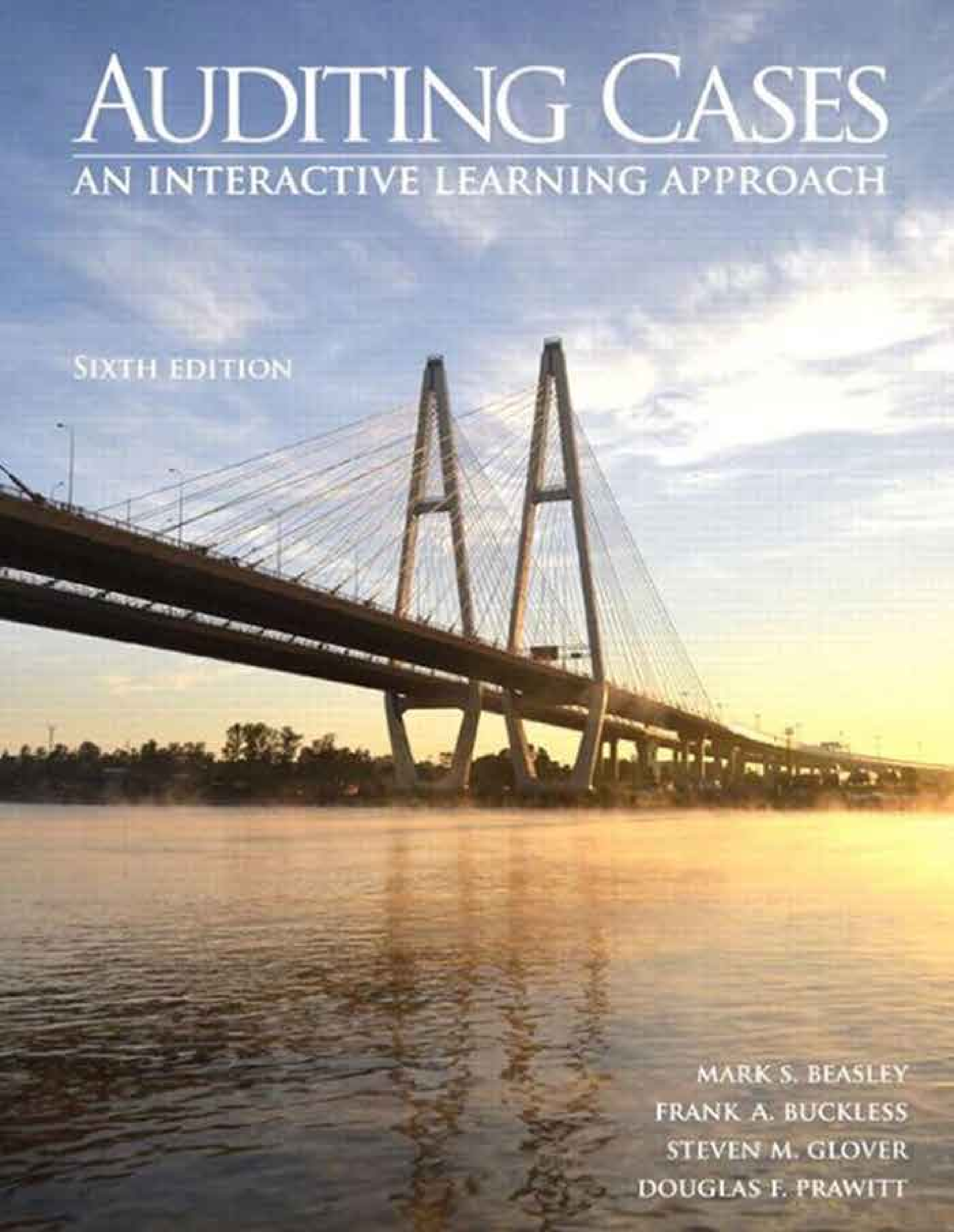
AUDITING CASES

AN INTERACTIVE LEARNING APPROACH

SIXTH EDITION



MARK S. BEASLEY
FRANK A. BUCKLESS
STEVEN M. GLOVER
DOUGLAS F. PRAWITT

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A C K N O W L E D G E M E N T S

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

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PREFACE

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

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

NEW TO THE SIXTH EDITION

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

- A new **Learning Module on Professional Judgment** that exposes students to a professional judgment framework and outlines a framework of good judgment as well as a number of judgment tendencies and traps that can introduce bias into the judgment process. Because professional judgments are required throughout the entire audit process, from client acceptance to report issuance, we included an Introduction to Professional Judgment as an upfront learning module rather than as an individual case. We encourage students to complete this learning module early in their auditing course to expose them to the fundamentals of professional judgment, which they can use as they complete the required professional judgment questions in many of the cases in this edition.

- New questions in many of the cases throughout the sixth edition to help students see the importance of professional judgment in auditing. These questions are separately identified as *"Professional Judgment Questions"* and they challenge students to understand the critical elements of an effective audit judgment process. A number of these questions raise student awareness of potential judgment tendencies and traps that may lead to biased judgments if not appropriately considered. The materials also help students to understand steps that can be taken to mitigate potential biases.

