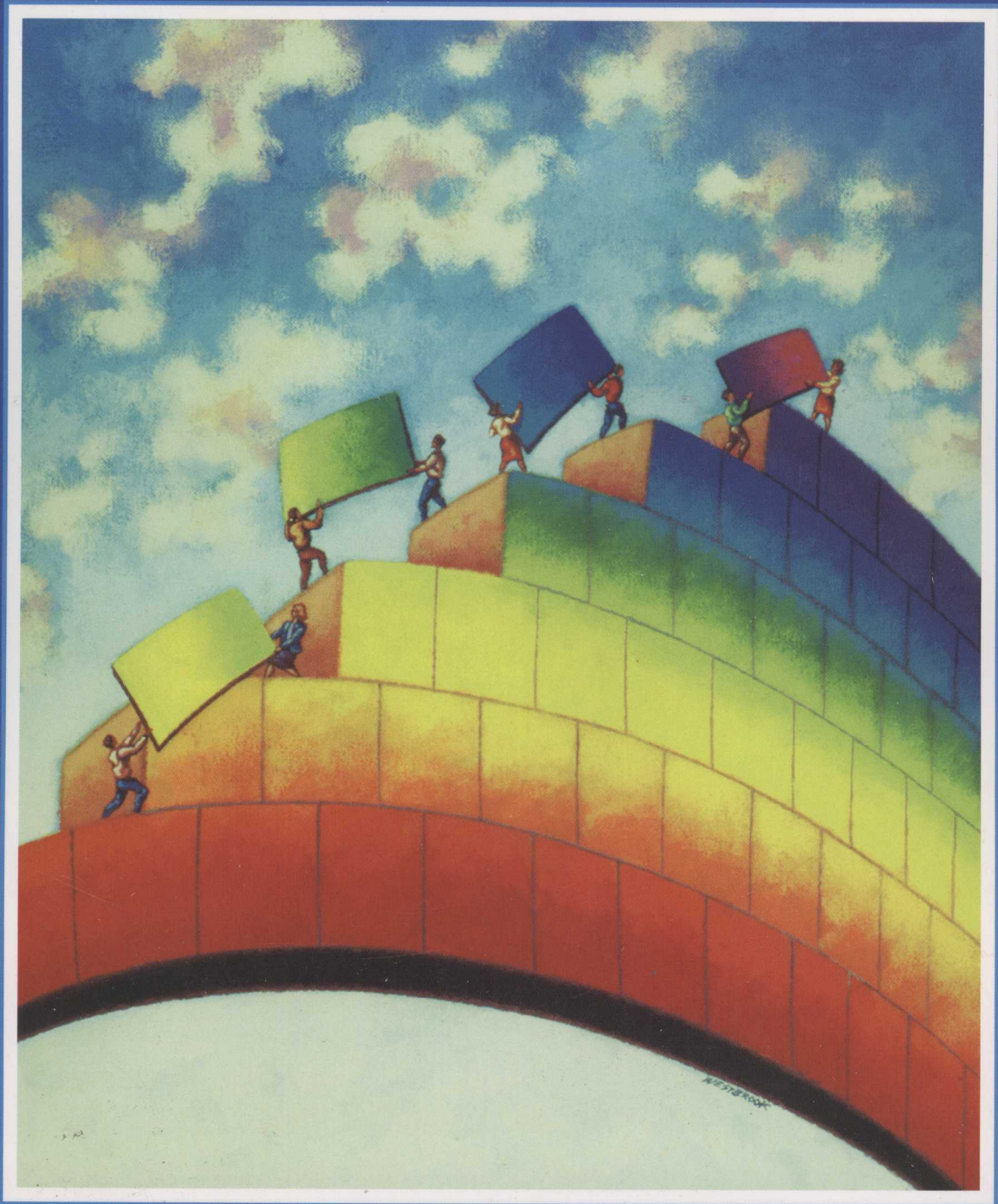


# AUDITING CASES

*An Interactive Learning Approach*

SECOND EDITION



BEASLEY ■ BUCKLESS ■ GLOVER ■ PRAWITT



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*An Interactive Learning Approach*

