audit files to determine the terms of the arrangements and obligations each company has to provide advertisements. Reviews of those contracts would help the auditor determine whether there are underlying accounting issues related to recognizing revenues for advertisements provided on the Your1040Return.com web site or expenses related to Your1040Return.com advertisements at Amazon.com's web site.

The web site systems can be designed to track the time and date advertisements are programmed to appear on the respective web sites. Reports or logs from these systems could be reconciled back to the ad contracts for compliance. Based on information obtained from the review of the ad contracts, the auditor could also visit the respective web sites at those scheduled times to determine if the ads actually appear as stipulated in the contracts.

Because neither Your1040Return.com nor Amazon.com actually pay each other for the advertising services, both companies have actually entered into a non-monetary barter transaction. While currently there is no formal pronouncement from the FASB specifically addressing the accounting for web site advertising arranged on a barter basis, there is relevant guidance for accounting for non-monetary transactions. Accounting Standards Codification No. 845, *Nonmonentary Transactions*, states that "*the accounting for nonmonetary transactions should be based on the fair values of the assets (or services) involved, which is the same basis as that used in monetary transactions. Thus, the cost of a nonmonetary asset acquired in exchange for another nonmonetary asset is the fair value of the asset surrendered to obtain it, and a gain or loss shall be recognized on the exchange. The fair value of the asset received shall be used to measure the cost if it is more clearly evident than the fair value of the asset surrendered.*" ASC No. 920, *Entertainment - Broadcasters*, contains guidance related to bartering of advertising in the broadcast industry that may be analogous to Your1040Return.com's use of bartering for banner related advertising. Paragraph 30-1 of ASC No. 920 states that *"All barter transactions except those involving the exchange of advertising time for network programming shall be reported at the estimated fair market value of the product or service received."*

As a result of these accounting provisions, Your1040Return.com needs to gather information to determine the fair market value of the revenues related to advertising it provides for Amazon.com on the Your1040Return.com web site. And, management needs to gather information to determine the fair market value of the expenses related to advertising Your1040Return.com incurs for advertisements on the Amazon.com web site. In addition, information in the contract may provide useful information about the timing of the banner advertisements to determine if there are related receivables and payables that should be reflected in Your1040Return.com's balance sheet.

[i] ***Address a memo to Steven Chicago detailing the appropriate contents for a customer privacy policy. (You may want to visit other company web sites, such as www.amazon.com, to see an example of a privacy policy.) Why is it important for Your1040Return.com to have an explicit privacy policy? How might the lack of a policy affect Your1040Return.com's financial statements in the future?***

Online privacy policies should focus on protecting the privacy of personal information an organization may collect from its customers through its electronic commerce systems. The AICPA's *Trust Services Principles and Criteria* provide useful guidance about the importance of online privacy protection for customers engaging in Internet-based businesses that could be pointed out in a memo to Steven Chicago. You could note that the following concepts are commonly used to facilitate the creation and implementation of privacy policies and practices:

- **Notice.** An entity should inform customers about its privacy policies and practices at or before the time information is collected or as soon as practicable thereafter. The notice should describe the purpose for which personal information is collected and how it will be used.

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- **Choice and Consent.** The entity should describe the choices available to individuals and obtain consent from them with respect to the collection, use, disclosure, and retention of personal information.
- **Collection.** The entity should limit the collection of personal information to that which is necessary for the purpose described in the notice.
- **Use and Retention.** The entity should limit the use of personal information to the purposes described in the notice and for which the individual has provided either implicit or explicit consent. The entity should retain personal information for only as long as necessary for the fulfillment of the stated purposes, or as required by law or regulation.
- **Access.** Customers should have access to their own personal or sensitive information for the purposes of correction, update and deletion.
- **Onward Transfer and Disclosure.** The entity should only disclose personal information to third parties for purposes described in the notice and for which the individual has provided either implicit or explicit consent, or as permitted by law or regulations. The entity should only disclose personal information to third parties who provide substantially equivalent privacy protection as the entity.
- **Security.** The entity that gathers, maintains, or uses personal information must take reasonable precautions to protect the information from loss, misuse, unauthorized access, disclosure, alteration, and destruction.
- **Integrity.** The entity should take reasonable care that the information it collects, whether personal or sensitive, be relevant for the purposes for which it is to be used.
- **Management and Enforcement.** The entity should provide procedures for assurance of compliance with its own privacy policies and independent recourse procedures to address any unresolved complaints and disputes. The entity should designate one or more individuals who are accountable for the entity's compliance with its privacy policies.

It is important for Your1040Return.com to consider developing an online privacy policy because it is important for consumers to have confidence that an entity takes appropriate steps to protect personal information, especially information as sensitive as that surrounding income and taxation. Because many consumers consider the use of private information about them to be an invasion of their privacy, it is important that entities inform their customers about the kinds of information that are collected about them, the uses of that information, customer options, and related matters. Additionally, some countries have implemented laws and regulations covering the privacy of information obtained through e-commerce.

Failure to develop a formal online privacy policy may lead to future issues that may have an impact on Your1040Return.com's financial statements. First, the lack of a policy may cause some customers to not purchase or renew tax preparation services from Your1040Return.com. Given that customers are using Your1040Return.com's services to prepare and submit highly-sensitive personal tax information, the lack of an adequate privacy policy may be of major concern to potential customers. That reluctance may put pressure on management to generate adequate revenues to be profitable. Second, the lack of an adequately stated privacy policy creates uncertainty as to how Your1040Return.com can use the information it collects from customers ordering tax services online. That lack of uncertainty may lead to inconsistent interpretations about the appropriate uses of the personal information. In some cases, customers may be offended by Your1040Return.com's decision to use the personal information it collects (e.g., decision to sell the customer lists to marketing agencies). Those customers may ultimately enter into litigation against Your1040Return.com to prevent further misuse. Any contingencies that arise related to the litigation may warrant disclosure and recording in the Your1040Return.com financial statements.

Delta Airlines' opening web page at www.delta.com contains an online link to its privacy & security policies. To examine the Delta privacy policy, visit this web site link:

http://www.delta.com/privacy_security/index.jsp

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[2] ***Your1040Return.com's main business strategy involves the delivery of services via the Internet. What are some threats to the viability of Your1040Return.com's business strategy?***

Because Your1040Return.com's core business strategy involves the delivery of services to customers via the Internet, there are several issues that threaten the viability of successfully continuing this service. Below are examples of some of those threats (note that the answers to this question are similar to those for question 1-c):

- **Customer Demand.** Because the business model is based solely on services delivered through the Internet, there may be individuals who are uncomfortable using the Internet to use the online tax services. Certain customers may be reluctant to submit personal tax related financial information over the public Internet. As a result, the customer base in the online marketplace may be limited. One of Your1040Return.com's comparative advantages is that it provides customers access to the most up-to-date tax preparation software. If providers of traditional tax preparation software purchased in retail stores make available easy access to updated software, there may be less demand for Your1040Return.com's online access to up-to-date software.
- **Software Technical Accuracy.** One of the main selling features for Your1040Return.com is access to an up-to-date popular tax software package. There is some risk that the tax preparation software contains errors in the interpretation and application of the complicated federal and state tax codes, which in turn may cause customers to file incorrect returns. If that risk is realized, Your1040Return.com may lose its customer base.
- **Service Availability.** Because Your1040Return.com's core business is based on services delivered via the Internet, the company faces the risk that customers may not be able to access the tax preparation software if there is a failure in the Internet link to the services. Any system failures with Your1040Return.com's computer servers would prevent the company from providing services for its customers, unless reliable and quick backup access is consistently maintained. If the service access is unavailable for a significant amount of time, the company may lose its core customer base.
- **Customer Privacy.** Certain customers may be reluctant to submit personal tax related financial information over the public Internet because of concerns about the privacy of their highly sensitive tax information. As a result, the customer base in the online marketplace may be limited. Any breaches in customer privacy may cause a deterioration of Your1040Return.com's customer base.
- **Competitors.** Given Your1040Return.com's success of offering online tax preparation software, other established tax preparers may decide to compete directly with Your1040Return.com. Tax preparers, such as H&R Block and national CPA firms, may decide to offer similar online tax preparation software services. To some extent, the IRS already competes with the Silver service package, given that individuals can access electronic copies of tax schedules, forms, and publication via the IRS web site (http://www.irs.gov/).

[3] ***When customers register for the Platinum package, they have online access to tax professionals who are paid on a contract basis. If you were in Steven Chicago's shoes, how would you compensate those professionals for their services? What controls could Your1040Return.com implement to ensure that the company does not overpay for those professional services?***

Currently, the tax professionals who provide online tax consulting to Platinum service customers are compensated on a contract basis. Most likely, Steven Chicago would compensate those individuals on an hourly basis for the work they perform. Perhaps a small set of those professionals may be contracted on a retainer basis to perform a minimum number of hours of service each month or quarter of the year for Your1040Return.com customers. Each month (or quarter) the tax professionals could submit a detailed time analysis of the work performed to determine if the minimum number of hours have been worked in accordance with the retainer agreement. In the event the number of hours worked exceed the contracted amount, the tax professionals would be paid for the additional work performed on an hourly rate basis.

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Your1040Return.com should design adequate controls to ensure that the tax professionals perform legitimate tax consulting services in exchange for their pay. Perhaps, the Your1040Return.com web site could be designed to capture information when the customer clicks on a link to activate the instant messenger program that allows communication between the Platinum customer and the tax professional service. The web site could be designed such that pertinent information is captured (e.g., time, date, customer number, question asked) automatically by Your1040Return.com's server. The server could also be designed to capture information about the tax professional (e.g., contractor id) who responds to the customer's inquiry. That information captured automatically could then be reconciled to the monthly time analysis submitted by the tax professional that indicates the services performed for the customer. The tax professional's time analysis would be set up to "charge" hours worked to each customer number serviced by that professional. Your1040Return.com could also require the tax professional to retain electronic or paper copies of the responses provided to the customer via the internet messenger program as backup of all services performed. Your1040Return.com could selectively "audit" charges submitted by the tax professionals back to these files on a periodic basis.

Thinking about the issues Your1040Return.com faces in paying its tax consultants is a valuable exercise that will bring students face-to-face with the challenging issues brought about by the unique e-business models made possible by the Internet. Thus, the specific content of student answers to this question is less important than the depth of their thinking and the quality of their insights.

[4] ***Auditing standards provide guidance for auditors when evaluating electronic evidence. What are the implications for an auditor when a client's accounting system produces and stores transaction evidence only electronically?***

Paragraph A134 of AU-C Section 315, "Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatement", summarizes the implications as follows:

> *"When such routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures in relation to the risk. For example, the auditor may consider this to be the case when a significant amount of an entity's information is initiated, authorized, recorded, processed, or reported only in electronic form, such as in an integrated system. In such cases*
>
> - *audit evidence may be available only in electronic form, and its sufficiency and appropriateness usually depend on the effectiveness of controls over its accuracy and completeness.*
> - *the potential for improper initiation or alteration of information to occur and not be detected may be greater if appropriate controls are not operating effectively."*

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Apple Inc.

Evaluation of Client Business Risk

2.2

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

INSTRUCTIONAL OBJECTIVES

[1] To provide experience with obtaining and reading a form 10-K report.

[2] To provide experience with identifying information relevant for assessing a client's business risks.

[3] To provide experience with linking business risks to audit implications.

[4] To provide experience linking an audit client's business risks to risks of material financial misstatement.

[5] To provide experience with writing a formal business memorandum.

KEY FACTS

- Apple Inc. (Apple) is a publicly traded company (NASDAQ) that had 5,332,313,000 shares of common stock outstanding with a trading price of $117.63 as of October 14, 2016.
- Apple offers a broad range of products and services including iPhone®, iPad®, Mac®, iPod®, Apple Watch®, Apple TV®, a portfolio of consumer and professional software applications, iOS, macOSTM, watchOS® and tvOSTM operating systems, iCloud®, Apple Pay® and a variety of accessory, service and support offerings.The Company sells and delivers digital content and applications through the iTunes Store®, App Store®, Mac App Store, TV App Store, iBooks StoreTM and Apple Music® (collectively "Internet Services").
- Apple's hardware products are manufactured primarily by outsourcing partners that are located in Asia.
- Apple's net revenue for fiscal 2016 was $215.6 billion while net income was $45.7 billion.
- Apple's percentage net sales by geographic mareket are: Americas 40%; Europe 23%; Greater China 22%; Japan 8%; and Rest of Asia Pacific 6%.
- Apple's percentage sales by product are: iPhone 63%; iPad 10%; Mac 11%; services 11%; and other procucts 5%.
- Apple is required to have an integrated audit of its consolidated financial statements and its internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States).
- Apple's fiscal year is the 52 or 53-week period that ends on the last Saturday of September.

USE OF CASE

Many students will be uncomfortable with this case assignment if they have had no previous experience analyzing a company's business risk. This case assignment will provide students with a structure for evaluating an audit client's business risk. The case assignment is best used in an undergraduate and graduating auditing course when understanding a client's business or audit risk and materiality are discussed.

1 The background information about Dell Computer Corporation was taken from Dell Computer Corporation's January 28, 2011 Form 10-K filed with the Securities and Exchange Commission.

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.

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The approach we recommend for this assignment is to first ask students to review the case assignment materials and conduct a preliminary "in-class" discussion of the business risks to be included in the evaluation memorandum and case requirements. Specifically, it is useful to begin with a discussion of emerging business forces and business strategies related to the electronics/computer industry. A useful learning activity for the "in-class" assignment is "roundtable." The basic process for this activity is to have students meet in small groups to state aloud and write down on a single sheet of paper their ideas for the external business forces (customers, competitors, suppliers, labor, capital market, and regulations). For example, students could first discuss their ideas concerning customers, then competitors, then suppliers, and so on. 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 answer with the class. Students normally do not have a difficult time identifying that the primary business strategy used by Apple is differnetiation. The selected financial information for Apple and Samsung (provided at the end of this document) is a useful to share with students to discuss Apple's strategy and highlight how the strategy can be understood by looking at the financial information. Before discussing with the class you can ask students to compare and contrast the financial information for the two companies in small groups and then call on individuals to share what was discussed in their group.