- A new case, **9.7 RedPack Beer Company**, that exposes students to the challenges of auditing accounting estimates, specifically the allowance for bad debts, at a hypothetical brewery. Students are provided the aged accounts receivable trial balance and other accounts receivable balance information including a transcript of the auditor's interview of the company's credit manager about accounts included in the aging schedule. Students use this information, along with the company's policy and procedures related to the allowance for bad debts, to evaluate the reasonableness of management's recorded estimate. Students are also asked to develop their own estimate and to propose any necessary audit adjustments.

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

APROPRIATE FOR BOTH UNDERGRADUATE AND GRADUATE AUDITING COURSES

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

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

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

Professional Judgment

Understanding and Developing Professional Judgment in Auditing and Accounting

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

THE IMPORTANCE OF PROFESSIONAL JUDGMENT IN AUDITING AND ACCOUNTING[1]

As you prepare for a professional career, have you ever wondered what characteristics distinguish an exceptional professional from one who is just average? One key distinguishing feature is the ability to consistently make high-quality professional judgments. Professional judgment, which is the bedrock of the accounting and auditing professions, is referenced throughout the professional literature. In some of your accounting or auditing classes, you may have had an instructor respond to a question with the classic answer, "That depends; it is a matter of professional judgment." This is often true in auditing, but it is not overly satisfying to a student who wonders exactly what good professional judgment looks like, or how he or she can develop the ability to make good professional judgments. The purpose of this module is to provide a very brief overview and introduction to help you understand what a good professional judgment process looks like, make you aware of common threats to exercising good judgment, and give you a head start in developing and improving your own professional judgment abilities.

A common question people have is, "Can you really teach good judgment?" Many believe that it is a gift; either you have it or you do not. Others would say you cannot teach good judgment; rather, it must be developed through the "school of hard knocks" after many years of experience. There is no question that talent and experience are important components of effective professional judgment, but it is possible to enhance your professional judgment skills through learning and applying some key concepts. As with other important skills, the sooner you start learning how to make good professional judgments, the better—which is why KPMG made a very significant investment of time and resources to produce the monograph from which this module is adapted to help the next generation of professionals get a head start on developing professional judgment.

Research in the areas of judgment and decision making over the last few decades indicates that additional knowledge about common threats to good judgment, together with tools and processes for making good judgments, can improve the professional judgment abilities of both new and seasoned professionals. With the movement in financial reporting toward more principles-based standards and more fair value measurements, exercising good professional judgment is increasingly important for auditors. While this module contains a brief overview of some of the most important topics, KPMG's full monograph contains considerably more in-depth information about professional judgment in auditing, including additional coverage of judgment traps and biases, judgment in groups, and other topics. That monograph is titled *Elevating Professional Judgment in Auditing and Accounting: The KPMG Professional Judgment Framework*; it is available without charge at *http://www.kpmguniversityconnection.com.*

1 This Professional Judgment Introduction is adapted from *The KPMG Professional Judgment Framework: Elevating Professional Judgment in Auditing* and is included with this casebook with permission from KPMG, LLP. © 2013 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

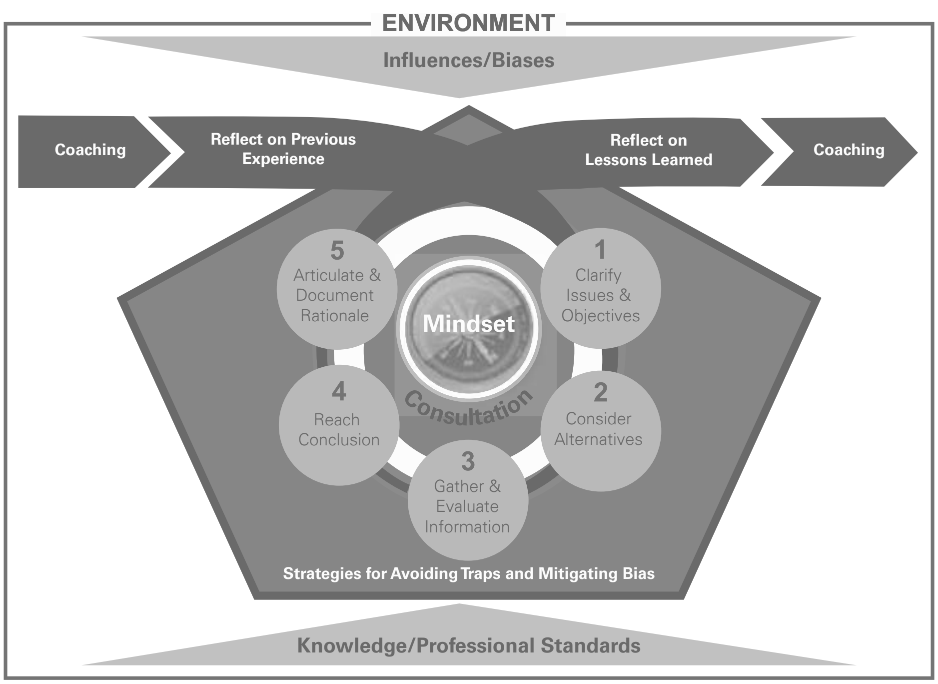
A MODEL OF A GOOD JUDGMENT PROCESS

Let's start with a common definition of judgment: *Judgment is the process of reaching a decision or drawing a conclusion where there are a number of possible alternative solutions.*[2] Judgment occurs in a setting of uncertainty and risk. In the areas of auditing and accounting, judgment is typically exercised in three broad areas:

