

Independent audit risks: cases



**ASSIGN
BUSTER**

- Lisa Ferguson

Case 1. 8

1. Misstated development costs and revenue measurement are both inherent risks when auditing live theatrical companies. To detect the first, auditors should design testing procedures to evaluate whether deferred development costs are reasonable to the production. This would involve obtaining itemized lists of costs and comparing them to similar expenditures industry-wide. To test for proper revenue measurement, the auditor would have to compare ticket sales with actual head counts. This could involve looking at recent ticket sales and observing the actual attendance of a show. Likewise, if it is a production transferring from out-of-town tryouts to Broadway, compare those out-of-town ticket sales to Broadway sales. If one is consistently different, there may be cause for further investigation.

2. A CFO owes their first loyalty to the company for which they work. They are usually responsible for the internal controls of the accounting and financial departments, planning overall tax strategies and consulting on financial matters. They manage the money. An audit partner's first loyalty is to their firm. They bring in new business and ensure that their auditors fulfill their duties while also upholding legal and ethical standards.

Both roles are very important. I think an audit partner is more important on a societal level, as auditors are meant to aid in the detection of misstatements, some of which could lead to widespread financial consequences. A CFO has the more stressful job, though. They are essentially serving two masters. They must maintain the legal and ethical

standards of their profession (many are accountants), while also generating financials that satisfy the CEO and Board of Directors. That could mean facing pressure to falsify accounts to lead to better numbers. I have little interest in auditing so would rather be a CFO.

3. Independent audits are required by law, hence the “ necessary” part. However, to do his job, an auditor must dig through a company’s financials, possibly bringing to light number fudging. An auditor can frame what they are doing as a service. The auditor is finding potential misstatements before the financials are filed with the government. If mistakes have occurred, and auditor gives the company a chance to fix them before potentially incurring disciplinary action from the government.

4. A secondary accounting firm has a responsibility to test the assumptions at the center of the dispute and issue and un-biased opinion about how the dispute should be resolved.

5. I do not think the \$12.5 million should have been declared in total. If the verbal contract fulfilled the requirements of a legal contract, then an amount associated with the existing theatre could be recorded as revenue. However, the amount associated with the theatre that had not yet been built should have been recorded as unearned revenue since it was, in fact, not yet earned. If the verbal contract did not meet the requirements for a contract, then nothing should have been recorded. This is about the concepts of matching and what constitutes a binding contract.

6. Messina was the engagement partner on the last two Livent audits. When she discovered the fraud, she likely felt that she should have caught it when

engaged in auditing the company. Having not done so, and then gone to work for the company, she felt guilty. While I can sympathize with the pressure to go along with fraud like that, I would use whatever the appropriate reporting procedures were to report the fraud. No job is worth that level of dishonesty. I would rather earn \$24, 000 a year honestly, than \$250, 000 facing the pressure and internal disgust of lying.

7. The standards that govern due diligence is AS 1015. AS 1015. 05 states that “(a)n auditor should possess “ the degree of skill commonly possessed” by other auditors and should exercise it with “ reasonable care and diligence” (that is, with due professional care).”

Case 2. 2

1. Accuracy and occurrence are both relevant. Arthur Andersen could have asked to see the “ un-booked cost” charges and compared them with previous periods to ascertain their accuracy as regards the new revenue recognition technique. For occurrence, they could have verified that contracts actually existed between Paragon and all the jobs they were recognizing revenue for.

2. I believe the SEC meant that Sullivan failed to do his due diligence. An auditor should not simply accept a management assertion. He should perform procedures that test that assertion. Sullivan did not perform with a level of competence expected by an auditor. Considering that Sullivan was the engagement partner, the ultimate responsibility does rest on him to ensure the audit is performed correctly.

3. A high-risk engagement requires thorough procedures and testing to minimize the audit risk. Because the auditor has assessed that the engagement carries a substantial risk of misstatement, he must be more exacting with procedures than on a normal audit. Every assertion should be questioned and professional skepticism should be in full force.

4. A good knowledge of the industry a company is in is necessary for an auditor. It falls under taking due care in performing the audit. If the auditor has another source of information, personal experience for instance, then it is not a requirement that she read the AICPA guides. However, if those guides will aid her in being thorough, then she should take advantage of a good resource. The guides carry no force of law or regulation and therefore do not supersede PCAOB standards.

5. It is a change in accounting principle as it is a change in how revenue is recognized. Such a change must be retroactively applied to previous financial statements. A change in accounting estimate must be fully disclosed, but is not required to be retroactively applied.

Case 7. 7

1. An engagement letter should include the following:

- The scope of the audit including the period being audited
- The auditor's responsibility, including the standards they will follow
- Management's responsibility
- A fee structure

If signed by the firm and the company, an engagement letter is a legally binding contract.

2. KPMG may have decided to reduce hours and put less experience personnel on the audit because the company being audited was small and it trafficked in material goods, which would be easier to verify than a more esoteric business. Both of these are valid reasons for reducing hours and putting some less experienced personnel on the audit, though they should have been under the supervision of an experienced auditor.

3. A reduction in hours can adversely affect the quality of an audit if that reduction is unreasonable. It is entirely possible to budget too many hours for an audit, in which case reducing the budget down to a realistic number is fine. However, if the reduction creates too much pressure on auditors, it may encourage them to cut corners to meet the budget, which would adversely affect the audit quality. If less experienced personnel are used with proper supervision, the quality is not reduced. Less experienced auditors need experience to become more experienced, after all. However, if those auditors are turned loose on an audit with the necessary experience or oversight, the quality is affected.

4. I agree with the court's decision. As long as the firm is not misleading the client or overcharging them, the firm should be allowed to use professional judgement. The firm is experienced with audits and will likely have a clearer picture of the time and personnel requirements to properly perform.