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Prentice  
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## Preface

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In recent years many accounting practitioners and academics have requested accounting educators to increase the emphasis on the development of students' critical thinking, communication, and interpersonal relationship skills. Development of these types of skills requires a shift from passive involvement to active involvement of students in the learning process. Unfortunately, current course materials provided by many publishers are not readily adaptable to this more active learning environment. The objective of writing this casebook was to develop course materials that would provide students hands-on-exposure to realistic cases involving all aspects of the audit process.

This casebook contains a collection of 36 auditing cases that address most major activities performed during the conduct of an audit from client acceptance to issuance of an audit report. Many of the cases are based on actual companies, some of which were engaged in financial reporting fraud. Several cases involve students working with realistic audit evidence and preparing and evaluating audit documentation. Some of the cases expose students to assurance and other value added services.

The cases included in this book are suitable for both undergraduate and graduate students. At the undergraduate level, the cases provide students with active learning experiences that reinforce key audit concepts addressed by the instructor and textbook. At the graduate level, the cases provide students with active learning experiences that expand the depth of their audit knowledge. Use of the casebook will provide undergraduate and graduate students with opportunities to develop critical thinking, communication, and interpersonal relationship skills.

The casebook provides a wide variety of cases to facilitate different learning and teaching styles. For example, several of the cases can be used either as in-class exercises or out-of-class assignments. The instructor resource manual accompanying the casebook clearly illustrates the different instructional approaches available for each case (e.g., examples of cooperative / active learning activities and identification of which cases are useful for brief in-class exercises and / or out-of-class individual or group assignments) and efficiently prepares the instructor for leading interactive discussions. To access this manual, log onto [www.prenhall.com/beasley](http://www.prenhall.com/beasley).

## ACKNOWLEDGMENTS

We would like to thank our families for their understanding and support while writing this casebook. We would also like to thank our editor, Thomas Sigel, for his support with this endeavor.

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**Case 1**  
**Jacksonville Jaguars:**  
**Evaluating IT Benefits and Risks and**  
**Identifying Assurance Services Opportunities**

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

## **LEARNING OBJECTIVES**

After completing and discussing this case, you should be able to

- Identify benefits to businesses from implementing information technologies
- Recognize risks that are associated with the use of information technology (IT)
- Determine how CPAs can provide assurance about processes designed to reduce risks created when new IT systems are introduced
- Understand ways CPAs can identify new assurance services opportunities, including the AICPA's *SysTrust*® service
- Prepare a formal business memorandum

## **INTRODUCTION – PART A**

The Jacksonville Jaguars National Football League (NFL) team is taking advantage of information technology (IT) tools in the sale of stadium snacks and souvenirs. At Alltel Stadium where the Jaguars play their home games, football fans can use Spot Cards to purchase soft drinks, beer, popcorn, and Jaguar souvenirs rather than fumble for cash and change when making their purchases.<sup>1</sup> These reloadable Spot Cards,

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<sup>1</sup>Many of the facts about the Spot Card system are based on an article titled, "Jacksonville Jaguars Fans Score Big with Smart Cards," by Maura McEnaney which appeared in *EC World*, January 1998, pp. 24–27.

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.

which contain an embedded computer chip, operate in a manner similar to other smart cards such as Kinko's ExpressPay cards and many university student identification cards used for fee payment, meal and book purchases, and building access.

Not only does the Spot Card offer benefits to fans in the stadium, but the use of IT offers advantages for snack and souvenir vendors by providing better information for monitoring their businesses. Although IT offers improvements for the fans and vendors, those who rely on the Spot Card to process sales need assurance that the technology and related information produced is accurate and reliable.