- **Evaluation of evidence** (e.g., does the evidence obtained from confirmations, combined with other audit evidence, provide sufficient appropriate audit evidence to determine whether accounts receivable is fairly stated)
- **Estimating probabilities** (e.g., determining whether the probability-weighted cash flows used by a company to determine the recoverability of long-lived assets are reasonable)
- **Deciding between options** (e.g., audit procedure choices, such as inquiry of management, inspection, or confirmation)

Of course, we do not need to invest significant time or effort when making easy or trivial judgments. However, as the judgments become more important and more difficult, it is helpful to have a reliable, tested framework to help guide our judgment process. KPMG's Professional Judgment Framework is an example of such a framework. Following a good process will not make hard judgments easy or always guarantee a good outcome, but a well-grounded process can improve the quality of judgments and help auditing professionals more effectively navigate through complexity and uncertainty.

In the figure below, you will see the KPMG Professional Judgment Framework. The Framework includes a number of components, such as mindset, consultation, knowledge and professional standards, influences and biases, reflection, and coaching. At the core of the Framework, you will see a five-step judgment process.



Summary of the KPMG Professional Judgment Framework", The following reproduction of the Summary of the KPMG Professional Judgment Framework is included with the permission of KPMG LLP. This summary is adapted from The KPMG Professional Judgment Framework: Elevating Professional Judgment in Auditing with permission from KPMG LLP. © 2013 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

2 Making judgments can be distinguished from making decisions. Decision making involves the act of choosing among options or alternatives, while judgment, according to Webster's 11th, involves "the process of forming an opinion or evaluation by discerning and comparing." Thus, judgment is a subset of the process of decision making—many judgments are typically made in coming to a decision. However, for simplicity in this module, we often refer to the combined processes of judgment and decision making as "judgment," "professional judgment," or "making judgments."

Take a moment to examine the steps in the process at the center of the framework. These steps are rather simple and intuitive. However, while the KPMG Professional Judgment Framework provides a good representation of the process we should follow when applying professional judgment, but it is not necessarily an accurate representation of the processes people follow consistently. The reality is that in a world of pressure, time constraints, and limited capacity, there are a number of judgment traps we can fall into. In addition, we can be subject to biases caused by self-interest or by unknowingly applying mental shortcuts.

The Professional Judgment Framework depicts constraints, influences, and biases that threaten good judgment with the box on the outer rim of the Framework labeled "Environment" and the triangle at the top labeled "Influences/Biases." At the bottom of the Professional Judgment Framework, you will see Knowledge and Professional Standards, as these factors are foundational to quality judgments. These are environmental influences that can affect professional judgment. The "ribbon" of coaching and reflection running through the Framework is of great importance to the development of professional judgment in young professionals. In the next section of this module, we will highlight common judgment tendencies and the associated biases that can influence auditor judgment.

At the very center of the KPMG framework is "mindset." It is important that auditors approach matters objectively and independently, with inquiring and incisive minds. Professional skepticism, which is required by professional auditing standards, is an objective attitude that includes a questioning mind and a critical assessment of audit evidence. Professional skepticism is not synonymous with professional judgment, but rather, it is an important component or subset of professional judgment. Professional skepticism helps to frame our "mindset."

Finally, wrapping around "mindset" in the Framework is "consultation." At professional services firms like KPMG, consultation with others, including engagement team members, specialists, or other professionals, is a vital part of maintaining consistently high judgment quality and enhancing the exercise of appropriate professional skepticism.

TRAPS THAT CATCH US IN THE EARLY STEPS OF THE JUDGMENT PROCESS

As we mentioned earlier, in reality people often do not follow a good process due to common judgment traps and tendencies that can lead to bias. These traps and tendencies are systematic—in other words, they are common to most people, and they are predictable. Some of these tendencies are judgment "shortcuts" that help simplify a complex world and facilitate more efficient judgments. These shortcuts are usually quite effective, but because they are shortcuts, they can lead to systematically biased judgments. As a simple illustration of how our mental processes that normally serve us very well can sometimes lead to bias, consider "optical illusions" you may have seen on the internet.[3] Our eyes and related perceptual skills ordinarily are quite good at perceiving and helping us to accurately judge shape similarity. However, optical illusions can predictably and systematically fool our eyes. Just as with perceptual biases, there are times when our intuitive judgment falls prey to systematic traps and biases. Research provides convincing evidence that even the smartest and most experienced people similarly fall into predictable judgment traps and biases.

The "Rush to Solve." One of the most common judgment traps is the tendency to want to immediately solve a problem by making a quick judgment. As a result, we under-invest in the important early steps in the judgment process and often go with the first workable alternative that comes to mind or that is presented. As a result of the rush-to-solve trap, we sometimes end up solving the wrong problem, or we settle for a suboptimal outcome because we did not consider a full set of alternatives.

