Auditing A Risk Based-Approach to Conducting a Quality Audit 10th edition Johnstone Solutions Manual

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Solutions for Chapter 2

True/False Questions

2-1 F
2-2 F
2-3 T
2-4 F
2-5 T
2-6 T
2-7 F
2-8 T
2-9 F
2-10 T
2-11 T
2-12 F

Multiple Choice Questions

2-13 B
2-14 B
2-15 B
2-16 E
2-17 D
2-18 C
2-19 C
2-20 D
2-21 A
2-22 D
2-23 A
2-24 B

Review and Short Case Questions

2-25

Fraud is an intentional act involving the use of deception that results in a misstatement of the financial statements. Two types of misstatements are relevant to auditors' consideration of fraud (a) misstatements arising from misappropriation of assets and (b) misstatements arising from fraudulent financial reporting. Intent to deceive is what distinguishes fraud from errors.

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2-26

Three common ways that fraudulent financial reporting can be perpetrated include:

- Manipulation, falsification or alteration of accounting records or supporting documents
- Misrepresentation or omission of events, transactions, or other significant information
- Intentional misapplication of accounting principles

Common types of fraudulent financial reporting include:

- Improper revenue recognition
- Improper deferral of costs and expenses
- Improper asset valuation
- Concealed liabilities
- Misrepresentations or omissions in financial statement footnotes of MD&A

2-27

The reporter's statement makes sense. Asset misappropriations are much easier to accomplish in small organizations that don't have sophisticated systems of internal control. Fraudulent financial reporting is more likely to occur in large organizations because management often has ownership of or rights to vast amounts of the company's stock. As the stock price goes up, management's worth also increases. However, the reporter may have the mistaken sense that financial fraud only occurs rarely in smaller businesses. That is not the case. Many smaller organizations are also motivated to misstate their financial statements in order to (a) prop up the value of the organization for potential sale, (b) obtain continuing financing from a bank or other financial institution, or (c) to present a picture of an organization that is healthy when it may be susceptible to not remaining a going concern. Finally, smaller organizations may conduct a fraud of a different sort, i.e., misstating earnings by understating revenue or masking owner distributions as expenses. This is often done to minimize taxes. It would also be a mistake to think that asset misappropriations do not happen in larger organizations. Whenever controls are weak, there is an opportunity for asset misappropriation. When the opportunity is coupled with motivation and a belief that the fraud could be covered up, some of those opportunities will result in asset misappropriation.

2-28

a. A Ponzi scheme occurs when the deposits of current investors are used to pay returns on the deposits of previous investors; no real investment is happening.

b. The key elements of the Bernie Madoff fraud include:

- Fabricated "gains" of almost $65 billion
- Defrauded thousands of investors
- Took advantage of his high profile investment leader status to establish trust in his victims

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- Accomplished the scheme by keeping all the fraudulent transactions off the real financial statements of the company
- Employed a CPA who conducted a sham audit
- Led to the PCAOB now having oversight of the audits of SEC-registered brokers and dealers

c. The Bernie Madoff fraud is primarily a case of asset misappropriation. However, it is important to note that asset misappropriation then led Madoff to commit fraudulent financial reporting to hide the asset misappropriation.

2-29

a. Management perpetrated the fraud by filling inside containers with water in the larger containers filled with oil. Further, they transferred the oil from tank to tank in the order in which they knew the auditors would proceed through the location.

b. The goal was to overstate inventory assets, thereby understanding cost of goods sold and overstating income.

c. The Great Salad Oil Swindle is primarily a case of fraudulent financial reporting.

2-30

Incentives relate to the rationale for the fraud, e.g., need for money, desire to enhance stock price. Opportunities relate to the ability of the fraudster to actually accomplish the fraud, e.g., through weak internal controls. Rationalization is the psychological process of justifying the fraud.

2-31

Common incentives for fraudulent financial reporting include:

- Management compensation schemes
- Other financial pressures for either improved earnings or an improved balance sheet
- Debt covenants
- Pending retirement or stock option expirations
- Personal wealth tied to either financial results or survival of the company
- Greed—for example, the backdating of stock options was performed by individuals who already had millions of dollars of wealth through stock

2-32

Factors, or red flags, that would be strong indicators of opportunity to commit fraud include:

- inadequate segregation of duties
- opportunities for management override
- absence of monitoring controls
- complex organizational structure

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- unauthorized access to physical assets
- inadequate reconciliations of key accounts, especially bank accounts
- access to cash that it not supervised or reconciled by someone else

2-33

The ability to rationalize is important. Unless fraudsters are outright criminals, they will often be able to come up with an excuse for their behavior. "Accounting rules don't specifically disallow it" or "the company owes me" are potential rationales. Other common rationalizations include:

- Unfair financial treatment (perceived) in relationship to other company employees
- "It is only temporary", or "it's a loan from the company"
- "I deserve it"
- "The company is so big they won't miss it"
- " The company is unethical"
- "The company comes by its profits in a way that exploits people".

2-34

a. incentive
b. incentive
c. opportunity
d. incentive
e. rationalization
f. opportunity

2-35

Refer to *Exhibit 2.3* for brief descriptions.

a. Enron: fraudulent financial reporting

b. WorldCom: fraudulent financial reporting

c. Parmalat: fraudulent financial reporting

d. HealthSouth: fraudulent financial reporting

e. Dell: fraudulent financial reporting

f. Koss Corporation: asset misappropriation

g. Olympus: fraudulent financial reporting

h. Longtop Financial Technologies: fraudulent financial reporting

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i. Peregrine Financial Group: asset misappropriation

j. Sino-Forest Corporation: fraudulent financial reporting

k. Diamond Foods, Inc.: fraudulent financial reporting

2-36

a. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence; requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist.

b. Professional skepticism is helpful in detecting fraud because without it the external auditor will be easily convinced of alternative explanations to the fraud that management will provide to conceal the fraud.

c. The key behaviors necessary to successfully exercise professional skepticism include validating information through probing questions, critically assessing evidence, and paying attention to inconsistencies.

d. It is difficult to exercise professional skepticism in practice for a variety of reasons including, the nature tendency to trust people (especially client personnel with whom you have worked), lack of repeated exposure to fraud, many repeated exposures to situations that do NOT involve fraud.

e. Personal characteristics and behaviors that might make you skeptical about an individual include some of the following:

- Providing inaccurate or conflicting evidence
- Interacting in a difficult or unhelpful manner
- Acting in an untrustworthy fashion
- Engaging in conspicuous consumption of material possessions beyond the level to which their salary would normally make that lifestyle possible.

