3

Professional and Ethical Issues

CASES INCLUDED IN THIS SECTION

CASE 3.1

A Day in the Life of Brent Dorsey

Staff Auditor Professional Pressures

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

INSTRUCTIONAL OBJECTIVES

[1] To illustrate some of the pressures new professionals sometimes face in the workplace.

[2] To help students consider alternatives in dealing professionally and tactfully with difficult workplace issues.

[3] To raise the specific issues of budget pressure, eating time, and premature sign-off.

[4] To initiate discussion and thought about balancing professional and personal demands.

KEY FACTS

- Brent Dorsey is a relatively new staff auditor, working on the audit of Northwest Steel Producers. His senior, John Peters, is under consideration for promotion to manager, and feels a great deal of pressure to finish the Northwest Steel audit within budget. He is pressuring his staff auditors, Brent, Scott, and Megan, to work over the weekend and to meet some impossible time budgets.
- Brent has been assigned to work on payables with Scott. He receives advice from Scott and Megan that eating time and premature sign-off are viable ways to deal with budget pressure.
- Brent has been married for almost a year. His wife, Kathleen, also has a career and is expecting a child. Kathleen is not happy that Brent will be coming home late again, and that he will have to work Saturday. The two are experiencing some of the stresses and difficulties associated with balancing professional and personal lives.

USE OF CASE

This case is designed to bring to life some of the pressures auditors and other young professionals can face early in their careers. The case can be used as a vehicle for discussing a variety of issues, including budget pressure, eating hours, premature sign-off, dealing with difficult political situations, and dealing tactfully with superiors. The case can also lead to a discussion of balancing personal life with professional demands. While there are no easy answers to the issues raised in the case, the issues are realistic and are worth raising to help students more effectively anticipate, plan for, and manage future challenges. Students will likely appreciate the instructor's perspective on the issues. It may even be worthwhile to invite a professional or two to assist in the classroom discussion of the case and to provide their perspectives on the issues raised. The instructor should help students understand that while the issues raised by the case are very real, it is unlikely that a staff auditor would encounter all of the issues discussed, especially all in the same day. The case is simply designed to illustrate and raise for discussion a rich set of issues in a compact format.

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. All characters and names represented are fictitious; any similarity to existing companies or persons is purely coincidental.

PROFESSIONAL STANDARDS

Relevant professional standards for this assignment include AU Section 230, "Due Professional Care in the Performance of Work," AU Section 311, "Planning and Supervision," AU Section 326, "Audit Evidence," ET Section 52, "Article I-Responsibilities," ET Section 53, "Article II-The Public Interest," ET Section 54, "Article III-Integrity," ET Section 55, "Article IV-Objectivity and Independence," ET Section 56, "Article V-Due Care," ET Section 57, "Article VI-Scope and Nature of Services," and ET Section 102, "Integrity and Objectivity."

SUGGESTED SOLUTION

[1] ***What alternatives are available to Brent in regards to the audit of payables? What are the pros and cons of each alternative?***

(a) Skip audit steps as Megan suggested, (b) "Eat time" as Scott suggested, (c) Do the job quickly, but do it right and record as many hours as it takes, regardless whether you come in under budget or not, (d) Go talk to John and express your concerns over the matter, (e) Go to John's "mentor" or supervisor—the engagement manager or partner—to discuss the matter and seek advice.

a) **Pro:** Skipping audit steps will allow Brent to complete the work in less time, thus allowing him to come in under budget and to spend some time with his wife.
Con: Skipping audit steps can lead to inaccurate audit decisions. Material misstatements could go unnoticed by the firm, leading to an inaccurate audit opinion. This alternative also raises a serious ethical issue with serious possible consequences for the auditors involved.

b) **Pro:** "Eating time" will mean a lot of extra "off-line" work for Brent, but he will come in under budget and he may be recognized as someone who can get the job done.
Con: "Eating time" will create inaccurate and progressively tighter budgets in the future, as the case suggests happened last year. "Eating time" also results in audit time records doing a poor job of reflecting the actual cost of doing the audit. This may result in poor decisions at higher levels of engagement management, especially if engagement management is unaware of the time being eaten. Many also see eating time as a serious ethical issue.

c) **Pro:** This alternative gets the job done and no shortcuts need to be made. Brent may receive a good reputation for not taking shortcuts to get the job done.
Con: Brent will come in over budget using this alternative. He may receive a bad reputation for not finishing segments in the budgeted time, and may receive a poor engagement performance evaluation from John.

d) **Pro:** This alternative allows Brent to discuss the matter with John and get his feedback. Brent can be sure there are no misunderstandings of what John wants. Brent can express his concerns over the alternatives he's faced with. John may be able to give some advice to help Brent legitimately complete the work (e.g., through valid substitutions of control reliance and analytical procedures or other less costly procedures) and still come in under budget.
Con: John may see Brent as a threat to his promotion. This could lead to Brent receiving a poor performance evaluation, etc.

e) **Pro:** This alternative allows Brent to receive feedback on expectations from higher levels of engagement management. If John's plans violate engagement management's expectations, they may resolve the situation directly with John.
Con: Going over a supervisor's head without first speaking with that supervisor brings several possible negative consequences, including the possible perception by John's supervisors that Brent lacks good judgment in dealing with workplace issues. Brent's reputation will almost certainly suffer with John, and could suffer with other professionals in the office as well.

[2] ***What consequences for Brent, the auditing firm, and others involved, may arise from "eating time," as Scott suggested? Similarly, what consequences for Brent, the auditing firm, and others involved, may arise from not completing audit procedures, as Megan suggested?***

"Eating time" can lead to inaccurate budgeting for future audits. Managers, as they prepare the budget for an audit, often use prior years' audits as a guide. Managers will see that the job was completed in a shorter time in previous years and prepare his/her budget accordingly. Staff accountants on future audits will have pressure to complete audit segments in less time than is realistic, and this can become a cycle, with each year's budget becoming tighter and less realistic. This can cause undo stress and problems for future staff accountants. In the end, eating time is dishonest in that it is an action intended to deceive the users of the time budget report.

Skipping audit steps can have very serious consequences. By not completing the audit steps, material misstatements may slip past the auditors. The auditors may then issue an inappropriate audit opinion, which can be very costly. Skipped audit steps make great ammunition for plaintiffs' attorneys.

[3] ***In your opinion, which of Brent's alternative courses of action would provide the best outcome and why? What should Brent do? How would you handle the ethical issues involved in this situation?***

Brent should probably try to talk to John first, and discuss his concerns directly with him. There may be some legitimate things John could do to relieve the budget pressure. For example, if payables is a low-risk area as Megan suggests, perhaps an audit approach that relies more heavily on analytics and less on detailed tests could be justified. But departing from the audit program is definitely not a decision within Brent's or Megan's authority. If John is unwilling or unable to give any helpful advice, Brent may consider talking to the manager above John. Either way, Brent should do his best to get the work done within the budgeted hours, but should never unjustifiably cut corners. If he comes in over budget, he can stand with good conscience that he did what was right. Many firms reward people who stand up for ethical behavior and look very negatively on either premature sign-off or eating hours. While short-run benefits may accrue, in the long run, compromising ethical standards rarely if ever pays off.

[4] ***What could John Peters and the other auditors do to better handle the demands of career and family life?***

John Peters is in a difficult position. He is under evaluation for promotion and feels he needs to make a good showing. The Northwest audit is a very important audit for the firm, so John feels an even greater need to do well on the audit. However, he is responsible for the work that his staff does. Instead of creating an atmosphere that could very easily lead to, and even encourage, unethical behavior, John should find better alternatives to helping the staff get back on budget. If there are no workable alternatives, in the long-run, honesty and ethical behavior is the best course of action.

Brent, Megan, and Scott are experiencing pressures that many young professionals face in the workplace. There are obviously no easy answers, but this question should be conducive to some interesting and valuable class discussion. Ideally, new professionals adjusting to the pressures of working life need to find ways to balance the competing demands on their time and energy. They need to make sure they are investing an adequate amount of time each week in other areas of their lives they deem important, such as spousal and family relationships. In the end, professionals whose personal lives suffer from neglect will likely find it more difficult to be productive employees, and likely will find their lives less than fulfilling.

