CASE 2.2

Apple Inc.
Evaluation of Client Business Risk

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

[1] Describe the implications of an audit client's business risk on the audit engagement

[2] Describe the types of information relevant to evaluate an audit client's business risk

[3] Identify and evaluate the factors important in assessing an audit client's business risk and risk of material financial misstatement

INTRODUCTION[1]

Apple Inc. (Apple) is a worldwide provider of innovative technology products and services. Apple's products and services include iPhone®, iPad®, Mac®, iPod®, Apple TV®, a portfolio of consumer and professional software applications, the iOS and OS X® operating systems, iCloud®, and a variety of accessory, service and support offerings. The Company also sells and delivers digital content and applications through the iTunes Store®, App Store™, iBooks Store™, and Mac App Store. Net revenue for fiscal 2013 was $170.9 billion and net income was $37.0 billion.

Apple's common stock is traded on the NASDAQ national market, and Apple is required to have an integrated audit of its consolidated financial statements and its internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). The Company's fiscal year is the 52 or 53-week period that ends on the last Saturday of September. As of the close of business on October 18, 2013, Apple had 899,738,000 shares of common stock outstanding with a trading price of $508.89.

INFORMATION ABOUT THE AUDIT

Your firm, Smith and Jones, PA., is in the initial planning phase for the fiscal 2014 audit of Apple for the year ended September 27, 2014. As the audit senior, you have been assigned responsibility for gathering and summarizing information necessary to evaluate Apple's business risk. Your firm's memorandum related to the client business risk evaluation has been provided to assist you with this assignment. Assume no material misstatements were discovered during the fiscal 2014 audit.

1 The background information about Apple Inc. was taken from Apple Inc.'s Form 10-K for the fiscal year 2013 filed with the Securities and Exchange Commission.

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.

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REQUIRED

[1] Go to Apple's website (investor.apple.com) and explore the website. Click on the "SEC Filings" link. Obtain the most recent SEC Form 10-K provided for Apple. Based on the information obtained from the website and your knowledge of the industry, prepare a memo discussing the following items:

[a] Apple's:
- Sales
- Net income
- Cash flow from operating activities
- Total assets
- Number of employees

[b] What are Apple's products?

[c] Who are Apple's competitors?

[d] Who are Apple's customers?

[e] Who are Apple's suppliers?

[f] How does Apple market and distribute its products?

[g] What is Apple's basic business strategy (cost leadership or differentiation)?

[h] What are critical business processes for Apple given its basic business strategy (for example, supply chain management)?

[i] What accounting information is associated with the critical business processes and how does Apple measure up on that information?

[j] What accounting methods does Apple use to report the accounting information associated with critical business processes and what is the risk of material misstatement?

This memo is to be used as a foundation document for the preliminary business risk assessment. In evaluating Apple's performance and assessing the risk of misstatement, please be sure to describe your reasoning. Your memo should be double-spaced and addressed to the partner for the engagement (your instructor). Your firm demands polished, concise, professional analyses and writing. Be thorough, but get to the issues without unnecessary verbiage. In describing your analyses and conclusions, please consider relatively short "punchy" or to-the-point sentences. When appropriate, consider using bullet point listings.

[2] Professional auditing standards provide guidance on the auditor's consideration of an entity's business risks. What is the auditor's objective for understanding an entity's business risks? Why does an auditor not have responsibility to identify or assess all business risks? Provide some examples of business risks associated with an entity that an auditor should consider when performing an audit.

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Smith and Jones, PA.
Memorandum: Business Risk Evaluation

This memorandum provides a general framework for firm personnel when evaluating client business risk for purposes of determining the nature, timing, and extent of audit procedures. Knowledge about the nature of the client's business activities and related business risks provides a basis for the auditor's assessment of the risk of material misstatement. The auditor's assessment of the risk of material misstatement is used to determine the nature, timing, and extent of audit procedures. The intent of this memorandum is not to suggest that this framework must be followed on all audit engagements. The appropriateness of this framework must be determined on an engagement by engagement basis, using professional judgement.

Client business risk is the risk that a client's business objectives will not be achieved. Business risk results from the interaction of internal and external business forces. Clients achieve business objectives by setting strategies and then designing and implementing processes to execute those strategies. Strategies represent the overall approaches used by management to achieve its business objectives. Business risk is reduced when the client effectively aligns its business strategy and processes with the external business environment. Business risk is increased when the client does not effectively align its business strategy and processes with the external business environment or when new external business conditions emerge to weaken the alignment.

The dynamic nature of today's business environment requires that clients do more than develop processes to execute their current business strategy. Clients must also develop processes to monitor the changing business environment and reorient their strategies and processes as environmental business conditions change. Clients must continually scan their business environments for changes that may threaten achievement of their business objectives.

To assess the risk of material misstatement auditors must understand the client's current business strategy and environment along with emerging business forces that may require reorientation of its current strategies and processes. A proper analysis of a client's business risk requires an understanding of the client's business strategy, the client's internal business processes, and emerging business forces. Important aspects of understanding each of these dimensions are discussed below.

Understand Emerging Business Forces

The starting point for performing a business risk analysis is to understand the external business environment in which the client operates. This analysis is an essential first step because it allows the auditor to properly frame the subsequent analysis of the client's strategy and internal business processes. Understanding the client's business environment enables the auditor to assess the sustainability of the client's business strategy and to identify critical business processes.

External business forces influencing business risk are:

- **Customers** – aspects to consider include size and number of customers in industry, availability of competitor products or services, similarity of competitor products or services, ability of customers to switch to competitor products or services, complementary/substitute products or services, and desired qualities/features of products or services.
- **Competitors** – aspects to consider include number and size of firms in industry, maturity of products or services in industry, production capacity of firms in industry, required capital investment to enter industry, availability/access to distribution channels, and legal or regulatory barriers to industry.
- **Suppliers** – aspects to consider include number and size of suppliers in industry, number and size of customers for supplier products or services, relative importance of supplier products or services to client's products or services, similarity of supplier products or services, complementary/substitute products or services, and cost of switching suppliers.
- **Labor** – aspects to consider include required competencies of employees, availability of employees, and other employment opportunities for employees.

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- **Capital market** – aspects to consider include availability of investors and creditors and alternative investment opportunities available to investors and creditors.
- **Regulations** – aspects to consider include nature of and changes to regulatory oversight and global differences in regulatory oversight.

Understand Business Strategy

The next step in evaluating the client's business risk is to understand the client's strategy to gain a competitive advantage. The sustainability of a client's competitive advantage is dependent on the external business environment. Changes in the external business environment may render the client's current business strategy ineffective. An understanding of the client's business strategy is also necessary to identify critical business processes for the client.

Business strategies influencing business risk can be broadly categorized as:

- **Cost leadership** – objective is to supply products or services at the lowest cost. Clients using this strategy have organizational structures and processes that promote cost control. These clients are primarily concerned with efficient production processes, lower input costs, lower overhead costs, and simple product design.
- **Differentiation** – objective is to supply products or services that are unique on some dimension valued by customers. Dimensions clients may use to differentiate include product/service quality, product/service features, product/service variety, product/service image, product/service support, or product/service delivery. Clients using this strategy have organizational structures and processes that promote creativity and innovation. These clients are primarily concerned with research and development, engineering, and/or marketing capabilities.

Regardless of the business strategy selected by a client, the other differentiation dimensions cannot be completely ignored. Clients focusing on cost leadership still must have products that customers desire and thus cannot completely ignore the product/service dimensions valued by customers. Similarly, clients focusing on differentiation still need to deliver their products or services at a reasonable price.

Evaluation of Internal Business Processes

The final step in evaluating the client's business risk is to understand and evaluate critical business processes. Success of a business strategy is not automatic. Business strategies fail because of changes in the external business environment and/or flawed client business processes. Clients must implement business processes that develop and maintain the core competencies necessary to execute the business strategy and sustain competitive advantage.

Internal business processes influencing business risk are broadly categorized as:

- **Control environment** – organizational processes concerned with integrity and ethical values, commitment to competence, board of directors and audit committee oversight, management's philosophy and operating style, organizational structure, and assignment of authority and responsibility.
- **Risk assessment** – organizational processes concerned with identification and analysis of risks associated with achieving business objectives.
- **Control activities** – organizational processes concerned with the execution of business strategies and achievement of business objectives. This includes core business processes related to product/service development, production, marketing, distribution, employee relations, supplier relations, and customer relations.
- **Information and communication system** – financial and non-financial information concerned with the measurement of the progress toward achievement of business objectives.
- **Monitoring system** – organizational process for evaluating the design, operation, and effectiveness of business processes.

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Asher Farms Inc.
Understanding of Client's Business Environment

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

[1] Describe the implications of an audit client's business environment on the audit engagement strategy

[2] Identify factors affecting an audit client's environment and related business risk

[3] Link business risk factors to the risk of material misstatements in financial statement accounts

INTRODUCTION

Asher Farms, Inc. is a fully-integrated poultry processing company engaged in the production, processing, marketing and distribution of fresh and frozen chicken products. Asher Farms sells ice pack, chill pack and frozen chicken, in whole, cut-up and boneless form to retailers, distributors, and casual dining operators principally in the southeastern and southwestern United States. During its fiscal year ended October 31, 2014 the company processed 343.6 million chickens, or approximately 2.0 billion dressed pounds. Based on industry statistics, Asher Farms is one of the largest processors of dressed chickens in the United States based on estimated average weekly processing. Asher Farms' common stock is traded on the NASDAQ national market with an aggregate market value of $677 million on October 31, 2014.

Asher Farms' chicken operations presently encompass 7 hatcheries, 6 feed mills and 8 processing plants employing 1,059 salaried and 8,646 hourly employees. The company has contracts with operators of approximately 530 broiler farms that provide the company with sufficient housing capacity for its current operations. Asher Farms also has contracts with 173 breeder farm operators and 44 pullet farm operators.

INFORMATION ABOUT THE AUDIT

Asher Farms is required to have an integrated audit of its consolidated financial statements and its internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Your firm, Smith and Jones, PA., recently accepted Asher Farms as an audit client and as a staff auditor you have been asked to obtain some preliminary information about the poultry industry to provide a basis for understanding the client's business environment. Background information about the poultry industry from Smith and Jones' industry database is provided for your review.

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. Asher Farms Inc. is a fictitious company. All characters and names represented are fictitious; any similarity to existing companies or persons is purely coincidental.

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REQUIRED

[1] A useful approach for understanding a client's business environment and associated business risks is to perform a PESTLE analysis. PESTLE is an acronym for Political, Economic, Social, Technological, Legal and Environmental factors that are used to asses the client's business environment. A PESTLE analysis focuses on factors that may affect an entity's business model, but are beyond the control or influence of the client. While beyond management's direct influence, such factors may significantly impact an entity's business risk. Read the background information about the poultry industry and conduct additional research on the internet to obtain the latest news and information on the industry. Brainstorm political, economic, social, technological, legal and environmental factors that could affect Asher Farms' business risk. Unless your instructor indicates otherwise, identify at least one business risk factor for each component of the PESTLE acronym.

[2] For each of the business risk factors identified in question 1 above, indicate how each risk factor might impact the risk of material misstatements in specific financial statement accounts or disclosures.

[3] Professional auditing standards provide guidance on the auditor's consideration of an entity's business environment and associated business risks. (a) What is the auditor's objective for understanding an entity's business environment? (b) Why does an auditor not have responsibility to identify or assess all business risks? (c) Provide some examples of business risks associated with an entity that an auditor should consider when performing an audit. (d) Provide some additional examples of business risks that might not lead to a risk of material misstatement in the financial statements.