3 KPMG's Professional Judgment student monograph contains illustrations, audio files, and links to internet files that vividly illustrate many of the concepts introduced in this module.

Judgment Triggers: Solving the Wrong Problem. Consider the following example. Two snack food companies are competing for market share—let's call them Ax Snack Company and Bobb Goodies Inc. Bobb's executives were convinced that Ax's competitive advantage was attributable to the company's distinctive, highly recognizable individual snack packaging design. The individual snack packages seemed to draw customers to the products. So, Bobb's executives determined that to gain market share, they would need to develop individual package designs that were equally distinctive. They spent millions on improved packaging appearance for their snack foods to compete against Ax's distinctive packaging. When increased market share did not follow, Bobb's executive team realized that they knew relatively little about what customers really wanted and what drove the consumption of their snack foods. Bobb's executives decided to conduct market research, and along the way, they discovered an important and somewhat unexpected aspect of consumer behavior: regardless of the quantity of product they placed in a home, it would be consumed in relatively short order. Thus, Bobb's executives clarified the decision problem as "how to get larger quantities of snack products into consumers' homes." Accordingly, they focused less on the appearance of individual snack packages and instead introduced bulk packaging that made it easier and more convenient to get more snacks into consumers' homes. The resulting gain in market share was dramatic.

This example illustrates one of the biggest traps we run into during the first couple of steps of the judgment process, which is under-investing in defining the fundamental issue. In the example above, Ax Snack Company's distinctive packaging functioned as what could be called a judgment trigger, or an assumed or inherited issue that can lead the decision maker to skip the crucial early steps in the judgment process. It caused Bobb Goodies' executives to focus, at first, on the wrong issue or problem. Judgment triggers can often be recognized when a particular alternative is used to define the problem in place of a well thought-out problem definition. Often, the trigger comes from the way others have defined the issue, which is often formulated in terms of one potential solution. Alternatively, we may create triggers ourselves because we are in such a hurry to "solve" or to be decisive. Judgment triggers often lead to judgments made on incomplete facts or understandings.

How might you overcome the very common trap of skipping the first couple of elements in the judgment process that comes about through the rush to solve or through judgment triggers? The answer is to ask "what" and "why" questions. For example, you might initially answer a "what" question regarding retirement goals with, "I want to have a certain amount of money in a retirement fund." That certainly is a worthy objective, but as with many initial objectives, it is only a means to an end. Following up by asking why you want a certain amount of money can help you uncover the more fundamental objective, which might be something like, "to maintain a high quality of life in retirement." Note that by clarifying the objective in this way, a number of additional approaches to achieving a high quality of life come to mind (such as good health, no debt, cost of living, location, availability of outdoor recreation, etc.). Carefully clarifying underlying objectives by asking "why" is a key step in making important judgments.

It often does not take a lot of time to consider the first step in the judgment process, but the more important the judgment, the more important it is to invest in clarifying the fundamental issues and objectives. A little extra investment in clarifying the issue and objectives will almost always pay off, sometimes in a big way. One very powerful way to improve your professional judgment is to make sure you are not accepting a judgment trigger in place of a solid problem definition, but rather that you are taking time to ensure your problem definition is complete and correct.

PROFESSIONAL SKEPTICISM AND "JUDGMENT FRAMING"

As noted previously, at the center of the Framework is "mindset." Professional skepticism helps to appropriately frame an auditor's mindset. Essential to an auditor's ability to effectively question a client's accounting choices is a fundamental but powerful concept called "judgment framing." This concept relates to the early steps in the judgment process. The definition of framing follows: *Frames are mental structures that we use, usually subconsciously, to simplify, organize, and guide our* *understanding of a situation. They shape our perspectives and determine the information that we will see as relevant or irrelevant, important or unimportant.* Frames are a necessary aspect of judgment, but it is important to realize that our judgment frames provide only one particular perspective. This is similar to looking out one window of your home—it provides one view that might be quite different from the view through another window facing a different direction.

Frames are necessary and helpful, but the problem is that we often are not aware of the perspective or frame we are using. Also, our frame can blind us to the fact that there are other valid perspectives. In other words, frames help us make sense of things but they also make it difficult for us to see other views. By being proactive in our use of judgment frames, we can improve how well we do with the initial steps in the judgment process: clarifying issues and objectives and considering alternatives. This is important because a distinguishing characteristic of professionals who consistently exercise sound judgment is that they recognize the judgment frame they are using, and they are able to consider the situation through different frames, or what KPMG professionals refer to as a "fresh lens." Sounds simple enough, but it is not always easy to do! The concept of judgment framing is important because appropriately questioning management's perspective by viewing the situation through other frames is fundamental to professional skepticism.

For example, suppose the results of a substantive analytical procedure suggest that a client's allowance for doubtful accounts is understated. The auditor's approach to gathering further audit evidence will be different if the results are framed in the context of a change in business condition or a change in the client's credit policy as compared to an indicator of a likely error. This is not to say one frame is necessarily better than the other, but the auditor can boost his or her professional skepticism by considering both frames.