For the "out-of-class" assignment, it is important to discuss the solution with students to maximize their learning experience. Active learning activities can easily be adapted to the "out-of-class" component of this assignment. The learning activity called "homework review" could be used to discuss the students' answers to this assignment. The basic process for this activity is to have the students meet in pairs or small groups to compare and discuss their responses to questions 2a through 2j. The tasks of answering and checking the accuracy of each explanation should be rotated among pairs or group members. After students have had the opportunity to review all their responses the instructor can randomly call on individual students to share their responses with the class. It is important for the instructor to randomly call on individual students to ensure that all students take responsibility for learning the material. Note, if students complete their answers in pairs or groups "out-of-class," it is best to have students discuss their answers with different students "in-class."

If the case assignment 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 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 their written solutions. Once an outline is developed, students individually draft a written response based on the outline. 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 draft to the outline and critiqued drafts when given to the instructor.

When multiple writing projects are assigned during the semester, the above approach can be modified to require students to complete a joint response in place of individual responses. The basic difference is that one student is assigned responsibility to compose and re-write the written response while the other student is assigned responsibility to critique the original draft. Students should still meet to create an outline for the written solution. The responsibilities of writer and reviewer should be alternated for each written assignment.

PROFESSIONAL STANDARDS

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

AICPA ASB Standards: AU-C Section 240 "Consideration of Fraud in a Financial Statement Audit," AU-C Section 300 "Planning an Audit," and AU-C Section 315 "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement."

PCAOB Standards: AS 1101 "Audit Risk," AS 2101 "Audit Planning," and AS 2110 "Identifying and Assessing Risks of Material Misstatement"

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QUESTIONS AND SUGGESTED SOLUTION

SOLUTION FOR "IN-CLASS" DISCUSSION

As discussed earlier in the "Use of Case" section, we suggest that you introduce this case by first having an "in-class" discussion of emerging business forces and Apple's business strategy. Here are some suggested points that could be made:

Emerging Business Forces

- **Customers** – Apple designs, manufactures and sells consumer electronics, computers, software and related services to a wide sepctrum of customers from large organizations to individuals. Apple's products are distinctive using their own operating system to ensure full software and hardware integration that enhances quality and usability.
- **Competitors** – Apple's major competitors include Samsung, Amazon, Google, Microsoft, Dell, Hewlett-Packard, IBM, and Lenovo. The markets for Apple's products and services are highly competitative. Apple's future success is dependent on its ability to continue to develop and offer new innovative products and services to its customers.
- **Suppliers** – Hardware components for Apple's products are obtained primarily from contract manufacturering partners. Many hardware components can be purchased in a highly competitive global market served by many contract manufacturers. In contrast, some hardware components are customized for Apple and may be available from only one manufacturering source. The cost of switching suppliers, other than customized component suppliers, is relatively low as there are many contract manufacturers available to provide components included in Apple's products.
- **Labor** – Labor is less than two percent of the total cost of producing an iPhone. Labor costs for other products are also a small proportion of the total cost of producing the products.
- **Capital Markets** –The market for mobile communicaton and media devices, personal computers, portable music and media devices, and related software and services is highly competitive and considered a high risk industry. There are several large and well financed companies participating in this industry. Therefore, there is not an overabundance of long-term investors and creditors available to finance new entrants into this market.
- **Regulations** – Apple must comply with various federal, state and international laws governing product safety (for example, U.S. Consumer Product Safety), radio frequency emission (for example, U.S. Federal Communications Commission), import/export activities (for example, U.S. Department of Commerce), anti-trust activities (for example, U.S. Federal Trade Commission and Department of Justice), environment activities (for example, U.S. Environmental Protection Agency), and labor activities (for example, U.S. Department of Labor Occupational Safety & Health Administration). There are no changes to the regulatory environment suggesting a change to Apple's competitive position.

Business Strategy

- Apple's products are noted for their innovative design and ease of use suggesting that Apple's primary mode of competition is differentiation and not cost leadership.
- Financial information is provided for Apple and Samsung as a percentage of net revenues and total assets. Apple generally has had a higher gross margin percent and lower asset turnover than Samsung. This information is consistent with Apple following a differentiation strategy. Although the information suggests that Samsung's gross margin has been improving.
- Other interesting insights that can be obtained from the information provided is that long-term operating assets represent less than ten percent of total assets for Apple but are more than thirty percent for Samsung. This information highlights that Apple relies on contract manugacturers more than Samsung and that Samsung manugactures and sells a broader range of products as compared to Apple. Both companies finance less than ten percent of their assests through long-term debt.

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SOLUTION FOR CASE ASSIGNMENT

[1] ***Go to Apple's website (investor.apple.com) and explore the website. Click on the "SEC Filings" link. Obtain the most recent SEC Form 10-K provided for Apple. Based on the information obtained from the website and your knowledge of the industry, prepare a memo discussing the following items:***

[a] ***Apple's information for fiscal year ended 9/24/2016:***

Sales	- $215.6 billion
Net income	- $45.7 billion
Cash flow from operating activities	- $65.8 billion
Total assets	- $321.7 billion
Number of employees	- Approximately 116,000 full-time employees

[b] ***What are Apple's products?***

Apple's primary product offerings include the following items: iPhone®, iPad®, Mac®, iPod®, Apple TV®, Apple Watch®, a portfolio of consumer and professional software applications, iOS, macOSTM, watchOS® and tvOSTM operating systems, iCloud®, Apple Pay® and a variety of accessory, service and support offerings. The Company also sells and delivers digital content and applications through the iTunes Store ®, App StoreTM, iBooks StoreTM, and Mac App Store.

[c] ***Who are Apple's competitors?***

Major competitors for Apple include Samsung, Amazon, Google, Microsoft, Dell, Hewlett-Packard, IBM, and Lenovo. The markets for the Company's products and services are highly competitive. The market for the company's products and services can be characterized by frequent product introductions and rapid technological advances.

[d] ***Who are Apple's customers?***

Apple sells its products and services to consumers; small and mid-sized businesses; and education, enterprise and government customers.

[e] ***Who are Apple's suppliers?***

Apple uses contract manufacturers for hardware components used in its products. Hardware components are generally available from multiple sources. Some hardware components are customized for Apple and may be available from only one manufacturering source. The final assembly of products is performed in whole or in part by a few outsourcing partners located primarily in Asia.

[f] ***How does Apple market and distribute its products?***

Apple sells its products and resells third-party products in most of its major markets directly to consumers and small and mid-sized businesses through its retail and online stores and its direct sales force. The Company also employs a variety of indirect distribution channels, such as third-party cellular network carriers, wholesalers, retailers, and value-added resellers. During 2016, the Company's net sales through its direct and indirect distribution channels accounted for 25% and 75%, respectively, of total net sales.

[g] ***What is Apple's basic business strategy (cost leadership or differentiation)?***

Apple's basic business strategy is differentiation. Apple is noted for providing products with innovative design and ease of use. The Company's objective is to design and develop operating systems, hardware, application software, and services that provide customers new products and solutions with superior ease-of-use, seamless integration, and innovative design. The Company believes continual investment in research and development, marketing and advertising is critical to the development and sale of innovative products and technologies. The Company does not try to sell its product and services at the lowest price, rather it wants its customer to have a superior experience with its prodcuts and services.

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[h] ***What are critical business processes for Apple given its basic business strategy (for example, supply chain management)?***

- Processes related to product development. The most critical business process for Apple is its product and service development. The Company has experienced substantial growth from the early 2000s with the introduction of the iPod, then iPhone and iPad. Recently the company introduced the iWatch. The company has relied on the introduction of new innovative products that have had a disruptive effect to the marketplace. Apple's ability to compete successfully depends heavily upon its ability to ensure a continual and timely flow of competitive products, services and technologies to the marketplace.
- Processes related to customer relations. Demand for technology products is volatile. Good communications between Apple and its customers can help it properly plan for changes in demand. Additionally, good communications with customers can help ensure that Apple introduces products and services with features most desirable to customers.
- Processes related to supplier relations. The manucfacturing and final assembly of Apple products is handled by contract manufacturers. Many components are available from multiple sources while some components and final assembly have few sources. Samsung, a primary competitor, is the only provider of application processors and Foxconn is the main assembler of Apple products. Apple must have good relations with its suppliers to continuously introduce reliable products with new innovative technology.

[i] ***What accounting information is associated with the critical business processes and how does Apple measure-up on that information?***

- Accounting information associated with product and service development would include sales and service revenues, gross margin, accounts receivable, inventory, and research and development expense. Financial information for Apple Inc. is provided at the end of this case. Apple's revenues have grown by over 300 percent over the last five years but the rate of growth has slowed in the most recent year. Apple's gross margin percent has ranged from 37.6 percent to 43.9 percent over the last five years with the gross margin percent for the most current year being 39.1 percent. Accounts receivable turnover have ranged from 12.0 to 19.2 over the last five years with the accounts receivable turnover for the most current year being 13.2. Inventory turnover has ranged from 57.9 to 112.1over the last five years with the inventory turnover for the most current year being 58.6. Reseach and development expenditures as a percent of revenues have ranged from 2.6 percent to 6.4 percent over the last five years with the most recent year being 4.7 percent. The accounting information suggests that Apple continues to be sucessful with prodcut and service development but there are competitive forces putting downward pressure on Apple's performance.
- Accounting information associated with customer relations would include sales and service revenue, accounts receivable, and selling expense. Selling, general and administrative expense as a percentage of net revenues have ranged from 2.2 percent to 6.6 percent over the last five years with the percent for the most current year being 6.6 percent. Selling, general, and adminsistrative expense has grown from 2.4 billion during fiscal 2012 to 14.2 billion during fiscal 2016. The accounting information suggests that Apple continues to be sucessful with customer relations but there are competitive forces putting downward pressure on Apple's performance.
- Accounting information associated with supplier relations would include cost of sales, inventory, accounts payable, and warranty expense. Cost of goods sold as a percent of revenues has ranged from 56.1 percent to 62.4 percent over the last five years with the percent for the most current year being 60.9 percent. Inventory turnover has ranged from 57.9 to 112.1over the last five years with the most recent inventory turnover of 58.6. Accounts payable turnover has ranged from 3.6 to 4.9 over the last five years with the most recent accounts payable turnover of 3.6. Warranty expense was $2.2 million in 2012, $5.0 million in 2013, $5.0 million in 2014, $5.0 million in 2015, and $3.6 million in 2016. As a percent of revenues warranty expense has ranged from 1.4 percent to 2.9 percent with the highest percent in 2013. The accounting information suggests that Apple has been sucessful with supplier relations but there may be some issues going forward.

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[j] ***What accounting method is Apple using to report the accounting information associated with critical business processes and what is the risk of material misstatement?***

- **Revenue** – recognized when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, and collection is probable. For most of the Company's sales, these criteria are met at the time the product is shipped. Service revenues are recongnized over the service coverage period. The company reduces revenues for esitmates related to returns and price reductions. There is extreme pressure for Apple to show continuous revenue growth. Additionally, Apple has experienced extreme competition in recent years with some of its key products like the iPhone. There is some risk of misstatement given the competitive nature of the industry, Apple's desire to show continuous revenue growth, and Apple's desire to be a market leader.
- **Accounts receivable** – allowance method for uncollectible accounts. The business economies are slowly recovering for Apple's primary markets reducing the likelihood of misstatement.
- **Cost of revenues (sales)** - method not discussed in notes to financial statements. Cost of revenues are required to be reported when the related sale is recorded. Some risk of misstatement as Apple is strategically focused on differentiation and strong gross margins are expected with this strategy.
- **Inventory** – The lower of cost or market. Cost is computed using FIFO. There is a low risk of misstatement given that Apple does not manufacture components or handle final assembly of its products and it has done an excellent job of minimizing its inventory levels (limiting the risk of obsolescence).
- **Accounts payable** – method not discussed in notes to financial statements. Accounts payable are required to be recorded when related goods or services are received. There is a low risk of misstatement as the numbers are consistent with our understanding of the current business environment.
- **Warranty expense** – estimated and recorded in year of sale. Warranty expense was 2.9 percent, 1.4 percent, and 1.5 percent of sales for the three most recent fiscal years. Some risk of misstatement as Apple is strategically focused on differentiation and thus is consistently introducing new product features creating uncertaining with the risk of failure.
- **Research and Development** – expensed as incurred. Low risk of misstatement as these costs are expensed immediately.
- **Selling expense** – expensed in year incurred. Low risk of misstatement as these costs are expensed immediately.

[2] ***Professional auditing standards provide guidance on the auditor's consideration of an entity's business risks. What is the auditor's objective for understanding an entity's business risks? Why does an auditor not have responsibility to identify or assess all business risks? Provide some examples of business risks associated with an entity that an auditor should consider when performing an audit?***

The auditor must obtain an understanding of the entity and its environment to assess the risk of material misstatement and to design the nature, timing, and extent of further audit procedures to perform.

Why does an auditor not have responsibility to identify or assess all business risks?

Not all business risks give rise to risks of material misstatement. The auditor needs to consider those business risks that could result in a material misstatement at either the financial statement level or assertion level to classes of transactions, account balances, and disclosures.

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Provide some examples of business risks associated with an entity that an auditor should consider when performing an audit.

Appendix C of AU Section 312 provides examples of business risks that could give rise to material misstatements. Some examples provided are:

- Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies.
- High degree of complex regulation.
- Marginally achieving explicitly stated strategic objectives.
- Constraints on the availability of capital and credit.
- Changes in the industry in which the entity operates.
- Changes in the supply chain.
- Developing or offering new products or services, or moving into new lines of business
- Expanding into new locations.

Similarly AS 2110 provides examples of business risks that could give rise to material misstatements. Some examples provided are:

- Company does not have the personnel or expertise to deal with the changes in the industry.
- New product or service will not be successful.
- Demand for the company's products or services have not been accurately estimated.
- IT systems and processes are incompatible.
- Loss of financing due to the company's inability to meet financing requirements.
- Incomplete or improper implementation of the business strategy.
- Increased legal exposure.