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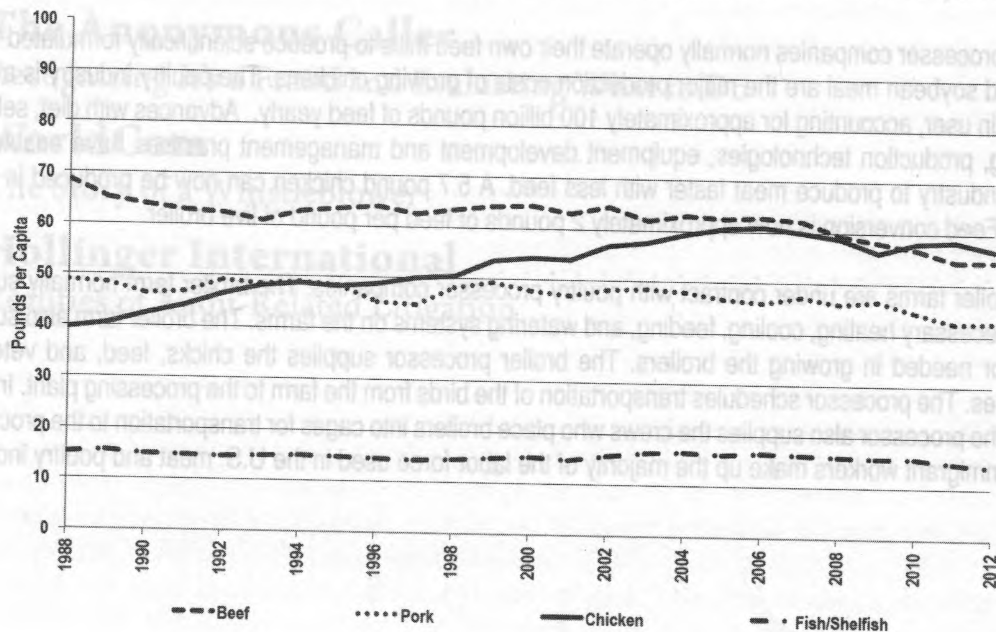
Smith and Jones, PA.
Background Information: Poultry Industry

Consumption

Over the past decade, both the mix of meat products, which includes beef, pork, chicken, and fish related products, and actual levels of per capita consumption within many nations has changed dramatically. Improved technologies and infrastructure development has expanded production and trade in meat products. At the same time, changing lifestyles, incomes, and a growing awareness of health issues related to meat consumption altered the patterns of meat demand worldwide. The large increase in meat consumption has been largely met by the worldwide growth in intensive livestock production, particularly poultry. This is expected to continue as real income grows in the emerging economies around the world.

The U.S. poultry industry is the world's largest producer and second largest exporter of poultry. U.S. consumption of poultry (broilers, other chicken, and turkey) is the fastest growing segment of all meats. Per capita consumption of meats in the United States from 1988 to 2012 is presented in Figure 1 (Source: U.S. Department of Agriculture).

Figure 1: US Beef, Pork, Chicken and Fish Consumption



With about 18 percent of total poultry production being exported, the U.S. poultry industry is heavily influenced by currency fluctuations, trade negotiations, and economic growth in its major importing markets.

Production

U.S. broiler chicken production is concentrated in a group of States stretching from Delaware, south along the Atlantic coast to Georgia, then westward through Alabama, Mississippi, and Arkansas. The top broiler-producing State is Georgia, followed by Arkansas, Alabama, Mississippi, and North Carolina. The poultry production industry faces issues common to most businesses, as well as issues that are unique to agriculture and the production of animal-based food products.

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There are seven stages involved in getting chicken meat to the consumer:

- Breeder flock
- Pullet farm
- Breeder farm
- Hatchery
- Broiler farm
- Processing
- Distribution

The production of broiler chickens for meat consumption begins with the grandparent breeder flocks. Breeder flock operators specialize in producing the generations of male and female strains that generate the parents that make the broiler chicken. The breeder flocks are raised to maturity in grandparent growing and laying farms where fertile eggs are produced. The fertile eggs are incubated at the grandparent hatchery to produce pullets. Pullets are young female breeder chickens that produce fertile hatching eggs that become broilers for the market. The pullets are sent to breeder farms to produce eggs. The eggs from the pullet breeder farms are sent to hatcheries for incubation. Hatched chicks are sent from the hatcheries to broiler farms. At the broiler farms the chicks are raised until they have reached the desired processing weight. Adult broiler chickens are caught and hauled to processing plants once they reach the desired processing weight at the broiler farms. The finished products are sent to distribution centers and then transported to customers.

Poultry processor companies normally operate their own feed mills to produce scientifically formulated feeds. Corn and soybean meal are the major production costs of growing chickens. The poultry industry is a major feed grain user, accounting for approximately 100 billion pounds of feed yearly. Advances with diet, selective breeding, production technologies, equipment development and management practices have enabled the poultry industry to produce meat faster with less feed. A 5.7 pound chicken can now be produced in seven weeks. Feed conversion is now approximately 2 pounds of feed per pound of live broiler.

Most broiler farms are under contract with poultry processor companies. The broiler farm normally supplies all the necessary heating, cooling, feeding, and watering systems on the farms. The broiler farm also supplies the labor needed in growing the broilers. The broiler processor supplies the chicks, feed, and veterinary medicines. The processor schedules transportation of the birds from the farm to the processing plant. In many cases, the processor also supplies the crews who place broilers into cages for transportation to the processing plant. Immigrant workers make up the majority of the labor force used in the U.S. meat and poultry industry.

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CASE 4.5

Xerox Corporation

Evaluating Risk of Financial Statement Fraud

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

[1] Describe the auditor's responsibility to detect material misstatements due to fraud

[2] Recognize risk factors suggesting the presence of fraud

[3] Describe auditor responsibilities for assessing the reasonableness of management's estimates

[4] Describe processes that can be used by audit firms to reduce the likelihood that auditors will subordinate their judgments to client preferences

[5] Identify audit procedures that could have been performed to assess the appropriateness of questionable accounting manipulations used by Xerox

INTRODUCTION

Xerox Corporation (Xerox), once a star in the technology sector of the economy, found itself engulfed in an accounting scandal alleging that it was too aggressive in recognizing equipment revenue.[1] The complaint filed by the Securities and Exchange Commission (SEC) alleged that Xerox used a variety of accounting manipulations over the period 1997 through 2000 to meet Wall Street expectations and disguise its true operating performance. The SEC alleged that between 1997 and 2000 Xerox overstated revenues by $3 billion and pre-tax earnings by $1.5 billion. Also engulfed in this scandal was KPMG, Xerox's auditor, whose actions were also investigated by the SEC for its possible involvement with the alleged accounting manipulations.

BACKGROUND

Xerox, a Stamford, Connecticut-based company, described itself as "the document company." At that time, Xerox focused on developing, manufacturing, marketing, servicing, and financing a complete range of document processing products and services to enhance its customers' productivity. It sold and leased document imaging products, services, and supplies to customers in the United States and 130 other countries. In 2000, Xerox had reported revenues of $18.7 billion (restated) and employed approximately 92,000 people worldwide. Xerox's stock trades on the New York and Chicago Stock Exchanges.

Fundamental changes have affected the document industry. The industry has steadily transitioned from black and white to color capable devices, from light-lens and analog technology to digital technology, from stand alone to network-connected devices, and from paper to electronic documents. Xerox's product revenues for 1997 through 1999 are shown on the next page.

1 The background information about this case was primarily obtained from 8-K's and 10-K's filed by Xerox with the Securities and Exchange Commission and Accounting and Auditing Enforcement Release Nos. 1542, 1796, 2235, 2333, 2379 issued by the Securities and Exchange Commission.

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.

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	1999	1998	1997
		(in billions)	
Digital products	$ 10.2	$ 8.6	$ 6.3
Light-lens copiers	5.8	7.4	8.3
Paper, Other products, currency	3.2	3.4	3.5
Total revenues	$ 19.2	$ 19.4	$ 18.1

Intense price competition from its overseas rivals during the late 1990s compounded the problems stemming from a changing business environment. Foreign competitors became more sophisticated and beat Xerox to the market with advanced color and digital copying technology. The intense competition and changing business environment made it difficult for Xerox to generate increased revenues and earnings in the late 1990s.

Unfortunately, several factors put pressure on Xerox to report continued revenue and earnings growth during this challenging period. The investment climate of the 1990s created high expectations for companies to report revenue and earnings growth. Companies that failed to meet Wall Street's earnings projections by even a penny often found themselves punished with significant declines in stock price. Xerox management also felt pressure to maintain its strong credit rating so it could continue to internally finance the majority of its customers' sales, by gaining access to the necessary credit markets. Finally, Xerox's compensation system put pressure on management to report revenue and earnings growth. Compensation of senior management was directly linked to Xerox's ability to report increasing revenues and earnings.

In 1998, management announced a restructuring program to address the emerging business challenges Xerox faced. Chairman and chief executive office (CEO) Paul A. Allaire, noted:

> *The markets we serve are growing strongly and transitioning rapidly to digital technologies. In the digital world, profitable revenue growth can only be assured by continuous significant productivity improvements in all operations and functions worldwide and we are determined to deliver these improvements. This restructuring is an important and integral part of implementing our strategy and ensuring that we maintain our leadership in the digital world. The continued adverse currency and pricing climate underscores the importance of continuous and, in certain areas, dramatic productivity improvements.*
>
> *This repositioning will strengthen us financially and enable strong cash generation. We have strong business momentum. We have exciting market opportunities and excellent customer acceptance of our broad product line. These initiatives will underpin the consistent delivery of double-digit revenue growth and mid- to high-teens earnings-per-share growth. This restructuring is another step in our sustained strategy to lead the digital document world and provide superior customer and shareholder value* (Source: Form 8-K, April 8, 1998).

Chief operating officer (COO), G. Richard Thoman, noted:

> *Xerox has accomplished what few other companies have — foreseen, adapted to and led a major transformation in its market. As our markets and customer needs continue to change, Xerox will continue to anticipate and lead. We are focused on being the best in class in the digital world in all respects. To enhance our competitive position, we must be competitive in terms of the cost of our products and infrastructure, the speed of our response to the marketplace, the service we provide our customers and the breadth and depth of our distribution channels* (Source: Form 8-K filed with SEC).

Selected financial information from Xerox's 1997 through 2000 financial statements is presented on the opposing page (before restatement).