CASE 3.2

Nathan Johnson's Rental Car Reimbursement

Solving Ethical Dilemmas–Should He Pocket the Cash?

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

INSTRUCTIONAL OBJECTIVES

[1] To help students understand the types of ethical issues they could encounter during the recruiting process and in practice, and why it is important to handle even the "small" issues appropriately.

[2] To illustrate the reasoning process students should go through when they face ethical issues.

KEY FACTS

- Nathan Johnson recently interviewed with an accounting firm that agreed to reimburse him for the full cost of his rental car used to travel to the firm's office. Before sending in the bill for reimbursement, Nathan realized the rental car agency had overcharged his credit card by $40. The accounting firm told Nathan he should just send them the bill anyway, and that they had no problem reimbursing the extra amount.
- Before sending the receipt for reimbursement, Nathan called the rental agency and they agreed to credit his card for the $40. But in doing so, Nathan spent two hours on the phone dealing with the rental agency and incurred long-distance phone charges.
- Nathan now has the opportunity to send the accounting firm the original receipt with the amount he originally paid and still receive the credit from the rental agency--essentially putting $40 in his pocket.

USE OF CASE

The intent of this case is to expose the students to some of the "little" ethical issues they may face as they begin the recruiting process and later as they begin work. The case is designed to present a somewhat ambiguous situation in which it may be quite easy to rationalize taking a self-beneficial position. Our experience is that students typically react to the case with a wide variety of responses, and with a high level of interest and intensity. The case can be used to specifically illustrate the topic of expense reimbursement, a common area for misunderstandings and even fraud in the workplace. The case can also lead to a discussion involving proper conduct in general during the recruiting process and the importance for students to maintain high ethical standards during their interaction with the recruiters. It may even be worthwhile for the instructor to invite a former student who has recently gone through the recruiting process to share with the class his/her experiences. For many of the students, this case could be their first exposure to recruiting issues at this level and a discussion of their conduct could prove very beneficial. Although there are no simple answers to the questions that may be raised by this case, the issues are realistic and they merit consideration. Most of all, the

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case is directed at exposing students to realistic ethical issues in the workplace and at promoting discussion of the importance of acting with complete professionalism. Hopefully, this case will help students think about the importance of handling even "small" issues appropriately—the instructor should point out that serious ethical and even criminal lapses usually begin by rationalizing away or taking even moderately aggressive positions on the "little" things.

PROFESSIONAL STANDARDS

Relevant professional standards for this assignment include ET Section 52, "Article I-Responsibilities," ET Section 54, "Article III-Integrity," and ET Section 102, "Integrity and Objectivity."

SUGGESTED SOLUTION

[1] ***Given that the firm did not have any problem paying the higher bill, would Nathan's planned course of action be ethical? Why or why not?***

It would be easy for Nathan to rationalize accepting the extra $40 from the accounting firm considering the fact that they had approved the reimbursement at that amount. Further, he spent so much of his own time and personal expense on resolving the issue that he could rationalize that he should be compensated in some way. However, in considering whether or not his plan is ethical, Nathan must put all other considerations aside (especially the consideration of how he will benefit from pocketing the $40) and ask himself if he is exercising integrity in dealing with the firm—would his decision change if he knew the firm would find out later?

Even though the firm agreed to reimburse the $40 over-charge, they did not know that Nathan would still seek reimbursement from the rental agency. How would the firm react if they found out that Nathan had profited? They may or may not agree with his actions, but they could very well be left with a negative impression of Nathan and his integrity. Even the risk of such a result would not be worth the small amount of money he was to gain. Further, rationalizing away "small" issues is usually the first step toward rationalizing away bigger and bigger issues later. The only way to establish and maintain unbending personal integrity is to take a principled stand, even on the "little" issues.

[2] ***What other courses of action might be available to Nathan? Which do you think would be the best action for him to take?***

While there are several possible courses of action Nathan could take, the most important factor is to consider which of the alternatives would be the most ethically appropriate. First, Nathan could pocket the $40 without telling the accounting firm. This would be an ethically questionable action given that the money is not really his to take. At a minimum, Nathan would be leaving his integrity open to question in the eyes of others. Second, Nathan could contact the person in charge of reimbursements at the firm, explain what happened and that he had incurred some costs to receive the refund, and ask for guidance. The HR contact may give Nathan permission to retain the $40, thus resolving the ethical issue. However, Nathan should carefully consider the impression he will leave with a potential future employer. Third, Nathan could send in the reimbursement request to the firm for the total amount less the $40 refund from the car rental agency. This latter course of action may well be the safest and most ethical course of action to take and will likely make a positive impression on his potential employer. It is important that Nathan is completely honest and that he not risk compromising his integrity for a $40 gain in the short term. The value of the accounting profession rests in the integrity of its professionals and firms are looking for character and integrity in their recruits. Nathan should learn now the importance of holding himself to a strict set of ethical principles and to a high level of personal integrity.

CASE 3.3

The Anonymous Caller

Recognizing It's a Fraud and Evaluating What to Do

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

INSTRUCTIONAL OBJECTIVES

[1] To sensitize students to real-world pressures to meet financial expectations of others.

[2] To highlight available courses of action when confronted with the possibility of a financial statement fraud.

[3] To illustrate risks associated with communicating information about a potential financial statement fraud to third parties.

[4] To highlight differences in fraudulent financial reporting and aggressive accounting.

KEY FACTS

- An accounting professor, Dr. Mitchell, received a telephone call early one Monday morning from a former accounting student who wished to remain anonymous.
- The caller was serving as a controller of a small start-up company that, in the caller's opinion, knowingly submitted fraudulently misstated financial statements to its local bankers.
- The individuals purportedly involved in the fraud were the company's chief executive officer (CEO), the vice president of finance, and the chief financial officer.
- The financial statements in question related to the just completed first quarter of the current fiscal year and purportedly overstated sales and receivables.
- The bank requested the first quarter financial statements to determine whether it would resume funding of the company's line of credit that was halted because of the company's weak operating performance. The company was experiencing a severe cash shortage.
- The caller claimed that she vehemently refused to sign the commitment letter required by the bank because some recorded sales and receivable transactions did not meet revenue recognition criteria required by generally accepted accounting principles (GAAP).
- The caller noted that company senior executives insisted that the transactions be included, because without those transactions the bank would not resume funding the line of credit. Those executives accused the caller of living in an "ivory tower" and emphasized that companies book these kinds of transactions all the time.
- The caller stated that there was no underlying customer order related to the sales and no goods had been shipped to the customer as of quarter end. The senior executives believe that the transactions represented sales expected to be completed in the very near future.
- The sales and receivables transactions were actually booked by an accounts payable clerk who was specifically instructed by the CEO to record the transactions while the caller was not in the office. Fortunately, the accounts payable clerk was concerned about the transactions and informed the caller when she subsequently returned to the office.
- The caller believed that the prior-year financial statements, which were audited, did not contain similar transactions.
- Following the Friday bank meeting, the bank resumed funding the line of credit.

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. It is not intended to illustrate either effective or ineffective handling of an administrative situation.

USE OF CASE

This particular case is appropriate for a variety of accounting courses. The case is useful for undergraduate or graduate auditing courses when professional ethics, responsibilities for the detection of material misstatements due to fraud, or responsibilities for auditing sales and accounts receivable transactions are covered. The case could also be included in a financial accounting course or an accounting capstone seminar course to highlight the importance of satisfying revenue recognition criteria specified by GAAP. Finally, it could be included in any class that highlights business ethics.

The case can be completed by students individually or in groups. If completed individually, students can be requested to complete their answers outside-of-class. One option is to have the students prepare their response in memorandum format. This provides students an additional opportunity to improve their written communication skills. Or, students can be assigned to groups to complete the assignment as either an in-class or out-of-class assignment. If the case is to be completed in class, the students can easily read the case in 5-10 minutes.

