CASE 1

SUGGESTED ANSWERS TO DISCUSSION QUESTIONS

(1)

Financial statements are frequently relied on by outside parties such as stockholders and banks when making decisions about an enterprise. Should equity securities be bought or sold? Should a long-term loan be given? However, financial statements are the representations of the management of the company. As such, these statements will not necessarily be fairly presented. Material misstatements may exist in the form of errors, irregularities, or illegal acts. The management might, for example, have an insufficient knowledge of generally accepted accounting principles to produce appropriate statements. Human error or bias is also possible in the gathering and reporting of financial information. In addition, the management may have fraudulently manipulated the data in hopes of achieving some objective.

Outside parties are aware that the financial information produced by a company and its management may not always be reliable. Hence, to add credibility to this reporting process, independent experts are retained to audit the financial statements and test the underlying accounting records. These auditors then issue an opinion for the benefit of outside parties as to the fair presentation of the financial statements in conformity with generally accepted accounting principles. This added degree of assuredness allows decision-makers to rely on reported financial information.

(2)

A CPA firm could not be expected to maintain expertise in every potential industry that it might audit. In reviewing a potential client, the firm should evaluate its ability to gain the necessary industry expertise prior to the actual audit, but no requirement exists that this knowledge must be possessed prior to accepting the engagement.

Each industry may have its own specific accounting practices. In addition, certain industries frequently offer unique auditing problems. Thus, without a thorough investigation, the auditor cannot ascertain the knowledge that will be needed in examining a potential client. In the consumer electronics business, for example, the methods of distribution as well as credit policies would be significantly different from those found in a car dealership. Damaged or obsolete inventory are other problems that might be more important in this specific industry. Hence, a knowledge of one type of operation does not necessarily mean that the auditor has the expertise needed to examine a client operating in a different industry.

Auditing standards require that auditor to have the expertise by the completion of the audit, but this expertise need not be in place at the beginning. It would be unethical to misrepresent a firm's experience, but it need not be volunteered.

(3)

A profit-sharing bonus plan gives employees an added incentive to seek increases in company income; a larger profit figure will lead to a larger bonus at the end of the year. Consequently, employees may be tempted to inflate income artificially by creating false sales or deferring the recording of expenses. An auditor must always be alert for situations that can promote the possibility of such irregularities. A profit-sharing bonus plan may well have only positive effects on company employees. However, the auditor should not be so naive as to fail to recognize that some individuals may take advantage of such plans by manipulating the financial records.

This problem may be especially significant in the Lakeside Company because the bonus plan is new and the stores are geographically located at a distance from the home office. New plans require adaptation by company controls and such separation always increases potential control concerns. In addition, Rogers has already mentioned that some of the internal control systems are no longer adequate. Thus, the possibility of inflated income figures is even more of a possibility.

(4)

Critics of the auditing profession have argued vehemently for a number of years that advisory services such as those discussed in this question taint the appearance (and possibly the reality) of independence. These services may appear, to the public, to give the audit firm a financial interest in the success of the company. This argument holds that the firm will now want the client to succeed as proof of the quality of the advice that was given. In addition, the audit team may be less judicious in investigating these systems since they are aware that members of their own firm designed and installed them.

Audit firms counter by stating that adequate safeguards have been put into place to ensure continued independence. For example, advisory services are frequently rendered by a separate division of the firm so that no proximity exists between this function and the audit staff. In addition, firms are not allowed to give many types of advice that might jeopardize their independence. Finally, audit firms must make certain that their services are limited to making recommendations, and are not for carrying out management decisions. The firm cannot make decisions for the client.

Sarbanes-Oxley specifically proscribes various activities that have traditionally been part of the CPA's repertoire. Design of accounting systems is prohibited, although helping a client with selection and implementation of off-the-shelf packages would be acceptable. So, in this case, it depends on what the client means by "developing." In the event that Lakeside goes forward with its public offering Abernathy and Chapman will need to decide whether to remain independent so they can continue as Lakeside's auditor, or sacrifice independence to do systems consulting. Sarbanes-Oxley prevents trying to do both.

(5)

In his article "The Initial Audit Engagement Conference" in the *Journal of Accountancy* for September 1976, Bernard Valek lists a number of steps that can be performed in a plant tour to avoid later "surprises" as well as to assist the firm in establishing an appropriate audit fee. The first three are typical of a plant tour. The others go beyond the typical tour. Students should not be expected to anticipate each of these procedures but the question can be used to emphasize the importance of the auditor's complete understanding of the audit client. These steps include:

* Inspect inventory for possible obsolescence and an indication of the major product lines of the company.

* Verify the presence or absence of a perpetual inventory system.

* Review manufacturing facilities for indication of level of activity as well as any idle machinery.

* Review journals for careful preparation.

* Review general ledger activity for unusual entries.

* Review monthly financial statements for unusual variations.

* Review bank reconciliations, and compare to general ledger.

* Examine accounts receivable reconciliation to general ledger balance.

* Review client physical inventory method.

* Discuss with client the policy for valuing inventory and identifying obsolete inventory items.

* Discuss with client the procedures for obtaining a proper year-end cutoff.

* Review depreciation schedules, and recalculate a sample of the depreciation expense figures.

* Review income tax returns.

* Examine information relating to any capital stock or retained earnings transactions for the past year.

* Review minutes of board of directors' meetings and stockholders' meetings for

unusual or material matters.

* Read lease agreements.

* Review past audit reports.

(6) A company may not want its CPAs to audit a client's records because the auditors gain a substantial amount of competitive information during an audit. However, CPAs are bound by confidentiality under the AICPA's *Code of Professional Conduct.* Also, a CPA's knowledge of the industry gained from having several clients in the same industry provides him or her with insights he/she may not have otherwise had.