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Apple Inc.	**9/24/16**	**9/26/15**	**9/27/14**	**9/28/13**	**9/29/12**
Income Statement Amounts as Percent of Net Revenue:					
Net Revenue	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of Revenue	60.9%	59.9%	61.4%	62.4%	56.1%
Gross Margin	39.1%	40.1%	38.6%	37.6%	43.9%
Selling, General, and Administrative	6.6%	6.1%	6.6%	6.3%	2.2%
Research and Development	4.7%	3.5%	3.3%	2.6%	6.4%
Other Income and Expenses, net	0.6%	0.5%	0.5%	0.7%	0.3%
Income Taxes	7.3%	8.2%	7.6%	7.7%	9.0%
Net Income	21.2%	22.8%	21.6%	21.7%	26.7%
Balance Sheet Amounts as Percent of Total Assets:					
Cash	6.4%	7.3%	6.0%	6.9%	6.1%
Short-term Investments	14.5%	7.1%	4.8%	12.7%	10.4%
Accounts Receivable	4.9%	5.8%	7.5%	6.3%	6.2%
Inventory	0.7%	0.8%	0.9%	0.9%	0.4%
Other	6.8%	9.8%	10.3%	8.6%	9.5%
Total Current Assets	33.2%	30.8%	29.6%	35.4%	32.7%
Investments	53.0%	56.5%	56.1%	51.3%	52.3%
Property, Plant and Equipment	8.4%	7.7%	8.9%	8.0%	8.8%
Goodwill	1.7%	1.8%	2.0%	0.8%	0.6%
Other Intangibles	1.0%	1.3%	1.8%	2.0%	2.4%
Other	2.7%	1.9%	1.6%	2.5%	3.1%
Total Assets	100.0%	100.0%	100.0%	100.0%	100.0%
Short-term Borrowings and Current Portion Long-term Debt	3.6%	3.8%	2.7%	0.0%	0.0%
Accounts Payable	11.6%	12.2%	13.0%	10.8%	12.0%
Accrued Liabilities	6.8%	8.7%	8.0%	6.7%	6.5%
Short-term Deferred Revenue	2.5%	3.1%	3.7%	3.6%	3.4%
Other Current Liabilities	0.0%	0.0%	0.0%	0.0%	0.0%
Total Current Liabilities	24.6%	27.8%	27.4%	21.1%	21.9%
Long-term Debt	23.4%	18.4%	12.5%	8.2%	0.0%
Long-term Deferred Revenue	0.9%	1.2%	1.3%	1.3%	1.5%
Other Non-Current Liabilities	11.2%	11.5%	10.7%	9.8%	9.5%
Total Liabilities	60.1%	58.9%	51.9%	40.3%	32.9%
Total Stockholders' Equity	39.9%	41.1%	48.1%	59.7%	67.1%
Total Liabilities and Stockholders' Equity	100.00%	100.00%	100.00%	100.00%	100.00%
Selected Ratios:					
Return on Assets	14.9%	20.5%	18.0%	19.3%	28.5%
Return on Stockholders' Equity	36.9%	46.2%	33.6%	30.6%	42.8%
Asset Turnover Ratio	0.70	0.90	0.83	0.89	1.07
Financial Leverage Ratio	2.47	2.26	1.87	1.58	1.50
Accounts Receivable Turnover	13.23	13.62	11.96	14.22	19.20
Inventory Turnover	58.64	62.82	57.94	83.45	112.12
Accounts Payable Turnover	3.61	4.27	4.27	4.90	4.91
Current Ratio	1.35	1.11	1.08	1.68	1.50

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Samsung Electronics Co. Ltd.	**12/31/16**	**12/31/15**	**12/31/14**	**12/31/13**	**12/31/12**
Income Statement Amounts as Percent of Net Revenue:					
Net Revenue	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of Revenue	59.6%	61.5%	62.2%	60.2%	63.0%
Gross Margin	40.4%	38.5%	37.8%	39.8%	37.0%
Selling, General, and Administrative	18.6%	17.9%	18.2%	17.2%	6.1%
Research and Development	7.3%	7.4%	7.4%	6.5%	16.5%
Other Income and Expenses, net	-0.7%	0.2%	-1.4%	-0.7%	0.4%
Income Taxes	4.0%	3.4%	2.2%	3.4%	3.0%
Net Income	11.3%	9.5%	11.3%	13.3%	11.9%
Balance Sheet Amounts as Percent of Total Assets:					
Cash	12.2%	9.3%	7.3%	7.6%	10.4%
Short-term Investments	21.4%	20.2%	19.5%	17.8%	10.3%
Accounts Receivable	9.3%	10.4%	10.7%	11.7%	14.7%
Inventory	7.0%	7.8%	7.5%	8.9%	9.8%
Other	4.0%	3.9%	4.9%	5.7%	3.0%
Total Current Assets	53.9%	51.5%	50.0%	51.7%	48.2%
Investments	4.8%	5.6%	7.8%	5.9%	7.7%
Property, Plant and Equipment	34.9%	35.7%	35.1%	35.3%	37.8%
Goodwill	0.0%	0.0%	0.0%	0.0%	0.0%
Other Intangibles	2.0%	2.2%	2.1%	1.9%	2.1%
Other	4.3%	4.9%	5.1%	5.2%	4.2%
Total Assets	100.0%	100.0%	100.0%	100.0%	100.0%
Current Portion and Short-term Borrowings	5.3%	4.7%	4.3%	4.1%	5.2%
Accounts Payable	6.9%	6.2%	7.9%	8.2%	9.3%
Accrued Liabilities	6.1%	6.6%	7.0%	7.4%	7.6%
Short-term Deferred Revenue	0.5%	0.6%	0.6%	0.8%	0.8%
Other Current Liabilities	2.0%	2.8%	2.8%	3.4%	3.0%
Total Current Liabilities	20.9%	20.9%	22.6%	24.0%	25.9%
Long-term Debt	0.5%	0.6%	0.6%	1.1%	3.0%
Long-term Deferred Revenue	0.0%	0.0%	0.0%	0.0%	0.0%
Other Liabilities	5.0%	4.6%	3.8%	4.9%	4.0%
Total Liabilities	26.4%	26.1%	27.1%	29.9%	32.9%
Total Stockholders' Equity	73.6%	73.9%	72.9%	70.1%	67.1%
Total Liabilities and Stockholders' Equity	100.0%	100.0%	100.0%	100.0%	100.0%
Selected Ratios:					
Return on Assets	9.0%	7.7%	10.5%	15.4%	14.7%
Return on Stockholders' Equity	12.2%	10.5%	14.7%	22.5%	22.2%
Asset Turnover Ratio	0.80	0.81	0.93	1.16	1.24
Financial Leverage Ratio	1.36	1.36	1.40	1.46	1.51
Accounts Receivable Turnover	8.16	7.66	8.30	8.86	8.25
Inventory Turnover	6.47	6.52	7.04	7.48	7.88

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Apple Inc.	**9/24/16**	**9/26/15**	**9/27/14**	**9/28/13**	**9/29/12**
Income Statement Amounts as Percent of Net Revenue:					
Net Revenue	215,639	233,715	182,795	170,910	156,508
Cost of Revenue	131,376	140,089	112,258	106,606	87,846
Gross Margin	84,263	93,626	70,537	64,304	68,662
Selling, General, and Administrative	14,194	14,329	11,993	10,830	3,381
Research and Development	10,045	8,067	6,041	4,475	10,040
Other Income and Expenses, net	1,348	1,285	980	1,156	522
Income Taxes	15,685	19,121	13,973	13,118	14,030
Net Income	45,687	53,394	39,510	37,037	41,733
Balance Sheet Amounts as Percent of Total Assets:					
Cash	20,484	21,120	13,844	14,259	10,746
Short-term Investments	46,671	20,481	11,233	26,287	18,383
Accounts Receivable	15,754	16,849	17,460	13,102	10,930
Inventory	2,132	2,349	2,111	1,764	791
Other	21,828	28,579	23,883	17,874	16,803
Total Current Assets	106,869	89,378	68,531	73,286	57,653
Investments	170,430	164,065	130,162	106,215	92,122
Financing Receivables					
Property, Plant and Equipment	27,010	22,471	20,624	16,597	15,452
Goodwill	5,414	5,116	4,616	1,577	1,135
Other Intangibles	3,206	3,893	4,142	4,179	4,224
Other	8,757	5,422	3,764	5,146	5,478
Total Assets	321,686	290,345	231,839	207,000	176,064
Short-term Borrowings and Current Portion Long-term Debt	11,605	10,999	6,308	-	-
Accounts Payable	37,294	35,490	30,196	22,367	21,175
Accrued Liabilities	22,027	25,181	18,453	13,856	11,414
Short-term Deferred Revenue	8,080	8,940	8,491	7,435	5,953
Other Current Liabilities					
Total Current Liabilities	79,006	80,610	63,448	43,658	38,542

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Asher Farms Inc.

Understanding of Client's Business Environment

2.4

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

INSTRUCTIONAL OBJECTIVES

[1] To provide experience with identifying information relevant for understanding a client's business environment.

[2] To provide experience with linking business risks to audit implications.

[3] To provide experience linking an audit client's business risks to financial statement accounts.

KEY FACTS

- Asher Farms' common stock is traded on the NASDAQ national market with an aggregate market value of $677 million on October 31, 2018.
- Asher Farms, Inc. is a fully-integrated poultry processing company engaged in the production, processing, marketing and distribution of fresh and frozen chicken products.
- During the year ended October 31, 2018 Asher Farms processed 343.6 million chickens, or approximately 2.0 billion dressed pounds and is one of the largest processors of dressed chickens in the United States.
- Asher Farms has 7 hatcheries, 6 feed mills and 8 processing plants employing 1,059 salaried and 8,646 hourly employees.
- Asher Farms uses 530 broiler farm contract operators, 173 breeder farm contract operators and 44 pullet farm contract operators.
- Asher Farms is required to have an integrated audit of its consolidated financial statements and its internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States).

USE OF CASE

Information from Sanderson Farms, Inc. was used in developing this case (see www.sandersonfarms.com for more information on Sanderson Farms). This case assignment is a relatively short case that will provide students with a process for starting to understand an audit client's business environment. The case assignment is best used in an undergraduate and/or graduating auditing course when understanding a client's business is discussed.

The case can be completed by students individually or in groups as an "in-class" or "out-of-class" assignment. If the case is going 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 "in-class" active learning technique is to have students breakup into small groups and then assign the small groups responsibility to brainstorm PESTLE factors (political, economic, social, technological, legal and regulatory, and environmental). 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 answer with the class. For example, students could first discuss their ideas concerning political, then economic, then social, and so on. The instructor can write

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.

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the factors identified on a board. The class time allocated to the group discussion can be shortened by assigning groups responsibility for just one or two PESTLE factors. It is important for the instructor to randomly call on individual students to share their group's answers to ensure that all students take responsibility for learning the material. Once PESTLE factors have been identified, the instructor can then ask the groups to list the financial statement accounts and disclosures related to the identified PESTLE factors. The instructor can then randomly call on students to share their group's responses with the rest of the class.

If the case assignment is going to be used as an "out-of-class" assignment, we recommend discussing the case requirements with the students prior to having them complete the assignment. The cooperative learning activity of "Homework Review" can be used for the "out-of-class" assignment. Students meet in small groups to compare and discuss PESTLE factors and related financial statement accounts and disclosures identified. After students have had a few minutes to compare and discuss their answers the instructor can randomly call on individual students to discuss their PESTLE factors and financial accounting accounts and disclosures.

An alternative approach to use this case at the graduate level is to first have students complete Asher Farms as an "in-class" assignment to provide students with experience in understanding a client's business environment and then have students complete requirements 1 and 2 in a group for a different company. The instructor could assign students a company from a list of companies or ask students to submit 3 companies to the instructor for feedback from the instructor on which company to research.

PROFESSIONAL STANDARDS

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

AICPA ASB Standards: AU-C Section 240 "Consideration of Fraud in a Financial Statement Audit," AU-C Section 300 "Planning an Audit" and AU-C Section 315 "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement."

PCAOB Standards: AS 1101 "Audit Risk," AS 2101 "Audit Planning," and AS 2110 "Identifying and Assessing Risks of Material Misstatement."

QUESTIONS AND SUGGESTED SOLUTION

[1] ***Professional auditing standards provide guidance on the auditor's consideration of an entity's business environment and associated business risks.***

[a] ***What is the auditor's objective for understanding an entity's business environment?***

The auditor must obtain an understanding of the entity and its environment to assess the risk of material misstatement and to design the nature, timing, and extent of further audit procedures to perform.

[b] ***Why does an auditor not have responsibility to identify or assess all business risks?***

Not all business risks give rise to risks of material misstatement. The auditor needs to consider those business risks that could result in a material misstatement at either the financial statement level or assertion level to classes of transactions, account balances, and disclosures.

[c] ***Provide some examples of business risks associated with an entity that an auditor should consider when performing an audit.***

Appendix C of AU-C Section 315 provides examples of business risks that could give rise to material misstatements. Some examples provided are:

- Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies.

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- High degree of complex regulation.
- Marginally achieving explicitly stated strategic objectives.
- Constraints on the availability of capital and credit.
- Changes in the industry in which the entity operates.
- Changes in the supply chain.
- Developing or offering new products or services, or moving into new lines of business
- Expanding into new locations.

Similarly AS 2110 provides examples of business risks that could give rise to material misstatements. Some examples provided are:

- Company does not have the personnel or expertise to deal with the changes in the industry.
- New product or service will not be successful.
- Demand for the company's products or services have not been accurately estimated.
- IT systems and processes are incompatible.
- Loss of financing due to the company's inability to meet financing requirements.
- Incomplete or improper implementation of the business strategy.
- Increased legal exposure.

[d] ***Provide some additional examples of business risks that might not lead to a risk of material misstatement in the financial statements.***

Most business risks will eventually have financial consequences. However not all business risks will give rise to material misstatements. A few examples of business risks that might not lead to a risk of material misstatement in the financial statements may include:

- Employee stealing petty cash funds.
- Employee use of company office supplies for personal benefit not company benefit.
- Employee running a personal side business from company facilities.