Publicly available evidence exists that might help you assess whether an individual warrants increased skepticism. Information can include: tax liens, credit scores, and legal filings.

2-37

a. If a company has good products, it would be expected that it should have comparable profitability with other industry participants. The fact that it does not have that profitability, coupled with a weakness in internal controls over disbursements, should lead the auditor to embrace the idea that there is an opportunity for a disbursements fraud and that such a fraud could be hurting the reported profitability of the company.

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b. The company is doing better than its competitors and it appears to have achieved these better results through cost control. While cost control might be a valid explanation, the auditor should consider other potential explanations such as inappropriately capitalizing expenses, inappropriately recognizing revenue, etc.

c. The company would appear to be using 'window dressing' in order to bypass debt covenants. It is doing so by sharply discounting current sales. These actions are not necessarily fraudulent, but they may be created to portray a misleading picture of the current economic health of the organization.

d. This brief description mirrors that of the Koss case where the CFO was very intimidating, not a CPA, and possessed limited accounting experience. The company did not increase profit during her tenure. The external auditor should consider these factors to suggest a heightened risk of fraud.

2-38

Some of the key findings of the COSO study included:

- The amount and incidence of fraud remains high.
- The median size of company perpetrating the fraud rose tenfold to $100 million during the 1998-2007 time period.
- There was heavy involvement in the fraud by the CEO and/or CFO.
- The most common fraud involved revenue recognition.
- Many of the fraud companies changed auditors.
- The majority of the frauds took place at companies that were listed on the Over-The-Counter (OTC) market rather than those listed on the NYSE or NASDAQ.

2-39

a. The various failures and environmental characteristics during the time of the Enron fraud include:

- Weak management accountability.
- Weak corporate governance.
- Accounting became more rule-oriented and complex.
- The financial analyst community was unduly influenced by management pressure.
- Bankers were unduly influenced by management pressure.
- Arthur Andersen was unduly influenced by management pressure, especially since consulting revenues at Enron were very high.

b. In terms of the fraud triangle,

- Incentives: management was very concerned about managing stock prices through keeping debt off the balance sheet; the underlying business model of the company was not working; the company had strayed too far away from its "utility" roots and employees

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were taking significant risks in the financial markets that did not yield expected profits, thereby creating strong incentives for top management to conduct the fraud.

- Opportunity: corporate governance and external auditor accountability were lacking.

- Rationalization: although not discussed in the text specifically, there have been speculations in the press that management thought they were smarter than everyone else and that they were very confident that they could get away with the fraud. It is difficult to know the internal rationalizations of top management.

2-40

Auditing standards historically have reflected a belief that it is not reasonable for auditors to detect cleverly implemented frauds. However, it is increasingly clear that the general public, as reflected in the orientation of the PCAOB, expects that auditors have a responsibility to detect and report on material frauds. Professional auditing standards do require the auditor to plan and perform an audit that will detect material misstatements resulting from fraud. As part of that requirement, auditors will begin an audit with a brainstorming session that focuses on how and where fraud could occur within the organization. Auditors also need to communicate with the audit committee and management about the risks of fraud and how they are addressed. The auditor should then plan the audit to be responsive to an organization's susceptibility to fraud.

2-41

The three ways in which individuals involved in the financial reporting process, including the external auditor, can mitigate the risk of fraudulent financial reporting include:

- Acknowledging that there needs to exist a strong, highly ethical tone at the top of an organization that permeates the corporate culture, including an effective fraud risk management program.
- Continually exercising professional skepticism, a questioning mindset that strengthens professional objectivity, in evaluating and/or preparing financial reports.
- Remember that strong communication among those involved in the financial reporting process is critical.

Will these actions be effective? This should promote a lively debate among students if this question is discussed in class. Some will argue that frauds happen no matter what, so these types of actions will be futile. Others will be more optimistic, arguing that these actions, if consistently applied, could help to mitigate fraud risk.

2-42

a. The financial literacy, integrity, and reputation of Board members enhance credibility of the regulation and oversight of the auditing profession. Inspections by the PCAOB act as a highly visible enforcement mechanism, hopefully leading to higher quality audits. Further,

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information that is learned through the inspection process can be used as a basis for modifying and enhancing auditing standards.

b. These sections improve auditor independence by separating consulting and auditing by the same audit firm. The partner rotation requirement ensures that a "fresh set of eyes" will be responsible for oversight on the engagement.

c. The "cooling off" period helps to avoid conflicts of interest between top members of the engagement team and the client. By requiring a cooling off period, an auditor will not be unduly influenced (or appear to be unduly influenced) by the possibility of high-level employment with the client.

d. Audit committees clearly serve the role of the "client" of the auditor. They act as surrogates for the shareholders who are the actual audit client. They act as the liaison between management and the external auditor. By being independent, they gain credibility and ensure that the external auditor can rely on them to perform their governance role. By requiring that audit committees can hire their own attorneys and by ensuring that they have adequate monetary resources, the external auditor has confidence that they will act as truly independent monitors of management.

e. The certification requirements help address the risk of fraud by forcing the CEO and CFO to take internal controls and high quality financial reporting seriously. By forcing them to sign, they will likely require individuals below them to provide assurance that those departments or organizational units are each committed to internal controls and high quality financial reporting as well. Of course, a signature is just a signature! So, the likelihood that a CFO who is committing fraud will certify falsely is probably 100%. Thus, this mechanism is not without practical flaws.

f. It addresses off-balance sheet transactions and special purpose entities, which were the main mechanisms used to conduct the Enron fraud.

g. A strong internal control system is critical to preventing fraud. These sections of Sarbanes-Oxley Act mandate the disclosure of weak internal controls, thereby providing a strong motivation to managers to ensure that controls are effective. By requiring external auditor assurance on management's assessment, financial statement users can believe in management's assertions about controls.

h. One member of the audit committee needs to be a financial expert to ensure that there is the knowledge necessary on the audit committee to critically evaluate management's financial reporting and internal control choices. Without that knowledge, the committee may be unduly influenced by management's preferences.

i. It imposes strict penalties for destroying documents, which was an element in the downfall of Andersen.