SUGGESTED ANSWERS TO EXERCISES

(1)

(a) and (b) The independent auditor must be able to review massive quantities of information and identify the fraud risk factors that may affect the amount of evidence to be gathered or the opinion to be rendered. This question calls upon the judgment abilities of the students. The format used by students for this memo is not important as long as it is clear and understandable. SAS 99 requires use of a brainstorming session in the planning stage to be sure that everyone associated with the audit understands the nature of the business and the potential risk of fraud. These sessions can also occur during the audit if additional evidence presents itself. Potential problems that students would be expected to identify are as follows. Additional fraud risk factors may also be identified by the students.

Fraud Risk Factors	**Auditor Follow Up**
Internal Control - The president of the company admits that the company's internal control is antiquated. Control problems may be heightened in that operations extend throughout two states.	Since understanding the internal control is one of the prerequisites for ultimately determining the amount of substantive testing that will be required, the weakness of the various controls may require the extensive gathering of evidence, or even preclude an opinion.
Uncertainty Involved with the Sixth Store - A qualified opinion was issued by the predecessor auditor in connection with this store.	Abernethy and Chapman must face the question as to whether this issue can be resolved during 2009.
Inventory - The mere size of the inventory of a business like Lakeside would make this account a critical audit area.	The auditor will face the problem of verifying the existence, cost, value, presentation, and ownership of the electronic equipment.
Distributorship Sales - The case	Any sudden change or fluctuation in an

Fraud Risk Factors	Auditor Follow Up
indicates that these sales have risen dramatically during the past two years.	account balance will always warrant the auditor's attention. In this instance, the auditor will be especially interested in verifying the validity of these sales figures.
Bonus System - This system has been recently installed by Lakeside, so very little is known about its effects upon the financial results of the company.	This factor alone can cause difficulty in the auditor's examination. In addition, any bonus system will provide an incentive for the employees to falsify the company's financial records. The auditor must be aware that employees can benefit from producing falsely inflated income figures.
Related Party Transactions - The case indicates that Lakeside has begun to have financial dealings with the president of the company.	Obviously, nothing is wrong with this arrangement, but such related party transactions are often difficult for the auditor to verify. In addition, they require clear disclosure.
Rental Agreements - Five of the stores have been leased and, apparently, Store Seven will be rented from Rogers. Rental agreements pose the question as to the need for capitalizing the lease.	Abernethy and Chapman will have to read the various agreements to see if any of them qualify as a capital lease under the criteria established by the Financial Accounting Standards Board.
Accounts Receivable - All distributorship sales are made on credit.	The size of the receivable account and the problem of determining collectibility will be a critical audit area for the auditor.
Loan Agreements - Lakeside has a number of loans outstanding.	The auditor will need to study each loan agreement to ascertain that the company is not violating any of the loan covenants.
Inventory Returns - For distributorship sales, up to 20% of the inventory items can be returned within four months. As of the end of the year, Lakeside will have a large contingent liability associated with the inventory items sold during the last four months.	Not only is the potential size of this liability a problem, but the auditor's ability to estimate the amount must be a concern.
Possible public offering of stock	A public offering raises risk for manipulation of the financial statements in order to attract capital. In addition, the number of potential readers of financial statements has changed dramatically, making the risk

Fraud Risk Factors	Auditor Follow Up
	associated with this audit much higher.

(2)

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors:

We have audited the accompanying balance sheet of the Lakeside Company as of December 31, 2011, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

During 2010, the Lakeside Company made a large investment in a retail store located in the eastern sector of Richmond, Virginia. This store has failed to reach a break-even sales point to date, and total recovery of the Company's investment is highly uncertain. In our opinion, the chances are reasonably possible that the asset's value has been permanently impaired and should be reduced to the net realizable value in conformity with generally accepted accounting principles. Management of the company has refused to recognize this impairment loss.

In our opinion, except for the effects of not recording or disclosing the impairment of value of the asset, as discussed in the preceding paragraph, the aforementioned financial statements present fairly, in all material respects, the financial position of the Lakeside Company at December 31, 2011, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

King and Company (*signed),* Certified Public Accountants
Date: (last day of audit fieldwork)

SUGGESTED ANSWERS TO SARBANES-OXLEY QUESTIONS

(1)

The issuance of stock is regulated by the Securities and Exchange Commission and the accounting, auditing and reporting is regulated by the PCAOB since 2002. A summary of the regulations follows:

Issuance of stocks are regulated primarily under the SEC acts of 1933 and 1934. Registration with the SEC is required, which includes financial reporting. The laws are summarized at: http://www.sec.gov/about/laws.shtml.

The financial reporting and auditing for public companies has been regulated by the PCAOB since 2002. The PCAOB registers, inspects and disciplines the auditors of public companies. Its effect on the public companies is indirect, through the regulation of the auditors.

Encourage students to visit the SEC EDGAR site to understand the nature of electronic, public financial information.

(2)

CPA firms wishing to be associated with public companies must be registered firms, accept the inspection process, and be subject to the discipline of the the PCAOB. CPAs in public practice ~~of~~have three choices. It is not only public vs. private, because some CPA firms are choosing to give up the requirement for independence and perform accounting, tax, and consulting services that are not possible for registered CPA firms. Thus their clients have two CPA firms, one for the non-independent services and one for the audit. In the case of Abernathy and Chapman, they will need to choose the nature of their practice. This is a major strategic choice. Most CPA firms do not perform public company audits. Large international and national firms handle almost all of the companies on the exchanges.

Commented [T1]: This is an incomplete sentence.