A key characteristic of those who make high-quality judgments is that they are frame-aware. They know how to seek and consider different frames to get a fuller picture of the situation. Seasoned, experienced auditors develop this ability and apply it in situations where they need to help client management see an alternative viewpoint on an important accounting issue. For example, an alternative frame that auditors might use could be an investor or analyst perspective, or a regulator perspective. Or it might be a "hindsight" perspective—in other words, how will management's judgment look if a regulator later questions it, or if it is reported in the press in six months? While experienced auditors are typically quite skilled at challenging frames and considering issues from different perspectives, this is an area where auditors entering the profession typically need improvement.

JUDGMENT TENDENCIES THAT CAN RESULT IN BIAS

Peoples' judgments can be unintentionally biased due to underlying self-interest or because they unknowingly use mental shortcuts. For the most part, the shortcuts we use are efficient and often effective, but in certain situations, they can result in systematic, predictable bias. Keep in mind that the tendencies or shortcuts we will discuss are simplifying judgment strategies or rules of thumb that we have unknowingly developed over time to help us cope with the complex environments in which we operate. They are efficient and often effective, but because they are shortcuts, they can lead to lower quality judgment in some situations. Here's a quick example of a simplifying shortcut. When crossing a city street, say in New York City, some people don't wait until they get a "walk" sign; rather, they move through intersections by quickly looking to the left for oncoming traffic. If the coast is clear, they will take a step out into the street and then look to the right for traffic coming the other way. This is a very efficient and often effective shortcut strategy. Over time, it can become an unconscious, automatic part of how people cross the street in a busy city. However, if we were to use this shortcut strategy in London, where they drive on the other side of the street, it could result in a very bad outcome. Even in New York City, the shortcut can lead to a bad outcome if applied to all streets, since there are one-way streets that come from the other direction.

Similarly, the judgment shortcuts we commonly use are efficient and generally effective.

However, there are situations where the use of a shortcut can predictably result in a lower quality or biased judgment. The good news is that once we understand the implications of a shortcut, we can devise ways to mitigate potential bias resulting from the shortcut. When it comes to crossing the street in London, transportation officials have devised rather ingenious ways to reduce the potentially serious consequences of using the "American" shortcut to start across the street looking first only to the left. They have placed signs on the sidewalk, on signposts, and even on the street, reminding visiting pedestrians of the direction of traffic flow. The signs are an attempt to get visitors out of the subconscious shortcut mode and apply more formal thinking, which is pretty important for the well-being of American tourists in London.

We will briefly introduce four common judgment tendencies that are most applicable and important for audit professionals: the availability tendency, the confirmation tendency, the overconfidence tendency, and the anchoring tendency.

The ***availability tendency*** is defined as: *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 other words, the information that is most "available" to our memory may unduly influence estimates, probability assessments, and other professional judgments. Like other mental shortcuts, the availability tendency often serves us well, but it has been shown to introduce bias into business and audit judgments. For example, an auditor may be inclined to follow the approach used in a prior period or on a recent engagement even if the approach is not the best for the current engagement. This tendency is especially powerful if the approach worked well on the prior engagement.

The ***confirmation tendency*** is defined as: *The tendency for decision makers to seek for and put more weight on information that is consistent with their initial beliefs or preferences.*

You may have heard the old joke, "My mind is made up; don't confuse me with the facts!" Hundreds of years ago, leading philosophers recognized that once people have adopted a preference or an opinion, they tend to consider and gather information that supports and agrees with their preference. Research in psychology backs this up: people tend to seek confirmatory evidence, rather than looking for something inconsistent with their opinions or preferences. After receiving this confirmatory evidence, decision makers often are confident that they have adequate evidence to support their belief. The more confirmatory evidence they are able to accumulate, the more confident they become. However, in many instances, we cannot know something to be true unless we explicitly consider how and why it may be false. As an example of the confirmation bias in auditing, research and reviews of working papers find that auditors may be prone to overrely on management's explanation for a significant difference between the auditor's expectation and management's recorded value, even when the client's explanation is inadequate.

The ***overconfidence tendency*** is defined as: *The tendency for decision makers to overestimate their own abilities to perform tasks or to make accurate diagnoses or other judgments and decisions.*

When groups of people are asked to assess their own abilities, whether in auditing or in driving a car, a majority of the participants assess themselves as above average relative to the group being surveyed. But, of course, it is not possible for all participants to be above average. This is a simple illustration of the fact that many of us are overconfident in our abilities and, as a result, we often tend not to acknowledge the actual uncertainty that exists. Overconfidence is a subconscious tendency that results from personal motivations or self-interest. Importantly, this tendency to be more confident than is justified is likely to affect us even when we are doing our best to be objective. Research indicates that many people, including very experienced professionals, are consistently overconfident when attempting to estimate outcomes or likelihoods. Studies involving practicing auditors demonstrate that auditors may be overconfident in their technical knowledge and their competence in auditing risky areas. In addition, partners and managers may be overly confident in the ability of less experienced people in completing complex tasks. Conversely, associates and senior associates may be overconfident in the competency of more experienced auditors to complete lower-level tasks that they aren't accustomed to performing on a regular basis. Such overconfidence can lead to a variety of suboptimal outcomes in auditing, including neglecting to ask for needed help or guidance, failing to acquire needed knowledge, poor task performance, budget overruns, assignment of audit tasks to underqualified subordinates, and underreview of subordinates' working papers.