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2-43

No, nonpublic organizations are not required to abide by the Sarbanes-Oxley Act. However, many organizations view these requirements as "best practice" and so nonpublic organizations sometimes adhere to certain requirements of the Sarbanes-Oxley Act voluntarily.

2-44

The major parties involved in corporate governance, and their role/activities are as follows:

Party	**Overview of Responsibilities**
Stockholders	**Broad Role:** Provide effective oversight through election of board members, through approval of major initiatives (such as buying or selling stock), and through annual reports on management compensation from the board
Board of Directors	**Broad Role:** The major representatives of stockholders; they ensure that the organization is run according to the organization's charter and that there is proper accountability. **Specific activities include:** • Selecting management • Reviewing management performance and determining compensation • Declaring dividends • Approving major changes, such as mergers • Approving corporate strategy • Overseeing accountability activities
Management	**Broad Role:** Manage the organization effectively; provide accurate and timely accountability to shareholders and other stakeholders **Specific activities include:** • Formulating strategy and risk management • Implementing effective internal controls • Developing financial and other reports to meet public, stakeholder, and regulatory requirements • Managing and reviewing operations • Implementing an effective ethical environment
Audit Committees of the Board of Directors	**Broad Role:** Provide oversight of the internal and external audit function and over the process of preparing the annual financial statements and public reports on internal control **Specific activities include:** • Selecting the external audit firm • Approving any nonaudit work performed by the audit firm • Selecting and/or approving the appointment of the Chief Audit Executive (Internal Auditor) • Reviewing and approving the scope and budget of the internal audit function

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	• Discussing audit findings with internal and external auditors, and advising the board (and management) on specific actions that should be taken
Regulatory Organizations: SEC, AICPA, FASB, PCAOB, IAASB	**Broad Role:** Set accounting and auditing standards dictating underlying financial reporting and auditing concepts; set the expectations of audit quality and accounting quality **Specific activities include:** • Establishing accounting principles • Establishing auditing standards • Interpreting previously issued standards • Enforcing adherence to relevant standards and rules for public companies and their auditors

2-45

These principles include:

- The board's fundamental objective should be to build long-term sustainable growth in shareholder value for the corporation.
- Successful corporate governance depends upon successful management of the company, as management has the primary responsibility for creating a culture of performance with integrity and ethical behavior.
- Effective corporate governance should be integrated with the company's business strategy and not viewed as simply a compliance obligation.
- Transparency is a critical element of effective corporate governance, and companies should make regular efforts to ensure that they have sound disclosure policies and practices.
- Independence and objectivity are necessary attributes of board members; however, companies must also strike the right balance in the appointment of independent and non-independent directors to ensure an appropriate range and mix of expertise, diversity, and knowledge on the board.

2-46

a. Independent directors are more likely to stand up to management and report fraud than those directors that are not independent.

b. Holding meetings without management present enables a frank and open discussion, including enabling board members with concerns about potential fraud or weak management to alert other board members to express those concerns.

c. By having a nominating/corporate governance committee composed of independent directors, the organization is more likely to attract high quality board members that are not unduly influenced by management. And by having a corporate governance committee, this important element of control achieves prominence in the organization and acts as a deterrent to fraud.

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d. Having a written charter and an annual performance evaluation ensures that the committee responsibilities are appropriate, and that the responsibilities are actually accomplished (or shareholders are alerted if they are not accomplished). Accomplishing such activities acts as a deterrent to fraud.

e. By having an independent compensation committee, top management will be less able to inappropriately influence compensation decisions for themselves.

f. Having a written charter and an annual performance evaluation ensures that the committee responsibilities are appropriate, and that the responsibilities are actually accomplished (or shareholders are alerted if they are not accomplished). Accomplishing such activities acts as a deterrent to fraud.

g. This requirement ensures an adequate size and independence of the audit committee, which acts to strengthen governance and deter fraud.

h. Having a written charter and an annual performance evaluation ensures that the committee responsibilities are appropriate, and that the responsibilities are actually accomplished (or shareholders are alerted if they are not accomplished). Accomplishing such activities acts as a deterrent to fraud.

i. These requirements encourage a high quality set of corporate governance behaviors, which taken together act as a deterrent to fraud.

j. By making the ethics issue a prominent disclosure, it encourages management and other individuals within the organization to take it more seriously. It acts to encourage a high quality "tone at the top".

k. By requiring this disclosure, users of the financial statements can evaluate for themselves whether the foreign companies' governance is adequate, or gain an appreciation for governance differences. This knowledge encourages companies to adopt corporate governance mechanisms that they otherwise may not, thereby affecting the control environment and the opportunity for fraud. It also helps users know where deficiencies may exist, making them more skeptical.

l. It attempts to ensure that the top-level executives place the appropriate importance on corporate governance and that they would be required to disclose if their company is not compliant, which would alert users to heightened fraud risk.

m. An internal audit function is important to the control environment. Having that oversight internally improves internal control, thereby deterring fraud.

2-47

a. This requirement forces audit committees to take internal controls seriously, and to consider any potential independence impairments for the external auditor. Both internal controls and high quality external auditing are critical for the prevention and/or detection of fraud.