CPAs are in a position to leverage their independence and their information accumulation and evaluation skills, among other abilities, to provide assurance to those relying on IT. The use of the Spot Card at Alltel Stadium offers opportunities for CPAs to provide valuable assurance particularly to stadium management and vendors who must rely on this IT to do business.

## **BACKGROUND ABOUT THE JAGUAR'S SPOT CARD**

The implementation of the Spot Card at the stadium in Jacksonville in the fall of 1995 represents one the first uses of that type of IT in a major sports stadium. The stadium contracted with First Union Bank, based in Charlotte, North Carolina, to develop and implement the Spot Card system. First Union contracted with Diebold Incorporated of Canton, Ohio, which manufactures card-based transaction systems, to develop the Spot Card system.

Customers purchase Spot Cards in various denominations such as \$20, \$50, and \$100. ATM-like machines in the stadium allow fans to transfer funds from their bank or credit card onto an electronic chip on the Spot Card. Fans can also buy cards with cash or with a debit card. Other terminals are also located in various First Union branches around Jacksonville. Card readers located throughout the stadium allow fans to check the balances remaining on their cards.

Fans purchasing snacks and souvenirs present their Spot Card to vendors at concession and souvenir stands, who calculate sales amounts and swipe the cards through point-of-sale (POS) machines. Software tracks each transaction for vendors. Before the transaction is complete, fans review the amount to be deducted and punch the "Yes" key on the POS machine. At that point, the POS device deducts the purchase amount from the chip-embedded balance on the fan's Spot Card. These cards can also be used at battery-operated POS computers carried by vendors who roam the stadium stands selling merchandise during the game.

The POS machines capture information about each transaction. The system records the card number, location code, and the date and time of the transaction as well as the items sold. That information is later summarized for vendors.

Once the game is over, vendors link their POS machines to a network that allows the transfer of data stored on each POS machine to a computer located in the stadium counting room. Once all the data are downloaded to that computer, the information is then transmitted to a host computer at First Union Bank in Jacksonville. The host computer uses the data transmitted to settle that day's sales with each vendor in the stadium. The host computer produces various reports, which provide vendors detailed information to track sales volume for specific products in specific sections of the stadium.

First Union Bank receives a fee from every Spot Card transaction, and the bank collects whatever remains on an unused Spot Card at the end of two years. First



Union also sells player-signature Spot Cards with pictures of selected Jaguar players on the front for an additional fee.

Other stadiums around the country, such as the Carolina Panthers' stadium in North Carolina, have started to use similar technologies. As fans grow more accustomed to the use of transaction cards like the Spot Card, there will undoubtedly be expanded opportunities for using the cards to pay for stadium parking or merchandise and promotions outside the stadium.

## OPPORTUNITIES FOR CPAS TO PROVIDE ASSURANCE

The American Institute of Certified Public Accountants (AICPA) continues to develop new CPA "assurance services" opportunities. These services are designed to allow CPAs to provide assurance about the reliability and relevance of information decision-makers use to run their businesses.

Certain forms of assurance services have always been performed by CPAs. For example, auditors of historical financial statements provide assurance about whether those financial statements are in conformity with generally accepted accounting principles. Continuous changes in IT will provide new opportunities for CPAs to provide assurance regarding the accuracy, reliability and relevance of information produced by these technologies. Organizations will have greater need for assurance on systems and controls as IT continues to play a larger role in business.

One of these newly developed services, AICPA SysTrust<sup>®</sup>, relates to assurance regarding IT systems reliability. In these engagements, CPAs can provide users with assurance that an IT system has been properly designed and produces reliable data. In doing so, CPAs might test the integrity of an information system by analyzing sample IT output for accuracy. Assurance providers can also provide valuable services to help organizations determine whether systems are secure and whether adequate contingency plans are in place in the event of system failure or disaster.

As First Union and its competitors attempt to market Spot Card technologies to other stadiums and businesses, there may be opportunities for CPAs to provide assurance that the processes related to this technology produce accurate and reliable information. Providers, such as First Union, can then use the assurance to better market their products.