PROFESSIONAL STANDARDS

Relevant professional standards for this assignment include AU Section 316 "Consideration of Fraud in a Financial Statement Audit," ET Section 54, "Article III-Integrity," and ET Section 102, "Integrity and Objectivity."

QUESTIONS AND SUGGESTED SOLUTIONS

[1] ***(a) What would you recommend to the caller if you were Dr. Mitchell? (b) What are the risks of continuing to work with the company? (c) What are the risks of resigning immediately? (d) Could the state board of accountancy be a source of advice?***

[a] ***One of the first actions that Dr. Mitchell might suggest would be for the caller to return to the office to gather any available evidence related to the transactions in question. Such a search would help to confirm that, to the caller's best knowledge, the inclusion of those transactions in the first quarter financial statements is clearly inappropriate. The caller could re-verify that there is no underlying customer order and that the goods were not shipped as of quarter end. The caller might also obtain documentation of the actual accounting entry(ies) related to the recording of the transactions in the accounting system. This additional search for any possible evidence related to the transaction will help ensure that the caller's views about the inappropriate accounting treatment are valid. To protect the caller from any future false allegations and assignment of blame for the transactions, the caller would be wise to maintain copies of all related evidence in a protected file. If the senior executives attempt to subsequently blame the caller for the inappropriate accounting, the ability to access such evidence may be extremely beneficial when mounting a defense.***

Dr. Mitchell might advise the caller to meet with senior executives one more time to re-emphasize concerns about the improper inclusion of the sales and receivable transactions in the first quarter financial statements. The caller could highlight the specific GAAP criteria required to recognize revenue. And, the caller might emphasize that the consequences of issuing intentionally misstated financial statement information to the bank could be extremely severe for both the company and the individuals who knowingly submitted the false financial information. Perhaps the senior executives involved are unaware of the serious consequences, including litigation and possible jail time that might result if the fraud is subsequently revealed.

Finally, Dr. Mitchell is likely to advise the caller to immediately seek the advice of a sound legal counselor. Issuing false and misleading financial statements to third parties who rely on them to make business decisions bears serious legal consequences. Thus, the advice of a professional knowledgeable of the legal responsibilities may be extremely helpful.

[b] ***Regardless of the senior executives' reaction to the caller's concern, Dr. Mitchell is likely to encourage the caller to seriously consider resigning from her position. Dr. Mitchell might point out that even if the company recalls the financial statements to remove the effects of the transactions, the caller now has strong evidence indicating that the integrity of senior executives is weak. Continued affiliation with a company and senior executive team known to have engaged in fraud casts obvious doubts about the professional reputation of all those associated. While discontinuing employment likely introduces significant personal costs, the costs of being associated with a company and management team that possesses little professional integrity are likely to be greater.***

[c] ***Dr. Mitchell would likely encourage the caller to not resign immediately upon returning to the office that Monday morning. Rather, Dr. Mitchell might emphasize the importance of first gathering sufficient copies of any available evidence related to the transaction. Such evidence, as noted earlier, may be extremely helpful if the senior executive team attempts to falsely place blame on the caller for the inappropriate accounting. Obtaining copies of such evidence would be the first priority.***

[d] ***The state board of accountancy may be a resource for the caller. There may be guidelines in the state code for dealing with situations like the one described by the caller. There may be available resources for the caller to discuss the issues with someone on an anonymous basis.***

[2] ***What responsibility, if any, does the caller have to report this situation directly to the bank involved? Before you respond, think about the risks present if the caller does inform the bank and it later turns out that the caller's assessment of the situation was inaccurate, i.e., there was no fraud.***

While the caller is likely concerned that the bank is inappropriately funding the line based on the overstated sales and accounts receivable balances presented in the first quarter financial statements, Dr. Mitchell may point out that there are risks associated with contacting the bank immediately. Obviously, the senior executives are responsible for submitting the financial statements to the bank during their meeting with bank representatives on Friday. They bear primary responsibility for notifying the bank, given that they represent senior management of the company. If the caller decides to notify the bank that the financial statements are misstated and then it is later determined that the accounting treatment was actually valid, the caller would face the consequences of overstepping her superiors and revealing false information about the company to third parties. Such action is likely to result in job loss and potential legal recourse from the company against the caller. Thus, before contacting the bank, the caller should be confident in the conclusion that the financial statements are misstated. In the meantime, the caller's refusal to sign the bank commitment letter for the first quarter financial statements should serve as a "red flag" to the bank. Once, however, the caller is convinced that the financial statements are truly misstated, direct contact with bank representatives may be appropriate. Before making such contact, however, it would be wise for the caller to seek legal counsel for advice about the appropriate actions to take.

[3] ***(a) What other parties, if any, should be notified in addition to the bank? (b) What concerns do you have about notifying the external auditors?***

[a] ***Unless the state board of accountancy has specific communication requirements for such circumstances, the caller has no obligation to contact third parties other than the bank. The caller would be wise to seek the advice of legal counsel before making any disclosures to***

others, including the external auditor.

[b] ***After considering the advice of legal counsel, the caller might benefit from obtaining input from the company's external auditor. The external auditor may provide the caller some assistance in convincing senior management that the current financial statement treatment is inappropriate. Upon learning about the first quarter misstatements, the external auditor may be concerned that the prior-year financial statements contain similar misstatements. Thus, their investigation of the first quarter transactions may prompt the auditors to extend their analysis back into the prior year. Knowledge of the first quarter events will likely heighten the auditor's skepticism about management's integrity. This may lead to the auditor's resignation from the current year audit.***

[4] ***(a) Do you think situations like this (i.e., aggressive accounting or even financial statement fraud) are common in practice? (b) What pressures or factors will executives use to encourage accounting managers and staff to go along? (c) What arguments can you use to resist those pressures? (d) How does one determine whether a company is aggressively reporting, but still in the guidelines of GAAP, versus fraudulently reporting financial information?***

[a] ***It is difficult to determine the extent that companies aggressively or even fraudulently misstate financial statements. Recently, the business press has been filled with highlights of alleged instances of financial statement fraud (e.g., Enron, WorldCom, Adelphia Communications, Tyco, etc.) In March 1999, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued a studied titled,*** *Fraudulent Financial Reporting 1987-1997: An Analysis of U.S. Public Companies*. ***The COSO study (see executive summary at www.coso.org) identified approximately 300 fraudulent financial statement cases investigated by the Securities and Exchange Commission (SEC) in the 11-year period examined. Given the number of publicly traded companies in the U.S., many view the number of cases identified to be low. However, the number of cases identified is directly affected by the SEC's limited resources available for fraud investigation. And, privately held businesses are not subject to SEC enforcement. So, the likely number of cases may be much higher. For the cases examined in the COSO study, 50% of those cases involved improper recognition of revenues and receivables like the situation described in this case. Thus, the technique used by the company in this case resembles a technique frequently used by companies issuing fraudulent financial statements. Consistent with these findings, AU Section 316, "Consideration of Fraud in a Financial Statement Audit," requires that the auditor presume that there is a risk of material misstatement due to fraud relating to revenue recognition in every audit.***

[b] ***Senior executives who face pressures to meet earnings expectations of others, such as analysts, bankers, stockholders, may place undue pressure on others in the organization to help meet those targets by employing a variety of techniques. The executive status of senior management can intimidate lower-level employees to comply with demands expressed from above. The threat of job loss or lack of promotion makes it difficult for lower-level employees to resist pressures from top management. The power and perceived business savvy of senior executives may also cause lower-level employees to doubt their own judgment about the situation. Convincing themselves that they must not understand the entire situation, lower-level employees often passively accept the demands of more senior employees.***