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b. This requires the audit committee to be engaged and informed about financial accounting at the company; being engaged and informed enhances the ability of the audit committee to detect fraud.

c. Analyst interactions and the pressure to meet their expectations provide incentives for fraud. By requiring that the audit committee discuss the earnings release process, audit committees have more control over what and how management engages with analysts, and that control should assist in deterring fraud.

d. Understanding risk assessment and risk management should alert the audit committee to weaknesses therein, thereby encouraging positive change, which should thereby deter fraud.

e. Meeting separately with these groups encourages frank conversations about concerns, and such communication is helpful to deterring or detecting fraud.

f. By understanding the nature of any problems that the external auditor is having with management, the audit committee gets a good sense of potential management aggressiveness, and the sources of disagreement between the auditor and management. In addition, this requirement gives the external auditor someone to turn to in reporting fraud on the part of management.

g. By setting hiring policies regarding employees of the external audit firm, the audit committee can ensure that management is not exerting undue influence over the members of the audit team by possibly promising them employment at the company.

h. By reporting regularly to the board of directors, the audit committee is put in a position of power in the organization, thereby giving them the clout necessary to oversee management and deter fraud.

2-48

a. The audit committee must be comprised of "outside" independent directors, one of whom must be a financial expert. The audit committee now has the authority to hire and fire the external auditor, and will therefore serve as the auditor's primary contact, especially for accounting and audit related issues. In addition, at many organizations the audit committee sets the scope for and hires internal auditors. They would also review the work of both internal and external auditors.

b. The audit committee certainly takes on much more responsibility with the new regulation. They will now be much more informed about the audit function and financial reporting processes within their company. The auditor must report all significant problems to the audit committee. For auditors, the reporting relationship should reinforce the need to keep the third-party users in mind in dealing with reporting choices.

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c. The audit committee is basically in a position of mediator, but not problem solver. One member must be a financial expert, but all members must be well versed in the field. This financial knowledge can help the audit committee to understand the disagreement. Ultimately, the company would like to receive an unqualified audit opinion. If the external auditor believes a certain accounting treatment to be wrong, they do not have to give an unqualified opinion. The audit committee's responsibility is to assist in resolution of the dispute so that financial reporting is accurate. Skills of audit committee members that would assist in this type of situation include interpersonal skills, negotiation skills, and communication skills.

2-49

Factors	Explain Your Reasoning and the Implications of Poor Governance
a. The company is in the financial services sector and has a large number of consumer loans, including mortgages, outstanding.	This is not necessarily poor governance. However, the auditor needs to determine the amount of risk that is inherent in the current loan portfolio and whether the risk could have been managed through better risk management by the organization. The lack of good risk management by the organization increases the risk that the financial statements will be misstated because of the difficulty of estimating the allowance for loan losses.
b. The CEO's and CFO's compensation is based on three components: (a) base salary, (b) bonus based on growth in assets and profits, and (c) significant stock options.	This is a rather common compensation package and, by itself, is not necessarily poor corporate governance. However, in combination with other things, the use of 'significant stock options' may create an incentive for management to potentially manage reported earnings in order to boost the price of the company's stock. The auditor can determine if it is poor corporate governance by determining the extent that other safeguards are in place to protect the company.
c. The audit committee meets semi-annually. It is chaired by a retired CFO who knows the company well because she had served as the CFO of a division of the firm before retirement. The other two members are local community members – one is the President of the Chamber of Commerce and the other is a retired executive from a successful local manufacturing firm.	This is a strong indicator of poor corporate governance. If the audit committee meets only twice a year, it is unlikely that it is devoting appropriate amounts of time to its oversight function, including reports from both internal and external audit. There is another problem in that the chair of the audit committee was previously employed by the company and would not meet the definition of an independent director. Finally, the other two audit committee members may not have adequate financial experience. This is an example of poor governance because (1) it signals that the organization has not made a commitment to

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Factors	Explain Your Reasoning and the Implications of Poor Governance
	independent oversight by the audit committee, (2) the lack of financial expertise means that the auditor does not have someone independent that they can discuss controversial accounting or audit issues that arise during the course of the audit. If there is a disagreement with management, the audit committee does not have the expertise to make independent judgments on whether the auditor or management has the appropriate view of the accounting or audit issues.
d. The company has an internal auditor who reports directly to the CFO, and makes an annual report to the audit committee.	The good news is that the organization has an internal audit function. However, the reporting relationship is not ideal. Further, the bad news is that a staff of one isn't necessarily as large or as diverse as it needs to be to cover the major risks of the organization.
e. The CEO is a dominating personality – not unusual in this environment. He has been on the job for 6 months and has decreed that he is streamlining the organization to reduce costs and centralize authority (most of it in him).	A dominant CEO is not especially unusual, but the centralization of power in the CEO is a risk that many aspects of governance, as well as internal control could be overridden. The centralization of power in the CEO is a risk that many aspects of governance, as well as internal control could be overridden, which of course increases the risk of fraud and the risk faced by the external auditor.
f. The Company has a loan committee. It meets quarterly to approve, on an ex-post basis all loans that are over $300 million (top 5% for this institution).	There are a couple of elements in this statement that yield great risk to the audit and to the organization, and that are indicative of poor governance. First, the loan committee only meets quarterly. Economic conditions change more rapidly than once a quarter, and thus the review is not timely. Second, the only loans reviewed are (a) large loans that (b) have already been made. Thus, the loan committee does not act as a control or a check on management or the organization. The risk is that many more loans than would be expected could be delinquent, and need to be written down.
g. The previous auditor has resigned because of a dispute regarding the accounting treatment and fair value assessment of some of the loans.	This is a very high risk indicator that is indicative of poor governance. The auditor would look extremely bad if the previous auditor resigned over a valuation issue and the new auditor failed to adequately address the same issue. Second, this is a risk factor because the organization shows that it is willing to get rid of auditors with whom they do not agree. This is a problem of auditor independence and coincides with the above identification of the weakness of the audit committee.

