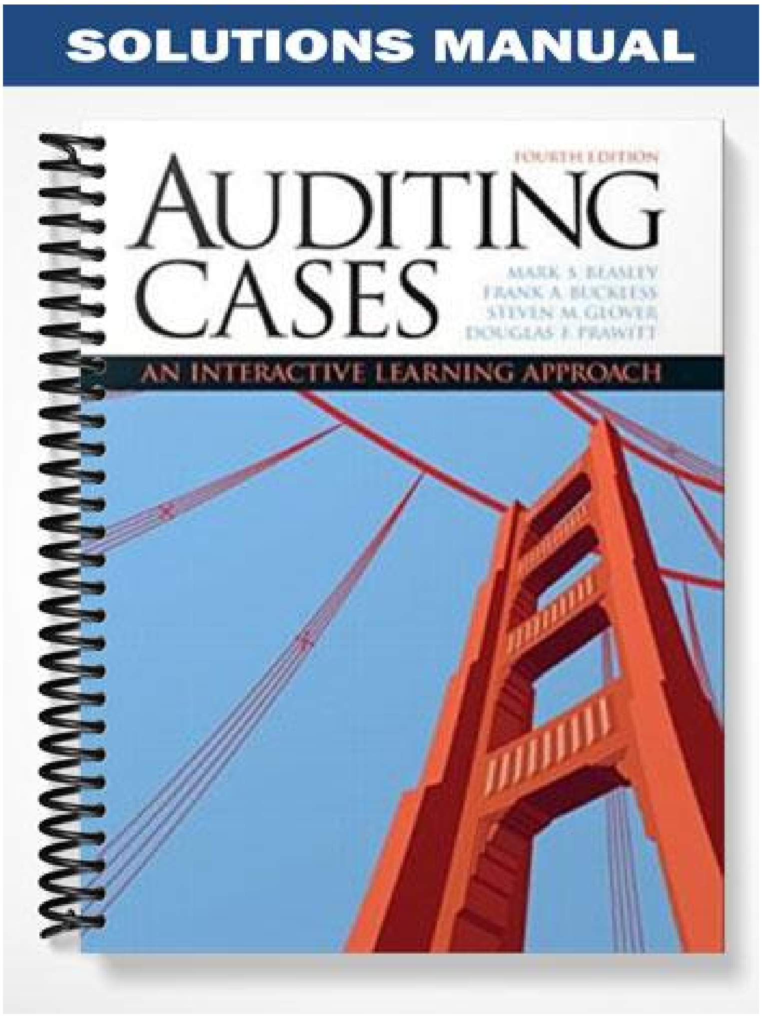
SOLUTIONS MANUAL
FOURTH EDITION
AUDITING CASES
MARK S. BEASLEY
FRANK A. BUCKLESS
STEVEN M. GLOVER
DOUGLAS F. PRAWITT
AN INTERACTIVE LEARNING APPROACH

Auditing Cases

Instructor Resource Manual

FOURTH EDITION

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Prentice Hall

Upper Saddle River, New Jersey

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PREFACE

Auditing educators are increasing their emphasis on the development of students' 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 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.

The casebook contains a collection of 44 auditing cases that allow the instructor to focus and deepen students' understanding in each of the major activities performed during the conduct of an audit, from client acceptance to issuance of an audit report. 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 several new authoritative auditing standards, including the PCAOB's Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements*, the new "risk assessment standards" issued by the AICPA's Auditing Standards Board as SAS Nos. 104 through 111, and SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, SAS No. 113, *Omnibus Statement on Auditing Standards – 2006*, and SAS No. 114, *The Auditor's Communication with Those Charged With Governance*. Several cases require students to gain a clearer understanding of the specific requirements contained in the Sarbanes–Oxley Act of 2002. Other cases provide additional exposure to the role information technology in today's assurance environment, including a focus on *Trust Services* such as *SysTrust* and *WebTrust*. Finally, some cases use excerpts from transcripts of financial statement fraud trails to illustrate the importance of following audit principles and procedures.

The cases 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. This manual 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.

Please submit any corrections or suggestions to: **auditingcases@byu.edu**

F O U R T H   E D I T I O N

UPDATES TO PRIOR CASES

Cases from the prior edition have been updated to reflect changes in professional standards . Cases based on events at real companies have been updated to reflect relevant recent developments. The Anne Aylor case (7.1), has been updated to reflect industry trends, including updated financial information. Dates in the hypothetical cases have been set in calendar year 2009 with audit procedures performed for the 2008 fiscal year and/or interim procedures performed for the 2009 fiscal year.

NEW TO THE FOURTH EDITION

The following cases have been added to the fourth edition to expand coverage of audit topics and provide timely coverage of recent high profile accounting-related events.