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	For the Year Ended December 31			
	2000	1999	1998	1997
	(in millions)			
Revenues	$ 18,632	$ 19,228	$ 19,447	$ 18,144
Cost and expenses (excluding income taxes)	19,188	17,192	18,684	16,003
Income/(loss) from continuing operations	(384)	1,424	585	1,452
Net income/(loss)	(384)	1,424	395	1,452
Cash flows from operating activities	(827)	1,224	(1,165)	472

	As of December 31			
	2000	1999	1998	1997
	(in millions)			
Assets				
Cash	$ 1,741	$ 126	$ 79	$ 75
Accounts receivable, net	2,281	2,622	2,671	2,145
Finance receivables, net	5,141	5,115	5,220	4,599
Inventory	1,930	2,961	3,269	2,792
Other current assets	2,001	1,161	1,236	1,155
Total current assets	13,094	11,985	12,475	10,766
Finance receivables	8,035	8,203	9,093	7,754
Land, building, and equipment, net	2,495	2,456	2,366	2,377
Investments in affiliates	1,362	1,615	1,456	1,332
Goodwill, net	1,639	1,724	1,731	1,375
Other assets	3,062	1,701	1,233	1,103
Investment in discontinued operations	—	1,130	1,670	3,025
Total assets	$ 29,687	$ 28,814	$ 30,024	$ 27,732
Liabilities and Equity				
Short-term and current portion of long-term debt	$ 2,693	$ 3,957	$ 4,104	$ 3,707
Accounts payable	1,033	1,016	948	776
Accrued compensation and benefit costs	662	630	722	811
Unearned income	250	186	210	205
Other current liabilities	1,648	2,161	2,523	2,193
Total current liabilities	6,286	7,950	8,507	7,692
Long-term debt	15,404	10,994	10,867	8,779
Postretirement medical benefits	1,197	1,133	1,092	1,079
Deferred taxes and other liabilities	1,933	2,263	2,711	2,469
Discontinued operations, liabilities, policyholders' deposits and other	—	428	911	1,693
Deferred ESOP benefits	(221)	(299)	(370)	(434)
Minorities' interests in equity subsidiaries	141	127	124	127
Obligation for equity put options	32	—	—	—
Company-obligated, mandatorily redeemable preferred securities of subsidiary trust holding solely subordinated debentures of the Company	638	638	638	637
Preferred stock	647	669	687	705
Common shareholders' equity	3,630	4,911	4,857	4,985
Total liabilities and equity	$ 29,687	$ 28,814	$ 30,024	$ 27,732

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The desired turnaround did not materialize in 1999. The worsening business environment had a negative affect on 1999 results. Revenues and earnings (before the restructuring charge) were down. Management's letter to shareholders in the 1999 annual report stated:

> *Our 1999 results were clearly a major disappointment. A number of factors contributed, some largely beyond our control. And the changes we're making to exploit the opportunities in the digital marketplace are taking longer and proving more disruptive than we anticipated. We remain confident, however, that these changes are the right ones to spur growth, reduce costs and improve shareholder value.*
>
> *We also saw intensifying pressure in the marketplace in 1999, as our competitors announced new products and attractive pricing. We're prepared to beat back this challenge and mount our own challenge from a position of strength* (Source: 1999 Xerox Annual Report).

ACCOUNTING MANIPULATIONS UNRAVELED

The SEC initiated an investigation in June 2000 when Xerox notified that agency of potential accounting irregularities occurring in its Mexico unit. After completing its investigation, the SEC alleged that Xerox used several accounting manipulations to inflate earnings from 1997 through 1999 including:

- ***Acceleration of Lease Revenue Recognition from Bundled Leases.*** The majority of Xerox's equipment sales revenues were generated from long-term lease agreements where customers paid a single negotiated monthly fee in return for equipment, service, supplies and financing (called bundled leases). Xerox accelerated the lease revenue recognition by allocating a higher portion of the lease payment to the equipment, instead of the service or financing activity. Generally accepted accounting principles (GAAP) allow most of the fair market value of a leased product to be recognized as revenue immediately if the lease meets the requirements for a sales-type lease. Non-equipment revenues such as service and financing are required to be recognized over the term of the lease. By reallocating revenues from the finance and service activities to the equipment, Xerox was able to recognize greater revenues in the current reporting period instead of deferring revenue recognition to future periods. The approach Xerox used to allocate a higher portion of the lease payment from the finance activity to equipment was called "return on equity." With this approach Xerox argued that its finance operation should obtain approximately a 15 percent return on equity. By periodically changing the assumptions used to calculate the return on equity, Xerox was able to reduce the interest rates used to discount the leases thereby increasing the allocation of the lease payment to equipment (and thus increasing the equipment sales revenue). The approach Xerox used to allocate a higher portion of the lease payment from services to equipment was called "margin normalization." With this approach Xerox allocated a higher portion of the lease payment to equipment in foreign countries where the equipment gross margins would otherwise be below gross margins reported in the United States due to foreign competition in those overseas markets. In essence, Xerox adjusted the lease payment allocations for bundled leases in foreign countries to achieve service and equipment margins consistent with those reported in the United States where competition was not as fierce.
- ***Acceleration of Lease Revenue from Lease Price Increases and Extensions.*** In some countries Xerox regularly renegotiated the terms of lease contracts. Xerox elected to recognize the revenues from lease price increases and extensions immediately instead of recognizing the revenues over the remaining lives of the leases. GAAP requires that increases in the price or length of a lease be recognized over the remaining life of the lease.
- ***Increases in the Residual Values of Leased Equipment.*** Cost of sales for leased equipment is derived by taking the equipment cost and subtracting the expected residual value of the leased equipment at the time the lease is signed. Periodically Xerox would increase

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the expected residual value of previously recorded leased equipment. The write-up of the residual value was reflected as a reduction to cost of sales in the period the residual value was increased. GAAP does not allow upward adjustment of estimated residual values after lease inception.

- ***Acceleration of Revenues from Portfolio Asset Strategy Transactions.*** Xerox was having difficulty using sales-type lease agreements in Brazil, so it switched to rental contracts. Because revenues from these rental contracts could not be recognized immediately, Xerox packaged and sold these lease revenue streams to investors to allow immediate revenue recognition. No disclosure of the change in business approach was made in any of Xerox's reports filed with the SEC.
- ***Manipulation of Reserves.*** GAAP requires the establishment of reserves for identifiable, probable, and estimable loss contingencies. Xerox established an acquisition reserve for unknown business risks and then recorded unrelated business expenses to the reserve account to inflate earnings. In other words, Xerox debited the reserve account for unrelated business expenses thereby reducing operating expenses and increasing net income. Additionally, Xerox tracked reserve accounts to identify excess reserves that could be used to inflate earnings in future periods as needed using similar techniques.
- ***Manipulation of Other Incomes.*** Xerox successfully resolved a tax dispute that required the Internal Revenue Service to refund taxes along with paying interest on the disputed amounts. Instead of recognizing the interest income during the periods 1995 and 1996, when the tax dispute was finalized and the interest was due, Xerox elected to recognize most of the interest income during the periods 1997 through 2000.
- ***Failure to Disclose Factoring Transactions.*** Analysts were raising concerns about Xerox's cash position. The accounting manipulations discussed above did nothing to improve Xerox's cash position. In an effort to improve its cash position, Xerox sold future cash streams from receivables to local banks for immediate cash (factoring transactions). No disclosure of these factoring transactions was made in any of the reports Xerox filed with the SEC.

Senior management allegedly directed or approved the above accounting manipulations frequently under protest from field managers who believed the actions distorted their operational results. Senior management viewed these accounting manipulations as "accounting opportunities." KPMG, Xerox's outside auditor, also questioned the appropriateness of many of the accounting manipulations used by Xerox. Discussions between KPMG personnel and senior management did not persuade management to change its accounting practices. Eventually KPMG allowed Xerox to continue using the questionable practices (with minor exceptions). The SEC noted in its complaint that:

> *Xerox's reliance on these accounting actions was so important to the company that when the engagement partner for the outside auditor [KPMG] challenged several of Xerox's non-GAAP accounting practices, Xerox's senior management told the audit firm that they wanted a new engagement partner assigned to its account. The audit firm complied* (Compliant: Securities and Exchange Commission v. Xerox Corporation, Civil Action No. 02-272789).

The aggregate impact of the previously listed accounting manipulations was to increase pretax earnings from 1997 to 1999 by the following amounts:

	For the Year Ended December 31				
	1997	1998	1999	2000	Total
			(in millions)		
The Total Net Impact to Pretax Earnings	$ 405	$ 656	$ 511	$ (55)	$ 1,517

Xerox's accounting manipulations enabled the company to meet Wall Street earnings expectations

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during the 1997 through 1999 reporting periods. Without the accounting manipulations, Xerox would have failed to meet Wall Street earnings expectations for 11 of 12 quarters from 1997 through 1999. Unfortunately, the prior years accounting manipulations and a deteriorating business environment caught up with Xerox in 2000. Xerox could no longer hide its declining business performance. There were not enough revenue inflating adjustments that could be made in 2000 to offset the lost revenues due to premature recognition in preceding years.

During the 1997 through 1999 reporting periods, Xerox publicly announced that it was an "earnings success story" and that it expected revenue and earnings growth to continue each quarter and year. The reported revenue and earnings growth allowed senior management to receive over $5 million in performance-based compensation and over $30 million in profits from the sale of stock. The SEC complaint also noted that Xerox did not properly disclose policies and risks associated with some of its unusual leasing practices and that it did not maintain adequate accounting controls at its Mexico unit. Xerox Mexico, pressured to meet financial targets established by corporate headquarters, relaxed its credit standards and leased equipment to high risk customers. This practice improved short-term earnings but quickly resulted in a large pool of uncollectible receivables. Xerox Mexico also improperly handled transactions with third-party resellers and government agencies to inflate earnings.

EPILOGUE

Xerox's stock, which traded at over $60 per share prior to the announcement of the accounting problems, dropped to less than $5 per share in 2000 after the questionable accounting practices were made public. In April 2002, Xerox reached an agreement to settle its lawsuit with the SEC. Under the Consent Decree, Xerox agreed to restate its 1997 through 2000 financial statements. Xerox also agreed to pay a $10 million fine and create a committee of outside directors to review the company's material accounting controls and policies. In June 2003, six senior executives of Xerox agreed to pay over $22 million to settle their lawsuit with the SEC related to the alleged fraud. The six executives were Paul A. Allaire, chairman and CEO; Barry B. Romeril, chief financial officer (CFO); G. Richard Thoman, president and COO; Philip D. Fishback, controller; and two other financial executives: Daniel S. Marchibroda and Gregory B. Tayler. Because the executives were not found guilty Xerox agreed to pay all but $3 million of the fines. All of these executives resigned their positions at Xerox.

PricewaterhouseCoopers replaced KPMG as Xerox's auditor on October 4, 2001. In April 2005, KPMG agreed to pay $22 million to the SEC to settle its lawsuit with the SEC in connection with the alleged fraud. KPMG also agreed to undertake reforms designed to improve its audit practice. In October of 2005 and February of 2006, four former KPMG partners involved with the Xerox engagement during the alleged fraud period each agreed to pay civil penalties from $100,000 to $150,000 and agreed to suspensions from practice before the SEC with rights to reapply from within one to three years. A fifth KPMG partner agreed to be censured by the SEC.

The alleged inappropriate accounting manipulations used in Xerox's financial statements resulted in multiple class action lawsuits against Xerox, management, and KPMG. In March 2008, Xerox agreed to pay $670 million and KPMG agreed to pay $80 million to settle a shareholder lawsuit related to the alleged fraud.[2]

2 "Xerox Settles Securities Lawsuit," News release issued by Xerox on March 27, 2008. See the following website: http://www.xerox.com.

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REQUIRED (CONTINUED ON NEXT PAGE)

[1] Financial information was provided for Xerox for the period 1997 through 2000. Go to the SEC website (www.sec.gov) and obtain financial information for Hewlett Packard Company for the same reporting periods. How were Xerox's and Hewlett Packard's businesses similar and dissimilar during the relevant time periods? Using the financial information, perform some basic ratio analyses for the two companies. How did the two companies financial performance compare? Explain your answers.

[2] Professional standards outline the auditor's consideration of material misstatements due to errors and fraud. (a) What responsibility does an auditor have to detect material misstatements due to errors and fraud? (b) What two main categories of fraud affect financial reporting? (c) What types of factors should auditors consider when assessing the likelihood of material misstatements due to fraud? (d) Which factors existed during the 1997 through 2000 audits of Xerox that created an environment conducive for fraud?