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Fraud Focus: Contemporary and Historical Cases

2-50

a. Management at Koss may have placed a high level of trust in Sachdeva because they knew her for a long period of time and she did not exhibit behaviors that caused concern. Further, management at the company was reportedly quite relaxed in its approach to monitoring and control. These behaviors led to a lack of professional skepticism on the part of management.

b. Grant Thornton was obligated to uncover the fraud in the sense that they ignored red flags (weakening financial condition, poor internal control and monitoring) that should have alerted them to problems in the company. Grant Thornton experienced an audit failure because they issued unqualified audit opinions on materially misstated financial statements. It appears that they may not have employed an appropriate level of professional skepticism.

c. Sachdeva's lavish lifestyle should have raised suspicions because her level of conspicuous consumption far exceeded her apparent ability to pay given her relatively modest salary. However, her lifestyle may have been explained away or ignored because of her husband's prominent medical practice. People likely assumed that her lifestyle was none of their business and that she simply used her family's joint money to fund her lavish purchases. Even when confronted with a known fraud, individuals that know a fraudster often have difficulty believing that it is true – denial is a common factor even in the face of seemingly obvious signs of fraud.

d. Management and the audit committee should have been skeptical of Sachdeva because of the weak internal controls in place, coupled with deteriorating financial conditions at the company. The auditors should have been more skeptical of her explanations for the financial condition of the company. The auditors should have collected more audit evidence to better understand the increase in cost of goods sold. The auditors should have realized that there was a risk of fraud given the lack of monitoring and the high level access to corporate bank accounts that Sachdeva had.

e. The audit committee plays an important oversight role in any organization. The benefit of the audit committee should be that they are independent from the daily operations of the organization, and should therefore be in a position to more critically evaluate the personalities and behaviors of senior management, including the CFO in this particular case. Further, audit committees of public companies are required to have at least one financial expert, and it is the obligation of that individual to consider and initiate investigation of anomalies in the financial statements. Clearly this oversight did not occur in the case of Koss.

f. Whenever an organization uses corporate credit cards, there should be controls over their use. Most typically, such controls involve review and approval of payment by a senior official. In Sachdeva's case, senior management allowed her to use the credit cards without review, and she was the individual in charge of making payments on the cards. Thus, basic controls involving review and segregation of duties were not used at Koss.

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g. Top-level managers should have been skeptical about the reasons for Sachdeva's behavior. In retrospect, it seems that she was purposely trying to intimidate her subordinates through this dominating behavior. Management may have questioned why she was trying to intimidate her subordinates. Was there something that she was trying to cover up? This tactic was also used at Enron, whereby top-level management would explicitly indicate that any questioning of its actions (from employees, external analysts, etc.) was an indication of how dense the questioner was. Top-level managers should have wondered why she felt the need to behave in this manner, and they should have objected to it in person or at least told her in private to eliminate the behavior if for no other reason than to establish and maintain a more professional tone in the workplace. This kind of behavior puts subordinates in a very awkward position. In Sachdeva's case, she reportedly acted dominating to the vast majority of her subordinates. In such a setting where one individual is not singled out, it should be easier for the group to act cohesively and approach senior management privately to complain about the situation. In a setting where one individual is singled out, that individual should consider finding a formal or informal mentor to help them decide how to garner the support to approach senior management with their concerns.

2-51

a. Yes, the members of the audit committee appear to be professionally qualified. They have all held financially responsible leadership positions at large companies in industries similar to those as Koss Corporation. The committee meets less frequently than quarterly, which is fairly infrequent. Prior to SOX, this level of audit committee involvement was common, but it is now more common for audit committees of public companies to meet at least bi-monthly, if not monthly. Without frequent meetings, committee members are not able to generate sufficient questions and then gather sufficient evidence in order to develop a professionally skeptical view of the true situation at the company, and that is what appears to have happened at Koss. You might consider gathering evidence to support your conclusions about the professional qualifications of audit committee members. For example, you might observe the questions that they ask during meetings, and their level of preparedness. You might inquire about their continuing professional education and experiences. You will obtain this information in various ways, but personal observation will likely be very important.

b. Lawrence Mattson is the audit committee financial expert. He is a retired president of a large consumer products company, which should make him financially knowledgeable. However, the fact that he has clearly been retired for quite some time (he is in his late 70's) calls into question whether he is currently "up to speed" on the financial reporting demands faced by a public company. Without adequate financial knowledge, it is nearly impossible to exercise adequate professional skepticism – knowledge is one of the bases upon which skepticism rests. Financial expertise is important for audit committee members because they play a significant role in corporate governance over financial matters – they are a key defense in potential problems with financial reporting.

c. Their compensation is very low given the important role that they play in the company, and the fact that this is a public board. Further, many audit committee members at public companies receive stock options or stock grants to align their interests with the long-term goals

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of stockholders. These audit committee members receive no stock options, and hold very few (if any) shares.

d. Theodore Nixon is the only audit committee member who is still an active, working financial professional. The other members of the audit committee are relatively older, and are no longer working in the public sector. This certainly does not disqualify them, but coupled with the relatively few meetings that the committee has, it calls into the question whether the audit committee is really functioning in a strong oversight capacity. The responsibilities that the proxy statement outlines seem reasonable, but it seems impossible that an audit committee with these characteristics could carry out those responsibilities in so few meetings.

2-52

This exercise is based on an article in the *Wall Street Journal* (Dell Investors Protest CEO in Board Vote, by: Joann S. Lublin and Don Clark, Aug 18, 2010). The article provides more details on shareholder voting for directors if the instructor is interested in pursuing that aspect of governance. In terms of the specific questions:

a. The following are the corporate governance principles presented in the chapter. Students could argue that many of the principles could be in question at Dell. Of great concern is that management has a great deal of control over the governance and there are questions about management's ethics and integrity. If the financial statements were intentionally misstated, this calls into question the company's commitment to transparency. Further, given Mr. Dell's roles, there are questions about the independence of the board.

- The Board's fundamental objective should be to build long-term sustainable growth in shareholder value for the corporation
- Successful corporate governance depends upon successful management of the company, as management has the primary responsibility for creating a culture of performance with integrity and ethical behavior
- Good corporate governance should be integrated with the company's business strategy and not viewed as simply a compliance obligation.
- Transparency is a critical element of good corporate governance, and companies should make regular efforts to ensure that they haves sound disclosure policies and practices.
- Independence and objectivity are necessary attributes of board members; however, companies must also strike the right balance between the appointment of independent and non-independent directors to ensure that there is an appropriate range and mix of expertise, diversity and knowledge on the board.

b. The discussion in part a. suggests that Dell's auditors should have some concerns about the quality of governance at Dell. And this in turn suggests that the audit might have heightened risk.

c. Dell's auditor can respond in various ways. At the extreme, the auditor may decide to not retain Dell as a client. Another approach would be to increase the audit work and audit rigor to mitigate any risks that may be associated with the lower quality governance. However, if the

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governance is really poor, extra audit work may not be sufficient. Further, if the auditors have reason to question the integrity and ethics of Mr. Dell it could be hard to "audit around that." This is a setting where it is important that the auditors employ an appropriate level of professional skepticism.

d. In general, having an independent board chair would improve governance. Given the alleged behavior of Mr. Dell, it may be even more important at Dell, Inc. Recall however that no individual or company admitted wrongdoing in this case.

e. Removing Mr. Dell from his CEO position may not be as likely as removing him from his board position. Student discussion will likely not come to a consensus on this point.