[c] ***One of the best defenses for lower-level employees to take is to rely on professional standards as the foundation for their actions. In this case, the caller's reasons for not agreeing with the recording of certain sales and receivables transactions is that the terms of the transactions do not satisfy explicit requirements noted in generally accepted accounting principles (GAAP). By highlighting the lack of compliance with GAAP, an employee can keep the focus of the issue on the need to satisfy professional standards. Until senior executives can prove that the terms of the transaction satisfy all GAAP criteria, they have little basis to justify their actions.***

[5] ***People who study instances of financial statement fraud often note that three conditions are generally present for fraud to occur. First, the person perpetrating the fraud has an <u>incentive</u> or pressure to engage in fraud. Second, there is an <u>opportunity</u> for that person to carry out the fraud. Third, the person's <u>attitude</u> or ethical values allows the perpetrator to rationalize the unethical behavior. Describe examples of incentive, opportunity, and attitude conditions that were present in this situation.***

Senior management faced several *incentives* that may have pressured them to engage in issuing fraudulently misstated quarterly financial statements. As a start-up company, management faced tremendous obstacles as they attempted to get the business up and running as an established competitor in the marketplace. The company, as a start-up enterprise had been operating at a net loss for a while. The company was facing a severe cash crunch, and the bank had recently halted the line of credit until the operating results for the first quarter could be analyzed. Thus, management was facing tremendous pressure to show its outside lenders that the company was viable. In addition, management's reputation as being successful entrepreneurs was a stake. These factors likely combined to provide tremendous incentives to misstate the first quarter financial results.

Given these incentives, management took advantage of *opportunities* to engage in fraudulent financial statement reporting. Because the financial statements requested by the bank related to the first-quarter of the year, the financial statements were not reviewed or audited by the external accountant. Thus, management had greater opportunity to misstate the first-quarter results than would have been available if the financial statements involved had been reviewed or audited. In addition, due to the company's small size and lack of sophisticated internal control systems, senior management was able to manipulate a temporary accounts payable clerk to book the fictitious sales and receivables transactions. The controller's absence provided management even greater opportunity to override the basic internal controls in place to book the inappropriate transactions.

Senior management's *attitude* about the controller's reaction to the inappropriate accounting treatment displayed a disregard towards the importance of quality financial reporting. Senior management rationalized their inappropriate actions by accusing the controller of living in an "ivory tower." They accused the controller of seeking a level of perfection and exactness that was unnecessary, reflecting the controller's lack of having a practical perspective to common business practices. Senior management had clearly convinced themselves that "companies booked these kinds of transactions all the time."

In this case, all the ingredients of fraud were present. Management had tremendous incentives to engage in fraud, and they took advantage of opportunities present to book the inappropriate entries. Finally, their attitude towards the importance of financial reporting displayed their ability to rationalize their unethical behavior.

[6] ***The Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 101,* Revenue Recognition in Financial Statements*, to provide guidance for publicly traded companies. Review SAB No. 101, which is available on the SEC's website (www.sec.gov) and determine how the company violated revenue recognition criteria.***

The determination of whether a company is reporting transactions within the confines of GAAP (aggressively reporting versus fraudulently reporting) requires professional judgment. In order to record revenue transactions, SAB No. 101 notes that GAAP requires the following conditions to be satisfied:

1. Evidence of an arrangement exists.
2. The earnings process is complete or nearly complete. Thus, the company has performed the service or provided the product and an exchange has taken place. In exchange for the company's provision of services or shipment of products, the

customer generally provides cash or a promise to pay cash in the future (i.e., a receivable).

3. The seller's price to the buyer is fixed or determinable.
4. Collection is reasonably assured. Thus, for sales on account, collection is considered reasonable as of the date of sale.

According to the caller's description of the receivables and revenue transactions in this case, customers had not submitted orders for the goods, and goods had not been shipped. Therefore, there was no evidence of any type of arrangement or establishment of the seller's price and other terms between the company and the customer. The earnings process was not complete given that goods had not been shipped and the customer had not provided cash or a promise to pay. Thus, there was no assurance that the receivables would be collected. As a result, the revenue recognition criteria were not satisfied, making the intentional recording of the underlying transactions a fraud.

[7] ***(a) Which financial statement assertion related to sales transactions did management violate when it issued the falsified financial statements? (b) What types of audit procedures could an external auditor perform that might help the auditor detect this fraudulent activity?***

[a] ***The caller's description of the fraud indicates that management recorded revenue and the related accounts receivable for customers who had not placed an order for those goods or before the goods had been shipped to customers. The recording of those entries would violate the*** *"occurrence"* ***financial statement assertion for sales transactions. According to AU 326,*** *Evidential Matter*, ***the occurrence assertion for classes of transactions addresses whether "Transactions and events that have been recorded have occurred and pertain to the entity." Because customers had not placed orders or the company had not shipped goods to customers, there was no type of formal arrangement and there was no exchange of goods for cash or other consideration. As a result, this activity violates the occurrence assertion for sales transactions.***

[b] ***Several possible audit procedures could be performed that might detect this fraudulent activity. The mailing of confirmations to customers associated with the recorded transactions may identify misstatements in the recorded receivable balances for the prematurely recorded revenue transactions. Most likely, customers would indicate discrepancies in the recorded receivable balances due to the overstated revenue transactions. Be sure to emphasize that they should select those customers for confirmation from recorded receivable balances. Other audit procedures might include the selection of transactions from the Sales Journal (or equivalent accounting record) and the examination of the related documentation for those transactions, including the customer's purchase order and the shipping documentation. Well-designed analytical procedures might also highlight the potential for misstatement, if the recorded amounts are not consistent with the auditor's pre-determined expectations based on prior year trends or other operating data. Finally, inquiry of key personnel involved in accounting, shipping, and sales might reveal unusual activities.***

CASE 3.4

WorldCom

The Story of a Whistleblower

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

INSTRUCTIONAL OBJECTIVES

[1] To sensitize students to the pressures a person faces when he or she becomes aware of fraud.

[2] To give students an overview of steps they could take if they become aware of potential unethical or illegal actions in organizations where they may be employed.

[3] To illustrate key characteristics of effective whistleblowing programs.

[4] To overview the key requirements of the Sarbanes-Oxley Act's whistleblowing and code of ethics provisions.

KEY FACTS

- WorldCom Inc., was a Mississippi-based telecommunications company, that became the 25th largest U.S. company by 2002.
- The company grew primarily through an aggressive merger and acquisition growth strategy.
- Bernie Ebbers, was the WorldCom CEO, and Scott Sullivan, was the WorldCom CFO.
- Cynthia Cooper, WorldCom's General Audit Executive, led the company's internal audit staff, which reported administratively to Scott Sullivan, CFO.
- Cynthia Cooper and others in the internal audit staff discovered and reported an alleged $3.4 billion fraud in June 2002 that ultimately grew to an alleged $11 billion fraud.
- Following the announcement of the fraud, WorldCom filed for bankruptcy protection, representing the largest bankruptcy in U.S. history.
- Arthur Andersen, LLP, served as WorldCom's external auditor until June 2002 when it was replaced by KPMG following Andersen's guilty verdict related to the Enron debacle.
- The fraud at WorldCom involved the erroneous capitalization of billions of dollars of network expenses as assets. Normal lease operating expenses related to fees paid by WorldCom to local telephone companies for use of their telephone networks were capitalized on the balance sheet.
- The fraud allowed the company to report a profit of $2.4 billion instead of a $662 million loss.
- During the initial stage of Cynthia Cooper's internal audit investigation, she was asked by Scott Sullivan, CFO, to delay her investigation.
- When Ms. Cooper initially approached the audit committee chairman, there was a delay in his taking action to her findings.
- At points during internal audit's investigation, internal audit staff members began to work secretly at night and copied key files for backup purposes.
- Ultimately, BernieEbbers was convicted for his role in the fraud and sentenced to over 20 years in prison. Currently, he is appealing his verdict.
- Scott Sullivan pled guilty and assisted the proscecution's case against Mr. Ebbers. Mr. Sullivan was sentenced to five years in prison.

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. It is not intended to illustrate either effective or ineffective handling of an administrative situation.