[3] Three conditions are often present when fraud exists. First, management or employees have an *incentive* or are under pressure, which provides them a reason to commit the fraud act. Second, circumstances exist – for example, absent or ineffective internal controls or the ability for management to override controls – that provide an *opportunity* for the fraud to be perpetrated. Third, those involved are able to rationalize the fraud as being consistent with their personal code of ethics. Some individuals possess an *attitude*, character, or set of ethical values that allows them to knowingly commit a fraudulent act. Using hindsight, identify factors present at Xerox that are indicative of each of the three fraud conditions: incentives, opportunities, and attitudes.

[4] Several questionable accounting manipulations were identified by the SEC. (a) For each accounting manipulation identified, indicate the financial statement accounts affected. (b) For each accounting manipulation identified, indicate one audit procedure the auditor could have used to assess the appropriateness of the practice.

[5] In its complaint, the SEC indicated that Xerox inappropriately used accounting reserves to inflate earnings. Walter P. Schuetze noted in a 1999 speech:

> *One of the accounting "hot spots" that we are considering this morning is accounting for restructuring charges and restructuring reserves. A better title would be accounting for general reserves, contingency reserves, rainy day reserves, or cookie jar reserves. Accounting for so-called restructurings has become an art form. Some companies like the idea so much that they establish restructuring reserves every year. Why not? Analysts seem to like the idea of recognizing as a liability today, a budget of expenditures planned for the next year or next several years in down-sizing, right-sizing, or improving operations, and portraying that amount as a special, below-the-line charge in the current period's income statement. This year's earnings are happily reported in press releases as "before charges." CNBC analysts and commentators talk about earnings "before charges." The financial press talks about earnings before "special charges." (Funny, no one talks about earnings before credits—only charges.) It's as if special charges aren't real. Out of sight, out of mind* (Speech by SEC Staff: Cookie Jar Reserves, April 22, 1999).

What responsibility do auditors have regarding accounting reserves established by company management? How should auditors test the reasonableness of accounting reserves established by company management?

[6] In 2002 Andersen was convicted for one felony count of obstructing justice related to its involvement with the Enron Corporation scandal (this conviction was later overturned by the United States Supreme Court). Read the "Enron Corporation and Andersen, LLP" case included in this casebook. (a) Based on your reading of that case and this case, how was Enron

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Corporation's situation similar or dissimilar to Xerox's situation? (b) How did the financial and business sectors react to the two situations when the accounting issues became public? (c) If the financial or business sectors reacted differently, why did they react differently? (d) How was KPMG's situation similar or dissimilar to Andersen's situation?

[7] On April 19, 2005, KPMG agreed to pay $22 million to the SEC to settle its lawsuit with the SEC in connection with the alleged fraud. Go to the SEC's website to read about the settlement of this lawsuit with the SEC (try, "http://www.sec.gov/news/press/2005-59.htm"). Do you agree or disagree with the findings? Explain your answer.

[8] The SEC outlines in Accounting and Auditing Enforcement Release No. 2234 its assessment of the Xerox fraud. Obtain and read a copy of the enforcement release (try http://www.sec.gov/litigation/admin/34-51574.pdf). Compared to the information presented in this case would your opinion of KPMG's audit performance change after reading the enforcement release. Explain your answer.

[9] The SEC outlines in Accounting and Auditing Enforcement Release No. 2234 five "undertakings" for KPMG to alter or amend its audit practices. Obtain and read a copy of the enforcement release (try http://www.sec.gov/litigation/admin/34-51574.pdf) and read the five "undertakings." Based on your reading of the five "undertakings," which elements of a system of quality control did KPMG have weaknesses? Explain your answer.

[10] A 2002 editorial in *BusinessWeek* raised issues with compensation received by corporate executives even when the company does not perform well. In 1980 corporate executive compensation was 42 times the average worker compensation while in 2000 it was 531 times the average worker compensation.[3] (a) Do you believe executive compensation levels are reasonable? (b) Explain your answer. (c) What type of procedures could corporations establish to help ensure the reasonableness of executive compensation?

PROFESSIONAL JUDGMENT QUESTIONS

It is recommended that you read the Professional Judgment Introduction found at the beginning of this book prior to responding to the following questions.

[11] KPMG has publicly stated that the main accounting issues raised in the Xerox case do not involve fraud, as suggested by the SEC, rather they involve differences in judgment.[4] (a)What is meant by the term professional judgment? (b) Which of the questionable accounting manipulations used by Xerox involved estimates? (c) Refer to professional auditing standards and describe the auditor's responsibilities for examining management-generated estimates and briegly describe the role of auditor professional judgement in evaluating estimates.

[12] Some will argue that KPMG inappropriately subordinated its judgments to Xerox preferences. What steps could accounting firms take to ensure that auditors do not subordinate their judgments to client preferences on other audit engagements?

[13] The SEC outlines in Accounting and Auditing Enforcement Release No. 2234 KPMG's alleged acts and ommisons (section C. 3.). Obtain and read a copy of the enforcement release (try http://www.sec.gov/litigation/admin/34-51574.pdf). Based on your reading of the enforcment release and KPMG's five-step judgment process, which of the five-steps might have improved the judgments made by KPMG professionals? Explain your answer.

3 "CEOs: Why They're So Unloved," *BusinessWeek*, April 22, 2002, p. 118.
4 "After Andersen KPMG's Work With Xerox Sets New Test for SEC," by James Bandler and Mark Maremont, *The Wall Street Journal*, May 6, 2002, pp. A:1 and A:10.

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CASE 4.6

Phar-Mor, Inc.

Accounting Fraud, Litigation, and Auditor Liability

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

[1] Identify factors contributing to an environment conducive to accounting fraud

[2] Understand what factors may inappropriately influence the client-auditor relationship and auditor independence

[3] Understand auditor legal liability issues related to suits brought by plaintiffs under both statutory and common law

INTRODUCTION

In December 1995, the flamboyant entrepreneur, Michael "Mickey" Monus, formerly president and chief operating officer (COO) of the deep-discount retail chain Phar-Mor, Inc., was sentenced to 19 years and seven months in prison. Monus was convicted for the accounting fraud that inflated Phar-Mor's shareholder equity by $500 million, resulted in over $1 billion in losses, and caused the bankruptcy of the twenty-eighth largest private company in the United States. The massive accounting fraud went largely undetected for nearly six years. Several members of top management confessed to, and were convicted of, financial-statement fraud. Former members of Phar-Mor management were collectively fined over $1 million, and two former Phar-Mor management employees received prison sentences. Phar-Mor's management, as well as Phar-Mor creditors and investors, subsequently brought suit against Phar-Mor's independent auditors, Coopers & Lybrand LLP (Coopers), alleging Coopers was reckless in performing its audits. At the time the suits were filed, Coopers faced claims in excess of $1 billion. Even though there were never allegations that the auditors knowingly participated in the Phar-Mor fraud, on February 14, 1996, a jury found Coopers liable under both state and federal laws. Ultimately, Coopers settled the claims for an undisclosed amount.

PHAR-MOR STORES[1]

Between 1985 and 1992, Phar-Mor grew from 15 stores to 310 stores in 32 states, posting sales of more than $3 billion. By seemingly all standards, Phar-Mor was a rising star touted by some retail experts as the next Wal-Mart. In fact, Sam Walton once announced that the only company he feared at all in the expansion of Wal-Mart was Phar-Mor.

Mickey Monus, Phar-Mor's president, COO and founder, was a local hero in his hometown of Youngstown, Ohio. As demonstration of his loyalty, Monus put Phar-Mor's headquarters in a deserted department store in downtown Youngstown. Monus—known as shy and introverted to friends, cold and aloof to others—became quite flashy as Phar-Mor grew. Before the fall of his Phar-Mor empire, Monus was known for buying his friends expensive gifts and he was building an extravagant personal residence, complete with an indoor basketball court. He was also an initial

1 Unless otherwise noted, the facts and statements included in this case are based on actual trial transcripts.

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.

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equity investor in the Colorado Rockies major league baseball franchise. This affiliation with the Colorado Rockies and other high profile sporting events sponsored by Phar-Mor fed Monus' love for the high life and fast action. He frequently flew to Las Vegas, where a suite was always available for him at Caesar's Palace. Mickey would often impress his traveling companions by giving them thousands of dollars for gambling.

Phar-Mor was a deep-discount retail chain selling a variety of household products and prescription drugs at substantially lower prices than other discount stores. The key to the low prices was "power buying," the phrase Monus used to describe his strategy of loading up on products when suppliers were offering rock-bottom prices. The strategy of deep-discount retailing is to beat competitors' prices, thereby attracting cost-conscious consumers. Phar-Mor's prices were so low that competitors wondered how Phar-Mor could turn a profit. Monus' strategy was to undersell Wal-Mart in each market where the two retailers directly competed.

Unfortunately, Phar-Mor's prices were so low that Phar-Mor began losing money. Unwilling to allow these shortfalls to damage Phar-Mor's appearance of success, Monus and his team began to engage in creative accounting so that Phar-Mor never reported these losses in its financial statements. Federal fraud examiners discerned later that 1987 was the last year Phar-Mor actually made a profit.

Investors, relying upon these erroneous financial statements, saw Phar-Mor as an opportunity to cash in on the retailing craze. Among the big investors were Westinghouse Credit Corp., Sears Roebuck & Co., mall developer Edward J. de Bartolo, and the prestigious Lazard Freres & Co. Corporate Partners Investment Fund. Prosecutors say banks and investors put $1.14 billion into Phar-Mor based on the phony records.

The fraud was ultimately uncovered when a travel agent received a Phar-Mor check signed by Monus paying for expenses that were unrelated to Phar-Mor. The agent showed the check to her landlord, who happened to be a Phar-Mor investor, and he contacted Phar-Mor's chief executive officer (CEO), David Shapira. On August 4, 1992, David Shapira announced to the business community that Phar-Mor had discovered a massive fraud perpetrated primarily by Michael Monus, former president and COO, and Patrick Finn, former chief financial officer (CFO). In order to hide Phar-Mor's cash flow problems, attract investors, and make the company look profitable, Monus and Finn altered Phar-Mor's accounting records to understate costs of goods sold and overstate inventory and income. In addition to the financial statement fraud, internal investigations by the company estimated an embezzlement in excess of $10 million.[2]

Phar-Mor's executives had cooked the books, and the magnitude of the collusive management fraud was almost inconceivable. The fraud was carefully carried out over several years by persons at many organizational layers, including the president and COO, CFO, vice president of marketing, director of accounting, controller, and a host of others.

The following list outlines seven key factors contributing to the fraud and the ability to cover it up for so long.

[1] ***The lack of adequate management information systems (MIS).*** According to the federal fraud examiner's report, Phar-Mor's MIS was inadequate on many levels. At one point, a Phar-Mor vice president raised concerns about the company's MIS and organized a committee to address the problem. However, senior officials involved in the scheme to defraud Phar-Mor dismissed the vice president's concerns and ordered the committee disbanded.

[2] ***Poor internal controls.*** For example, Phar-Mor's accounting department was able to bypass normal accounts payable controls by maintaining a supply of blank checks on two different bank accounts and by using them to make disbursements. Only those involved in the fraud were authorized to approve the use of these checks.

[3] ***The hands-off management style of David Shapira, CEO.*** For example, in at least two instances Shapira was made aware of potential problems with Monus' behavior and Phar-Mor's financial information. In both cases Shapira chose to distance himself from the knowledge.