[2] ***A useful approach for understanding a client's business environment and associated business risks is to perform a PESTLE analysis. PESTLE is an acronym for Political, Economic, Social, Technological, Legal and Environmental factors that are used to asses the client's business environment. A PESTLE analysis focuses on factors that may affect an entity's business model, but are beyond the control or influence of the client. While beyond management's direct influence, such factors may significantly impact an entity's business risk. Read the background information about the poultry industry and conduct additional research on the internet to obtain the latest news and information on the industry. Brainstorm political, economic, social, technological, legal and environmental factors that could affect Asher Farms' business risk. Unless your instructor indicates otherwise, identify at least one business risk factor for each component of the PESTLE acronym.***

Political

- Political instability in customer markets from the effects of war and terrorist activities could adversely affect ability to obtain production supplies or sell chicken products.

  Financial Statement Accounts/Disclosures that could be affected: Going concern disclosure, cost of sales, revenue, inventory

  The company may not be able to continue as a going concern or may have to pay more to produce poultry or not be able to obtain supplies or sell poultry from/in important markets.

- Immigration reform continues to attract significant attention. New immigration legislation at the federal or state level could make it more difficult or costly for the company to hire United States citizens and/or legal immigrant workers. Also, increased enforcement efforts with respect to existing immigration laws by governmental authorities could disrupt a portion of the workforce in the industry and thus adversely impact production of chicken products.

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Financial Statement Accounts/Disclosures that could be affected: Cost of sales, revenue

The company may have to pay higher labor costs or may not be able to produce and sell as much poultry.

- Changes in tax rates could adversely affect company earnings.

  Financial Statement Accounts/Disclosures that could be affected: Taxes payable, deferred taxes, tax expense

  The company may have to remit more in taxes to government.

Economic

- Changes in national or global macro-economic conditions, including currency translation rates, inflation, interest rates and consumer spending rates could adversely affect company earnings.

  Financial Statement Accounts/Disclosures that could be affected: Cost of sales, revenue, inventory

  The company may have to pay higher production costs or may not be able to produce or sell as much poultry.

- The strong economic growth in the developing world has resulted in higher demand for chicken products. A decline in the growth of the developing world due to dramatic increases in energy costs could adversely affect the demand for company products.

  Financial Statement Accounts/Disclosures that could be affected: Revenue, inventory

  The company may not be able to sell as much poultry.

- Competing demand for corn and soybean meal for use in the manufacture of renewable energy could adversely affect company earnings. Corn and soybean meal represent approximately 41 percent of production costs in the poultry industry.

  Financial Statement Accounts/Disclosures that could be affected: Cost of sales, revenue

  The company may have to pay higher production costs or may not be able to produce and sell as much poultry.

- Changes in global weather patterns has resulted in more crop failures and sharply higher costs for grains. Continuation of the changing weather patterns throughout the world could adversely affect the cost of feed.

  Financial Statement Accounts/Disclosures that could be affected: Cost of sales, revenue

  The company may have to pay higher production costs or may not be able to produce and sell as much poultry.

- Availability and relative costs of labor could adversely affect the cost of production.

  Financial Statement Accounts/Disclosures that could be affected: Cost of sales, revenue

  The company may have to pay higher production costs or may not be able to produce and sell as much poultry.

- Availability and relative costs associated with using independent contract growers to raise the live chickens processed in the poultry operations could adversely affect the cost of production.

  Financial Statement Accounts/Disclosures that could be affected: Cost of sales, revenue

  The company may have to pay higher production costs or may not be able to produce and sell as much poultry.

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Social

- Changing consumer trends, demands and preferences for meat products. Trends within the food industry change often, and failure to identify and react to changes in these trends could lead to reduced demand and price reductions for chicken products. In recent years there has been a movement towards low carbohydrate and low fat diets as consumer become more aware of the effects of unhealthy lifestyles on their long term well being. This has resulted in a positive impact on the demand for chicken products.

  Financial Statement Accounts/Disclosures that could be affected: Revenues, inventory

  The company may not be able to sell as much poultry.

- Public concern over outbreak of livestock diseases such as avian influenza. Negative publicity of the outbreak of a disease related to chicken stock could raise health concerns with consumers and adversely impact the demand for chicken products from the company.

  Financial Statement Accounts/Disclosures that could be affected: Revenues, inventory

  The company may not be able to sell as much poultry.

- Public concern over contamination of chicken products by disease-producing organisms or pathogens, such as Listeria monocytogenes, Salmonella and generic E. coli. Negative publicity related to the contamination of chicken products with these pathogens could raise health concerns and adversely impact the demand for chicken products from the company

  Financial Statement Accounts/Disclosures that could be affected: Revenues, inventory

  The company may not be able to sell as much poultry.

- Public concern over corporate social responsibility and the humane treatment of chicken livestock. Negative publicity related to intensive factory production and beak trimming of chicken could raise social responsibility concerns and adversely impact the demand for chicken products from the company.

  Financial Statement Accounts/Disclosures that could be affected: Revenues, inventory

  The company may not be able to sell as much poultry.

- Public concern over discharge of chicken manure. Negative publicity related to the discharge of chicken manure could raise social responsibility concerns and adversely impact the demand for chicken products from the company.

  Financial Statement Accounts/Disclosures that could be affected: Revenues, inventory

  The company may not be able to sell as much poultry.

- Public concern over use of hormones and antibiotics in feed stock. Negative publicity related to the use of hormones and antibiotics in feed stock could raise health concerns with consumers and adversely impact the demand for chicken products from the company.

  Financial Statement Accounts/Disclosures that could be affected: Revenues, inventory

  The company may not be able to sell as much poultry.

- Public concern over use of genetically altered chickens. Negative publicity related to the use of genetically altered chickens could raise health and social concerns with consumers and adversely impact the demand for chicken products from the company.

  Financial Statement Accounts/Disclosures that could be affected: Revenues, inventory

  The company may not be able to sell as much poultry.

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Technological

- Technological advances with diet, selective breeding, production technologies, equipment development and management practices related to chicken production could help the company control production costs.

  Financial Statement Accounts/Disclosures that could be affected: Going concern disclosure, cost of sales, revenue, inventory, property, plant and equipment

  If the company does not keep pace with technological advances it could find its production costs to be higher than competitors negatively affecting its ability to sell chicken at a profit.

- Technological advances on the use of poultry litter from contract growers, to generate energy and other value-added products could provide the company new markets for by products of the production process.

  Financial Statement Accounts/Disclosures that could be affected: Revenues, inventory

  If the company does not keep pace with technological advances it could find itself at a competitive disadvantage negatively impacting its ability to sell chicken at a profit.

Legal and Regulatory

- Chicken producers are subject to international, federal, and state laws and regulations concerning food safety standards and processing, packaging, storage, distribution, advertising and labeling of chicken products. Non-compliance could adversely affect the cost of producing or ability to sell chicken products.

  Financial Statement Accounts/Disclosures that could be affected: Cost of sales, revenues, inventory

  The company may have to pay higher production costs or may not be able to produce and/or sell as much poultry.

- Facilities for processing chicken and milling feed and for housing live chickens are covered by a variety of international, federal, state and local laws relating to the protection of the environment and to the health and safety of employees. Non-compliance could adversely affect the cost of producing or ability to sell chicken products.

  Financial Statement Accounts/Disclosures that could be affected: Cost of sales, revenues, inventory

  The company may have to pay higher production costs or may not be able to produce and/or sell as much poultry.

- Regulatory changes concerning the discharge of chicken manure by government agencies could adversely affect the cost of producing or ability to sell chicken products.

  Financial Statement Accounts/Disclosures that could be affected: Cost of sales, revenues, inventory

  The company may have to pay higher production costs or may not be able to produce and/or sell as much poultry.

- Agricultural policies of the United States and foreign governments all affect the supply of feed and could adversely impact the cost of feed.

  Financial Statement Accounts/Disclosures that could be affected: Cost of sales, revenues

  The company may have to pay higher production costs or may not be able to produce and sell as much poultry.

- Imposition of tariffs, quotas, trade barriers and other trade protection measures imposed by foreign countries like Russia, China, Mexico, etc. could impact demand for chicken products causing domestic chicken prices to decline.

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Financial Statement Accounts/Disclosures that could be affected: Revenues, inventory

The company may not be able to sell as much poultry.

- Outbreak of a livestock disease such as avian influenza could result in governmental restrictions on the import and export of our fresh chicken to or from company suppliers, facilities or customers.

  Financial Statement Accounts/Disclosures that could be affected: Revenues, inventory

  The company may not be able to sell as much poultry.

- Contamination of chicken products by disease-producing organisms or pathogens, such as Listeria monocytogenes, Salmonella and generic E. coli could lead to increased risk of exposure to product liability claims, product recalls, increased scrutiny and penalties, including injunctive relief and plant closings by government agencies.

  Financial Statement Accounts/Disclosures that could be affected: Cost of sales, revenues, property, plant and equipment, inventory

  The company may have to pay higher production costs or may not be able to produce and/or sell as much poultry.

Environmental

- Global warming could affect weather patterns that could adversely impact the production of feed and chicken products. The changing weather patterns could have a negative impact on the cost of chicken products.

  Financial Statement Accounts/Disclosures that could be affected: Cost of sales, revenues

  The company may have to pay higher production costs or may not be able to produce and sell as much poultry.

- Excess chicken manure can potentially foul water streams. The nutrients from excess chicken manure can fuel algae blooms which block sunlight to important beds of underwater grasses. Algae blooms can rob the water of oxygen needed by fish and other aquatic life. Excess nutrients have also been blamed for contributing to outbreaks of toxic Pfiesteria piscicida.

  Financial Statement Accounts/Disclosures that could be affected: Cost of sales, revenues, inventory, property, plant and equipment

  The company may have to pay higher production costs or may not be able to produce and/or sell as much poultry.

[3] ***For each of the business risk factors identified in question 1 above, indicate how each risk factor might impact the risk of material misstatements in specific financial statement accounts or disclosures.***

See answers to one above for affected accounts and/or disclosures.

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Flash Technologies, Inc.

ONLINE

Risk Analysis

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

INSTRUCTIONAL OBJECTIVES

[1] To provide students with an opportunity to learn (by doing) how auditors identify various client and audit risks. The case also provides students with insight into how a risk analysis ties in to the strategic audit planning process.

[2] This case requires students to comprehend Flash's business as well as apply their broader business knowledge. The case also requires students to apply writing and team building skills (if the case is completed in groups).

[3] This case helps students integrate a number of concepts including client acceptance, inherent risk, analytical procedures, acceptable audit risk, audit planning, fraud red flags, and risk assessment and financial reporting research.

[4] Flash Technology is based on an actual company (Centennial Technologies, Inc.) that committed a large accounting fraud from 1996 to 1998. When the instructor outlines the details of the fraud the students can compare the risks they identified with the areas containing fraud.

[5] To illustrate that "incredible" intentional accounting manipulations that still take place today (many famous high profile accounting frauds included in well-known audit cases took place before the average audit student was born).

KEY FACTS

- Flash is a rapidly growing high-tech firm primarily in the flash memory business.
- Flash is in the process of changing auditors. The company believes they need a larger international professional services firm to manage their growing international business.
- The students are asked to assume the role of team members from the new audit firm. While there is a tentative agreement with respect to the December 2018 audit, the students' "firm" is conducting additional analyses.
- The case provides students with audit memos written to the planning files, Flash's draft financial statements, industry ratios, and industry articles.
- Flash faces a number of important business risks (e.g., intense competition, rapidly changing technology, and foreign operations). There are also a number of firm characteristics that increase auditor business risk (e.g., public company, management integrity) and inherent risks (e.g., related party transactions, nature of business, initial engagement, and likelihood of fraud).
- The company has been acquiring ownership interests in other companies. The company recently began selling a new product, "Flashwall 2018" that is alleged to have a cost of less than $20 but a sales price of $300. In the actual case, "Flash 98" was claimed to have a cost of 10 cents and a sales price of over $500.
- Manny Schwimez is the CEO and Chairman of the Board. Students are provided with background information that is similar to Emanuel Pinez, who was the actual CEO of Centennial. Pinez, 58, was convicted of masterminding a scheme that inflated sales by over $20 million from 1996 through 1998. Centennial's stock price rose an astonishing 450 percent in 1998.

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.

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USE OF CASE

We have used this case after the client acceptance, audit risk or analytical procedures modules. We recommend the case be assigned to small groups of students (2 to 4 students) for a the following reasons: (1) in our experience students benefit greatly by discussing the various aspects of this company, risks posed and implications for the audit, (2) students will be expected to function in small groups after they graduate, (3) the case is long and somewhat complex, and (4) group solutions reduce the grading burden for the instructor. We also recommend that you give the students at least one week to complete the assignment.

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 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with GAAS," AU-C 240, "Consideration of Fraud in a Financial Statement Audit," AU-C 330, "Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence," and AU-C 560, "Subsequent Events and Subsequently Discovered Facts."

PCAOB Standards: AS8, "Audit Risk," AS12, "Identifying and Assessing Risks of Material Misstatement," AS13, "The Auditor's Responses to the Risks of Material Misstatement," and AS14, "Evaluating Audit Results."

SUGGESTED SOLUTION

NOTE: This case has been simplified from prior editions by removing technical accounting issues and by providing students with solution templates.

Regarding the risk analysis, obviously student solutions will differ. However, student groups should identify many of the risks noted below. We typically debrief the case in class on the day it is due. We usually do indicate when we begin the debriefing that the case is based on an actual company, ***but we do not*** indicate there was accounting fraud until later. When we do begin discussing the actual fraud we always have concerned students ask if their group was expected to have detected the fraud. We reassure the students that we do not expect them to have detected the fraud, but that there were risky areas they should have identified as potential red flags. We further explain that they can see how their group did at identifying risky areas that did, in fact, contain fraud. In our experience we find that most groups do identify, as risky, many of the accounts that had been intentionally manipulated in the fraud. We discuss the background of the case as well as suggested solutions. The debriefing is not intended to cover a complete solution and students are encouraged to discuss their solutions. We typically ask the students to discuss potential audit implications of identified risks.