The ***anchoring tendency*** is defined as: *The tendency of decision makers to make assessments by starting from an initial numerical value and then to adjust insufficiently away from that initial value in forming a final judgment.*

To illustrate the anchoring tendency, managers often make salary decisions by adjusting from the starting point of an employee's previous salary. A prospective employer might quickly realize the unreasonableness of the anchor (e.g., her previous employer only paid her $48,000 before she earned an MBA degree), but proposes a starting salary irrationally close to the starting point, or anchor. So, in this example, the job applicant is likely to receive a lower salary offer if the prospective employer knows her salary before she earned her MBA. There are two components of anchoring and adjustment—the tendency to anchor on an initial value and the tendency to make adjustments away from that initial value that are smaller than what is actually justified by the situation. The anchoring tendency clearly has direct relevance to auditing in many settings. For example, management's estimate or unaudited account balance can serve as an anchor. The auditor is charged with objectively assessing the fairness of an account balance. But if his or her judgments are influenced by the amount asserted by management in an unaudited account balance, that objectivity might be compromised. In other words, the auditor might become anchored to management's estimate.

MITIGATING THE EFFECTS OF JUDGMENT BIASES

The most important step in avoiding judgment traps and reducing bias caused by subconscious mental shortcuts or self-interest is "awareness." By better understanding traps and biases, and recognizing common situations where they are likely to present themselves, we can identify potential problems and often formulate logical steps to improve our judgment. If we don't have any idea where the common judgment traps are, or where we are likely to be systematically biased, we do not even have a starting point. As we said earlier, some of the most serious judgment traps have to do with the failure to follow a judgment process. In other words, we might be influenced by a judgment trigger, solve the wrong problem, fail to clarify our objectives, or push too quickly through the initial steps in the judgment process because we want to quickly arrive at a solution or conclusion. In terms of mitigating bias, the first step is to recognize situations where we might be vulnerable. Awareness, coupled with the terminology to identify and label the potential traps and biases, is key to improving judgment. In fact, research exploring mitigation techniques suggests that simply providing instructions to decision makers about the seriousness of a bias can reduce the effect of these biases.

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

The bottom line is that we need to realize where and how we may be biased in order to develop simple approaches for mitigating the effects of those biases. And the good news is that once you are aware of traps and biases, the mitigation approach often is a matter of applying logic and common sense. Bias-mitigation techniques are important, but just as important in avoiding traps and mitigating bias is to bake the steps of good judgment, such as those provided in the KPMG Professional Judgment Framework, into your judgment-making process. Thoughtfully applying the steps of a judgment process can in itself mitigate bias. And, finally, in auditing, the requirement to conclude and document provides the auditor the opportunity to carefully reconsider the preceding steps of good judgment and the possibility that judgment traps or biases may have influenced the final conclusion.

CONCLUSION

Professional judgment is an increasingly important subject in accounting and auditing. As accounting standards become more subjective and fair value measurement increasingly takes center stage, professionals will be required to apply more and better professional judgment on a consistent basis. In reality, none of us will ever make perfect judgments or be completely free from bias or from judgment traps. But by becoming aware of where we can fall prey to such influences and by practicing common sense mitigation techniques, including the steps in a judgment process, we can improve the quality of our professional judgment. And this, more than just about anything else you can do, will set you apart as an outstanding professional.

For more in-depth information about professional judgment in auditing, including additional coverage of judgment traps and biases, judgment in groups, and other topics, see the award-winning monograph, *Elevating Professional Judgment in Auditing and Accounting: The KPMG Professional Judgment Framework*, available without charge at *http://www.kpmguniversityconnection.com.*

REQUIRED

[1] Identify and describe two common judgment traps.

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

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

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

DISCUSSION CASES

The following discussion cases provide opportunity to apply the principles presented in this Professional Judgment Introduction.

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

[6] A client is determining its accounting treatment for new types of long-term contracts. Consider the differences in outcome for the two scenarios that follow regarding the approach the client and auditor took. How does framing relate to the two different scenarios?

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

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

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

[a] A staff auditor is testing accounts payable balances. The auditor observes an unexpected fluctuation in the account balance compared to the prior year. The client happens to be walking by, so the auditor asks the client about the fluctuation. The client provides a plausible

and reasonable explanation. In considering other possible causes for the fluctuation, the client's explanation seems to be the most likely, so the staff auditor documents it as evidence supporting the fluctuation. Later, it is determined that other facts encountered during the audit do not support the client's explanation.

[b] A client has provided the audit engagement team an estimate of the inventory valuation reserve. The client used a method for calculating the reserve that had been used in prior years. To audit the reserve, the engagement team obtained and reviewed the client's calculation. However, the team noted that the client's calculation did not reflect a significant decline in customer demand for an older product line that was losing popularity relative to the newer products. The engagement team suggested that the client adjust the reserve upward. The client argued that the current reserve amount was adequate but indicated that a small increase in the reserve would be acceptable. The engagement team reviewed the client's proposal, and ultimately accepted the inventory account as fairly stated in view of the increase to the reserve. However, within a few months after the financial statements and audit report were issued, it became apparent that the reserve was insufficient as significant inventory write-downs were recorded for obsolete inventory that was discarded at scrap value.