- In December 2002, ***Time*** magazine named Cynthia Cooper as one of its "Persons of the Year" along with two other whistleblowers: Sherron Watkins of Enron and Colen Rowley of the FBI.

USE OF CASE

This particular case is appropriate for a variety of accounting courses as well as any business course focused on corporate ethics. The case is useful for undergraduate or graduate auditing courses when professional ethics, responsibilities for the detection of material misstatements due to fraud, or responsibilities for reporting concerns about inappropriate financial reporting or other corporate ethics concerns are discussed. The case could also be included in a financial accounting course or an accounting capstone seminar course to highlight the importance of proper treatment of lease accounting, including expense versus capitalization of lease expenses.

The case can be completed by students individually or in groups. If completed individually, students can be requested to complete their answers outside-of-class. One option is to have the students prepare their response in memorandum format. This provides students an additional opportunity to improve their written communication skills. Or, students can be assigned to groups to complete the assignment as either an out-of-class assignment, particularly those questions requiring Internet-based research. Certain questions could be completed in-class. If so, the students can easily read the case in 10-15 minutes.

You might consider having the students read the ***Time*** (December 30, 2002 – January 6, 2003) article titled "The Night Detective" (pp. 32 and 45) before they complete this case. The article provides excellent background reading related to the issues presented in this case. Instructors might find the book by Cynthia Cooper, *Extraordinary Circumstances: The Journey of a Corporate Whistleblower*, an interesting read as well.

PROFESSIONAL STANDARDS

Relevant professional standards for this assignment include AU Section 316 "Consideration of Fraud in a Financial Statement Audit," ET Section 54, "Article III-Integrity," and ET Section 102, "Integrity and Objectivity."

QUESTIONS AND SUGGESTED SOLUTIONS

[1] ***At the time Cynthia Cooper discovered the accounting fraud, WorldCom did not have a whistleblower hotline process in place. Instead, Cynthia took on significant risks when she stepped over Scott Sullivan's head and notified the audit committee chairman of her findings. Conduct an Internet search to locate a copy of the Sarbanes–Oxley Act of 2002. Summarize the requirements of Section 301.4 of the Act.***

Section 301.4 of the Sarbanes-Oxley Act of 2002 requires the audit committee of a public company to establish procedures for the receipt, retention, and treatment of complaints received by the company regarding accounting, internal controls, or auditing matters. The audit committee is required to establish procedures for those complaints to be treated confidentially, and for the submission process to be anonymous for employees submitting the complaints about accounting or auditing matters. These procedures are often referred to as "whistleblowing" procedures.

[2] ***Use the Internet to conduct research related to whistleblower processes. Prepare a report summarizing key characteristics for the operation of an effective corporate whistleblower hotline. Be sure to highlight potential pitfalls that should be avoided.***

If effectively implemented, a whistleblower program can be a key defense against management override of internal control for purposes of engaging in fraud. According to survey results of the Association of Certified Fraud Examiners, almost 40 percent of frauds are detected through tips.

The AICPA's *Management Override of Internal Control: The Achilles Heel of Fraud Prevention*, (search for this at www.aicpa.org) notes that effective whistleblower programs should be overseen by the board's audit committee. That document notes that the audit committee can assist by encouraging the development of a culture in which employees view whistleblowing as a valuable contribution to an attractive workplace of integrity. Effective whistleblowing programs must demonstrate confidentiality so potential whistleblowers are assured that their concerns will be properly considered and that they will not be subjected to retribution. To ensure this level of confidentiality and trust, the audit committee should provide strong leadership in the development and maintenance of whistleblowing programs.

According to the AICPA, an effective whistleblowing program must ensure that submissions of complaints related to accounting, internal controls, and auditing are automatically and directly submitted to the audit committee. Management or other entity personnel should not have the opportunity to filter or screen such complaints before submission to the audit committee.

Many companies are engaging third-party vendors to administer the whistleblowing program. Such vendors provide and staff the telephone or Internet-based hotline for reporting complaints and they prepare periodic reports to the audit committee and others within the organization about tips received. Internal audit also serves as an effective monitor of the whistleblowing program.

Pitfalls occur whenever the perception of confidentiality or anonymity is breached. Once employees lose trust in the process, they will no longer feel comfortable submitting potential concerns. Also, employees must believe that follow-up actions will be taken whenever complaints are submitted. Several prior instances of fraud reveal that employees provided tips or complaints, but no actions were taken. Finally, if management has the ability to screen complaints received before they are submitted to independent parties, such as the audit committee or internal audit, there is a risk that complaints about management fraud will not be revealed to key oversight groups.

[3] ***As Vice President of Internal Audit, Cynthia Cooper reported directly to WorldCom's CFO, Scott Sullivan, and not to the CEO or audit committee. Research professional standards of the Institute of Internal Auditors to identity recommendations for the organizational reporting lines of authority appropriate for an effective internal audit function within an organization.***

International Standards for the Professional Practice of Internal Auditing issued by The Institute of Internal Auditors (see www.theiia.org) note that "The chief audit executive should report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. The internal audit activity should be free from interference in determining the scope of internal auditing, performing work, and communicating results" (see Section 1110 of those standards).

Most recommend that internal audit report directly to the audit committee of the board of directors. Because of its independence from top management, the audit committee can effectively ensure that internal audit's scope is not restricted by top management and that the findings are addressed appropriately by top management (with oversight from the audit committee). While internal audit reports functionally to the audit committee on matters related to audit scope and findings, often internal audit reports administratively to the CEO.

[4] ***Conduct an Internet search to locate a copy of the Sarbanes–Oxley Act of 2002 and summarize the requirements of Section 406 of the Act. Then, search the SEC's web site (www.sec.gov) to locate the SEC's Final Rule: "Disclosure Required by Sections 406 and 407 of the Sarbanes–Oxley Act of 2002 [Release No. 33-8177]. Summarize the SEC's rule related to implementation of the Section 406 requirements?***

Section 406 of the Sarbanes-Oxley Act of 2002 requires that the SEC issue rules that require a public company to disclose whether the company has adopted a code of ethics and if the company has not, reasons for no such adoption must be disclosed. Section 406 also requires that the SEC revise its regulations related to matters requiring prompt disclosure on a Form 8-K regarding any change in or waiver of the code of ethics for senior financial officers.

According to Section 406, a "code of ethics" refers to standards that promote the following:

- Honest and ethical conduct, including ethical handling of actual or apparent conflict of interests between personnel and professional relationships;
- Full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer.
- Compliance with applicable governmental rules and regulations.

In March 2003, the SEC adopted its final rule, *"Disclosure Required by Sections 406 and 407 of the Sarbanes–Oxley Act of 2002 [Release No. 33-8177],* to require a public company to disclose whether it has adopted a code of ethics that applies to the company's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. A company disclosing that it has not adopted such a code must disclose this fact and explain why it has not done so. A public company also will be required to promptly disclose amendments to, and waivers from, the code of ethics relating to any of those officers.

[5] ***Often the life of a whistleblower involves tremendous ridicule and scrutiny from others, despite doing the "right thing." Describe your views as to why whistleblowers face tremendous obstacles as a result of bringing the inappropriate actions of others to light.***

Most individuals who have blown the whistle about alleged unethical actions argue that it is one of the most stressful experiences of their lives. Initially they are faced with questions of doubt as to whether their claims are accurate. Unfortunately, some individuals blow the whistle as an emotional reaction to some event, such as job dissatisfaction or an overlooked promotion, and the claims are often not based on fact, but rather are based on opinion, perception, and in some cases falsehoods. Because some whistleblowing claims are deemed to be without merit, all whistleblowers are subject to initial skepticism regarding their claims. As a result, whistleblowers typically are not welcomed with enthusiasm and are usually asked to back-up their claims with evidence.

Unfortunately, whistleblowers are often put in the same camp as old-fashioned "tattle-tellers." As the old saying goes, "no one likes a tattle-teller" and that's often the view extended towards many whistleblowers. No one likes to hear bad news, even though the news may reflect reality. Often the whistleblower is ostracized merely because they are the messenger of bad news.