Notes to instructors. Many of the facts of the actual Centennial case described in the following pages were obtained from articles in the popular press. For example:
"How Centennial Technologies, a Hot Stock, Cooled", *The Wall Street Journal*, Jon G. Auerbach, April 11, 1999, A1, and "Multimillion-dollar illusion: Centennial Technologies' Rise and Fall is a Tale of Fakery and Overreaching," *The Boston Globe*, Joann Muller, June 13, 1999, A1.

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RISK ANALYSIS

General Areas of Risk. The following listing specifies general risks faced by Flash (Centennial) Technology:

- Public high tech company—extensive reliance on audited financial statements, rapidly changing technology
- Industry Risks: rapid technological change, evolving industry standards, rapid product obsolescence, intense competition
- Korean Venture and other acquisitions (DCI)—does the current management team posses the necessary global management skills, DCI history of losing money, many uncertainties
- Flash memory represents 98% of sales—extreme reliance on one product, what happens if better technology is developed by a competitor
- Supplier relations—financial statements indicate this is a critical issue as the company has only one supplier for some critical components, no long-term contracts exist, and materials shortages occur often
- Two major customers represent 25% of sales
- Extreme growth—operating and financial management expertise
- Short sales of stock increasing
- Flashwall 2018 sales to one company and that company is or will be a related party
- Patent litigation
- SEC Investigation
- Allegations that Manny is a "pathological liar" and has a history of wrong doing

As we cover specific risks we ask students to discuss audit implications (i.e., nature, timing and extent of testing). In the actual case the foreign venture was in Thailand and "Flashwall 2018" was Flash 1998.

Financial Statement Risks. The following listing includes some of the high-risk areas associated with Flash's financial statements:

- Accounts receivable is up significantly and the allowance does not appear to be keeping pace
- What is the increase in other current assets due to?
- Inventory up significantly, turnover ratio is only 1.8 suggesting potential problems with obsolescence or existence
- Rapid increase in sales, is this reasonable, does it raise revenue recognition issues?
- It would seem that research and development expense would be greater given the growth
- Large negative cash outflow from operations—the company is funding operations via financing activities, is there a going concern issue?

One issue that needs to be pointed out is that in instances of extreme growth, as with Flash Technologies, simple comparison-type analytical procedures may not be too informative. Again, as we cover specific risks we ask students to discuss potential audit implications (i.e., nature, timing and extent of testing).

Flash and the Industry. Comparisons of Flash to the industry point out areas of concern:

- Flash's inventory turnover ratio is 1.8 while the industry average is 8.1. This raises concerns with respect to existence and obsolescence (valuation)
- Flash's operating profit has been outpacing the industry. In 2018 Flash is reporting over a 20% operating profit while the industry is about 14%
- Flash is a small player in the industry, competitors (e.g., Intel, Mitsubishi, Epson) are well established and have greater access to investment capital
- The industry Flash competes in is rapidly changing and extremely competitive

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POSITIVE ASPECTS OF FLASH

There are certainly risks associated with Flash. But every client will have risks; particularly public high-tech clients in the growth stage. There is also good news with respect to Flash. Ask the students to identify the positive aspects associated with Flash. Some of these include:

- Strong cash position
- PC Card market is a leading edge industry with great potential
- Flash has entered into several strategic alliances with reputable firms
- Flash has reported strong growth—NIBT has doubled as a % of sales
- Excellent market performance
- Flash is ISO 9001 certified
- Flash represents many audit/assurance/consulting opportunities for the professional services firm

THE TRUTH BREAKS

The Flash Technology case is based on the real company Centennial Technologies. Emanuel "Manny" Schimez is really Emanuel "Manny" Pinez. Centennial engaged in a massive accounting fraud. The financial statements included in the case contain nearly $23 million in fictitious revenue. The fraud was carried out over several years. Allegedly only a few people were involved in the fraud. The story broke in the popular press. Three of the articles reporting on Centennial were:

- April 11, 1999 "How Centennial Technologies, a Hot Stock, Cooled," WSJ
- June 13, 1999, "Multimillion-Dollar Illusion: Centennial Technologies' Rise and Fall is a Tale of Fakery and Overreaching," The Boston Globe
- June 13, 1999, "Centennial Details Extent of Fake Profits" The New York Times

Not only were the auditors fooled by the Centennial fraud, but so were other sophisticated investors, creditors, brokerage houses, business partners, underwriters, and members of the Board of Directors.

EMANUEL PINEZ

With the benefit of hindsight, management integrity was an obvious issue at Centennial. Manny was a well-know con artist (unfortunately, this fact was not discovered by the auditors until it was too late). Important aspects of Manny's background are provided in the following listing:

- Manny claimed on his resume that he received a degree from Hebrew University, but admitted that he never actually earned a degree. Manny explained that, "It looks much better if you say you graduated." Likewise, after studying computers in London for six months, he claimed to have received a master's degree from the London School of Economics. He concedes this claim is also false.
- Manny was fired from a Swiss computer services company in 1971 because phony invoices were found in his office drawer. The invoices had never been sent out, but corresponding amounts of sales had been booked.
- In early 1980's Manny headed ABL Technologies, a company involved in many lawsuits regarding infringing on other manufacturers' patents.
- Arial Cohen, the vice mayor of Jerusalem said, "I was absolutely surprised that nobody checked about his past because he is a man known in Israel for his propensity to tell whoppers." In 1958, he conned an Israeli magazine into sending him to France for a swimming race across the English Channel. He cabled the magazine from Paris saying he had won and set a new world record crossing in 10 hours, 21 minutes. The magazine published the remarkable story and Manny was hailed as a national hero. Several weeks later, after suspicions were raised by the French press, no evidence could be found that the race ever took place. Manny admitted it was a lie causing enormous embarrassment to the magazine.
- Friends say Pinez often boasted he was a paratrooper in the Israeli army during the Six-Day War, but he admits it is a lie.
- Rachel Pinez, wife of 36 years, says her husband is a pathological liar.

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- Manny was very flamboyant, he was a lover of fast cars, fine wine and food.
- In 1998 Manny began telling institutional investors about a $300 million sale to AT&T for a system to track truck fleets by satellite. No evidence was ever produced to substantiate the claims and AT&T denied the report.
- While Manny claimed to not have profited from the fraud because he did not sell his shares, he did use 3.5 million of his 4.2 million Centennial shares as collateral to borrow a total of $18.5 million from Lehman Brothers Inc. and PaineWebber Inc.

DETAILS OF THE FRAUD

Flash 98 Scam. An audit memo in the student case refers to "Flashwall 2008," a new product. In reality the product was called Flash 98. In the student's case the cost was claimed to be less than $20 while the sales price exceeded $300. In actuality, Centennial (Pinez) claimed the cost of the new product was 10 cents with a sales price of a whopping $500. It turns out there was no such product. As noted in the case, all sales were to one company. The actual company was BBC Computers, and BBC purchased $2.1 million of Flash 98. Robert Lockwood, who ran BBC was a close personal friend of Pinez. Lockwood would later be indicted on 13 counts of tax evasion related to his companies. To fool the auditors into thinking an actual sale took place, Pinez wired $1 million of his own personal funds to a third company, St. Jude Management Corp., which then paid Centennial on behalf of BBC for its Flash 98 purchases. The explanation provided for this rather unconventional form of payment was a "financial agreement" between St. Jude and BBC. Even though the check was from St. Jude Management, the $1 million payment was considered reasonable evidence supporting the sale. After the fraud was uncovered the auditors, Coopers & Lybrand, claimed that the Flash 98 scam was a "unique" fraud because it appeared product was going out and cash was coming in.

While students would not be expected to identify the scam, they should identify the increased risk associated with Flashwall 2008 because of the secrecy and related party transaction.

PC Card Scam. Some investors started to crave a first-hand look at Centennial's operations. One investor sent an analyst to meet with Pinez and tour the headquarters in Billerica, MA. Although the analyst noticed some computer equipment he noticed there was none in Manny's office. During a tour of Centennial's manufacturing facilities, he saw "a room full of people banging on cards with rubber mallets. I had a bad feeling." He returned to his firm and they "dumped the Centennial shares immediately."

In truth, Pinez had enlisted a handful of employees in the company's Billerica manufacturing plant to assemble fake memory cards by simply welding the casings together and leaving out a critical silicon computer chip. These fake cards made their way into inventory and sales. Most of the sales of these cards are alleged to have gone to other companies controlled by Pinez. While students would not be expected to have identified this scam, they will remember an audit memo referring to "empty cards."

The Fruit Basket Scheme. As noted in the student case Manny had decided to send holiday fruit baskets to some of his most valued customers and other associates. By weighing the fruit baskets before they were shipped, Pinez created paperwork showing a package of a specific weight being sent to one of the company's customers. The papers were later falsified to make it appear as if Centennial had shipped memory cards, instead of bananas, nuts and grapefruit. Because memory cards are small and light, even a 10-pound shipment would amount to hundreds of cards, which sold for $100 to $500 each. The fruit shipments were booked as sales by Centennial.

FINANCIAL STATEMENTS RESTATED

In addition to the specific fraud tactics discussed above, post-fraud examinations also revealed that Centennial had recorded as revenue "bill and hold" transactions which did not ultimately meet revenue recognition criteria. Centennial had also overvalued investments and advances to related companies. Necessary restatements to Centennial's (Flash's 2008) financial statements to remove the fraud included:

- Sales were reduced from $37.8 to $33.4 million

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- COGS was increased from $23.6 to $29.7 million
- Net income went from a profit of $5 million to loss $4.2 million
- Inventory was reduced from $18 to $8 million
- PPE was reduced from $4.6 to $2 million
- Stockholder Equity was reduced from $45 to $32 million

Cumulative adjustments to the previously reported financial statements included reductions to sales of $21.2 million, increase to COGS of $8.8 million, write-offs of investments in, and advances to, several companies of $15.8 million and other miscellaneous adjustments to expenses of $2.4 million. On the bright side, after the restatement, Centennial was eligible for an $8.1 million federal tax refund!

HOW THE FRAUD WAS DETECTED

Coopers & Lybrand rightly considered Centennial a high-risk client. In fact in mid 1996 Coopers changed Centennial's status to that of "high-level risk alert." In the last part of 1996 and early 1997 short sellers began driving the stock price down. These sellers did not believe the company had actually obtained the $300 million AT&T contract, and an article in Financial World claimed there was no evidence Pinez was awarded degrees by either the London School of Economics or Hebrew University.

In January 1997 the auditors noticed "fishy" bill and hold transactions. The auditors warned the company to not release earnings until the concern is resolved; however, the company released earnings anyway. Coopers went to the Board of Directors (BOD) with their concerns, and a full financial review was ordered by the board. In a subsequent BOD meeting lasting many hours, one of the fraudsters, Murphy, fingered Pinez as the mastermind of a multimillion dollar accounting fraud. While Coopers was instrumental in uncovering the fraud, unfortunately they had issued unqualified audit opinions on previous year's financial statements that also included fraud.

Manny Pinez was arrested and imprisoned in the Plymouth County Correctional Facility in 1997. Manny was described as "charming," "confident he will prevail," and "thoroughly compromising with the truth." From his prison cell he denied any wrongdoing and indicated that his defense would be that his actions were undertaken to benefit the company. Manny attributed his problems to the scrutiny that inevitably comes with success, "You get lightning when you're very high." Despite his initial confidence, in 2000 he pleaded guilty to conspiring to commit securities fraud and was sentenced to 5 years in prison and ordered to pay restitution of $150 million for doctoring the company's financial results from 1994 to 1997 and inflating the stock price. In 2000 Pinez also agreed to pay $5.3 million to settle a civil complaint of illegal stock trading filed by the SEC. The deal will leave Pinez nearly penniless when he gets out of jail and is deported to Israel, his lawyer said.

Centennial's former chief financial officer, James M. Murphy, was sentenced to 15 months in a halfway house and ordered to make the same amount of restitution as Pinez. He had also pleaded guilty. Centennial's former chief operating officer, Bond Fletcher, was sentenced to eight months in a halfway house and ordered to pay $7 million in restitution. The SEC has filed complaints against Murphy and Gilboa Peretz in connection with the fruit basket scam. Murphy sent the baskets and created fake sales documents. Peretz, a firm business partner, is accused of taking a fruit basket while saying he had bought a Centennial product.

ADDITIONAL FACTS–AFTERMATH

- In 1996 Centennials' surging stock graduated to the New York Stock Exchange just two years after going public. It finished 1996 as the best-performing stock on the Big Board, up a stunning 451%. Just before the fraud was uncovered analysts still had "strong buy" recommendations outstanding. After the accounting irregularities were discovered the stock was delisted from the NYSE. As of the end of 1998 it was not listed on any organized exchange. Based on information reported on internet-based bulletin boards, Centennial shares were priced at $1-3 ¾ per share in 1998 down from a peak of $58.25 in late 1996.
- As noted earlier, Manny used his stock as collateral for an $18.5 million loan, and he gave away as gifts shares that were worth $21 million at the time but would have climbed to several times that value. Four

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days before he was fired Manny placed an order for 5,400 option contracts betting the stock would fall; the proceeds ($4 million) were frozen by the court.