## REQUIRED – PART A

1. To become more familiar with emerging assurance services opportunities, review the Assurance Services site at the AICPA's Web page ([www.aicpa.org](http://www.aicpa.org)). The Assurance Services Site link on the opening page of this web site provides a great overview of the information contained in this site. Search this web site about assurance services to complete the following exercises:
  - a. Summarize in your own words the definition of assurance services
  - b. Describe the 10 major themes the Special Committee on Assurances Services used to develop the new assurance service opportunities
  - c. Drill down under the link "About Assurance Services" to locate the link for the "Future of the Financial Statement Audit." Read the Executive Summary and describe the "old paradigm" and "new paradigm" for providing assurance
  - d. Describe briefly these assurance services: *WebTrust*, *SysTrust*, *ElderCare*, and *CPA Performance View*
  - e. Explore the information about the *SysTrust* service and describe the

- Basic objective of this service
  - Four Principles that CPAs use to assess system reliability
  - Parties likely to benefit from this service
  - Reasons why CPAs have a competitive edge for conducting *SysTrust* engagements
2. The use of IT offers tremendous advantages. What benefits does the use of Spot Cards offer to following groups:
    - Jaguar stadium snack and souvenir vendors?
    - Fans in the stadium?
    - First Union Bank?
  3. While the Spot Card offers several benefits, the use of the related information technology to process snack and souvenir transactions does create new risks. Identify risks for the following groups:
    - Snack and souvenir vendors
    - Fans in the stadium
    - First Union Bank
  4. What processes or controls could the stadium and First Union implement to help reduce these risks?
  5. How might CPAs be able to structure an assurance services engagement to assure stadium vendors that information processed through the Spot Card system is reliable? What kind of information could the CPA examine and evaluate in order to assure stadium vendors that they can reasonably rely on the Spot Card system to conduct business?

## INTRODUCTION - PART B

After completing Part A of this assignment, your instructor may ask you to complete Part B. Do not proceed to Part B unless requested to do so by your instructor.

## BACKGROUND

Congratulations!!! You were recently promoted to audit manager. Your strong work ethic and, of course, your excellent college training have propelled your career to new heights.

One of the challenges of your new role is that you are now held accountable (i.e., raises, bonuses, the partnership!) for bringing in new business. You have been regularly reading the financial business press (i.e., newspapers, business magazines) to see if you can identify new service opportunities.

The managing partner came to you today and asked if you know of any companies that recently introduced new IT that could lead to consulting or assurance services opportunities. He is particularly interested in identifying opportunities to provide some form of assurance about risks related to newly implemented IT. After you indicated you are actually working on a couple of ideas, he was excited to hear more. He asked you to prepare a memorandum outlining your answers to address the following issues:

## REQUIRED - PART B

1. Please describe a situation where a company recently introduced a new IT into their business operations. You should look for a real world example from the business press. Look for a business that recently increased its reliance on IT. The Spot Card technology used at the Jacksonville Jaguars stadium is a good example. Please attach a copy of the article you use to prepare your memorandum.
2. Please describe the new technology and how it is used. Provide enough information for the partner to understand the technology without having to go back to the attached article.
3. Explain why the company introduced the technology. Highlight the benefits to various constituents affected by the technology. The benefits related to the technology are probably easily identified and may even be discussed in the related article. However, the article does not likely address risks that are introduced. Please provide a thorough discussion of the risks to all parties affected by the new technology.
4. Given the risks identified, describe whether there are any related assurance services and discuss who would likely buy these services. Describe information risks about which your firm intends to provide assurance. Your memo will serve as the basis for the formal business proposal that will be sent to the potential client. Please be sure to briefly outline in your memo what assurance services are because the potential client may not have heard the terms. Make sure you explain the term “assurance services” in your own words so that the potential client has a better idea of exactly what services you propose to provide.