2 Stern, Gabriella, "Phar-Mor Vendors Halt Deliveries; More Layoffs Made," *The Wall Street Journal*, August 10, 1992.

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[4] ***Inadequate internal audit function.*** Ironically, Michael Monus was appointed a member of the audit committee. When the internal auditor reported that he wanted to investigate certain payroll irregularities associated with some of the Phar-Mor related parties, Monus and CFO Finn forestalled these activities and then eliminated the internal audit function altogether.

[5] ***Collusion among upper management.*** At least six members of Phar-Mor's upper management, as well as other employees in the accounting department, were involved in the fraud.

[6] ***Phar-Mor's knowledge of audit procedures and objectives.*** Phar-Mor's fraud team was made up of several former auditors, including at least one former auditor who had worked for Coopers on the Phar-Mor audit. The fraud team indicated that one reason they were successful in hiding the fraud from the auditors was because they knew what the auditors were looking for.

[7] ***Related parties.*** Coopers & Lybrand, in a countersuit, stated that Shapira and Monus set up a web of companies to do business with Phar-Mor. Coopers contended that the companies formed by Shapira and Monus received millions in payments from Phar-Mor. The federal fraud examiner's report confirms Coopers' allegations. The complexity of the related parties involved with Phar-Mor made detection of improprieties and fraudulent activity difficult. During its investigation, the federal fraud examiner identified 91 related parties.

ALLEGATIONS AGAINST COOPERS

Attorneys representing creditors and investors pointed out that every year from 1987 to 1992, Coopers & Lybrand acted as Phar-Mor's auditor and declared the retailer's books in order. At the same time, Coopers repeatedly expressed concerns in its annual audit reports and letters to management that Phar-Mor was engaged in hard-to-reconcile accounting practices and called for improvements. Coopers identified Phar-Mor as a "high risk" audit client and Coopers documented that Phar-Mor appeared to be systematically exaggerating its accounts receivables and inventory, its primary assets. Phar-Mor's bankruptcy examiner would later note that the retailer said its inventory jumped from $11 million in 1989 to $36 million in 1990 to a whopping $153 million in 1991.

Creditors suggested that the audit partner's judgment was clouded by his desire to sell additional services to Phar-Mor and other related parties. Such "cross-selling" was common, and it was not against professional standards; however, the creditors claimed Coopers put extraordinary pressure on its auditors to get more business.[3] The audit partner was said to be hungry for new business because he had been passed over for additional profit sharing for failing to sell enough of the firm's services. The following year, the audit partner began acquiring clients connected to Mickey Monus and eventually sold over $900,000 worth of services to 23 persons who were either Monus' relatives or friends.

INVESTORS AND CREDITORS—WHAT COURSE OF ACTION TO TAKE?

After the fraud was uncovered, investors and creditors sued Phar-Mor and individual executives. These lawsuits were settled for undisclosed terms. Although many of the investors were large corporations like Sears and Westinghouse, representatives from these companies were quick to point out that their stockholders, many of whom were pension funds and individual investors, were the ultimate losers. These investors claimed they were willing to accept the business risk associated with Phar-Mor; however, they did not feel they should have had to bear the information risk associated with fraudulent financial statements. One course of action was to sue Phar-Mor's external auditors,

3 Subsequent to Coopers & Lybrand's audits of Phar-Mor, cross selling of certain services (e.g., information systems implementation, aggressive tax strategies) was prohibited for public company auditors by the Sarbanes-Oxley Act of 2002 and related rulings of the PCAOB, SEC and AICPA.

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Coopers & Lybrand. However, although the investors and creditors were provided with copies of the audited financial statements, they did not have a written agreement with the auditor outlining the auditor's duty of care. As is common with many audits, the only written contract was between Coopers and Phar-Mor.

Thirty-eight investors and creditors filed suit against Coopers, under Section 10(b) of the Federal Securities Exchange Act of 1934 and under Pennsylvania common law. All but eight plaintiffs settled their claims with Coopers without going to trial. However, the remaining plaintiffs chose to take their cases to a jury trial.

COURTROOM STRATEGIES

The Defense

Attorneys for Coopers continually impressed upon the jury that this was a massive fraud perpetrated by Phar-Mor's management. They clearly illustrated the fraud was a collusive effort by multiple individuals within the upper management at Phar-Mor who continually worked to hide evidence from the auditors. The auditors were portrayed as victims of a fraud team at Phar-Mor that would do, and did, whatever it took to cover up the fraud. After the verdict the defense attorney said:

> *The jury [rightly] saw that a corporate fraud had been committed, but it mistakenly blamed the outside auditor for not uncovering something no one but the perpetrators could have known about... It's a first...that effectively turns outside auditors into insurers against crooked management. (Robert J. Sisk, chairman of New York's Hughes Hubbard & Reed)*

The Plaintiffs

The plaintiffs opened their case by acknowledging the incidence of fraud does not, by itself, prove there was an audit failure. Moreover, they did not allege that Coopers knowingly participated in the Phar-Mor fraud; nor did they allege Coopers was liable because it did not find the fraud. Rather, plaintiffs alleged Coopers made misrepresentations in its audit opinions. The following quotes from plaintiff attorneys' statements to the jury illustrate the plaintiffs' strategy:

> *. . . [W]e're not going to try to prove in this case what happened at Coopers & Lybrand. That's not our burden. We don't know what happened. We do know that we invested in Phar-Mor on the basis of the financials of Phar-Mor, with the clean opinions of Coopers & Lybrand. We've now lost our investment, and it's a very simple case. We just want our money back...[I]f Coopers can demonstrate to you that they performed a GAAS audit in the relevant time periods, then you should find for them. But if you find based upon the testimony of our experts and our witnesses that Coopers never, ever conducted a GAAS audit...then I submit you should ultimately find for the [plaintiffs]. (Ed Klett, attorney for Westinghouse)*

> *So the question, ladies and gentlemen, is not whether Coopers could have discovered the fraud. The question is whether Coopers falsely and misleadingly stated that it conducted a GAAS audit and falsely and misleadingly told [plaintiffs] that Phar-Mor's worthless financial statements were fairly presented. And the answer to that question is yes. (Sarah Wolff, attorney for Sears)*

Throughout the five-month trial, the plaintiffs continually emphasized the following facts in an effort to have the jury believe the auditors were motivated to overlook any problems that might have been apparent to a diligent auditor:

- The fraud went on for a period of six years, and, therefore, should have become apparent to a diligent auditor.
- Coopers was aware that Phar-Mor's internal accountants never provided the auditors with requested documents or data without first carefully reviewing them.
- Greg Finnerty, the Coopers partner in-charge of the Phar-Mor audit, had previously been criticized for exceeding audit budgets and, therefore, was under pressure to carefully control audit costs.

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- Mickey Monus, Phar-Mor's president, was viewed by Finnerty as a constant source of new business.

The areas where the plaintiffs alleged the auditors were reckless and did not perform an audit in accordance with GAAS centered around the accounting for inventory and its corresponding effects on both the balance sheet and the income statement. The plaintiffs' allegations centered on the five major issues detailed below.

EARLY WARNING SIGNS—THE TAMCO SETTLEMENT

The Fact Pattern

In 1988, internal gross profit reports at Phar-Mor indicated serious deterioration in margins. Phar-Mor was facing an unexpected $5 million pretax loss. It was determined, with the assistance of a specialist from Coopers, that the drop in margins was due mainly to inventory shortages from one of Phar-Mor's primary suppliers, Tamco. Tamco, a subsidiary of Giant Eagle, Phar-Mor's principal shareholder, had been shipping partial orders, but billing Phar-Mor for full orders. Unfortunately, Tamco's records were so poor that it could not calculate the amount of the shortage. Likewise, Phar-Mor had no way to determine the exact amount of the shortage because during this time period Phar-Mor was not logging in shipments from Tamco.

A Phar-Mor accountant performed the only formal analysis of the shortage, which he estimated at $4 million. However, negotiations between Phar-Mor and Tamco (along with its parent company Giant Eagle) resulted in a $7 million settlement. Phar-Mor recorded the $7 million as a reduction to purchases, resulting in a pretax profit of approximately $2 million in 1988. Because Tamco and Phar-Mor were both subsidiaries of Giant Eagle, the settlement was disclosed in a related-party footnote to the financial statements.

Trial evidence indicates the final settlement amount was determined, in part, by looking at Phar-Mor's profitability in prior years. After the settlement, Phar-Mor's gross margin was nearly identical to the prior year. After the fraud was uncovered, it was determined there were signals that Phar-Mor's profitability had slipped in 1988.

Plaintiff Allegations

The plaintiffs claimed the settlement was a disguised capital contribution and thus simply a vehicle to artificially inflate Phar-Mor's earnings. The plaintiffs alleged Coopers acted recklessly by not obtaining sufficient persuasive evidence to support this highly material transaction. The following excerpts are from testimony given (in a deposition) by Pat Finn, former CFO of Phar-Mor, and Charles Drott, an expert witness for the plaintiffs:

> *There was really no way to support the amount of the settlement. We did a number of tests, but based on our in-house review, we didn't think that we could support $7 million. Mickey [Monus] did an excellent job of negotiating with David [Shapira] and he got us $7 million. (Pat Finn, former CFO of Phar-Mor)*

> *What Mr. Finn is basically describing is that, although there may well have been some shortages, that what Phar-Mor was really doing was entering into a transaction, which would enable them to manipulate its profit to overcome losses, to hide losses. So, essentially what he's describing is fraudulent financial reporting...[T]he Coopers & Lybrand workpapers contain no independent verification, nor was there any attempt by Coopers & Lybrand to determine the actual amount of the shortages. It simply just was not done. (Charles Drott, expert witness for the plaintiffs)*

Plaintiffs also alleged the footnote documenting the receipt and the accounting treatment of the settlement was misleading. Although the footnote disclosed the nature and amount of the related-party transaction, the plaintiffs argued the footnote should have more clearly indicated the uncertainty in the settlement estimate. And plaintiffs felt the footnote should have explicitly stated that without the settlement, Phar-Mor would have shown a loss.

Defense Response

A copy of the analysis conducted by the Phar-Mor accountant indicating a $4 million shortage was included in Coopers' workpapers. However, Coopers considered the analysis very crude and included it only as support for the existence of a shortage, not the dollar amount. Although the workpapers contained relatively little documentation specifically supporting a $7 million settlement, Coopers, who audited all three companies party to the negotiation, did perform a number of procedures to satisfy themselves of the propriety of the settlement. After the internal investigation pointed to Tamco, Phar-Mor began to maintain a log of Tamco shipments. Coopers tracked the results of the log and in every subsequent Tamco shipment shortages were found. Coopers also contacted another company that had received Tamco shipments during this time period and learned that retailer was also experiencing shortages from Tamco.