In cases like WorldCom and Enron, the whistleblower's actions often lead to the eventual demise of the company. For both WorldCom and Enron, the revelations of alleged fraud led to the bankruptcies of those organizations. As a result, thousands of employees are without work, along with the erosion of pensions, stockholdings, and other personal investments tied to the organization. The loss of job, income, and savings naturally creates stress and huge amounts of negative emotions that often are directed at the person who "spilled the beans."

Finally, in most instances the whistleblower personally experiences these same losses as well. And, in some instances they are forced to defend their actions, often involving extensive personal legal defense costs. In other cases, they are shoved aside within the organization or are dismissed.

[6] ***Describe the personal characteristics a person should possess to be an effective whistleblower. As you prepare your list, consider whether you think you've got what it takes to be a whistleblower.***

Most whistleblowers describe their experience as one of the most challenging events of their lives. Often whistleblowers face tremendous pressure and resistance from those more senior and their claims are not immediately embraced as truth. As a result, many whistleblowers experience tremendous personal hardship through their whistleblowing experience.

Whistleblowers need to possess courage and conviction as they put forward and defend their claims. Because those receiving the complaints have to maintain objectivity and perform due diligence procedures regarding the legitimacy of the claim, there are times when the whistleblower must defend the basis for their claim. This type of pressure requires courage and conviction to carry through with the complaint to ensure truth is revealed. Often those investigating a particular complaint may be members of the audit committee or outside investigators or legal counsel. A whistleblower must be confident and comfortable defending his or her concerns in front of individuals who may be perceived as intimidating. Thus, whistleblowers need to maintain a level of confidence to ensure they are not intimidated by others who may be challenging the legitimacy of their claims.

Whistleblowers need to be effective communicators. They need to be able to clearly layout their concerns and arguments for why they submitted a complaint. Thus, effective communication of key facts and observations, along with supporting documentation, increases their ability to successfully relay their concerns to those investigating the complaint.

Unfortunately, whistleblowers have to be willing to suffer certain consequences often associated with whistleblowing incidents. Often whistleblowers are shunned by colleagues for disclosing bad news, not being a team player, or for being a "tattle-tell". Furthermore, in instances, such as WorldCom, even the whistleblower suffers similar consequences as all other employees, including loss of a job (due to the bankruptcy of the company) and loss of value in stock related holdings. Thus, whistleblowers must possess the character to do what is right regardless the consequences.

[7] ***Assume that a close family member came to you with information about a potential fraud at his or her employer. Prepare a summary of the advice you would offer as he or she considers taking the information forward.***

One of the most critical steps in reporting concerns about a potential fraud is to be certain the individual has a clear understanding of the facts giving rise to the concern. To avoid prematurely filing a complaint that may be based on perception or emotion, a potential whistleblower should gather as much evidence documenting the facts and circumstances surrounding the concern as possible. Many prior whistleblowers note that they also made backup copies of any relevant documentation to be stored off-site.

Once key facts and circumstances are documented, the potential whistleblower should consider approaching his or her superiors to give them the opportunity to provide additional information that may be relevant to the situation. In certain cases, the potential whistleblower may not have access to legitimate facts or information that alter the circumstances. Thus, superiors should have the opportunity to provide any relevant information.

When the information provided does not alleviate the concern, the potential whistleblower should follow established company procedures for filing complaints related to integrity and ethics. Depending on the response to filed complaints, the individual may consider the need for direct reporting to the audit committee and internal audit.

Depending on the seriousness of the complaint, the individual should consider the need to obtain outside legal counsel. Most argue that legal counsel from outside the organization, rather than in-house legal counsel, should be pursued, given their independence from management. Legal counsel should be obtained before making any claims to authorities outside the organization's chain of command (e.g., before reporting to the SEC).

If an individual decides to leave the organization, it would be important to disclose noted concerns during the exit interview process. And, those discussions should be documented (i.e., date, time, individuals present, and topics discussed). Leaving the company without reporting the concern to appropriate authorities may not provide adequate legal protection, even for the whistleblower.

[8] ***Conduct an Internet search to locate a copy of the Sarbanes–Oxley Act of 2002. Read and summarize the requirements of Section 302 of the Act. Discuss how those provisions would or would not have deterred the actions of Scott Sullivan, CFO at WorldCom.***

Section 302 of the Sarbanes-Oxley Act of 2002 requires a public company's CEO and CFO to certify in each annual and quarterly financial statement report filed with the SEC the following:

- They have reviewed the report.
- That, based on the signing officers' knowledge, the report does not contain any untrue statements of material fact or omit any material fact necessary to make the report misleading.
- The financial statements, based on the officers' knowledge, are fairly presented.
- The signing officers
  - A. Are responsible for establishing and maintaining internal controls.
  - B. Have designed such internal controls to ensure that material information related to the company and its subsidiaries is made known to those officers by others in the entity.
  - C. Have evaluated the effectiveness of internal controls as of a date within 90 days prior to the report
  - D. Have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date.
- The signing officers have disclosed to its auditors and the audit committee
  - A. All significant deficiencies in the design or operation of internal controls and have identified all material weaknesses identified.
  - B. Any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal controls.
- The signing officers have indicated in the report whether there were any significant changes in internal controls that could significantly affect internal controls subsequent to the date of their evaluation.

It is difficult to assess whether the presence of these provisions would prevent or deter someone like Scott Sullivan from falsifying the financial statements. However, many have noted how the Section 302 provisions have finally alerted senior management to the importance of the financial reporting process. The penalties issued by the SEC in its final rules issued to implement the provisions of Section 302 significantly extend the criminal penalties associated with violating the provisions of Section 302. Violators are subject to million dollar fines and up to 20 years imprisonment. Hopefully, these harsh consequences will deter individuals, like Scott Sullivan, from engaging in material financial statement fraud.

[9] ***Document your views about the effectiveness of regulatory reforms, such as the Sarbanes–Oxley Act of 2002, in preventing and deterring financial reporting fraud and other unethical actions. Discuss whether you believe the solution for preventing and deterring such acts is more effective through regulation and other legal reforms or through teaching and instruction about moral and ethical values conducted in school, at home, in church, or through other avenues outside legislation.***

The public debate surrounding the effectiveness of the Sarbanes-Oxley Act and related regulations has been intense. Many proponents for the Act argue that the provisions have strengthened senior management's engagement in the financial reporting process. Provisions, such as the Section 302 certification responsibilities for the CEO and CFO along with related criminal penalties, have increased management's focus and scrutiny over financial reporting and related internal controls, which should lead to increased quality in financial reporting. Similarly, expanded requirements for audit committees and stricter oversight of external auditors have increased the effectiveness of the audit committee's and the external auditor's oversight of the financial reporting process.

In contrast, many opponents to the Sarbanes-Oxley Act have argued that the cost of compliance with the provisions, particularly those related to Section 404's reporting on internal control have been overly burdensome for public companies, especially small public companies. They argue that the extent of work involved to comply with the Act has been tremendous and has distracted management from monitoring more strategic actions and decisions that directly impact shareholder value. Furthermore, many argue that the level of focus on internal controls is too detailed and auditors and management are being forced to test key controls that likely have no practical effect on the prevention of material misstatements in financial statements due to fraud.

While many argue that it is difficult to teach moral or ethical values to adults, most believe that awareness and discussion of key ethical decision making helps sensitize individuals to the realities of issues they might face in the business world. Thus, most believe that the importance of ethical training and ethical decision making can't be taught too early or taught too much. Most likely, the combination of ethical training and decision making combined with stringent regulatory requirements are most effective at preventing, deterring, and detecting material fraud.

CASE 3.5

Hollinger International

Realities of Audit-Related Litigation

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

INSTRUCTIONAL OBJECTIVES

[1] To appreciate the nature and significance of testimony in an alleged financial statement fraud case.

[2] To understand the importance of audit documentation.