- Approximately 35 class action lawsuits were filed in US District court against the Company, its directors, certain officers, its independent accountants, Coopers & Lybrand, and others, asserting claims under Section 10(b) of the SEC Act of 1934 and Rule 10b-5 promulgated thereunder, and related state law claims of fraud, deceit and negligent misrepresentation. In addition several shareholder lawsuits were filed seeking recovery for alleged breach of fiduciary duties, gross negligence, breach of contract and insider trading. In April of 1998 the US District Court granted final approval of the Company's proposed settlement of the class action and derivative claims described above. The settlement consisted of payment of over $1.5 million in cash and stock valued at $18.5 million (37% of the estimated market capitalization of the company) as well as agreements to adopt certain corporate governance policies and procedures. The settlement did not release Pinez or Coopers & Lybrand.
- Shortly after the fraud was discovered the United States Department of Justice (DOJ) subpoenaed the company to produce documents in connection with a grand jury investigation regarding various irregularities in the Company's previous press releases and financial statements. The DOJ also requested information regarding former officers, stock transactions by Pinez, and correspondence with Coopers and Lybrand. At the same time the SEC launched an investigation. In a statement from the SEC they indicated that its inquiry should not be construed as an indication by the SEC or its staff that any violations had occurred, or as a reflection upon the merits of the securities involved or upon any person who effected transactions in such securities.
- Centennial Technologies survived the fraud and returned to profitability. The company's computer cards are inserted in laptops, defibrillators and wireless telephones to increase memory and communications capacity. In 1999 Intel Inc. took a 16 percent share in Centennial and in 2001 Giant Solectron Corp. purchased the Company for almost $22 per share in Solectron stock.

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[1] SUGGESTED SOLUTION FOR FLASH TECHNOLOGIES MEMO

General Business and Industry Risks

As illustrated in the table below, provide an analysis of business objectives and strategies and how they map to business risk, audit risk, related accounts, and their potential effect on the audit plan. For the two business objectives illustrated below, identify one or two additional risks associated with each objective and complete the remaining columns for all risks (note that the template has been partially completed).

Business Objective and Strategy	Business Risks	Audit Risk (auditor's concern)	Related Accounts and Assertions	Potential Effect on the Audit Plan
1. Continue Expansion Internationally (acquisitions in other countries)	Foreign Currency Risks.	Gains/losses not properly calculated or accrued on hedging activity.	Gains/Losses from currency hedging: Valuation Accuracy Classification	**Gains/losses:** Increase the number of hedging contracts tested with particular emphasis on contracts in currencies with less developed countries. Examine unrealized and realized gains/losses to ensure that they are properly classified.
	Lack of understanding of culture and business practices.	*Overstatement of revenue due to pricing and accounting issues*	*Revenue:* *Accuracy* *Valuation* *Cutoff* *Existence*	***Revenue:** Perform cutoff testing. Observe and test controls over pricing and revenue recognition. Gather more extensive evidence for international revenue accuracy and valuation (tests of controls, inspection of documentation, analytical procedures, confirmation, detail testing). Extensive transactional and balance testing on foreign sales.*
	Lack of understanding of credit risks in new countries	*Accounting estimate manipulation to help Flash reach targets*	*Allowance for Bad Debt Expense:* *Valuation*	***Allowance for Bad Debt Expense:** Look at industry competitors' ability to collect from local customers. Obtain credit checks on customers.*
	Weak economy or unpopular demand for our product	*Overstatement of inventory due to cost being greater than market or obsolescence*	*Inventory:* *Valuation*	***Inventory:** Look at inventory turnover ratios that examine inventory cost/obsolescence concern. Physically observe the inventory and inquire about it. Use analytics to determine proper amount and valuation. Look at market versus book pricing. Observe local trends and valuation methods.*
	Lack of understanding of local laws and regulations	*Understatement of potential contingency*	*Contingent Liability (i.e., litigation)* *Completeness* *Presentation*	***Contingency:** Understand the legal environment, extrapolate U.S. experience to international countries, and inquire of client and local attorney regarding possible problematic areas and complicated laws.*
	Mismatch between US design and international preferences	*Understatement of sales return reserve due to lack of history and failure to properly track returns*	*Reserve for Returns:* *Completeness*	***Reserve:** Observe and test controls over returns, examine patterns of returns before and after period end, compare returns levels to U.S. to assess adequacy of reserve by location.*

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2. Be a leader by having the latest technological advances and releases in the flash memory market	Insufficient number of existing and new customers accept the new technology	Overstatement of accounts receivables through fictitious sales.	*Accounts Receivable:* *Existence* *Valuation* *Sales:* *Existence* *Cutoff*	***Accounts Receivable:*** *Send a confirmation to test the existence of A/R. Viewing subsequent payments to gain evidence about the existence of accounts receivable.* ***Sales:*** *Review a selection of customer sales for proper documentation (order, shipping documents, payment receipt) and authorization.*
	High amounts of R&D expenses cause margins to diminish and cause concern among investors.	*Improper treatment of capitalizing R&D expenditures*	*R&D Expense:* *Completeness* *Classification*	***R&D Expense:*** *Understand the policies and standards on expensing R&D for GAAP and IFRS. Trace R&D source documents to cash disbursements and GL and check accounts for proper classification.*
	Funding for market research and R&D expenses is insufficient to carry out the long-term vision of the objective	*Inadequate disclosure of the insufficient funds needed to carry out the long-term vision*	*Presentation and Disclosure:* *Completeness*	***Presentation and Disclosure:*** *Ensure that the risk of insufficient funding for R&D is disclosed properly in the financial statements.*
	The market doesn't embrace the new flash memory technology as anticipated	*Overstatement of revenue and account receivable from fictitious sales*	*Accounts Receivable:* *Existence* *Valuation* *Sales:* *Existence* *Cutoff*	***Accounts Receivable:*** *Send a confirmation to test the existence of A/R. Viewing subsequent payments to gain evidence about the existence of accounts receivable.* ***Sales:*** *Review a selection of customer sales for proper documentation (order, shipping documents, payment receipt) and authorization.*

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Additional General and Industry Risks

Provide a list of additional general and industry risks you identified. Only list the risk, no need to fill out a table as shown above. You should identify at least three additional risks beyond those listed in the table above and provided in the example immediately below:

- DCI experiencing losses
- There is pressure to increase sales to be a leader in the flash memory market
- *Conflict on the Korean peninsula halts manufacturing procedures in Korea*
- *Suppliers are unable to meet our demands of needed inventory for production*
- *Risk of currency fluctuation having an adverse effect on company pricing, accounts receivable, and operations*
- *Threat of new market competitors with better technology and cheaper prices*
- *SEC investigation finds material errors in the financial statements*
- *Risk of emergence of new technology that undermines our Flash Memory*
- *Risk that AT&T contract doesn't go through*
- *Major customers failing to pay off receivable on a timely basis*
- *Delays in beginning operations in Korean leads to an inability to meet demands*
- *Two major customers represent 25% of sales*
- *Short sales of stock increasing*
- *Patent litigation*
- *Allegations that Manny is a "pathological liar" and has a history of wrong doing*

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Financial Accounting/Reporting Risks

Fill in the table below by completing the final box for the first risk and by identifying two additional financial accounting/reporting risks through examination of Flash's financial statements and related disclosures (e.g., significant or unusual increases in ending balances, unexpected patterns such as slower growth in accounts receivable than sales, unexpected differences between Flash's ratios and the industry averages). The two additional risks included in the table below should be the financial accounting/reporting risks you consider most significant.

Financial Accounting/ Reporting Risk	Audit Risk (auditor's concern)	Related Accounts and Assertions	Potential Effect on the Audit Plan
Inventory turnover is much lower than the industry	Overstatement of inventory due to obsolescence. Is inventory properly valued at the lower of cost or market?	Inventory: Valuation Existence	***Inventory:*** Examine ratios and trends to understand inventory cost/obsolescence concern. Increase testing during our year-end physical inventory observation (existence) as well as our testing related to inventory pricing/cost. Be alert to signs of slow-moving or obsolete inventory, inquire of operations and marketing personnel regarding outdated product. Develop analytics and analyses examining recent sales data to establish proper valuation. Test the client's analysis on market versus book pricing. Examine Flash's policies in valuing inventory. For slow moving items that are not considered impaired, consider bringing in an expert to test inventory valuation.
2. Even though sales and A/R have more than tripled, accounts payable have decreased. Also, the Quick Ratio is nearly three times the industry average.	*Understatement of accounts payable to improve quick and other balance sheet ratios.*	*Accounts Payable:* *Completeness*	***Accounts Payable:*** *Inquiry of A/P clerk/staff and management regarding credit arrangements with suppliers to see if any policies have changed. Examine any documentation supporting the policies. The audit plan will need to include a more extensive search for unrecorded liabilities. This involves examining payments to vendors subsequent to year end to assure that the corresponding liabilities were correctly recorded at year end.*
3. Even though sales have increased by 204%, G&A expense only increase by 36%. Additionally, in 2007 G&A expense was 26% of sales and in the current year, it decreased dramatically to only 12% of sales.	*Understatement of G&A expenses to improve reported performance.*	*G&A Expense:* *Completeness* *Classification*	***G&A Expense:*** *Inquire of management regarding the dramatic change in G&A expense. Review company policy for classifying G&A expenses and check to see if the Korean facilities are being included in those expenses. Review source documents and cash disbursements and trace them to the GL. Examine entries to ensure that proper accounts are being used. Inquire of management regarding product verses period costs. Make sure that G&A expenses aren't being included as product costs, which would inflate inventory and decrease G&A expense. Perform analytical procedures to obtain a reasonable estimate of G&A expense. Compare with industry.*

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Additional Financial Accounting/Reporting Risks

Provide a list of additional financial accounting/reporting risks you identified. You need only list the risk, no need to fill out a table as shown above. You should identify at least three additional risks beyond those listed above.

- *Dramatic sales increase with higher increase in cost of goods sold resulting in a 7% decrease in gross profit as a percentage of sales*
- *There was a large increase in accounts receivable without a similar increase in the allowance for doubtful accounts*
- *Debt to equity ratio changed significantly in the past year, decreasing 11%*
- *R&D expense seems relatively low, especially considering their development of new products*
- *Flash's operating profit is significantly higher than the industry*

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.

[2] ***Describe how the confirmation tendency might affect auditors' risk assessments. Describe some strategies to mitigate potential bias caused by this tendency.***

Students should demonstrate an understanding that due to the confirmation tendency, the auditor may tend to seek and find evidence that supports his or her initial beliefs about Flash, which are likely based on management's views. The confirmation tendency can result in auditors putting more weight on information that is consistent with their initial beliefs and underweight potentially disconfirming evidence. This tendency can lead to bias due to truncated or shallow information searches for objective information as there could be persuasive disconfirming evidence. In the case of Flash, there were red flags and the auditor will want to be objective in the pursuit and evaluation of audit evidence. Often we don't know what we know until we consider what we might not know.

Awareness is key to mitigating potential judgment biases. By understanding the confirmation tendency the auditor can develop logical ways to reduce potential bias such as making the opposing case, explicitly seeking and evaluating disconfirming information, reconsidering the weighting or importance attached to potentially disconfirming information, and investing sufficient time in the early steps of the professional judgment process.

[3] ***What "judgment frames" does management of Flash use when discussing the company's performance and prospects? How might judgment framing be used to boost professional skepticism in performing a risk assessment?***

At the center of the KPMG Professional Judgment Framework is "mindset." To be appropriately professionally skeptical, and auditor has to maintain and objective and independent mindset. A key to maintaining an objective and independent mindset is the proactive use of judgment framing. Frames are mental structures that we use to simplify, organize, and guide our understanding of a situation. They shape our perspective and determine the information we see as relevant or irrelevant, important or unimportant. As frames shape our perspective and our information search, judgment framing is interrelated with the confirmation tendency, in that people will tend to seek information that supports a current frame.

Management of Flash, particularly Manny Schwimez will put a positive spin on essentially all aspects of Flash's business and his experience and background. Even when there might be risk indicators, Manny always saw the glass as not just half full, but essentially full. The frame will be one of a very successful and rapidly growing company. The technology is leading edge, which explains whey Flashwall 2014 can sell at such a profit. Potential sign of risk, such as the SEC investigation, are simply "routine" and nothing to worry about. Things like the SEC investigation are really no concern. Allegations that Manny was a pathological liar and dismissed because he is an aggressive, successful

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businessman and others are simply envious of his success.

It is important for auditors to understand management's judgment frame overall and management's perspective on transactions and accounting method and disclosure choices. Often management's view is well founded and accurate. However, to maintain an independent and objective mindset, the auditor also wants to recognize the frame management is using and proactively consider other frames. Considerations such as, "What could go wrong?", "What is the opposing perspective?", "How would competitors view the company's strategy and claims?", "How would a shareholder or regulator want me to follow-up on risk indicators?", "If actual performance and the underlying economics really are not as strong as management says, what alternative explanations are there for the strength of Flash's reported numbers where would I look to find such evidence?", and "Is Flashwall 2014 too good to be true?", can help the auditor to consider alternative frames and boost professional skepticism.

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SECTION 3

Professional and Ethical Issues

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3.1

A Day in the Life of Brent Dorsey

Staff Auditor Professional Pressures

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

INSTRUCTIONAL OBJECTIVES

[1] To illustrate some of the pressures new professionals sometimes face in the workplace.

[2] To help students consider alternatives in dealing professionally and tactfully with difficult workplace issues.

[3] To raise the specific issues of budget pressure, eating time, and premature sign-off.

[4] To initiate discussion and thought about balancing professional and personal demands.

KEY FACTS

- Brent Dorsey is a relatively new staff auditor, working on the audit of Northwest Steel Producers. His senior, John Peters, is under consideration for promotion to manager, and feels a great deal of pressure to finish the Northwest Steel audit within budget. He is pressuring his staff auditors, Brent, Han, and Megan, to work over the weekend and to meet some impossible time budgets.
- Brent has been assigned to work on payables with Han. He receives advice from Han and Megan that eating time and premature sign-off are viable ways to deal with budget pressure.
- Brent has been married for almost a year. His wife, Kathleen, also has a career and is expecting a child. Kathleen is not happy that Brent will be coming home late again, and that he will have to work Saturday. The two are experiencing some of the stresses and difficulties associated with balancing professional and personal lives.

USE OF CASE

This case is designed to bring to life some of the pressures auditors and other young professionals can face early in their careers. The case can be used as a vehicle for discussing a variety of issues, including budget pressure, eating hours, premature sign-off, dealing with difficult political situations, and dealing tactfully with superiors. The case can also lead to a discussion of balancing personal life with professional demands. While there are no easy answers to the issues raised in the case, the issues are realistic and are worth raising to help students more effectively anticipate, plan for, and manage future challenges. Students will likely appreciate the instructor's perspective on the issues. It may even be worthwhile to invite a professional or two to assist in the classroom discussion of the case and to provide their perspectives on the issues raised. The instructor should help students understand that while the issues raised by the case are very real, it is unlikely that a staff auditor would encounter all of the issues discussed, especially all in the same day. The case is simply designed to illustrate and raise for discussion a rich set of issues in a compact format.

