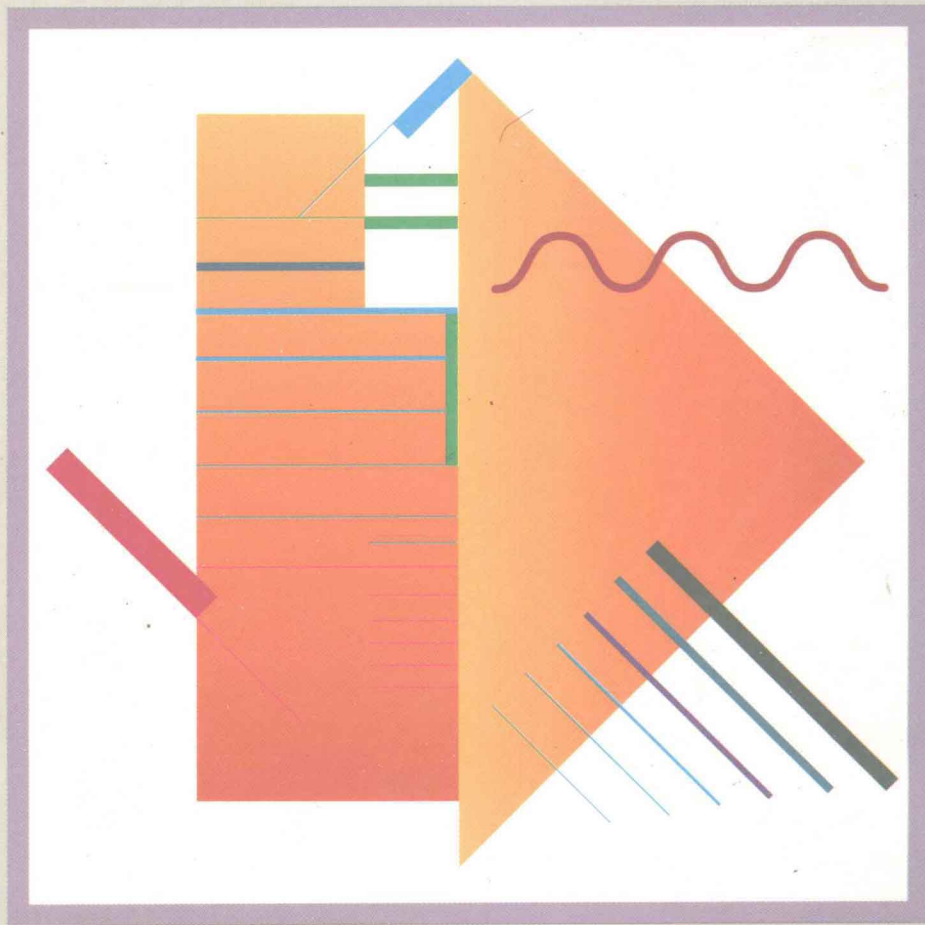
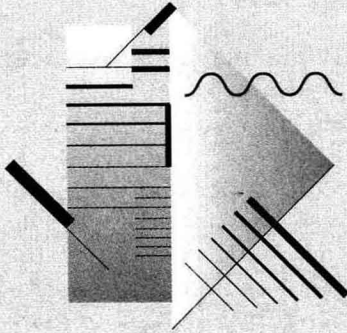


# CONTEMPORARY AUDITING ISSUES AND CASES



**Michael C. Knapp**



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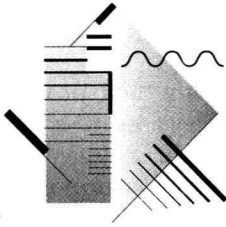
# CONTEMPORARY AUDITING

## ISSUES AND CASES

## **DEDICATION**

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**To Jessi, John, and Lindsay**



## PREFACE

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The next decade will see pervasive changes in accounting curricula across the nation. Criticism of the accounting profession by congressional investigative committees, the financial press, and the general public forced the profession in recent years to reassess its societal purpose and future direction. One result of this reassessment was a call for exploring ways of improving accounting education. The academic literature in recent years is replete with recommendations for accounting educators to move away from textbook-driven methods of instruction that place heavy emphasis on rote memory of professional standards and concepts. Critics of traditional pedagogical methods in accounting curricula suggest that accounting educators should employ a broader array of instructional resources, particularly resources that are experiential in nature and designed to stimulate active learning on the part of students. In fact, a primary objective of the Accounting Education Change Commission is to encourage the development of a more extensive set of these types of materials for use in accounting courses. The purpose of this casebook is to provide instructors with a source of such materials for use in both undergraduate and graduate auditing courses.

All of the cases presented in this text are derived from actual events or situations involving auditors and accountants. With two exceptions, Leigh Ann Walker and Laurel Valley Estates, the names of the actual parties who were involved in these cases have *not* been changed, the purpose being to underline the realism of the cases. In fact, by design, this casebook stresses the “people” aspect of independent audits. Even a cursory review of alleged problem audits of recent years will quickly confirm that these situations almost never arise as a result of the failure of audit technology. Instead, problem audits typically result from the presence of one or both of the following two conditions: (1) client personnel who intentionally subvert the audit or (2) auditors who fail to carry out the responsibilities assigned to them.