[3] To outline GAAP requirements with respect to related party transactions.

[4] To describe auditor responsibilities for identifying related party transactions.

[5] To understand required auditor communications with those charged with governance.

KEY FACTS

- This case focuses on trial testimony related to financial statement fraud at Hollinger International, a Chicago-based company that owns several newspapers including the *Chicago-Sun Times*, *The Daily Telegraph* in London, and *The Jerusalem Post*.
- Hollinger International's Class A common shares trade on the New York Stock Exchange, while its Class B common shares are owned by Hollinger Inc., a Toronto-based company.
- The fraud was orchestrated by members of the Hollinger International senior executive team, including the Chairman and Chief Executive Officer, Conrad Black, and the Chief Operating Officer, David Radler.
- These individuals allegedly siphoned off $85 million for themselves through a series of related party transactions that were never approved by Hollinger International's board of directors. And, many of these transactions were not disclosed in the financial statements. They also attempted to disguise these transactions from their auditors, KPMG LLP.
- The fraud technique was fairly simple. As Hollinger International sold some of its newspaper subsidiaries to other companies, Black and Radler included provisions in the sales contracts that provided for "non-compete" payments made payable to them and to Hollinger Inc. (the Toronto-based owner of the Class B common shares) as part of the transaction sales proceeds.
- The payments were made to Black, Radler, and Hollinger Inc. so that they would allegedly agree to not compete directly with the buyers of the newspaper subsidiaries.
- As various newspaper subsidiaries were sold, Black, Radler, and Hollinger Inc. received a portion of the proceeds that should have actually gone to Hollinger International.
- Given Black's and Radler's positions at Hollinger International, these payments negotiated by them to benefit themselves represented related party transactions that should have been approved by the board of directors and disclosed in the financial statements.
- The SEC filed a civil action against Black, Radler, and Hollinger Inc. related to these related-party transactions.
- The trial occurred over several weeks in spring 2007. Partners from KPMG had to testify as witnesses in the trial.
- This case centers around the trial testimony on April 23, 2007 of Marilyn Stitt, a Toronto-based audit partner at KPMG.

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. It is not intended to illustrate either effective or ineffective handling of an administrative situation.

- The testimony is presented verbatim from trial transcripts of her testimony. Selected excerpts of her testimony are provided to give students a first-hand example of the realities of fraud-related courtroom proceedings.
- Students can begin to appreciate the level of stress associated with serving as a witness in a trial that occurs years after the audit is completed.

USE OF CASE

This particular case is appropriate for a variety of accounting courses. The case is useful for undergraduate or graduate auditing courses when professional ethics, auditor liability, responsibilities for the detection of material misstatements due to fraud, or audit documentation are covered. The case could also be included in a financial accounting course or an accounting capstone seminar course to highlight the importance of related party transaction disclosures specified by GAAP. Finally, it could be included in any class that highlights business ethics and the importance of transparent financial reporting.

The case can be completed by students individually or in groups. If completed individually, students can be requested to complete their answers outside-of-class. One option is to have the students prepare their response in memorandum format. This provides students an additional opportunity to improve their written communication skills. Or, students can be assigned to groups to complete the assignment as either an in-class or out-of-class assignment. If the case is to be completed in class, it would be most efficient for the students to read the case prior to class.

PROFESSIONAL STANDARDS

Relevant professional standards for this assignment include AU Section 230, "Due Professional Care in the Performance of Work," AU Section 311, "Planning and Supervision," AU Section 316 "Consideration of Fraud in a Financial Statement Audit," AU Section 339, "Audit Documentation," AU Section 380, "The Auditor's Communication with Those Charged with Governance," ET Section 54, "Article III-Integrity," and ET Section 102, "Integrity and Objectivity."

QUESTIONS AND SUGGESTED SOLUTIONS

[1] ***The following requirements relate to Ms. Stitt's testimony about the concept of reasonable assurance:***

[a] ***Research the auditing standards for "reasonable assurance" and provide your assessment as to the accuracy of Ms. Stitt's description of that concept in her testimony.***

AU Section 230, *Due Professional Care in the Performance of Work*, describes "reasonable assurance" as a high, but not absolute level of assurance about whether the financial statements are free of material misstatement. That section notes that absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. The auditor's objective is to plan and perform the audit to obtain sufficient appropriate evidence so that audit risk will be limited to a low level in order to provide an opinion on the financial statements. Even with good faith and integrity, mistakes and errors in judgment can be made and accounting presentations include accounting estimates. Thus, an audit conducted in accordance with GAAS may not detect a material misstatement.

Ms. Stitt's testimony about the concept of reasonable assurance is consistent with the guidance contained in AU 230. She contrasted reasonable assurance with absolute assurance and noted that auditors cannot provide absolute assurance because of the nature of audit evidence, the characteristics of fraud, the fact that audit procedures do not examine every transaction, and the reliance on auditor judgment, consistent with guidance in AU 230.

[b] ***Ms. Stitt testified that audit evidence is often not conclusive. Describe the GAAS fieldwork standard related to the need to collect audit evidence and provide a summary of what is meant by "sufficient appropriate audit evidence."***

While auditors are not expected to examine all information that may exist, the second standard of fieldwork requires the auditor to obtain sufficient appropriate evidence to provide a reasonable basis for an opinion regarding the financial statements under audit. The auditor obtains most evidence through selective testing of data being audited and the auditor must apply judgment as to the nature, timing, and extent of tests performed. Additionally, judgment is required in interpreting the results of audit testing and evaluating audit evidence. Errors and mistakes in audit judgments can be made, and many accounts are based on audit estimates whose measurements are inherently uncertain and depend on future events. Thus, the auditor has to rely on evidence that is pervasive rather than convincing (or conclusive).

[c] ***As part of Ms. Stitt's testimony, she describes auditor responsibility for detecting material misstatements due to fraud. Review AU 316, Consideration of Fraud in a Financial Statement Audit, and assess whether her testimony is consistent with auditing standards.***

Paragraph 1 of AU 316, *Consideration of Fraud in a Financial Statement Audit,* states that "The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud." Auditors have a responsibility to plan the audit and perform auditing procedures to obtain reasonable assurance that material misstatements are detected regardless of cause. As a result, auditors have a responsibility to plan and perform audit procedures with the purpose of obtaining reasonable assurance that material misstatements due to fraud are detected.

Ms. Stitt's testimony about the concept of reasonable assurance includes a brief description about auditor responsibility for fraud. She stated the following: "So, we're generally not necessarily doing a whole bunch of procedures to find, you know, necessarily fraud or illegal activity; but we become – keep our radar up, in terms of if there's something that comes to our attention; and this general risk assessment upfront as to where the risk of fraud may occur." Her comments seem to suggest that auditors do not have a responsibility to perform procedures to obtain reasonable assurance that material misstatements due to fraud are detected. Rather, she suggests that auditors should maintain an awareness of the possibility for fraud without performing procedures specifically designed to detect material misstatements due to fraud. This particular excerpt that contains Ms. Stitt's testimony about auditor detection of material misstatements due to fraud does not appear to be consistent with the level of responsibility described in paragraph 1 of AU 316.

[2] ***The following requirements relate to Ms. Stitt's testimony about the CanWest non-compete payments:***

[a] ***The concept of a "related party" is defined by generally accepted accounting principles (GAAP). Provide a brief overview of the concept of "related party transactions."***

FASB Statement No. 57, *Related Party Disclosures,* describes the requirements for related party disclosures in financial statements. The glossary of that statement defines related parties as follows:

"Affiliates of the enterprise; entities for which investments are accounted for by the equity method by the enterprise; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners of the enterprise; its management; members of the immediate families of principal owners of the enterprise and its management; and other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests."