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. All characters and names represented are fictitious; any similarity to existing companies or persons is purely coincidental.

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PROFESSIONAL STANDARDS

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

AICPA ASB Standards: AU-C 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With GAAS," AU-C 210, "Terms of Engagement," AU-C 300, "Planning an Audit," AU-C 500, "Audit Evidence," Code of Professional Conduct Section 0.300 and Section 1.100, "Integrity and Objectivity."

PCAOB Standards: AS 1105, "Audit Evidence."

QUESTIONS AND SUGGESTED SOLUTIONS

[1] ***What alternatives are available to Brent in regards to the audit of payables? What are the pros and cons of each alternative?***

(a) Skip audit steps as Megan suggested, (b) "Eat time" as Han suggested, (c) Do the job quickly, but do it right and record as many hours as it takes, regardless whether you come in under budget or not, (d) Go talk to John and express your concerns over the matter, (e) Go to John's "mentor" or supervisor–the engagement manager or partner–to discuss the matter and seek advice.

a) **Pro:** Skipping audit steps will allow Brent to complete the work in less time, thus allowing him to come in under budget and to spend some time with his wife.
Con: Skipping audit steps can lead to inaccurate audit decisions. Material misstatements could go unnoticed by the firm, leading to an inaccurate audit opinion. This alternative also raises a serious ethical issue with serious possible consequences for the auditors involved.

b) **Pro:** "Eating time" will mean a lot of extra "off-line" work for Brent, but he will come in under budget and he may be recognized as someone who can get the job done.
Con: "Eating time" will create inaccurate and progressively tighter budgets in the future, as the case suggests happened last year. "Eating time" also results in audit time records doing a poor job of reflecting the actual cost of doing the audit. This may result in poor decisions at higher levels of engagement management, especially if engagement management is unaware of the time being eaten. Many also see eating time as a serious ethical issue.

c) **Pro:** This alternative gets the job done and no shortcuts need to be made. Brent may receive a good reputation for not taking shortcuts to get the job done.
Con: Brent will come in over budget. He may receive a bad reputation for not finishing segments in the budgeted time, and may receive a poor engagement performance evaluation from John.

d) **Pro:** This alternative allows Brent to discuss the matter with John and get his feedback. Brent can be sure there are no misunderstandings of what John wants. Brent can express his concerns over the alternatives he's faced with. John may be able to give some advice to help Brent legitimately complete the work (e.g., through valid substitutions of control reliance and analytical procedures or other less costly procedures) and still come in under budget.
Con: John may see Brent as a threat to his promotion. This could lead to Brent receiving a poor performance evaluation, etc.

e) **Pro:** This alternative allows Brent to receive feedback on expectations from higher levels of engagement management. If John's plans violate engagement management's expectations, they may resolve the situation directly with John.
Con: Going over a supervisor's head without first speaking with that supervisor brings several possible negative consequences, including the possible perception by John's supervisors that Brent lacks good judgment in dealing with workplace issues. Brent's reputation will almost certainly suffer with John, and could suffer with other professionals in the office as well.

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[2] ***Identify at least three specific things John, Brent, and the other auditors could do to better handle the demands of career and family life and proactively manage their work/life balance?***

John Peters is in a difficult position. He is under evaluation for promotion and feels he needs to make a good showing, especially given the "up or out" model commonly used in public accounting firms. The Northwest audit is a very important audit for the firm, so John feels an even greater need to do well on the audit. However, he is responsible for the work that his staff does. Instead of creating an atmosphere that could very easily lead to and even encourage unethical behavior, John should find better alternatives to help the staff get back on budget. If there are no workable alternatives, in the long-run, honesty and ethical behavior is the best course of action. A professional's primary asset in the long run is her or his reputation.

Brent, Megan, and Han are experiencing pressures that many young professionals face in the workplace. There are obviously no easy answers, but this question should be conducive to some interesting and valuable class discussion. Ideally, new professionals adjusting to the pressures of working life need to find ways to balance the competing demands on their time and energy. They need to make sure they are investing an adequate amount of time each week in other areas of their lives they deem important, such as spousal and family relationships. In the end, professionals whose personal lives suffer from neglect will likely find it more difficult to be productive employees and will likely find their lives less than fulfilling. Again, however, balancing work/life demands should never be done by taking actions that undermine integrity.

[3] ***What consequences for Brent, the auditing firm, and others involved, may arise from "eating time," as Han suggested? Similarly, what consequences for Brent, the auditing firm, and others involved, may arise from not completing but signing off on audit procedures, as Megan suggested?***

"Eating time" can lead to inaccurate budgeting for future audits. Managers, as they prepare the budget for an audit, often use prior years' audits as a guide. Managers will see that the job was completed in a shorter time in previous years and prepare his/her budget accordingly. Staff accountants on future audits will have pressure to complete audit segments in less time than is realistic, and this can become a cycle, with each year's budget becoming tighter and less realistic. This can cause undo stress and problems for future staff accountants. In the end, eating time is dishonest in that it is an action intended to deceive the users of the time budget report.

Skipping audit steps can have very serious consequences. By not completing the audit steps, material misstatements may slip past the auditors. The auditors may then issue an inappropriate audit opinion, which can be very costly. Skipped audit steps make great ammunition for plaintiffs' attorneys.

[4] ***In your opinion, which of Brent's alternative courses of action would provide the best outcome and why? What should Brent do? How would you handle the ethical issues involved in this situation if you were Brent...what would you do and who would you talk to?***

Brent should probably try to talk to John first, and discuss his concerns directly with him. There may be some legitimate things John could do to relieve the budget pressure. For example, if payables is a low-risk area as Megan suggests, perhaps an audit approach that relies more heavily on analytics and less on detailed tests could be justified. But departing from the audit program is definitely not a decision within Brent's or Megan's authority. If John is unwilling or unable to give any helpful advice, Brent may consider talking to the manager above John. Either way, Brent should do his best to get the work done within the budgeted hours, but should never unjustifiably cut corners. If he comes in over budget, he can stand with good conscience that he did what was right. Many firms reward people who stand up for ethical behavior and look very negatively on either premature sign-off or eating hours. While short-run benefits may accrue, in the long run, compromising ethical standards rarely if ever pays off.

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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.

[5] [a] ***How might the confirmation tendency affect Brent's decision?***

Students should demonstrate an understanding that due to the confirmation tendency, Brent might tend to seek and over-emphasize evidence that supports his initial beliefs or preferences about what action he should take. For example, he may give more weight to evidence that supports his initial plan to spend time with his wife. The confirmation tendency 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 availability tendency come into play in Brent's decision?***

Students should demonstrate an understanding that availability tendency is the tendency for decision makers to consider information that is easily retrievable from memory as being more likely, more relevant, and more important for a judgment. In this case, for example, the information from Megan about previous audits is more readily available and might bias Brent's decision.

[c] ***What could Brent do to mitigate the effects of the confirmation and availability tendencies to improve his professional judgment?***

To mitigate the effects of the confirmation tendency, Brent could focus on obtaining all of the facts rather than rushing into a decision. Also, as mentioned in question 6, Brent could benefit by looking at the issue using several different judgment frames. By doing this, Brent can avoid the issue of seeking or giving disproportionate weight to evidence that confirms his initial belief or preference. To mitigate the effects of the availability tendency, Brent could focus on what it will take to maintain his professional skepticism. Although Megan informed Brent that the account in question "never has any problems," auditing standards and professional skepticism require that Brent complete planned audit procedures and obtain "sufficient appropriate evidence" to justify a conclusion that the account is fairly stated.

[6] ***Consider what judgment frames Brent seems to be focused on. What other frames might be useful for Brent to consider in making a well-considered decision in this case?***

Brent is focused on his frame as a staff auditor, John's as Senior, and Katherine's as his wife. These are important frames to consider. However, it would also be insightful for Brent to consider the shareholders', employees', and even his own firm's partners' respective frames to get a broader picture of the implications of his decision. He might also consider what a decision to cut corners might look like from the perspective of being in the future looking back on this "past" decision under the hypothetical assumption that a material misstatement was subsequently detected in the account.

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Nathan Johnson's Rental Car Reimbursement

3.2

Should He Pocket the Cash?

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

INSTRUCTIONAL OBJECTIVES

[1] To help students understand the types of ethical issues they could encounter during the recruiting process and in practice, and why it is important to handle even the "small" issues appropriately.

[2] To illustrate the reasoning process students should go through when they face ethical issues.

KEY FACTS

- Nathan Johnson recently interviewed with an accounting firm that agreed to reimburse him for the full cost of his rental car used to travel to the firm's office. Before sending in the bill for reimbursement, Nathan realized the rental car agency had overcharged his credit card by $75. The accounting firm told Nathan he should just send them the bill anyway, and that they had no problem reimbursing the extra amount.
- Before sending the receipt for reimbursement, Nathan called the rental agency and they agreed to credit his card for the $75. But in doing so, Nathan spent two hours on the phone dealing with the rental agency.
- Nathan now has the opportunity to send the accounting firm the original receipt with the amount he originally paid and still receive the credit from the rental agency--essentially putting $75 in his pocket.

USE OF CASE

The intent of this case is to expose the students to some of the "little" ethical issues they may face as they begin the recruiting process and later as they begin work. The case is designed to present a somewhat ambiguous situation in which it may be quite easy to rationalize taking a self-beneficial position. Our experience is that students typically react to the case with a wide variety of responses and with a high level of interest and intensity. The case can be used to specifically illustrate the topic of expense reimbursement, a common area for misunderstandings and even fraud in the workplace. The case can also lead to a discussion involving proper conduct in general during the recruiting process and the importance for students to maintain high ethical standards during their interaction with the recruiters. It may even be worthwhile for the instructor to invite a former student who has recently gone through the recruiting process to share with the class his/her experiences. For many of the students, this case could be their first exposure to recruiting issues at this level and a discussion of their conduct could prove very beneficial. Although there are no simple answers to the questions that may be raised by this case, the issues are realistic and they merit consideration. Most of all, the case is directed at exposing students to realistic ethical issues in the workplace and at promoting discussion of the importance of acting with complete professionalism. Hopefully, this case will help students think about the importance of handling even "small" issues appropriately—the instructor should point out that serious ethical and even criminal lapses usually begin by rationalizing away or taking even moderately aggressive positions on the "little" things.

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. All characters and names represented are fictitious; any similarity to existing companies or persons is purely coincidental.

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PROFESSIONAL STANDARDS

Relevant professional standards for this assignment are: AICPA Code of Professional Conduct Section 0.300 and Section 1.100, "Integrity and Objectivity."

QUESTIONS AND SUGGESTED SOLUTIONS

[1] ***Given that the firm didn't have any problem paying the higher bill, would Nathan's planned course of action be ethical? Why or why not?***

It would be easy for Nathan to rationalize accepting the extra $75 from the accounting firm considering the fact that they had approved the reimbursement at that amount. Further, he spent so much of his own time on resolving the issue that he could rationalize that he should be compensated in some way. However, in considering whether or not his plan is ethical, Nathan must put all other considerations aside (especially the consideration of how he will benefit from pocketing the $75) and ask himself if he is exercising integrity in dealing with the firm—would his decision change if he knew the firm would find out later?

Even though the firm agreed to reimburse the $75 over-charge, they did not know that Nathan would still seek reimbursement from the rental agency. How would the firm react if they found out that Nathan had profited? They may or may not agree with his actions, but they could very well be left with a negative impression of Nathan and his integrity. Even the risk of such a result would not be worth the small amount of money he was to gain. Further, rationalizing away "small" issues is usually the first step toward rationalizing away bigger and bigger issues later. The only way to establish and maintain unbending personal integrity is to take a principled stand, even on the "little" issues.

[2] ***What other courses of action might be available to Nathan? Which do you think would be the best action for him to take?***

While there are several possible courses of action Nathan could take, the most important factor is to consider which of the alternatives would be the most ethically appropriate. First, Nathan could pocket the $75 without telling the accounting firm. This would be an ethically questionable action given that the money is not really his to take. At a minimum, Nathan would be leaving his integrity open to question in the eyes of others. Second, Nathan could contact the person in charge of reimbursements at the firm, explain what happened, and ask for guidance. The HR contact may give Nathan permission to retain the $75, thus resolving the ethical issue. However, Nathan should carefully consider the impression he will leave with a potential future employer. Third, Nathan could send in the reimbursement request to the firm for the total amount less the $75 refund from the car rental agency. This latter course of action may well be the safest and most ethical course of action to take and will likely make a positive impression on his potential employer. It is important that Nathan is completely honest and that he not risk compromising his integrity for a $75 gain in the short term. The value of the accounting profession rests in the integrity of its professionals and firms are looking for character and integrity in their recruits. Nathan should learn now the importance of holding himself to a strict set of ethical principles and to a high level of personal integrity.

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PROFESSIONAL JUDGMENT QUESTION

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

[3] ***How might the confirmation tendency affect Nathan's decision and what could he do to mitigate the possible effects of this tendency in order to improve his professional judgment?***

Students should demonstrate an understanding that due to the confirmation tendency, Nathan will tend to seek and place undue emphasis on evidence that supports his beliefs about which course of action to follow. The confirmation tendency is the tendency for decision makers to seek for and put more weight on information that is consistent with their initial beliefs or preferences. Therefore, if Nathan prefers to pocket the $75, then he will give more weight to the information or evidence that supports that decision. To avoid succumbing to the confirmation tendency, Nathan could consult the firm's code of ethical conduct to determine whether there is an objective, predetermined answer to his situation. Also, he could get in touch with his HR contact again and explain the situation fully. By seeking the opinions of the other stakeholders in the decision, Nathan has a better chance of seeing the situation from someone else's point of view and avoiding the confirmation tendency.