Coopers' experts examined Tamco's operations and confirmed the shortages were due to a new computer inventory system at Tamco. Greg Finnerty, Coopers' partner in charge of the audit, explained the auditors' position as follows:

> *...[I]t's a related-party transaction, and we don't have the responsibility to validate the amount. The responsibilities in accordance with GAAS standards are twofold. One, in any related-party transaction, is to understand the business purpose of the transaction; and two, to agree to the disclosure of the transaction...[W]e understood the business transaction, and the disclosure was adequate. It talked about the $7 million transaction; and we saw a check, not just an intercompany account. We did a lot of those transactions, so we fulfilled our two responsibilities that are the standards for related-party transactions. I was not in that settlement session, nor should I have been. That was between the two related parties. When the discussions were over with, I talked to both parties separately, myself, and talked to them about the settlement, the reasonableness of that settlement. I, in fact, asked David Shapira—and I specifically recall asking David Shapira—of the $7 million, is that all merchandise or is there any sense that you are—you or the board of directors of Giant Eagle—passing additional capital into Phar-Mor through this transaction? And I was given absolute assurance that he was satisfied that the $7 million was a reasonable number; and, in fact, he indicated that this was a number much lower than what Phar-Mor thought it should have been. So it seemed to me that there was a reasonable negotiation that went on between these parties. (Greg Finnerty, engagement partner for the Phar-Mor audit)*

Regarding the footnote disclosure, Coopers pointed out the footnote was typical of related-party footnotes, and that it was rather obvious that without the $7 million settlement, Phar-Mor would have reported a loss. Evidence also showed that, prior to the release of the financial statements, Phar-Mor met with investors and creditors to cover the terms and significance of the settlement. Finally, to this day, none of the parties involved—not Tamco, Phar-Mor, or Giant Eagle—have suggested the settlement was part of the fraud. Further testimony in the trial suggested the Tamco settlement was not an issue of concern with investors and creditors until their attorneys made it an issue years later in the litigation.

THE PRICE TEST

The Fact Pattern

Inventory at Phar-Mor increased rapidly from $11 million in 1989 to $36 million in 1990 to $153 million in 1991. Phar-Mor's inventory system did not include a perpetual inventory record. Therefore, Phar-Mor used the retail method for valuing inventory. Phar-Mor contracted with an outside firm to physically count and provide the retail price of each item in inventory twice per year. Phar-Mor would then apply a cost complement to determine the cost of inventory. Phar-Mor's initial strategy was to mark all merchandise up 20%, resulting in a gross margin of 16.7% and a cost complement of 83.3%. However, to be competitive, Phar-Mor lowered the margins on certain

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"price sensitive" items to get customers in the door. As a result, Phar-Mor's overall budgeted gross margin fell to 15.5%, resulting in a cost complement of 84.5%.

Coopers identified inventory valuation as a high-risk area in its workpapers. As a detailed test of Phar-Mor's inventory costing, Coopers annually attended the physical inventory count at four stores and selected from 25 to 30 items per store to perform price testing. Sample items were selected by the attending auditor in a haphazard fashion. Purchase invoices were examined for the items selected and an overall gross margin for the sample was determined. In the years 1988 through 1991, Coopers' sample gross margins averaged from 16.1% to 17.7%. Coopers explained the difference between the expected 15.5% gross margin and the sample gross margin resulted because the sample taken did not include many price sensitive items, and, therefore, the sample gross margin was higher than Phar-Mor's overall margin. Coopers concluded the difference noted was reasonable and consistent with expectations.

After the fraud was uncovered, it was determined that Phar-Mor's actual margins were really much lower than the budgeted 15.5%, because the price sensitive items made up a relatively large percentage of sales. When Phar-Mor's management saw the fiscal 1989 gross profit reports were coming in below historical levels, it started changing the gross margin reports because it feared Giant Eagle would want back some of the $7 million paid in Tamco settlement money. Management continued to alter the gross profit reports from that time until the fraud was uncovered.

Plaintiff Allegations

The plaintiffs argued that had the Coopers auditors employed a more extensive and representative price test, they would have known what Phar-Mor's gross margins actually were, no matter what the fraud team was doing to the gross profit reports. Plaintiffs alleged the way the auditors conducted their price test and the way they interpreted the results, were both woefully inadequate and unreliable due to the sample size and acknowledged lack of representativeness.

> *...[T]he attitudes of the people involved in this were simply that even though there was clear recognition in the workpapers that this test was so flawed that it was virtually worthless, did not produce anything to them that they could use in their audit, yet they still concluded year after year that everything was reasonable, and that's—that defies my imagination. I don't understand how that conclusion can come from their own recognition of that, the test was so severely flawed. Also, they gave consideration to doing a better price test, but in fact never made any attempt to do so because in each of the four years they did the same exact kind of test, year after year after year, even though they knew the test produced unreliable results. (Charles Drott, expert witness for the plaintiffs)*

The plaintiffs also pointed to Coopers' workpapers where the auditors had indicated that even a one-half percent misstatement in gross margin would result in a material misstatement. Plaintiffs argued the auditors recklessly ignored the sample results indicating a material misstatement.

The plaintiffs also argued the gross profit schedules could not be used to independently test the cost complement because the calculated profit margin and ending inventory were a function of the standard cost complement that was applied to the retail inventory balance derived from the physical inventory.

> *So, what we have here is a daisy chain...the price test is the basis for the gross margin test. The price test is reasonable because the gross margins are reasonable. But, the only reason the gross margins are reasonable is because they are based on the price test. It keeps ping-ponging back and forth. And the problem is, none of this was tested. And when it was tested...the price tests [and] the cost complement did not meet Coopers' expectations. It was not what it was supposed to be. (Sarah Wolff, attorney for Sears)*

Defense Response

Coopers explained to the jury that the price test was simply a reasonableness test intended to provide limited assurance that Phar-Mor was properly applying its methodology for pricing and costing inventory.

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...[I]n the context of all our inventory testing and testing the gross profit, which is a continuous testing of the pricing philosophy, we felt it was adequate testing for our purposes...[T]he price test is just one element of what we did to confirm our understanding and the representation of management as to their pricing philosophy. The primary test of all that is the continuation of taking the physical inventories that they did throughout the year, reconciling that through the compilation and determining the gross profit. If [Phar-Mor is] receiving the gross profit that [they] expected, that is the truest indication and the most valid indication that the pricing philosophy is, in fact, working. It was a valid test, it still is a valid test after reviewing it time and time again. And the staff person suggesting we drop it was just not...right. And throughout the whole time that we audited Phar-Mor, we continued to do the price test. It was a valid test, and it still is. (Greg Finnerty, engagement partner for the Phar-Mor audit)

Further, Coopers pointed out that differences are expected in reasonableness tests and those differences do not represent actual misstatements. It was obvious to Coopers that while Phar-Mor's costing method was applying one standard cost factor, Phar-Mor was applying a variety of pricing strategies. Coopers' price tests on the individual items selected resulted in a wide range of gross margins from items sold below cost to margins of 30% or higher.

Coopers also pointed out that the auditors performed a number of other procedures that compensated for the weaknesses in the price tests. The primary testing was performed on Phar-Mor's gross profit reports. For a sample of gross profit schedules, Coopers recalculated percentages and traced inventory balances back to the physical inventory report submitted by the independent count firm. This was an important procedure for Coopers because, if the margins were consistent, this indicated that the controls over purchases and sales were operating properly. In addition to these procedures, the control environment over purchases and inventory was documented, and certain controls were tested. Individual store and overall company inventory levels and gross margins were compared to prior years. Analytics, such as inventory turnover and days in inventory, were also examined.

INVENTORY COMPILATIONS

The Fact Pattern

After the outside inventory service submitted a report of its physical count, Phar-Mor accountants would prepare an inventory compilation packet. The package included the physical counts, retail pricing, Phar-Mor's calculations of inventory at cost, and cost of goods sold. Based on the compilation, a series of journal entries were prepared and recorded in the operating general ledger to adjust inventory per books to the physical count. Each year, the auditors randomly selected 1 compilation packet for extensive testing and 14 other packets for limited testing. The auditors reviewed journal entries for reasonableness for all 15 packets.

The postfraud examination determined that many of Phar-Mor's inventory compilations packets contained fraudulent journal entries. The entries were often large, in even dollar amounts, did not have journal entry numbers, had no explanation or supporting documentation, and contained suspicious account names like "Accounts Receivable Inventory Contra" or "Cookies." Phar-Mor's fraud team used these entries to inflate inventory and earnings. Based on the physical count and results of the compilation, an appropriate entry was made to reduce (credit) inventory. However, rather than record the offsetting debit to cost of goods sold, a debit entry was recorded to a "bucket" account. The bucket accounts accumulated the fraudulent entries during the year. At year-end, to avoid auditor detection, the bucket accounts were emptied by allocating a portion back to the individual stores as inventory or some other asset.

Plaintiff Allegations

The plaintiffs alleged that some of the compilations reviewed by the auditors contained fraudulent entries. Plaintiffs' experts claimed Coopers should have noticed these unusual entries.

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Coopers' audit work in this inventory compilation area, because of its failure to investigate all of these fraudulent entries which were obvious, suspicious entries on their face, their failure to do this is a failure, in my opinion, that is reckless professional conduct, meaning that it is an extreme departure from the standard of care. They had the entries in front of them, and they chose to do nothing whatsoever to investigate. Had they done so, they would have found the fraud right then and there. (Charles Drott, expert witness for the plaintiffs)

Defense Response

Coopers was able to prove with its workpapers that none of the compilations selected by the auditors for extensive review over the years contained fraudulent entries. Although Coopers did retain an entire copy of the extensively tested compilation packet in its workpapers, it noted only key information from the packets on which it performed limited testing.

In preparation for the trial, the packets that had been subjected to only limited testing were pulled from Phar-Mor's files, many of them containing fraudulent journal entries. However, there was evidence suggesting these compilations may have been altered after Coopers reviewed them. For instance, in many cases even the key information Coopers had noted in its workpapers no longer agreed to the file copies. Mark Kirsten, a Coopers audit manager who was the staff and senior auditor on the Phar-Mor engagement, testified why he believes the compilations retrieved from Phar-Mor's files were altered after Coopers performed its audit work:

I never saw this entry or any other fraudulent entries. When we got these packages, we got them from John Anderson who was part of this fraud. And I refuse to agree that John Anderson walked into my audit room, and we are poring over these for a couple days at a time, and says, here, if you happen to turn to the third page, you are going to find a fraudulent entry that has no support. That's unimaginable...we know there is a fraud. That's why we are here. I know I did my job. My job was to review the packages. These packages went through extensive reviews. So, I am saying when you show me a package that has on one page something that...is fraud, I can't imagine that I saw that. We didn't see these packages for ten seconds during the audit. We spent days with these. I am a staff accountant who is doing my job, and I am poring through these and asking questions. We don't audit in a box. (Mark Kirsten, engagement senior for the Phar-Mor audit)

GENERAL LEDGER

The Fact Pattern

A monthly operating general ledger (GL) was prepared and printed for each store and for corporate headquarters. The plaintiffs argued that not only could the fraud have been uncovered by examining the journal entries proposed on the inventory compilations, but also by scanning the GL. Post-fraud reviews of the GLs revealed the fraudulent entries from the compilation reports were posted directly to the GLs. The GLs contained other fraudulent entries as well. Because the fraud team was aware that zero balance accounts typically draw little attention from the auditor, they recorded numerous "blow-out" entries in the last monthly corporate GL to empty the bucket accounts that had fraudulently accumulated during the year. The bucket accounts were emptied by allocating a portion, usually in equal dollar amounts, back to the stores as inventory or other assets. These entries were typically very large. For example, in 1991, there was an entry labeled "Accrued Inventory" for $9,999,999.99. Also, in 1991, there was an entry labeled "Alloc Inv" (Allocate Inventory) for $139 million.

Plaintiff Allegations

The plaintiffs pointed out that scanning the GL, which was a recognized procedure in Coopers' audit manual and training materials, would certainly and easily have uncovered the fraud. Further, plaintiffs pointed to Coopers' inventory audit program for Phar-Mor that included procedures requiring the examination of large and unusual entries. The following comments from plaintiff attorney, Sarah Wolff, to the jury illustrate the plaintiffs' allegations.