5. In describing the nature of the assurance services that you plan to provide, please highlight the types of evidence you would want to gather as a basis for providing the assurance. For example, you might consider evaluating the contingency plan describing how the company would deal with breakdowns in technology hardware or software or the communication infrastructure. In this example, you would want to specifically describe what types of information you would look for in that plan.

Your partner is very busy and doesn't want your memo to be too long. So, strive to be clear and concise and be sure to attach the related article(s) to your memo. Try to step out of the typical accountant's box and be creative!!! You'll be expected to do so in the real world.

One of the challenges of your new role is that you are now responsible for identifying new business opportunities (e.g., clients, business partners, etc.) for the firm. You have been assigned the task of identifying new business opportunities in the technology industry. The managing partner wants to know if you know of any opportunities that recently introduced new IT that could lead to consulting or assurance services opportunities. He is particularly interested in identifying opportunities to provide some form of assurance about risks related to newly implemented IT. After you indicated you are working on a couple of ideas, he was excited to hear that the idea was to prepare a memorandum analyzing your answers to address the following issues:

## REQUIRED - PART B

1. Please describe a situation where a company recently introduced a new IT into their business operations. You should look for a real world example from the business press. Look for a business that recently increased its reliance on IT. The spot (and technology used at the Jacksonville Jaguars stadium is a good example. Please attach a copy of the article you use to prepare your memorandum.
2. Please describe the new technology and how it is used. Provide enough information for the partner to understand the technology without having to go back to the attached article.
3. Explain why the company introduced the technology. Highlight the benefits to various components affected by the technology. The benefits related to the technology are typically easily identified and may even be discussed in the attached article. However, the article does not likely address risks that are inherent. Please provide a thorough discussion of the risks to all parties affected by the new technology.
4. Given the risks identified, describe whether there are any related assurance services and discuss what you think might be the best type of assurance service to provide for the firm's clients in this situation. Your memo will serve as the basis for the formal business proposal that will be sent to the potential client. Please be sure to briefly outline in your memo what assurance services the potential client may not have heard the term. Make sure you explain the term "assurance services" in your own words so that the potential client has a better idea of exactly what services you propose to provide.



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**Case 2**  
**Your 1040.com:**  
**Evaluating eBusiness Revenue Recognition,**  
**Information Privacy, and**  
**Electronic Evidence Issues**

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

## **LEARNING OBJECTIVES**

After completing and discussing this case, you should be able to

- Identify business risks for Internet-only business models
- Recommend internal control improvements for an eBusiness-based company
- Understand selected eBusiness related revenue recognition issues
- Identify accounting issues that arise when Internet-only companies exchange in banner ad services
- Recognize issues surrounding the privacy of customer information
- Describe audit implications when transaction evidence is solely electronic
- Recognize threats to eBusiness strategies, which rely solely on the delivery of services via Internet

## **INTRODUCTION**

After being in business for only two years, Your1040.com has quickly become a leading provider of online income tax preparation and filing services for individual taxpayers.<sup>1</sup> Steven Chicago founded the company after a business idea came to him while shopping for individual tax preparation software. As he stared at all the

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<sup>1</sup>Your1040.com is a fictitious company developed solely for instructional use in this case. All characters and names represented are fictitious, and any similarity to existing companies or persons is purely coincidental.

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.

software packages on the shelves at a local computer supply store, the following thought kept racing through his mind:

*"With all of the tax law changes from year to year, why should I shell out \$50 for a CD that will be obsolete next year, not to mention the \$20 I have to pay to file my taxes electronically over the Internet? Too bad a company doesn't exist that charges me a small membership fee to use continually updated tax preparation software. I'd sure pay for a service like that."*

Not long after his shopping experience, Chicago, an entrepreneur at heart, decided to create such a company. Just one year later, Your1040.com began operations in time for the next tax season.