[b] ***Based on your understanding of the concept of "related party transactions," why would the non-compete payments described in this case be considered a "related party transaction?"***

The definition of related parties in FASB Statement No. 57, *Related Party Disclosures*, includes an entity's management as a related party. Thus, Conrad Black's service as Chairman and Chief Executive Officer (CEO) of Hollinger International and David Radler's service as Chief Operating Officer (COO) meant that both Black and Radler would be considered related parties. Thus, any transactions, such as the non-compete payments, directly involving either individual would constitute a related party transaction. Because of their management positions, Black and Radler were able to directly influence the negotiations for the sales of the newspaper subsidiaries to benefit themselves personally at the expense (and approval) of Hollinger International Class A shareholders. Thus, portions of the proceeds due to the Hollinger International shareholders were diverted to Black and Radler through their actions that were taken without explicit approval of the board and shareholders. Said differently, Black and Radler used their positions to influence the outcome of these transactions for personal gain. These transactions were not conducted at "arms length" as described in FASB Statement No. 57.

[c] ***Summarize what the auditing standards say regarding auditor's responsibilities with respect to identifying related party relationships and transactions.***

AU Section 334, *Related Parties*, describes auditor responsibility for identifying related party transactions in an audit of financial statements. That standard notes that an audit performed in accordance with generally accepted auditing standards cannot be expected to provide assurance that all related party transactions will be discovered. Thus, the auditor does not have a responsibility to obtain reasonable assurance that all material related party transactions are detected by audit procedures. However, during the course of an audit, the auditor is required to be aware of the possible existence of material related party transactions that could affect the financial statements. When the auditor identifies transactions with related parties, AU 334 requires the auditor to perform audit procedures to understand the purpose, nature, and extent of these transactions and to evaluate their effect on the financial statements. Even if the auditor has no reason to suspect that related party transactions exist, many procedures are normally performed in an audit to determine the existence of related parties and to identify any transactions with those related parties.

[d] ***What financial statement disclosures are required by generally accepted accounting principles (GAAP) for related party transactions?***

FASB Standard No. 57, *Related Party Disclosures*, requires disclosure in the financial statements of each material related party transaction (or aggregation of similar transactions) or common ownership or management control relationship. Financial statements shall include disclosures of material related party transactions, other than compensation arrangements, expense allowances, and other similar items in the ordinary course of business. According to FASB Standard No. 57, the disclosures shall include the following:

i. The nature of the relationship(s) involved.
ii. A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which income statements are presented, and such other information deemed necessary to understand the effects of the transactions on the financial statements.
iii. The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period.
iv. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement.
v. The information required by paragraph 49 of FASB Statement No. 109, *Accounting for Income Taxes.*

[3] ***The following requirements relate to Ms. Stitt's testimony about the audit committee presentation:***

[a] ***Provide a brief overview of the requirements of AU Section 380, The Auditor's Communication with Those Charged with Governance. Be sure to describe the overall purpose of this required communication.***

AU Section 380, *The Auditor's Communication with Those Charged with Governance,* establishes standards and provides guidance on the auditor's communication with those charged with governance in relation to the audit of financial statements. Those charged with governance include those persons with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability for the entity, including the financial reporting process. AU 380 provides a framework to encourage two-way communication between the auditor and those charged with governance. The principal purposes of communication with those charged with governance are to:
i. Communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the scope and timing of the audit.
ii. Obtain from those charged with governance information relevant to the audit.
iii. Provide those charged with governance with timely observations arising from the audit that are relevant to their responsibilities in overseeing the financial reporting process.

AU 380 requires that auditors communicate the auditor's responsibilities under GAAS, an overview of the planned scope and timing of the audit, and significant findings from the audit.

[b] ***Based on your overview of the auditor's communication responsibilities, why was it appropriate for KPMG to discuss the related party transactions with Hollinger International's Audit Committee?***

The non-compete payments to Black and Radler represented a significant audit finding requiring communication by the auditor to the Hollinger International Audit Committee. The transactions were material (aggregated more than $85 million) and represented significant related party transactions involving the CEO and COO. Due to their significance, these transactions directly affected the nature and extent of disclosures needed in the Hollinger International's financial statements. Additionally, there was some disagreement between Hollinger International's management team and KPMG as to whether the transactions constituted related party transactions. Paragraph 42 of AU 380 requires the auditor to discuss with those charged with governance any disagreements with management, whether or not satisfactorily resolved.

[c] ***Based on your review of the transcript about the audit committee meeting, describe whether you believe KPMG exercised due professional care in pursuing this issue with Hollinger International's Audit Committee. Did KPMG accomplish the intent of AU Section 380? What could KPMG have done differently with respect to this issue during this meeting?***

Based on review of the description of KPMG's communications with the Hollinger International Audit Committee contained in these excerpted trial transcripts, one might question whether KPMG exercised due professional care in pursing resolution of the non-compete payments with the Audit Committee during its meeting with them on February 20, 2002. According to Ms. Stitt, KPMG wanted to make sure that the Audit Committee was aware of the non-compete payments and they were seeking confirmation of that. However, during the meeting KPMG did not explicitly inquire of the Audit Committee about their awareness of the transactions. Ms. Stitt even noted that "I took their silence as meaning that they had – they had – considered them before and they had been approved."

AU Section 230, *Due Professional Care in the Performance of Work*, notes that professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. Professional skepticism requires the auditor to use the knowledge, skill, and ability called for by the profession of public accounting to diligently perform, in good faith and with integrity, the gathering and objective evaluation of evidence. KPMG's reliance on "silence" as evidence does not appear to be consistent with concepts of a questioning mind and critical evaluation of audit evidence described in AU 230.

[4] ***The following requirements relate to Ms. Stitt's testimony about the audit workpapers:***

[a] ***Based on your review of AU Section 339, Audit Documentation, why must auditors prepare audit documentation?***

AU Section 339, *Audit Documentation*, requires the auditor to prepare audit documentation in connection with each engagement in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of audit procedures), the audit evidence obtained and its source, and the conclusions reached. Audit documentation provides the principal support for the representation in the auditor's report that the audit was performed in accordance with generally accepted auditing standards and audit documentation provides the principal support for the opinion expressed about the financial statements.

[b] ***Discuss the concept of "experienced auditors" as described in AU Section 339 and highlight how that concept relates to the form, content, and extent of audit documentation.***

Paragraph 10 of AU Section 339 requires the auditor to prepare audit documentation that enables an experienced auditor, having no previous connection to the audit, to understand the following:

- i. The nature, timing, and extent of auditing procedures performed to comply with SASs and applicable legal and regulatory requirements;
- ii. The results of the audit procedures performed and the audit evidence obtained;
- iii. The conclusions reached on significant matters; and
- iv. That the accounting records agree or reconcile with the audited financial statements or other audited information.

An experienced auditor means an individual (whether internal or external to the firm) who possesses the competencies and skills that would have enabled him or her to perform the audit.

[c] ***Summarize the requirements in AU Section 339 for identifying the preparer and reviewer of audit documentation. Is Ms. Stitt's testimony consistent with those requirements? Briefly explain.***

AU Section 339 requires that the audit documentation record who performed the audit work and the date such work was completed and who reviewed specific audit documentation and the date of such review. Each working paper does not need to include specific evidence of review. But, it should be clear from the audit documentation who reviewed specified elements of the audit work performed and when.

Ms. Stitt's testimony about initialing working papers is consistent with the spirit of AU 339. As she noted, a reviewer should not initial a working paper until that person is comfortable with the work performed and conclusions reached as documented on the working paper.

[d] ***Summarize the responsibilities for reviewing audit documentation as described in AU Section 311, Planning and Supervision.***

The first standard of fieldwork requires that the audit be properly planned and supervised. AU Section 311, *Planning and Supervision,* notes that supervision involves directing the efforts of assistants who are involved in accomplishing the objectives of the audit and determining whether those objectives were accomplished. One element of supervision includes reviewing the work performed. Paragraph 31 of AU 311 notes that the work performed by each assistant, including the audit documentation, should be reviewed to determine whether it was adequately performed and documented and to evaluate the results, relative to the conclusions to be presented in the auditor's report. The person with final responsibility for the audit may delegate parts of the review responsibility to other assistants.