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

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

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

SECTION 1

Client Acceptance

CASES INCLUDED IN THIS SECTION

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CASE 1.1

Ocean Manufacturing, Inc.
The New Client Acceptance Decision

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

LEARNING OBJECTIVES

After completing and discussing this case you should be able to

[1] Understand the types of information relevant to evaluating a prospective audit client

[2] List some of the steps an auditor should take in deciding whether to accept a prospective client

[3] Identify and evaluate factors important to the client acceptance decision

[4] Understand the process of making and justifying a recommendation regarding client acceptance

INTRODUCTION

The accounting firm of Barnes and Fischer, LLP, is a medium-sized, national CPA firm. The partnership, formed in 1954, now has over 6,000 professionals on the payroll. The firm mainly provides auditing and tax services, but it has recently had success building the information systems consulting side of the business for non-audit clients and for audit clients that are not publicly traded.

It is mid-January 2015, and you are a newly promoted audit manager in an office of Barnes and Fischer, located in the Pacific Northwest. You have been a senior auditor for the past three of your five years with Barnes and Fischer. Your first assignment as audit manager is to assist an audit partner on a client acceptance decision. The partner explains to you that the prospective client, Ocean Manufacturing, is a medium-sized manufacturer of small home appliances. The partner recently met the company's president at a local chamber of commerce meeting. The president indicated that, after some difficult negotiations, the company has decided to terminate its relationship with its current auditor. The president explained that the main reason for the switch is to build a relationship with a more nationally established CPA firm because the company plans to make an initial public offering (IPO) of its common stock within the next few years. Ocean's annual financial statements have been audited each of the past 12 years in order to comply with debt covenants and to receive favorable interest rates on the company's existing line of credit. Because the company's December 31 fiscal year-end has already passed, time is of the essence for the company to contract with a new auditor to get the audit under way.

The partner, Jane Hunter, is intrigued with the idea of having a client in the home appliance industry, especially one with the favorable market position and growth potential of Ocean Manufacturing. Although there are several manufacturers of small home appliances in the area, your office has never had a client in the industry. Most of your office's current audit clients are in the healthcare services industry. Thus, the partner feels the engagement presents an excellent opportunity for Barnes and Fischer to enter a new market. On the other hand, knowing the risks involved, the partner wants to make sure the client acceptance decision is carefully considered.

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

BACKGROUND

Ocean Manufacturing, Inc. manufactures small- to medium-sized home appliances. The company's products include items like toasters, blenders, and trash compactors. Although Ocean's common stock and other securities are not publicly traded, the company is planning an IPO in the next few years in hopes that it will be able to trade Ocean's common stock on the NASDAQ. You have been assigned to gather information in order to make a recommendation on whether your firm should accept Ocean Manufacturing as a client.

Ocean wants to hire your firm to issue an opinion on its December 31, 2014 financial statements and has expressed interest in obtaining help to get its recently installed information technology (IT) system in better shape. Ocean also wants your firm's advice and guidance on getting everything in order for the upcoming IPO. During the initial meeting with Ocean's management, the following information was obtained about the industry and the company.

The Home Appliances Industry

Over the past several years, the domestic home appliances industry has been growing at a steady pace. The industry consists of a wide variety of manufacturers (domestic and foreign) who sell to a large number of wholesale and retail outlets. Though responsive to technological improvements, product marketability is linked to growth in the housing market. Retail outlets are served by both wholesale and manufacturer representatives.

Ocean Manufacturing, Inc

Ocean's unaudited December 31, 2014 financial statements report total assets of $76 million, sales revenues of $156 million, and net profit of $3.9 million. In the past, the company has not attempted to expand aggressively or develop new product lines. Rather, it has concentrated on maintaining a steady growth rate by providing reliable products within a moderate to low price range. However, Ocean hopes to use the capital from the upcoming IPO to aggressively expand from a regional to a national market. Ocean primarily sells its products in small quantities to individually owned appliance stores. Over the last few years the company has begun to supply larger quantities to three national retail chains. Two of these larger retailers started buying Ocean's products about two years ago. In order to handle the increased sales, Ocean significantly expanded its manufacturing capacity.

Though shaken by recent management turnover and ongoing difficulties with the company's new accounting system, management feels that Ocean is in a position to grow considerably. Management notes that earnings have increased substantially each year over the past three years and that Ocean's products have received increasing acceptance in the small appliance marketplace. Three years ago, the company received a qualified audit opinion relating to revenues and receivables. Ocean has changed auditors three times over the past 12 years.

Management

In October 2014, the company experienced significant management turnover when both the vice-president of operations and the controller resigned to take jobs in other cities. The reason for their leaving was disclosed by management as being related to "personal issues." A new vice-president, Jessica Wood, was hired in November, and the new controller joined early last month. Jessica is an MBA with almost 12 years of experience in the industry. Theodore Jones, the new controller, has little relevant experience and seems frustrated with the company's new IT system. The company's president, Andrew Cole, has a BBA and, as the founder, has worked at all levels of the business. Mr. Zachery, who is principally in charge of the company's procurement and manufacturing functions, meets weekly with Mr. Cole, as does Frank Stevens, who has served as vice president over finance for the past eight years.