## OVERVIEW OF YOUR1040.COM OPERATIONS

Your1040.com is an entirely Internet-based tax preparation web site for preparing and filing federal and state individual income tax returns. Most of its revenues come from individuals seeking to avoid preparation of a paper-based tax return and who are willing to "rent" access to a popular tax preparation software package through Your1040.com. Other revenues come from individuals wanting to electronically file an already prepared paper-based return.

For a minimal fee, Your1040.com provides an interface for individuals to electronically file their returns with the appropriate federal and state regulatory bodies. Typical users come from middle-class households wanting to simplify yearly tax return preparation tasks. These users are generally searching for an accurate, easy, and economic alternative to other professional tax services.

Individuals can access these services through Your1040.com's web site. To log on, customers must first register for a user name and password. Once the customer logs on with the information, they are prompted to provide their full name, mailing address, Social Security number, birth date, phone number, email address, and a major credit card number. This registers the individual on Your1040.com's web site and initiates the credit card approval process. Once the credit card number is validated, customers select from one of three service packages: Silver, Gold, or Platinum.

The Silver package provides basic tax services, including electronic access to tax forms, schedules, and publications. Customers can enter tax return information directly onto the forms and schedules, and Your1040.com will file the completed materials electronically, which eliminates the need for mailing paper copies to tax agencies. The Silver package also provides a service that allows customers to apply electronically for a return extension. The Silver package, however, does not give subscribers access to the tax preparation software package.

In addition to the benefits of the Silver package, the Gold package grants customers online access to a commercially developed and continually maintained tax preparation software package. The package helps customers easily prepare tax returns ranging from the simple 1040-EZ to a complex return, such as one filed by a self-employed businessperson with nationwide real estate investments and actively traded securities. Both the Gold and the Silver packages provide access to services for one tax season only.

Premium services are offered through the Platinum package, which allows customers to sign up for Your1040.com membership ranging between two to five years. Through this multiple-year package service, customers receive year-round access to the tax preparation software provided to Gold customers, which allows them to continually track changes to their tax basis in securities and periodically evaluate tax implications of possible transactions. Furthermore, Platinum customers receive personalized attention and real-time tax support from qualified income tax specialists, who work on a contract basis, via an online instant messenger program.

Your1040.com experiences high seasonal demand for its services from early February to the filing deadline of April 15. Because Your1040.com allows customers to apply for filing extensions online, the company also experiences strong demand for its services just before extension deadlines.

If the IRS finds a problem with a return submitted through Your1040.com, Your1040.com does not correct the problem, but informs the customer of the problem so that the individual can correct the error and refile the return free of charge. The estimated frequency and cost of expected refilings are factored into the price of the service packages.

Your1040.com does not handle tax refund or tax liability payments. If a customer is eligible for a refund, the IRS remits the payment directly to the taxpayer. If a customer is required to pay income taxes, the IRS simply charges the appropriate amount to the customer's credit card number that is electronically submitted with the income tax return. Your1040.com assumes no liability for inappropriately filed returns or the tax positions of its customers. All liability resides with the customer who prepared the return.

Your1040.com recognizes revenue differently for each product. The revenue for the first year of Platinum service is recognized immediately after the customer selects this option. The company assumes customers will use the package for an entire year without cancellation even though Your1040.com has a fairly simple cancellation policy. All revenues from subsequent years of Platinum service are recognized in like manner. For the Gold package, a portion of the revenue is recognized when the customer accesses the tax preparation software package via the Internet for the first time. The company recognizes the remaining revenue when the customer submits the return to the IRS. The company does not recognize revenue for the Silver package until the customer submits a return to the IRS.

In addition to fees generated for its individual tax preparation services, Your1040.com engages in ad swapping with a number of major Internet companies. For example, Amazon.com swapped a significant amount of advertising with Your1040.com from January to April of this year. Amazon.com placed a banner ad on its web site reminding visitors to visit Your1040.com for all of their tax needs. In exchange for this ad, Your1040.com placed a similar ad directing its visitors to shop online at Amazon.com.