ACKNOWLEDGEMENTS

We would like to thank our families for their understanding and support while writing this casebook. We would also like to thank Jonathan Liljegren for his excellent work in the design and layout of this casebook as well as Kierra Kashickey and Judy Leale for their editorial support with this endeavor.

We are grateful to the many research assistants both past and present who have helped write, revise, and review the cases in this edition. We especially thank Scott Asay, Daniel Strange, and Devin Williams for their assistance with this latest edition.

1

Client Acceptance

CASES INCLUDED IN THIS SECTION

CASE 1.1

Ocean Manufacturing, Inc.

The New Client Acceptance Decision

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

INSTRUCTIONAL OBJECTIVES

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

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

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

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

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

KEY FACTS

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

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

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

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

USE OF CASE

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

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

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

PROFESSIONAL STANDARDS

Relevant professional standards for this assignment include AU Section 311, "Planning and Supervision," AU Section 315, "Communications Between Predecessor and Successor Auditors," ET Section 101 "Independence," ET Section 301, "Confidential Client Information," and QC Section 20, "System of Quality Control for a CPA Firm's Accounting and Auditing Practice."

SUGGESTED SOLUTION

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

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

a) Obtain and review client financial information such as annual reports and income tax returns.
b) *Evaluate the integrity of client management.
c) *Communicate with the predecessor auditor after receiving permission from the client, as AU 315 requires. Topics discussed should include management integrity and any disagreements about accounting or auditing issues.
d) *Determine the independence of your firm with respect to the client.
e) Inquire of third parties about the client (banks, attorneys, credit agencies, etc.).
f) *Take various steps to obtain an understanding of the client and its industry (e.g., on-site tour, reviewing industry publications), and determine if your firm has or can reasonably expect to obtain the technical skills and industry knowledge needed to perform the audit properly.
g) Consider whether the client has any unusual or special circumstances that will require special attention by your firm. Also consider whether issues such as litigation or going-concern problems exist for the client.
h) Perform preliminary analytical procedures to obtain an understanding of the prospective client and its industry.
i) Evaluate the opportunities and business risks posed by the client to your auditing firm.

[2] ***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.***

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

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

	2008	2007	2006
ROE	8.94%	7.11%	6.28%
ROA	4.54%	3.77%	3.39%
Asset to equity	1.97	1.88	1.85
Accounts Receivable Turnover	11.69	13.11	14.02
Average Collection Period	31.23	27.85	26.03
Inventory Turnover	6.08	4.51	3.48
Days in Inventory	59.98	80.89	104.99
Debt Ratio	0.49	0.47	0.46
Debt to Equity	0.97	0.88	0.85
Times interest earned	4.70	4.24	6.23
Current ratio	1.85	1.92	1.69
Profit Margin	5.5%	6.0%	4.7%

Industry Ratios for Comparison:

	2008	2007
ROE	22.1%	28.5%
ROA	7.2%	8.8%
Asset to equity	3.59	3.06
Accounts Receivable Turnover	8.14	7.57
Average Collection Period	44.84	48.21
Inventory Turnover	8.80	7.50
Days in Inventory	41.48	47.67
Debt to Equity	2.58	2.06
Times interest earned	1.50	2.20
Current ratio	1.20	1.30
Profit Margin	9.8%	10.0%

Major Differences to be noted:

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

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

Relevant non-financial matters include the following:

a) Recent management turnover. This matter may or may not pose a potential problem to the audit, but may be a sign of other problems that should be investigated. The controller is very new and has little relevant experience, which may make audit work slower and more difficult.
b) High auditor turnover rate. This should be a red flag to the auditors. The auditors should look into why Ocean has employed so many different auditors in so few years.

c) Complicated new computer system. The complicated system poses a couple of problems for the auditors. First, the auditors may have difficulty getting the information they need from the system, and a question arises regarding auditability. Second, inadequate controls over the new system may increase the amount of substantive testing required.

d) Client hesitant to allow new auditor to speak with previous auditor. Anytime a client is hesitant or unwilling to allow new auditors to communicate with the previous auditor, a red flag should be raised in the mind of the successor auditor, and a careful examination of the issue, including consideration of management integrity, should ensue.

e) Illegal gambling incident. This is a matter of concern because it raises the management integrity issue. What the V.P. of finance did was definitely wrong, but the impact on the overall integrity of management is a matter of judgment. This issue can be debated among the students. Some will come down on one side saying that if a key member of management is dishonest in one thing, he is likely to be dishonest in others. Other students will argue that the incident has little to do with the business and its management, especially since there are no other known incidents. At a minimum, this incident creates an opportunity to raise and discuss the central role of management integrity in the client acceptance decision.

f) Initial public offering. Ocean has plans to go public and aggressively expand into the national market. If successful, these plans will make Ocean a more attractive client for Barnes and Fischer, but they also serve to increase the auditor's business risk (increased reliance on the statements, increased litigation risk, etc.) and should be considered.