Accounting & Control Systems

The company switched to a new, integrated central accounting system in early 2014. This new system maintains integrated inventory, accounts receivable, accounts payable, payroll, and general ledger software modules. The transition to the new system throughout last year was handled mainly by the former controller. Unfortunately, the transition to this new system was not well managed. The company is still working to modify it to better meet company needs, to retrain the accounting staff, and to adapt the company's accounting controls to better complement the system.

Problems still exist in inventory tracking and cost accumulation, receivables billing and aging, payroll tax deductions, payables, and balance sheet account classifications. The company stopped parallel processing the old accounting system in April 2014. During several brief periods throughout 2014, conventional audit trails were not kept intact due to system failures and errors made by untrained personnel.

The company's accounting staff and management are both frustrated with the situation because, among other problems, internal management budget reports, inventory status reports, and receivables billings are often late and inaccurate, and several shipping deadlines have been missed.

Your office has never audited a company with the specific IT system in place at Ocean. However, your local office's IT team is fairly confident they will be able to diagnose Ocean's control weaknesses and help Ocean overcome current difficulties.

Accounts Receivable, Cash, and Inventories

The sales/receivables system handles a volume ranging from 2,900 to 3,400 transactions per month, including sales and payments on account for about 1,200 active credit customers. The six largest customers currently account for about 15% of accounts receivable, whereas the remainder of the accounts range from $1,500 to $32,000, with an average balance around $8,900.

Finished goods inventories are organized and well protected, but in-process inventories appear somewhat less organized. The company uses a complicated hybrid form of process-costing to accumulate inventory costs and to account for interdepartmental in-process inventory transfers for its four major product lines.

Predecessor Auditor

When you approached Frank Stevens, Ocean's vice-president of finance, to request permission to speak with the previous auditor, he seemed hesitant to discuss much about the prior audit firm. He explained that, in his opinion, the previous auditor did not understand Ocean's business environment very well and was not technically competent to help the company with its new IT system. He further indicated that the predecessor auditor and Ocean's management had disagreed on minor accounting issues during the prior year's audit. In Mr. Stevens' opinion, the disagreement was primarily due to the auditor's lack of understanding of Ocean's business and industry environment. According to Mr. Stevens, the audit partner indicated that because of the accounting issues, he would be unable to issue a clean opinion on the financial statements. In order to receive an unqualified opinion, Ocean had to record certain adjustments to revenues and receivables. Mr. Stevens believed the adjustments were unnecessary but felt forced to make them to receive a clean audit opinion.

Mr. Stevens noted that Ocean's management feels confident that your firm's personnel possess better business judgment skills and have the knowledge and ability to understand and help improve Ocean's IT system. Mr. Stevens also indicated that Ocean wants to switch auditors at this time to prepare for the upcoming IPO, noting that companies often switch to larger accounting firms with national reputations in preparation for going public. Your firm has been highly recommended to him by a friend who is an administrator of a hospital audited by Barnes and Fischer. After some discussion between Mr. Stevens and Mr. Cole, Ocean's president, they granted you permission to contact the previous auditor.

During your visit with the previous auditor, he indicated that the problems his firm had with Ocean primarily related to (1) the complexities and problems with Ocean's new IT system and (2) management's tendency to aggressively adjust year-end accruals in order to meet creditors' requirements. The auditor also disclosed that the dissolution of the relationship with Ocean was a mutual agreement between the two parties, and that his firm's relationship with management had been somewhat difficult almost from the beginning. Apparently, the final straw that broke the relationship involved a disagreement over the fee for the upcoming audit.

Client Background Check

A background check on Ocean's management revealed that five years ago Ocean's vice president of finance was charged with a misdemeanor involving illegal gambling on local college football games. According to the news reports, charges were later dropped in return for Mr. Stevens' agreeing to pay a fine of $500 and to perform 100 hours of community service. The background check revealed no other legal or ethical problems with any other Ocean executives.

Independence Review

As part of Barnes and Fischer's quality control program, each employee of Barnes and Fischer is required to file with the firm an updated disclosure of their personal stock investments every three months. You ask a staff auditor to review the disclosures as part of the process of considering Ocean as a potential client. She reports to you that there appears to be no stock ownership issue except that a partner in Barnes and Fischer's Salt Lake City office owns shares in a venture capital fund which in turn holds a private equity investment in Ocean common stock. The venture capital fund holds 50,000 shares of Ocean stock, currently valued at approximately $18 a share. The stock is not publicly traded, so this value is estimated. This investment represents just over a half of one percent of the value of the fund's total holdings. The partner's total investment in the mutual fund is currently valued at about $56,000. No other independence issues were noted.

Financial Statements

You acquired the past three years' financial statements from Ocean, including the unaudited statements for the most recent year ended December 31, 2014. This financial information is provided on the pages that follow. The partner who will be in charge of the Ocean engagement, Jane Hunter, wants you to look them over to see what information you can draw from them, paying particular attention to items that might be helpful in determining whether or not to accept Ocean as a new audit client.

REQUIRED

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

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

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

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

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

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

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

PROFESSIONAL JUDGMENT QUESTIONS

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

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

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

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