## **SECURING CUSTOMER INFORMATION**

Protecting unauthorized access to customer information is a high priority at Your1040.com. The company houses its web server and microcomputers, which run critical applications, in a key-coded room accessible only to the programmer and Chicago, the CEO. The web server is also protected by a proxy-server firewall to prevent outside hackers from attacking the database. In addition to these security

measures, all customers are required to create alphanumeric passwords that are at least six characters in length, to prevent unauthorized access to customer accounts.

Your1040.com does not maintain a “bricks and mortar” storefront or interact face-to-face with customers. The company engages in all transactions electronically and stores all purchase orders, sales invoices, and advertising contracts in electronic form. The company backs up data daily, but the backup data are not readily available at all times. After six months of soft storage on the company’s server network, backup files are removed from the network to free up the limited storage capacity. The files are downloaded to compact discs for storage and future retrieval. A significant upgrade of Your1040.com’s limited information system is in the planning stages.

Two of Chicago’s nephews—Nathan Randall and Matthew Gilbert—oversee the maintenance of the company’s information system. Both employees will graduate with degrees in Information Systems at the end of the semester from a local university and will begin working full time for the company after graduation. The accounting system is maintained by Chicago’s niece, Emily Parkin, who is a Master’s student studying accounting. She has been with the company since the beginning and is responsible for the preparation of all internal financial statements.

Given the growth in the number of individuals using Your1040.com’s services, several marketing executives have recently begun to offer Chicago large sums of money for purchasing Your1040.com’s customer lists. Although Chicago has yet to formally draft an official privacy statement for his company, he feels responsible for the privacy of his customers’ information and is unsure if he should sell the lists. The cash offers have been tempting, however, given that the money would allow him to move ahead with planned information system upgrades. In the meantime, Chicago arranged a line of credit with a local bank to fund the upgrades. As part of that financing transaction, the bank has required an audit of Your1040.com’s annual financial statements.

## REQUIREMENTS

1. You are an audit senior with Gooch & Brown CPA, LLP, a local accounting firm specializing in audits of information systems and financial statements. Your1040.com engaged your firm to perform its financial statement audit. You have been asked by the partner to perform the following tasks:
  - a. Describe to Steven Chicago why it is important for your firm to have an understanding of Your1040.com’s business model.
  - b. Identify Your1040.com’s major business risks and describe how those risks may increase the likelihood of material misstatements in Your1040.com’s financial statements.
  - c. What should Your1040.com do to improve its internal control?
  - d. What audit implications arise if you decide that the controls over electronic records at Your1040.com are inadequate to ensure that records have not been altered?
  - e. Authoritative literature provides guidelines for proper revenue recognition policies for transactions such as those discussed in the case. Analyze Your1040.com’s revenue recognition policies for the three package services. Provide appropriate citations to authoritative literature.



- f. How can you obtain evidence that ad swapping actually occurred between the Your1040.com and Amazon.com? Describe accounting issues that arise when Internet-based companies swap ad services and identify relevant authoritative literature.
  - g. Address a memo to Steven Chicago detailing the appropriate contents for a customer privacy policy. (You may want to visit other company web sites, such as [www.cpamoneywatch.com](http://www.cpamoneywatch.com), to see an example of a privacy policy.) Why is it important for Your1040.com to have an explicit privacy policy? How might the lack of a policy affect Your1040.com's financial statements in the future?
2. Statement on Auditing Standard No. 31, *Evidential Matter*, provides guidance for auditors when evaluating electronic evidence. What are the implications for an auditor when a client's accounting system produces and stores transaction evidence only electronically?
  3. Your1040.com's main business strategy involves the delivery of services via the Internet. What are some threats to the viability of Your1040.com's business strategy?
  4. When customers register for the Platinum package, they have online access to tax professionals who are paid on a contract basis. If you were in Steven Chicago's shoes, how would you compensate those professionals for their services? What controls could Your1040.com implement to ensure that the company does not overpay for those professional services?