Application Activities

2-53

a. The skepticism continuum is founded on the belief that professional skepticism is related to a questioning mind, and that an individual may range from a neutral mindset, to a presumptive doubt mindset, to complete doubt. Complete trust would be outside the range on the continuum of professional skepticism. The continuum then relates to evidence collection, whereby lower skepticism is associated with less audit evidence and documentation and higher skepticism is associated with more audit evidence and documentation.

b. Threats to individual auditor professional skepticism include judgment biases, lack of knowledge and expertise, deadline pressures, auditor character/personal attributes, cultural attributes, and performance incentives. Mitigating factors include professional education and licensing requirements, supervision, review, performance metrics that reward the auditor for quality work, effective recruiting requirements, effective engagement partner leadership, and training.

c. Common human judgment tendencies that can weaken individual auditor professional skepticism include the following:

- Overconfidence. The tendency of individuals to overestimate their own abilities. Overconfidence can lead the auditor to not spend enough time critically thinking about client-related facts that would otherwise raise red flags.
- Confirmation. The tendency of individuals to seek information and evidence that supports their initial beliefs or preferences. If the individual auditor does not seek contradictory evidence, their professional skepticism is not heightened because the auditor does not detect discrepancies.
- Anchoring. The tendency of individuals to evaluate information from a starting point and then not adjusting sufficiently away from that starting point despite evidence to the contrary. For example, the individual auditor may anchor on last year's account balance or procedures used last year and insufficiently adjust for new information.
- Availability. The tendency of individuals to consider information that is more easily available from memory to be more likely, relevant, or important. By focusing on more

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readily available information, the individual auditor may not make the effort to engage in critical thinking about patterns available in audit evidence.

2-54

This research question asks students to summarize the PCAOB's concerns with respect to problems their inspection teams have noted in auditors' performance in each of the following areas.

a. Auditors' overall approach to the detection of fraud

Problems noted:

1. auditors often document their consideration of fraud merely by checking off items on standard audit programs and checklists rather than by considering unique features of their individual clients

2. lack of involvement by senior members of the engagement team

3. failure to expand audit procedures despite recognition of heightened fraud risk

b. Brainstorming sessions

Problems noted:

1. Engagement teams have been found not to conduct brainstorming sessions

2. Brainstorming sessions were sometimes conducted AFTER audit evidence collection had begun, rather than as an integral part of the planning process

3. Key members of the engagement team did not attend the brainstorming session.

c. Auditors' responses to fraud risk factors

Problems noted:

1. Auditors sometimes do not address known fraud risk factors via evidence.

2. Auditors sometimes collect evidence, but do not tie it to specific known fraud risk factors.

d. Financial statement misstatements

Problems noted:

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1. Failure to appropriately determine whether items are material or not.

2. Failure to investigate known departures from GAAP to determine if those departures were indicative of fraud.

3. Failure to post material items to a summary sheet indicating material misstatements, or inappropriately netting misstatements. This causes senior engagement personnel and audit committee members to be unaware of problems that engagement teams encountered on the engagement that could be indicative of fraud.

e. Risk of management override of controls

Problems noted:

1. Failure to evaluate the risk of management override of controls.

2. Failure to evaluate the fraud risk potential associated with end of period journal entries or accounting estimates.

3. Failure to document or test management's assumptions about accounting estimates.

f. Other areas to improve fraud detection

Problems noted:

1. Improper use of analytical procedures in fraud detection.

2. Failure to adequately audit accounts receivables, which are related to revenue recognition (an area in which auditors are supposed to presume fraud)

3. Failure to determine that interim audit testing appropriately rolled forward to apply to end of year conclusions.

2-55

a. The PCAOB sets standards for audits of public companies and defines the auditing profession's responsibilities for detecting fraud and other financial misdeeds. They also establish and test quality control guidelines for external audit firms that audit public companies. The inspection process keeps the external audit profession acutely alert to its responsibilities of

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assuring audit quality, i.e., the threat of inspection should lead to more consistently high audit quality on all engagements even though not all engagements will actually be inspected.

b. The rationale for the requirement was probably to get people from diverse disciplines to comprise the Board. This way, more thoughts are generated. Congress probably was under the impression that CPA's tend to think alike. The disadvantage to having only two CPA's on the board is that they do not form a majority and that the board may not have a sufficient level of accounting and auditing expertise. The Board sets standards for an industry made up almost entirely of CPA's, yet the strongest voice may not be that of a CPA.

c. No, the audit standards promulgated by the PCAOB apply only to public listed companies in the U.S. However, many of the auditing standards that have been adopted by the PCAOB include U.S. audit standards originally developed by the Auditing Standards Board of the AICPA.

2-56

a. Shareholders would normally not know what qualifications are important for their external auditors. If the CEO or CFO had these responsibilities, the auditor would be more likely to bend to their wishes rather than take the hard stances that may be required for fair financial reporting. Part of the purpose of designating the audit committee to oversee the audit is to have an advocate for the stockholders of the company.

b. Factors to consider in evaluating the external auditor's independence include:

- The nature and extent of non-audit services provided to the client.
- The policies and procedures the external auditor's firm has to assure independence.
- The lengths of time individuals have been in charge of the audit.
- Any pending or completed investigations by the SEC or PCAOB of the firm.

c. This part of the problem will vary based upon the company that each student selected. This is a good problem to assign if you feel that your students are unfamiliar with locating basic public company filings using the SEC online data system.