g) Management's aggressiveness. There are some indications in the case that management is willing to manipulate the financial statements via year-end accruals and revenue recognition to achieve relatively low interest rates from creditors. This raises a potential management integrity issue, and should be heavily weighted in view of the fact that the upcoming IPO may give management even greater incentive to manipulate the financial statements.

h) Relationship with predecessor auditor. This issue is left intentionally debatable in the case, but is certainly a concern that should be raised. The relationship with the predecessor auditor has been negative, and this is cause for concern. On the other hand, the poor relations may be present because the auditor did not have a sound understanding of Ocean's business and was not competent in helping Ocean with its new IT system. Personality issues can also play a role. Further, the apparent differences over the current year's audit fee should be a concern to Barnes and Fischer from a business perspective.

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

[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.***

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

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

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

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

The memo should be professional in appearance and in substance, and should be well written. The memo should include the points brought out in the preceding questions, which are designed to help prepare the students to make reasoned and informed recommendations. The memo should also include a clear recommendation as to whether the client should be accepted. There is no right or wrong recommendation as long as a student demonstrates s/he weighed the issues and made a reasonable decision based on the information provided.

However, in our experience, students tend to be much more negative about the prospect of accepting Ocean as an audit client than are auditing professionals. Most of our students tend to reject Ocean as a client; audit partners visiting our classrooms, especially those partners from non-big 4 firms, often indicate that Ocean is similar to many of their own clients. Students tend to want an ideal client; audit professionals have to make a living in the real world, which includes dealing with clients that have some issues and that present some risks. Emphasize that the client acceptance decision is a very subjective one that is ultimately determined by professional judgment.

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

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

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

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

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

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

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

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

g) The predecessor auditor indicated that Ocean's management tended to become aggressive in the treatment of accruals and revenue recognition toward the year-end. This is clearly an area where the auditors will want to focus a great deal of attention, increasing the extent of cut-off tests, reasonableness of accruals, etc. Frequent material fourth-quarter adjustments are also considered a red flag for fraud, so the audit program should probably take into account a heightened risk of fraud, in accordance with AU 316.

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

2

Understanding the Client's Business and Assessing Risk

CASES INCLUDED IN THIS SECTION

CASE 2.1

Your1040Return.com

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

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

INSTRUCTIONAL OBJECTIVES

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

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

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

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

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

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

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

KEY FACTS

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

The case was prepared by Mark S. Beasley, Ph.D. and Frank A. Buckless, Ph.D. of North Carolina State University and Steven M. Glover, Ph.D. and Douglas F. Prawitt, Ph.D. of Brigham Young University, as a basis for class discussion. Your1040Return.com is a fictitious company. All characters and names represented are fictitious; any similarity to existing companies or persons is purely coincidental.

time tax support from qualified income tax specialists.

- Revenue recognition differs for each product offered by Your1040Return.com.
- Your1040Return.com's business is seasonal with its highest demand from early February through April 15th each year. The company experiences peaks in demand during periods surrounding extension deadlines.
- Tax payments and refunds are not funded by Your1040Return.com. Rather, tax refunds are remitted directly from the IRS or state agency to the individual. Tax payments are charged by the IRS or state agency to the individual's credit card account.
- Your1040Return.com also engages in ad swapping with a number of major Internet companies. In exchange for providing electronic advertisements on the Your1040Return.com web site, the company receives free banner ads on other web sites.
- Servers located at Your1040Return.com's offices support the tax preparation software. The servers are in facilities with physical access securities and are protected logically by firewalls and access passwords.
- Two of the founder's nephews who are currently in college oversee the maintenance of the company's information system. The accounting system is maintained by the founder's niece, who is a graduate student seeking her Masters in accounting.
- The company does not have an official customer privacy policy. The company has been approached by marketing executives who are interested in purchasing Your1040Return.com's customer lists.
- As part of a recent line of credit arrangement with the local bank, Your1040Return.com's financial statements must now be audited.

USE OF CASE

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

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

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

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

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

Students can complete the case individually or in groups as an in-class or out-of-class assignment. Because the case is relatively short, students can read the case during the class period to prepare for an in-class discussion of several of the questions. Other questions, however, may be better suited as an out-of-class assignment (e.g., see question 1.e and 1.g) that students complete before an in-class discussion is held.

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

PROFESSIONAL STANDARDS

Relevant professional standards for this assignment include AU 150, "Generally Accepted Auditing Standards," AU Section 312 "Audit Risk and Materiality in Conducting an Audit," AU Section 314 "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," and AU Section 318, "Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained."

QUESTIONS AND SUGGESTED SOLUTIONS

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

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

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

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

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

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

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