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I want to talk about the issue of general ledger...All we ask you to do in this issue is, don't listen to what the lawyers have told you...what we ask you to do is look at Coopers' own words. Look at Coopers' training materials. The auditor must also review for large or unusual nonstandard adjustments to inventory accounts. Read Coopers & Lybrand's own audit program for this particular engagement that has steps nine and steps eleven that say look for fourth quarter large and unusual adjustments. Those are their words, ladies and gentlemen. That's their audit program, and you have seen witness after witness run from those words. (Sarah Wolff, attorney for Sears)

Although a witness for the plaintiffs agreed it would not have been practical to carefully scan all the operating GLs, (which would have been a pile of computer paper 300 hundred feet tall), they felt it was reckless, and a failure to comply with GAAS, to not carefully scan at least the last month of the corporate office GL.

The plaintiffs repeatedly played a video clip of one of the chief perpetrators of the Phar-Mor fraud, the former CFO, saying that if Coopers had asked for the backup to any one of the fraudulent journal entries, *"It [the fraud] would have been all over."*

Defense Response

Coopers' audit program did have a step to obtain selected nonstandard adjusting journal entries so that any large and unusual items could be further examined. The step was signed-off by staff auditors without further explanation. Coopers witnesses testified that the fact that the step was signed-off indicated that either the step was performed or was considered not necessary. Trial testimony indicated Coopers auditors asked Phar-Mor accountants if there were any large and unusual adjusting entries and the auditors were told there were none. Coopers pointed out it is normal for the client to provide the auditor with an audit packet including lead schedules that agree to the GL and tie to the financial statements. None of the lead schedules contained fraudulent or "bucket" accounts. When it was suggested by plaintiff attorneys that if the auditors had reviewed the operating general ledgers, there would have been a high probability that they would have discovered the fraud, the partner responded:

No. I would say that it wouldn't be a high probability of that because we are doing a GAAS audit. A GAAS audit requires us to do the procedures that we did. There is no requirement in GAAS—none of my partners or I have ever followed a procedure that says you review operating general ledgers line by line, or whatever, unless you are doing a fraud audit. In the course of doing our GAAS audit, we would look to the general ledgers to the extent necessary in order to do our work on the account balances. We don't audit all the various ways that the balances are arrived at....We don't look at day-to-day activity. This is not what we do as accountants, not only at Phar-Mor, but in every audit we do. We look at the ending balances and audit the ending balances. (Greg Finnerty, engagement partner for the Phar-Mor audit)

Although Coopers was aware of the operating GLs, it worked primarily with the consolidated GL, which combined all the operating GLs and included only ending balances and not transaction details. In the consolidated GL, the "bucket" or fraud accounts were either completely absent or had zero balances. To counter the plaintiffs' video clip of the CFO saying the auditors never asked for backup to the blowout entries, the defense played its own video clip of this same CFO (who was a former Big Six auditor), testifying he and his fraud team went to great lengths to prepare for the audit. On this same video clip, the former CFO also testified that if Coopers had asked for the closing journal entry binder, he would have removed the journal entries that emptied the fraud bucket before giving it to the auditors. Members of the fraud team also testified that had Coopers changed its approach to more carefully scrutinize the operating GLs, they would have changed their approach to cover up the fraud.

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ROLL FORWARD

The Fact Pattern

Because the physical inventories were completed during the fiscal year, it was necessary to roll forward or account for the inventory purchase and sales transactions between the inventory count date and the balance sheet date. Coopers' roll-forward examinations always revealed there was a large increase in the ending book inventory balance. Phar-Mor explained to the auditors that the "spike" was due to two factors. First, inventory levels at the physical count date were always lower than normal because a store would reduce inventory shipments in the weeks prior to the physical inventory to prepare for the physical count. Second, since the fiscal year-end was June 30, there was always a buildup of inventory to handle the big July 4th holiday demand. The drop-off in inventory just after year-end was attributed mainly to the large amounts of inventory sold over July 4th. Although the client's explanation did account for a portion of the spike, investigations performed subsequent to the discovery of the fraud indicate that a large portion of the spike was due to the fraud.

Plaintiff Allegations

Plaintiffs claimed the spike was a big red flag that Coopers recklessly overlooked.

> *And what this is simply showing is that the increase is a sharp spike upward at fiscal year-end. Interestingly, also, is that subsequent to the fiscal year, just a short time thereafter—the inventory levels drop off. Now, that is a very interesting red flag as to why would that be. If I were an auditor, I'd certainly want to know why the inventories increase sharply, reaching its crest right at the fiscal year-end date. In other words, when the financial statements were prepared, and why they drop off again after fiscal year-end, just two weeks later, as a matter of fact, and go down that much. It's what I call the spike. Clearly the spike, in my opinion, was caused in large part by the actual fraud at Phar-Mor, because if you recall, these fraudulent entries, these blow-out entries that I described, were these very large journal entries that were adding false inventory to each of the stores, and it was done at fiscal year-end; so if you're adding—and we're talking like entries as high as $139 million of false inventory being added in one journal entry to these stores. When you have that, being false inventory, added to the stores at fiscal year-end, that's obviously going to spike up the books at year-end. And then subsequent to year-end, many of these entries are what we call reversed or taken out of the stores, which would cause some of that spike, if not all of it, to come down. (Charles Drott, expert witness for the plaintiffs)*

The plaintiffs also argued that auditing texts and an AICPA practice guide describe tests of controls and tests of detail that must be performed for the interim period. In addition, plaintiffs pointed to a procedure described as scrutinizing the books of original entry to identify unusual transactions during the roll-forward period.

Defense Response

When asked if the spike would cause an experienced retail auditor to have suspicions about inventory at Phar-Mor, the audit partner responded:

> *Well, no, it wouldn't. But, let me give you an example. At Christmastime, it's the same concept. There is a tremendous spike in inventory of retailers at Christmastime, and then after that, after Christmas, sales go down. That is, you are going to see a natural decline in the inventory levels of a retailer after Christmas. So, it so happens in this analysis, this has to do with the year-end of Phar-Mor, June 30. (Greg Finnerty, engagement partner for the Phar-Mor audit)*

Given that this sort of spike was not unusual, Coopers expected the inventory roll forward comparisons to result in differences. Coopers explained the difference noted in its reasonableness test comparing year-end inventory and the previous physical inventory was within expectations and differences in reasonableness tests do not represent known, actual misstatements.

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Coopers elected not to test specific purchases or sales transactions during the roll-forward period. Rather, it relied on its tests of the gross profit schedules both before and after year-end, which suggested that controls over purchases and sales were functioning properly. Coopers contended that if any large or unusual journal entries were recorded after the last physical inventory and before year-end, they should affect the gross profit of the general ledger, which was one of the comparisons made on the gross profit reports. Unfortunately, the fraud team was falsifying the gross profit reports.

VERDICT

On February 14, 1996, a federal jury found Coopers & Lybrand, LLP guilty of fraud under both state and federal law. Even though neither Phar-Mor's management, the plaintiffs' attorneys, or anyone else associated with the case ever alleged the auditors knowingly participated in the Phar-Mor fraud, Coopers was liable under a fraud claim. The crux of this fraud charge was the plaintiffs' allegation that Coopers made representations recklessly without regard to whether they were true or false, which legally enabled plaintiffs to sue the auditors for fraud. After the verdict, plaintiff attorney Sarah Wolff indicated this case could prove to be the model for getting a jury to find a respected accounting firm behaved recklessly. Ultimately, Coopers settled the claims for an undisclosed amount.

POSTFRAUD PHAR-MOR

Discovery of the fraud resulted in immediate layoffs of over 16,000 people and the closure of 200 stores. In September of 1995, after over three years of turmoil, Phar-Mor emerged from Chapter 11 bankruptcy. Phar-Mor's CEO at that time, Robert Half, was optimistic about the company's future: "You can make money in this business. It's our job to prove it."[4]

In September 2001, Phar-Mor operated 139 stores in 24 states under the names of Phar-Mor, Rx Place, and Pharmhouse. However, on September 24, 2001, Phar-Mor and certain of its affiliates filed voluntary petitions under Chapter 11 of the United States Bankruptcy Code to restructure their operations in an effort to return to profitability. Management determined that the reorganization was necessary to address operational and liquidity difficulties resulting from factors such as the slowing economy, increased competition from larger retail chains, the reduction of credit terms by vendors and the service of high-cost debt. Phar-Mor was not able to recover from these problems and liquidated the last of its assets in 2002.

In 1998, Mickey Monus was back in court to hear another jury's decision. Monus was charged with obstruction of justice related to a jury tampering charge from his first trial. One of Monus' friends did plead guilty to offering a $50,000 bribe to a juror. Monus was sentenced to 19 ½ years in federal prison for his involvement in the corporate fraud, he denied any knowledge of the bribery and cried when a U.S. District Court jury acquitted him on the jury tampering charges. His sentence was later reduced when Mickey and wife Mary Ciferno cooperated with the FBI in a case against another Youngstown fraudster. Mickey and Mary were married at the Elkton, Ohio prison camp in 1998. Mary served as a paralegal on Mickey's defense team.[5]

4 "Our Destiny is in Our Hands," *Drug Store News*, October 9, 1995, p. 3.
5 Bill Moushey, "No Deal for Monus, Bad Deal for Fraud Victims," *The Pittsburgh Post-Gazette*, September 17, 2000, and Gene Wojciechowski, "Rockies born of Monus' work, but he never saw his baby grow up", *ESPN.com*, October 23, 2007.

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REQUIRED

[1] Some of the members of Phar-Mor's financial management team were former auditors for Coopers & Lybrand. (a) Why would a company want to hire a member of its external audit team? (b) If the client has hired former auditors, would this affect the independence of the existing external auditors? (c) How did the Sarbanes-Oxley Act of 2002 and related rulings by the PCAOB, SEC or AICPA affect a public company's ability to hire members of its external audit team? (d) Is it appropriate for auditors to trust executives of a client?

[2] (a) What factors in the auditor-client relationship can put the client in a more powerful position than the auditor? (b) What measures has and/or can the profession take to reduce the potential consequences of this power imbalance?

[3] (a) Assuming you were an equity investor, would you pursue legal action against the auditor? Assuming the answer is yes, under what law(s) would you bring suit and what would be the basis of your claim? (b) Define negligence as it is used in legal cases involving independent auditors. (c) What is the primary difference between negligence and fraud; between fraud and recklessness?

[4] Coopers & Lybrand was sued under both federal statutory and state common law. The judge ruled that under Pennsylvania law the plaintiffs were not primary beneficiaries. Pennsylvania follows the legal precedent inherent in the Ultramares Case. (a) In jurisdictions following the Ultramares doctrine, under what conditions can auditors be held liable under common law to third parties who are not primary beneficiaries? (b) How do jurisdictions that follow the legal precedent inherent in the Rusch Factors case differ from jurisdictions following Ultramares?

[5] Coopers was also sued under the Securities Exchange Act of 1934. The burden of proof is not the same under the Securities Acts of 1933 and 1934. Identify the important differences and discuss the primary objective behind the differences in the laws (1933 and 1934) as they relate to auditor liability?

[6] (a) The auditors considered Phar-Mor to be an inherently "high risk" client. List several factors at Phar-Mor that would have contributed to a high inherent risk assessment. (b) Should auditors have equal responsibility to detect material misstatements due to errors and fraud? (c) Which conditions, attitudes, and motivations at Phar-Mor created an environment conducive for fraud could have been identified as red flags by the external auditors?