2-57

The purpose of this project is to get students familiar with resources related to businesses and acquaint them with the process of gathering evidence about corporate governance and evaluating the effectiveness of corporate governance. Another alternative is to discuss what students have observed in their part-time jobs.

2-58

The goal of this exercise is to allow the student to see how audit committees really function in the "real world." The differences between the various companies will likely indicate that audit committees, charters, and company goals differ across organizations.

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2-59

This exercise illustrates that the issue of corporate governance is a global issue. The insights the students will obtain will depend, in part, on the countries selected for research. For example, a report on Turkey would likely point out that: (1) there have been recent efforts to improve governance, in part, due to Turkey's efforts to join the European Union, (2) the concepts of transparency and disclosure are not well accepted by many companies because of their "family business" nature, etc.

Academic Research Cases

2-60

a. The issue being addressed is the role that risk, internal controls, and risk management within a company has on external audit demand and therefore, audit fees. Much research has been done on factors that may have an effect on audit fees. Some research has indicated that audit fees are affected by the size of the company, inherent risks such as receivables and litigation risk attributable to the auditor. Other research has indicated that these results are not consistent. Specifically, this research focuses on four risk issues that may affect audit fees. The risks that confront the stakeholders of a company may affect audit demand as each stakeholder may face different risks. Risk associated with the amount of internal controls, as well as whether the controls in place are voluntary or mandatory, in a company may also affect the need for external auditing. The level of corporate governance in a company may also have an effect on the level of necessity for auditing services, thus affecting fees.

b. The research indicated that there is a positive association between internal control/ risk management in an organization and audit fees as well as corporate governance and audit fees. In an organization with multiple stakeholders, the stakeholders are able to share control costs and therefore more apt to lead to an increased voluntary demand for levels of control. Audit fees are higher when a company has an audit committee, discloses a high level of financial risk management, and has a larger proportion of independent Board Members. Audit fees are lower when a company does not have an audit committee, has a smaller portion of independent board members, and discloses a relatively high level of compliance risk management, which is consistent with the theory that mandated internal controls lower audit fees.

c. Companies with greater corporate governance and voluntary controls have an increased need and desire for external audit assurance. This would also imply that these companies expect a higher quality audit, but they are more willing to pay for the higher quality audit. Companies with less corporate governance and only mandatory controls are more willing to sacrifice audit quality to reduce audit fees for the company.

d. Data was gathered using companies in Belgium as Belgium has an environment where stakeholders other than shareholders have a significant effect on corporate behavior. The researchers contacted 102 individual companies and requested disclosure of total fees paid for statutory audits of 2001 accounts. Information about corporate governance was also requested.

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Only 50 companies elected to provide all information necessary to complete the research. Risk and risk-management data for these companies was hand-collected from the 2001 annual reports. Estimation models were used to determine the effect of risk variables, governance variables, and the joint effect of these risks. Risk variables were given a score of 1 to 5 and included disclosures about management of financial risk, disclosures about management of compliance risk, disclosures about management of environmental risk, disclosures about management of technology risk, and disclosures about management of internal process risk as well as disclosure about management of change management risk. Dummy variables include a variable equal to 1 if the company has an internal auditor and 0 if not as well as a variable equal to 1 if the company has a formal model of risk management and 0 if not. The standard risk measures of net income and receivables average of total assets was also used in the research. Governance variables included if external auditors were part of the Big 5, if the company has an audit committee, number of non-execs on the board, percentage of board members that are non-execs, number of independent board members, percentage of board members that were independent, total number of board members, and if the CEO was chairperson on the board.

e. The research is somewhat limited due to a relatively small sampling of companies being used. Also, the risk and risk management data was retrieved from the 2001 annual reports. Therefore, there is the risk that the companies used for this research may have had incentives for disclosing or not disclosing information that affect management actions. Also, the Belgian economy and market is unique so it is not clear how these results would apply to a more market-driven economy like the United States.

2-61

a. The issue being addressed is the need for an internal audit report (IAR) to increase governance transparency for external stakeholders. Governance transparency is defined as the availability and extent of governance-related disclosures. The internal audit function is critical to the corporate governance of a company, as it provides assurance and ongoing assessments of the company's risk management processes and systems of internal control. Internal stakeholders have access to the information provided by internal audit. However, external stakeholders do not. This asymmetry raises the concern that corporate governance is not transparent to the external stakeholders and that this may represent an information risk to them. A commitment to an increase in the transparency of corporate governance is believed to result in an increase in trust and confidence with shareholders and stakeholders. This research is being performed to determine if the external stakeholders would benefit from additional information that could be provided to them in an IAR, what information they would benefit from, and if the benefit received would outweigh the cost of providing such information.

The legal liability for internal auditors may increase as a result of the potential to become more accountable for the performance of an internal audit. Additional requirements for performance of the audit could result in loss of flexibility in determining the scope of the internal audit as necessary for a specific company. The IAR would not only highlight the work that the internal auditor is doing, but it would also highlight what internal audit is not doing. However, the requirement of an IAR could also provide the internal audit profession additional leverage that

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would increase internal auditor value within the corporate world, as well as the audit profession itself.

b. The results of the interviews that were conducted definitely indicate that an IAR has the potential to improve external stakeholder understanding of the internal audit function and corporate governance. As a result, corporate governance would be more transparent to the external stakeholders. The interview results indicate that increased transparency may lead to increased quality standardization of and investment in internal audit activities. The IAR would provide the external stakeholders with information about what is and is not being audited within the company. This would provide external stakeholders with an increased confidence in the information that they are being provided.

Increased cost considerations determined in the interviews included increased legal exposure for internal auditors as they would be held more accountable for their performance as well as more accountable for financial reporting failures. This increased liability could affect availability of qualified auditors as well as their desired compensation as a result of the increased liability. Increased information load for users is another cost concern. The corporate disclosure is already lengthy and complex; the concern was expressed that users may not be able to fully understand the report. Additional reporting costs were not viewed as being a major issue if the internal auditor is doing a thorough job already but that there was the concern of increased risk due to limitations on audit scope as a result of not wanting to disclose results.