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The Anonymous Caller

3.3

Recognizing It's a Fraud and Evaluating What to Do

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

INSTRUCTIONAL OBJECTIVES

[1] To sensitize students to real-world pressures to meet financial expectations of others.

[2] To highlight available courses of action when confronted with the possibility of a financial statement fraud.

[3] To illustrate risks associated with communicating information about a potential financial statement fraud to third parties.

[4] To highlight differences in fraudulent financial reporting and aggressive accounting.

KEY FACTS

- An accounting professor, Dr. Mitchell, received a telephone call early one Monday morning from a former accounting student who wished to remain anonymous.
- The caller was serving as a controller of a small start-up company that, in the caller's opinion, knowingly submitted fraudulently misstated financial statements to its local bankers.
- The individuals purportedly involved in the fraud were the company's chief executive officer (CEO), the vice president of finance, and the chief financial officer.
- The financial statements in question related to the just completed first quarter of the current fiscal year and purportedly overstated sales and receivables.
- The bank requested the first quarter financial statements to determine whether it would resume funding of the company's line of credit that was halted because of the company's weak operating performance. The company was experiencing a severe cash shortage.
- The caller claimed that she vehemently refused to sign the commitment letter required by the bank because some recorded sales and receivable transactions did not meet revenue recognition criteria required by generally accepted accounting principles (GAAP).
- The caller noted that company senior executives insisted that the transactions be included, because without those transactions the bank would not resume funding the line of credit. Those executives accused the caller of living in an "ivory tower" and emphasized that companies book these kinds of transactions all the time.
- The caller stated that there was no underlying customer order related to the sales and no goods had been shipped to the customer as of quarter end. The senior executives believe that the transactions represented sales expected to be completed in the very near future.
- The sales and receivables transactions were actually booked by an accounts payable clerk who was specifically instructed by the CEO to record the transactions while the caller was not in the office. Fortunately, the accounts payable clerk was concerned about the transactions and informed the caller when she subsequently returned to the office.
- The caller believed that the prior-year financial statements, which were audited, did not contain similar transactions.
- Following the Friday bank meeting, the bank resumed funding the line of credit.

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.

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USE OF CASE

This particular case is appropriate for a variety of accounting courses. The case is useful for undergraduate or graduate auditing courses when professional ethics, responsibilities for the detection of material misstatements due to fraud, or responsibilities for auditing sales and accounts receivable transactions are covered. The case could also be included in a financial accounting course or an accounting capstone seminar course to highlight the revenue recognition guidance recently issued jointly by the FASB and IASB that is now codified in the Accounting Standards Codification as Topic 606, "Revenue from Contracts with Customers." This case can help emphasize the importance of satisfying revenue recognition criteria specified by GAAP. Finally, it could be included in any class that highlights business ethics and it also provides an opportunity to expose students to the AICPA *Code of Professional Conduct,* which the AICPA revised to make it more readable and to converge the Code to international standards.

The case can be completed by students individually or in groups. If completed individually, students can be requested to complete their answers outside-of-class. One option is to have the students prepare their response in memorandum format. This provides students an additional opportunity to improve their written communication skills. Or, students can be assigned to groups to complete the assignment as either an in-class or out-of-class assignment. If the case is to be completed in class, the students can easily read the case in 5-10 minutes.

PROFESSIONAL STANDARDS

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

AICPA ASB Standards: AU-C 240, "Consideration of Fraud in a Financial Statement Audit," and the AICPA's *Code of Professional Conduct*.

PCAOB Standards: AS 2110, "Identifying and Assessing Risks of Material Misstatement."

QUESTIONS AND SUGGESTED SOLUTIONS

[1] ***The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) recently completed a joint project to develop a common revenue standard for U.S. GAAP and IFRS to improve revenue recognition practices and to remove inconsistencies and weaknesses in revenue requirements. The updated guidance is contained in the Accounting Standards Codification as Topic 606, "Revenue from Contracts with Customers." Review that guidance to summarize the core principle for recognizing revenue and briefly describe the five steps needed to achieve the core principle. Also, describe how the core principle was not achieved in this situation.***

The determination of whether a entity is reporting transactions within the confines of GAAP (aggressively reporting versus fraudulently reporting) requires professional judgment. In order to record revenue transactions, ASC 606, "Revenue from Contracts with Customers," describes the core principle for revenue recognition as follows: "...the entity should recognize revenue to depict the transfer of promised goods or services to customers in the amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services." To achieve that core principle, ASC 606 notes that the entity should apply the following steps:

Step 1: Identify the contract(s) with a customer.
Step 2: Identify the performance obligations in the contract.
Step 3: Determine the transaction price.
Step 4: Allocate the transaction price to the performance obligations in the contract.
Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

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According to the caller's description of the receivables and revenue transactions in this case, customers had not submitted orders for the goods, there was no underlying contract in place for the sale of those goods, and goods had not been shipped. Therefore, there was no evidence of any type of arrangement or commitment in place and there was no evidence of any establishment of the seller's price and other terms between the company and the customer. The earnings process was not complete given that goods had not been shipped and the customer had not provided cash or a promise to pay. Thus, there was no assurance that the receivables would be collected. As a result, the revenue recognition criteria were not satisfied, making the intentional recording of the underlying transactions a fraud.

[2] ***Do you think situations like this (i.e., aggressive accounting or even financial statement fraud) are common in practice?***

It is difficult to determine the extent that companies aggressively or even fraudulently misstate financial statements. There are several examples in the business press of alleged instances of financial statement fraud (e.g., Satyam, Enron, WorldCom, Adelphia Communications, Tyco, etc.) In May 2010, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued a studied titled, *Fraudulent Financial Reporting 1998-2007: An Analysis of U.S. Public Companies*. The COSO study (see full study at www.coso.org) identified 347 fraudulent financial statement cases investigated by the Securities and Exchange Commission (SEC) in the 10-year period examined. Given the number of publicly traded companies in the U.S., many view the number of cases identified to be low. However, the number of cases identified is directly affected by the SEC's limited resources available for fraud investigation. And, privately held businesses are not subject to SEC enforcement. So, the likely number of cases may be much higher. For the cases examined in the COSO study, 61% of those cases involved improper recognition of revenues and receivables like the situation described in this case. Thus, the technique used by the company in this case resembles a technique frequently used by companies issuing fraudulent financial statements. Consistent with these findings, AU-C Section 240, "Consideration of Fraud in a Financial Statement Audit," and PCAOB AS 2110, "Identifying and Assessing Risks of Material Misstatement," require that the auditor presume that there is a risk of material misstatement due to fraud relating to revenue recognition in every audit.

[3] ***Which financial statement assertion related to sales transactions did management violate when it issued the falsified financial statements?***

The caller's description of the fraud indicates that management recorded revenue and the related accounts receivable for customers who had not placed an order for those goods or before the goods had been shipped to customers. The recording of those entries would violate the "occurrence" financial statement assertion for sales transactions. According to AU-C 315, "Understanding the Entity and Its Environment," the occurrence assertion for classes of transactions addresses whether "Transactions and events that have been recorded have occurred and pertain to the entity." Because customers had not placed orders or the company had not shipped goods to customers, there was no type of formal arrangement and there was no exchange of goods for cash or other consideration. As a result, this activity violates the occurrence assertion for sales transactions.

[4] ***(a) What would you recommend to the caller if you were Dr. Mitchell? (b) What are the risks of continuing to work with the company? (c) What are the risks of resigning immediately?***

[a] One of the first actions that Dr. Mitchell might suggest would be for the caller to return to the office to gather any available evidence related to the transactions in question. Such a search would help to confirm that, to the caller's best knowledge, the inclusion of those transactions in the first quarter financial statements is clearly inappropriate. The caller could re-verify that there is no underlying customer order and that the goods were not shipped as of quarter end. The caller might also obtain documentation of the actual accounting entry(ies) related to the recording of the transactions in the accounting system. This additional search for any possible evidence related to the transaction will help

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ensure that the caller's views about the inappropriate accounting treatment are valid. To protect the caller from any future false allegations and assignment of blame for the transactions, the caller would be wise to maintain copies of all related evidence in a protected file. If the senior executives attempt to subsequently blame the caller for the inappropriate accounting, the ability to access such evidence may be extremely beneficial when mounting a defense.

Dr. Mitchell might advise the caller to meet with senior executives one more time to re-emphasize concerns about the improper inclusion of the sales and receivable transactions in the first quarter financial statements. The caller could highlight the specific GAAP criteria required to recognize revenue. And, the caller might emphasize that the consequences of issuing intentionally misstated financial statement information to the bank could be extremely severe for both the company and the individuals who knowingly submitted the false financial information. Perhaps the senior executives involved are unaware of the serious consequences, including litigation and possible jail time that might result if the fraud is subsequently revealed.

Finally, Dr. Mitchell is likely to advise the caller to immediately seek the advice of a sound legal counselor. Issuing false and misleading financial statements to third parties who rely on them to make business decisions bears serious legal consequences. Thus, the advice of a professional knowledgeable of the legal responsibilities may be extremely helpful.

[b] Regardless of the senior executives' reaction to the caller's concern, Dr. Mitchell is likely to encourage the caller to seriously consider resigning from her position. Dr. Mitchell might point out that even if the company recalls the financial statements to remove the effects of the transactions, the caller now has strong evidence indicating that the integrity of senior executives is weak. Continued affiliation with a company and senior executive team known to have engaged in fraud casts obvious doubts about the professional reputation of all those associated. While discontinuing employment likely introduces significant personal costs, the costs of being associated with a company and management team that possesses little professional integrity are likely to be greater.

[c] Dr. Mitchell would likely encourage the caller to not resign immediately upon returning to the office that Monday morning. Rather, Dr. Mitchell might emphasize the importance of first gathering sufficient copies of any available evidence related to the transaction. Such evidence, as noted earlier, may be extremely helpful if the senior executive team attempts to falsely place blame on the caller for the inappropriate accounting. Obtaining copies of such evidence would be the first priority.

[5] ***What types of audit procedures could an external auditor perform that might help the auditor detect this fraudulent activity?***

Several possible audit procedures could be performed that might detect this fraudulent activity. The mailing of confirmations to customers associated with the recorded transactions may identify misstatements in the recorded receivable balances for the prematurely recorded revenue transactions. Most likely, customers would indicate discrepancies in the recorded receivable balances due to the overstated revenue transactions. Be sure to emphasize that they should select those customers for confirmation from recorded receivable balances. Other audit procedures might include the selection of transactions from the Sales Journal (or equivalent accounting record) and the examination of the related documentation for those transactions, including the customer's purchase order and the shipping documentation. Well-designed analytical procedures might also highlight the potential for misstatement, if the recorded amounts are not consistent with the auditor's pre-determined expectations based on prior year trends or other operating data. Finally, inquiry of key personnel involved in accounting, shipping, and sales might reveal unusual activities.

[6] ***People who study instances of financial statement fraud often note that three conditions are generally present for fraud to occur. First, the person perpetrating the fraud has an incentive or pressure to engage in fraud. Second, there is an opportunity for that person to carry out the fraud. Third, the person's attitude or ethical values allows the perpetrator to rationalize the unethical behavior. Describe examples of incentive, opportunity, and attitude conditions that were present in this situation.***

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Senior management faced several *incentives* that may have pressured them to engage in issuing fraudulently misstated quarterly financial statements. As a start-up company, management faced tremendous obstacles as they attempted to get the business up and running as an established competitor in the marketplace. The company, as a start-up enterprise had been operating at a net loss for a while. The company was facing a severe cash crunch, and the bank had recently halted the line of credit until the operating results for the first quarter could be analyzed. Thus, management was facing tremendous pressure to show its outside lenders that the company was viable. In addition, management's reputation as being successful entrepreneurs was a stake. These factors likely combined to provide tremendous incentives to misstate the first quarter financial results.

Given these incentives, management took advantage of *opportunities* to engage in fraudulent financial statement reporting. Because the financial statements requested by the bank related to the first-quarter of the year, the financial statements were not reviewed or audited by the external accountant. Thus, management had greater opportunity to misstate the first-quarter results than would have been available if the financial statements involved had been reviewed or audited. In addition, due to the company's small size and lack of sophisticated internal control systems, senior management was able to manipulate a temporary accounts payable clerk to book the fictitious sales and receivables transactions. The controller's absence provided management even greater opportunity to override the basic internal controls in place to book the inappropriate transactions.

Senior management's *attitude* about the controller's reaction to the inappropriate accounting treatment displayed a disregard towards the importance of quality financial reporting. Senior management rationalized their inappropriate actions by accusing the controller of living in an "ivory tower." They accused the controller of seeking a level of perfection and exactness that was unnecessary, reflecting the controller's lack of having a practical perspective to common business practices. Senior management had clearly convinced themselves that "companies booked these kinds of transactions all the time."

In this case, all the ingredients of fraud were present. Management had tremendous incentives to engage in fraud, and they took advantage of opportunities present to book the inappropriate entries. Finally, their attitude towards the importance of financial reporting displayed their ability to rationalize their unethical behavior.

[7] *The AICPA's Code of Professional Conduct outlines key elements of an accountant's professional ethics responsibilities. Briefly describe how the Code is structured and indicate where would you find guidance about the importance of integrity.*

The AICPA Code is organized into separate parts. The **Preface** is applicable to all members and includes an overview of the Code, a summary of the structure and application of the Code, and the Principles of professional conduct. The remaining part of the Code is divided into three parts according to member's practice.

Part 1 is applicable to members in public practice,
Part 2 is applicable to members in business, and
Part 3 is applicable to all other members such as those who are retired or unemployed.

For members who are both in public practice and in business, content that is relevant to both parts appears in the corresponding citation. The actual content differs only where necessary (for example, part 1 might refer to a firm whereas part 2 might refer to employer).

As a result of the 2014 restructuring of the Code of Professional Conduct, the Code no longer uses specific rule numbers (For example, Rule 101, Independence is now referred to as the Independence Rule.). While the specific rule number is no longer used, the bylaws of the AICPA require that members adhere to the rules of the AICPA Code. This has not been changed with the restructured AICPA Code.

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