The purpose of this text is not to criticize the individuals who have been involved in alleged problem audits but rather to allow students to learn from these situations. Textbooks do an excellent job of discussing the proper procedures for auditors to employ across various settings. However, my experience suggests that students can learn much more by studying situa-



tions in which auditors failed, for whatever reason, to satisfy their professional responsibilities. Presented in this text, for example, are cases in which auditors failed to identify the key management assertion for a given account balance, collected an inferior form of audit evidence to support a given management assertion, and overlooked a critical “red flag” in a client’s financial statements. Students who study an actual situation in which an auditor failed to identify a key management assertion for a given account balance are much more likely to understand the concept and purpose of assertion-based auditing. Additionally, by studying such settings, students are given a “reality jolt,” since they are shown the often serious consequences that can result from the exercise of poor judgment by an auditor.

In addition to an emphasis on the human element in the independent audit, the cases in this text also provide students with contextual information concerning the case settings that, at first reading, may not appear to be necessary. However, the emphasis on context richness in these cases allows the students to understand the environment in which auditors must operate. As a result, after studying these cases, students should more readily comprehend the subtle pressures and nuances that make the independent auditor’s professional role so complex. Client pressure (both explicit and implicit), peer pressure, and time budgets are among the variables interwoven in these cases that can create frustration for the independent auditor. Also depicted in these cases is the ambiguity and lack of structure with which auditors must cope each day. Missing documents, conflicting audit evidence, the dual obligation to the client and to financial statement users, and the lack of definitive professional standards for many situations are facets of the audit environment that complicate the professional auditor’s role.

The cases in this text are organized into five groups. A list of these groups follows, along with a brief overview of the types of cases included in each group. In addition, the table of contents provides a short description of each case and, for the “Comprehensive Cases,” lists several of the key topics they address.

### **Comprehensive Cases**

Most of these cases deal with high-profile problem audits occurring over the past decade, including ESM Government Securities, ZZZZ Best Company, and Lincoln Savings and Loan Association. These cases address a wide range of technical auditing, accounting, and ethical issues.

### **Audits of High-Risk Accounts**

In contrast to the cases in the prior section, the cases in this group are more focused, generally addressing only one or two auditing issues or concepts. For example, the focus of the Doughtie’s Foods case is inventory observation audit procedures, whereas the J. B. Lippincott Company case addresses audit procedures relevant to accounts receivable.

## **Ethical Responsibilities of Auditors**

Integrating ethics into an auditing course requires much more than simply discussing the AICPA's Code of Professional Conduct. This section presents actual situations in which auditors have faced perplexing ethical dilemmas. Students required to study such cases and to consider the context in which ethical issues arise should be better prepared to deal with these types of situations in their own professional careers.

## **Emerging Issues in Auditing**

The dynamic nature of the public accounting profession in recent years has resulted in a number of changes in the work environment of public accountants and the nature of the services they provide. For example, the *Hopkins v. Price Waterhouse* case discusses the unique problems faced by women pursuing a career in public accounting. Two decades ago, this was not a widely discussed issue in the profession, since relatively few women at that time chose careers in public accounting.

## **Classic Litigation Cases**

Most auditing textbooks focus almost exclusively on the legal liability issues inherent in the classic auditor litigation cases that have arisen over the past several decades. In this text, the underlying auditing issues or controversies inherent in these cases are presented, as well as the pertinent legal liability issues.

This casebook is designed for use in a number of different ways. The casebook can be used as a supplemental text for the undergraduate auditing course or as a primary text for a graduate-level seminar in auditing. The instructor's manual identifies additional readings that instructors can assign if the casebook is being used as a primary text for a graduate-level auditing course. A syllabus included in the instructor's manual for such a course also identifies project assignments related to these cases that instructors can choose to give their students. Finally, the casebook can be used in the capstone professional practice course that is included in many five-year accounting programs.

The instructor's manual also provides two topical indexes to facilitate the use of this casebook. One index arrays the cases by auditing topic, and the second index arrays auditing topics by individual case. Also provided for each case is a synopsis, a listing of key facts, a listing of instructional objectives, specific suggestions for classroom use, and suggested solutions to the case questions.

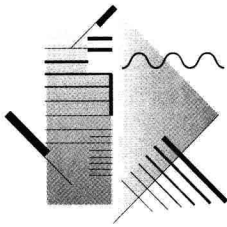
## **The Customized Casebook Option: *Westtext***

To maximize the flexibility of using these cases, West Publishing Company is including *Contemporary Auditing: Issues and Cases* in its custom publishing program, *Westtext*. This program makes it possible for adopters to select among the cases included here and create a customized casebook ideally



suited to their needs. For more information on how to design your own customized casebook, please contact your West sales representative.

I greatly appreciate the insight and suggestions provided by the following reviewers during the writing of this casebook: Ed Blocher, University of North Carolina; Kurt Chaloupecky, Southwest Missouri State University; Ray Clay, University of North Texas; Mary Doucet, University of Georgia; Jim Lampe, Texas Tech University; Alan Lord, University of Alabama; Donald McConnell, University of Texas at Arlington; Heidi Meier, Cleveland State University; Don Nichols, Texas Christian University; Rajendra Srivastava, University of Kansas; and Jim Yardley, Virginia Polytechnic University. This project also benefited greatly from the guidance and patience of Rick Leyh and Jessica Evans of West Educational Publishing, as well as the editorial assistance of Mary C. Berry and my sister, Paula Conatser. Finally, I would like to acknowledge the contributions of my students, who have provided invaluable comments and suggestions on the content and use of these cases.



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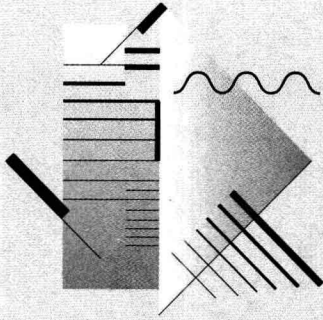
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