The IAR should include information that will provide valuable insight of the internal audit function to the external stakeholders. Some of the suggested information that should be included is the composition of the internal audit department, as well as their responsibilities, accountability, activities, and resources. The majority of the interviewees did not feel that an actual audit opinion was necessary as it would basically be the same as the opinion over internal controls.

c. An internal audit report supplied to external stakeholders could have several implications on audit quality. The report would potentially increase the accountability of the internal auditor, providing the auditor an incentive to apply more diligent care to the audit itself, therefore increasing the quality of the audit. The increased accountability and public review could provide the internal audit group with leverage for asking for critical resources and access within the company. Management would potentially have more incentive to provide the additional support and access that is requested. Another implication to the audit quality would be that the increase in accountability may lead the auditor to limit the scope of their audits due to having to disclose the results which would result in a decrease in audit quality. Further, as the quality of the internal audit function is affected, there are implications for external auditors who may choose to rely on the work of the internal auditors when performing the financial statement audit.

d. Data was gathered by conducting 18 semi-structured interviews, which averaged 20 minutes in length. A semi-structured interview format was used to allow new topics and questions to be introduced by the interviewees. The interviewees were selected using a convenience sampling. The interviewees consisted of four audit committee members (including 2 audit committee chairs), three analysts from investment firms, five internal auditors (including

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three CAE's), two members from the AICPA, 2 members from HA, and 2 members from the SEC. All participants had a minimum of ten years of experience with governance and audit related issues.

The authors also reviewed relevant literature to gain insights on issues related to disclosures made via an IAR.

e. The research for this paper did not consider the extent to which external stakeholders deduce adequate information about the internal audit function from current governance disclosures. Additional research is also needed to determine the costs and benefits derived from various wordings on an IAR within a mandatory versus voluntary environment.

2-62

a. The authors examine newsworthy cases in the pre-SOX era to identify the correlation between audit committee (AC) characteristics (independence and financial expertise including both accounting and non-accounting financial expertise) and the occurrence of misappropriation of assets. They are particularly interested in how AC financial expertise and independence relate to the incidence of misappropriation of assets in publicly-held companies.

Accounting expertise described AC members with prior roles as CPAs, auditors, or other major accounting positions. Non-accounting financial expertise referred to AC members with prior roles as CEO, president, chair of the board, or other major roles in the financial services industry.

The distinction between accounting and non-accounting expertise is intentionally made to measure the efficacy of SOX's broad definition of financial expert which lacks a requirement for accounting expertise (a condition formerly proposed by the initial exposure draft). An underlying objective in this study is to contribute to the ongoing debate as to the appropriateness of the definition of financial expert (e.g., whether SOX's broad definition of financial expert could be improved).

b. Companies whose AC members were independent and possessed non-accounting financial expertise had a reduced likelihood for the occurrence of misappropriation of assets. The presence of a financial expert was especially necessary (even with accounting expertise, but to a lesser extent than non-accounting), as ACs with independence but no financial expertise were not significant in reducing the occurrence.

Without considering AC independence, overall financial expertise (comprised of both accounting and non-accounting financial expertise) and non-accounting financial expertise were both significantly and negatively correlated to the occurrence of misappropriation of assets. Accounting expertise was not significantly related to the occurrence of asset misappropriation. The authors suggest that this finding is possibly due to overreliance on the expert by other members or because the AC spends very little time actually reviewing financial statements.

c. When assessing the internal controls of a company, the auditor should not automatically assume an increased control risk solely due to lack of accounting expertise on the AC. As shown

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by this study, non-accounting financial expertise is actually correlated with a stronger control environment that deters instances of fraud. So, auditors need not be overly-skeptical of (nor overly-reliant upon) the company's internal controls based on the background of the financial expert.

d. A sample of 28 companies experiencing incidents of misappropriation of assets during 1987-1998 was compared to a set of 28 control companies without asset misappropriation (similar size, industry, time period) to determine the association between AC characteristics and the occurrence of asset misappropriation.

e. Sample size was a limiting factor, as only 56 companies were analyzed. Further, the time period examined could be a limitation. Because the years sampled encompass a pre-SOX era, the results may be somewhat dated. Since 1998, there has been heightened emphasis on internal controls and increased public scrutiny of audits. Therefore, the ACs may currently devote additional time to reviewing financial statements, possibly increasing the value of accounting financial experts.

Ford and Toyota

2-63

Note to instructor: The solutions based upon the FYE 2012 annual reports for Ford and Toyota are posted at the Cengage web site for the 9th edition of this text. The solutions for FYE 2014 will be posted at the Cengage web site for the 10th edition of this text.

Ford and Toyota Semester Project: Using these instructional resources based on Ford and Toyota, students will have the opportunity to apply the concepts from each chapter within the context of two actual companies. We have used these types of exercises in our undergraduate and graduate auditing classes . In the undergraduate classes, the authors used these types of materials as the basis for in-class group activities. In the graduate classes, the instructors used these types of materials as the basis for both in-class group activities, and out-of-class small group cases and projects.

If you are looking for a semester project using these materials, one of the authors always assigns a semester paper that is completed in small groups (with 15 minutes of class time used each class period for group discussion, along with the expectation that groups will also meet periodically outside of class). For this project, the author assigns each of the questions for the chapters that are covered in the syllabus. Below, we reproduce the grading criteria and student instructions related to that project. Perhaps you will find this useful as a basis for constructing a similar project of your own.

FORD AND TOYOTA GROUP PAPER DESCRIPTION

The purpose of this group paper is to summarize your in-class discussions of the Ford and Toyota materials. The case is worth 100 points and will be due the last day of class. Note the following:

1. There is no page limit. Simply type up your answers (single space text is

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appropriate, and please use 12cpi font) to each class assignment as we proceed throughout the course. Keep them in a file and hand them in at the end of the course.

2. Your group will have three to five members.
3. Start a new class day/assignment on a new page of paper.
4. The text of your responses should address the assigned questions. Assign one group member per class day/assignment to be a note-taker, and that person will also be responsible for updating the "master" file.

Note: The questions are located at the end of selected chapters in the book, immediately following the homework problems.

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