[7] The popular press has indicated that inventory fraud is one of the biggest reasons for the proliferation of accounting scandals. (a) Name two other high profile cases where a company has committed fraud by misstating inventory. (b) What makes the intentional misstatement of inventory difficult to detect? How was Phar-Mor successful in fooling Coopers & Lybrand for several years with overstated inventory? (c) To help prevent or detect the overstatement of inventory, what are some audit procedures that could be effectively employed?

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CASE 5.3

Red Bluff Inn & Café

Establishing Effective Internal Control in a Small Business

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

[1] Assess how the absence of effective internal controls in a small business operation increases the likelihood of fraud

[2] Use common sense and creativity to generate internal control suggestions that will effectively and efficiently reduce the potential for fraud

BACKGROUND

An entrepreneur by the name of Francisco Fernandez recently entered into a new venture involving ownership and operation of a small, 26-room motel and café. The motel is located in a remote area of southern Utah. The area is popular for tourists, who come to hike and mountain bike through the area's unique red rock terrain. Francisco has hired you to provide advice.

Francisco hired a young couple to run the motel and café on a day-to-day basis and plans to pay them a monthly salary. They will live for free in a small apartment behind the motel office. The couple will also be responsible for hiring and supervising the four or five part-time personnel who will help with cleaning the rooms, cooking, and waiting on customers in the café, etc. The couple will maintain records of rooms rented, meals served, and payments received (whether by cash, check, or credit card). They will make weekly deposits of the business's proceeds at the local bank.

As the time approaches for the business to open, Francisco is concerned that he will have little control over the operations or records relating to the motel and café, given that the day-to-day control is fully in the hands of the couple. He lives almost five hours away, in northern Utah, and will only be able to visit periodically. The distance is beginning to make Francisco a bit nervous. He trusts the couple he has hired, but has been around long enough to know that it is unwise to place employees in situations where they might be tempted.

Francisco needs your help to identify possible ways his motel and café could be defrauded. He especially wants your assistance to devise creative internal controls to help prevent or detect fraud.

REQUIRED (CONTINUED ON NEXT PAGE)

[1] What are your two biggest concerns relating to possible fraud for the café part of the business? For each concern, generate two or three controls that could effectively reduce risk related to your concerns. Use common sense and be creative!

[2] What are your two biggest concerns relating to possible fraud for the motel part of the business? For each concern, generate two or three controls that could effectively reduce risk related to your concerns. Use common sense and be creative!

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

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[3] Describe the potential impact of your proposed controls on the morale of the couple in charge of the day-to-day operations. How might Francisco deal with these concerns?

[4] Briefly describe the impact each proposed control would have on the efficiency of running the business. Are the controls you generated both effective and efficient?

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CASE 7.1

Anne Aylor, Inc. Determination of Planning Materiality and Performance Materiality

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

[1] Determine planning materiality for an audit client

[2] Provide support for your materiality decisions

[3] Allocate planning materiality to financial statement elements

INTRODUCTION

Anne Aylor, Inc. (Anne Aylor) is a leading national specialty retailer of high-quality women's apparel, shoes, and accessories sold primarily under the "Anne Aylor" brand name. Anne Aylor is a highly recognized national brand that defines a distinct fashion point of view. Anne Aylor merchandise represents classic styles, updated to reflect current fashion trends. Company stores offer a full range of career and casual separates, dresses, tops, weekend wear, shoes and accessories coordinated as part of a total wardrobing strategy. The company places a significant emphasis on customer service. Company sales associates are trained to assist customers in merchandise selection and wardrobe coordination, helping them achieve the "Anne Aylor" look while maintaining the customers' personal styles.

The company follows the standard fiscal year of the retail industry, which is a 52- or 53-week period ending on the Saturday closest to January 31 of the following year. Net revenue for the year ended February 1, 2014 (referred to as fiscal 2014) was $1.2 billion and net income was $50.8 million.

At the end of fiscal 2014, the company operated approximately 584 retail stores located in 46 states under the name Anne Aylor. The company's core business focuses on relatively affluent, fashion-conscious professional women with limited shopping time. Substantially all of the company's merchandise is developed in-house by its product design and development teams. Production of merchandise is sourced to 131 independent manufacturers located in 19 countries. Approximately 45 percent, 16 percent, 13 percent, 12 percent, and 9 percent of the company's merchandise is manufactured in China, Philippines, Indonesia, India, and Vietnam, respectively. Merchandise is distributed to the company's retail stores through a single distribution center, located in Louisville, Kentucky.

Anne Aylor stock trades on The New York Stock Exchange and Anne Aylor is required to have an integrated audit of its consolidated financial statements and its internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). As of the close of business on March 14, 2014 Anne Aylor had 48,879,663 shares of common stock outstanding with a trading price of $22.57.

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. Anne Aylor, Inc. is a fictitious company. All characters and names represented are fictitious; any similarity to existing companies or persons is purely coincidental.

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BACKGROUND

Your firm, Smith and Jones, PA., is in the initial planning phase for the fiscal 2015 audit of Anne Aylor, Inc. (i.e., the audit for the year that will end on January 31, 2015). As the audit manager, you have been assigned responsibility for determining planning materiality and performance materiality for key financial statement accounts. Your firm's materiality and performance materiality guidelines have been provided to assist you with this assignment (see Exhibit 1).

Donna Fontain, the audit partner, has performed a preliminary analysis of the company and its performance and believes the likelihood of management fraud is low. Donna's initial analysis of the company's performance is documented in the memo referenced as *G-3* (top right hand corner of the document). Additionally, Donna has documented current events/issues noted while performing the preliminary analysis in a separate memo, *G-4*. You have recorded the audited fiscal 2014 and projected fiscal 2015 financial statement numbers on audit schedule *G-7*. The company's accounting policies are provided in Exhibit 2. Assume no material misstatements were discovered during the fiscal 2014 audit.

REQUIRED

[1] Review Exhibits 1 and 2; audit memos *G-3* and *G-4*; and audit schedules *G-5*, *G-6* and *G-7*. Based on your review, answer each of the following questions:

- **[a]** Why are different materiality bases considered when determining planning materiality?
- **[b]** Why are different materiality thresholds relevant for different audit engagements?
- **[c]** Why is the materiality base that results in the smallest threshold generally used for planning purposes?
- **[d]** Why is the risk of management fraud considered when determining performance materiality?
- **[e]** Why might an auditor not use the same performance materiality amount or percentage of account balance for all financial statement accounts?
- **[f]** Why does the combined total of individual account performance materiality commonly exceed the estimate of planning materiality?
- **[g]** Why might certain trial balance amounts be projected when considering planning materiality?

[2] Based on your review of the Exhibits (1 and 2) and audit memos (*G-3* and *G-4*), complete audit schedules *G-5*, *G-6* and *G-7*.

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EXHIBIT 1

Smith and Jones, PA.
Policy Statement: Planning Materiality

This policy statement provides general guidelines for firm personnel when establishing planning materiality and performance materiality for purposes of determining the nature, timing, and extent of audit procedures. The intent of this policy statement is not to suggest that these materiality guidelines must be followed on all audit engagements. The appropriateness of these materiality guidelines must be determined on an engagement by engagement basis, using professional judgment.

Planning Materiality Guidelines

Planning materiality represents the maximum, combined financial statement misstatement or omission that could occur before influencing the decisions of reasonable individuals relying on the financial statements. The magnitude and nature of financial statement misstatements or omissions will not have the same influence on all financial statement users. For example, a 5 percent misstatement with current assets may be more relevant for a creditor than a stockholder, while a 5 percent misstatement with net income before income taxes may be more relevant for a stockholder than a creditor. Therefore, the primary consideration when determining materiality is the expected users of the financial statements.

Relevant financial statement elements and presumptions on the effect of combined misstatements or omissions that would be considered immaterial and material are provided below:

- **Net Income Before Income Taxes** – combined misstatements or omissions less than 2 percent of Net Income Before Income Taxes are presumed to be immaterial and combined misstatements or omissions greater than 7 percent are presumed to be material. (Note: Net Income Before Income Taxes may not be an appropriate base if the client's Net Income Before Income Taxes is substantially below other companies of equal size or is highly variable.)
- **Net Revenue** – combined misstatements or omissions less than 0.5 percent of Net Revenue are presumed to be immaterial, and combined misstatements or omissions greater than 2 percent are presumed to be material.
- **Current Assets** – combined misstatements or omissions less than 2 percent of Current Assets are presumed to be immaterial, and combined misstatements or omissions greater than 7 percent are presumed to be material.
- **Current Liabilities** – combined misstatements or omissions less than 2 percent of Current Liabilities are presumed to be immaterial and combined misstatements or omissions greater than 7 percent are presumed to be material.
- **Total Assets** – combined misstatements or omissions less than 0.5 percent of Total Assets are presumed to be immaterial, and combined misstatements or omissions greater than 2 percent are presumed to be material. (Note: Total Assets may not be an appropriate base for service organizations or other organizations that have few operating assets.)

The specific amounts established for each financial statement element must be determined by considering the primary users as well as qualitative factors. For example, if the client is close to violating the minimum current ratio requirement for a loan agreement, a smaller planning materiality amount should be used for current assets and liabilities. Conversely, if the client is substantially above the minimum current ratio requirement for a loan agreement, it would be reasonable to use a higher planning materiality amount for current assets and current liabilities.

Planning materiality should be based on the smallest amount established from relevant materiality bases to provide reasonable assurance that the financial statements, taken as a whole, are not materially misstated for any user.

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Performance Materiality Guidelines

In addition to establishing materiality for the overall financial statements, materiality for individual financial statement accounts should be established. The amount established for individual accounts is referred to as "performance materiality." Performance materiality represents the amount individual financial statement accounts can differ from their true amount without affecting the fair presentation of the financial statements taken as a whole. Establishment of performance materiality for particular accounts enables the auditor to design and execute an audit strategy for each audit cycle.

The objective in setting performance materiality for particular financial statement accounts is to provide reasonable assurance that the financial statements taken as a whole are fairly presented in all material respects.

To provide reasonable assurance that the financial statements taken as a whole do not contain material misstatements, the performance materiality established for particular financial statement accounts/transactions should not exceed 75 percent of planning materiality. The percentage threshold should be lower as the expectation for management fraud increases. In many audits it is reasonable to expect that individual financial statement account misstatements identified will be less than performance materiality and that misstatements across accounts will offset each other (some identified misstatements will overstate net income and some identified misstatements will understate net income). This expectation is not reasonable when the likelihood of management fraud is high. If management is intentionally trying to misstate the financial statements, it is likely that misstatements will be systematically biased in one direction across accounts.

The performance materiality percentage threshold should not exceed:

- 75 percent of planning materiality if low likelihood of management fraud
- 50 percent of planning materiality if reasonably low likelihood of management fraud, and
- 25 percent of planning materiality if moderate likelihood of management fraud

Finally a lower performance materiality may be required for specific accounts because of the relevance of the account to users. Performance materiality for a specific account should not exceed that amount that would influence the decision of reasonable users.

Approved: April 24, 2012

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EXHIBIT 2

Anne Aylor, Inc.
Accounting Policies

Revenue Recognition – The Company records revenue as merchandise is sold to clients. The Company's policy with respect to gift certificates and gift cards is to record revenue as they are redeemed for merchandise. Prior to their redemption, these gift certificates and gift cards are recorded as a liability. While the Company honors all gift certificates and gift cards presented for payment, management reviews unclaimed property laws to determine gift certificate and gift card balances required for escheatment to the appropriate government agency. Amounts related to shipping and handling billed to clients in a sales transaction are classified as revenue and the costs related to shipping product to clients are classified as cost of sales. A reserve for estimated returns is established when sales are recorded. The Company excludes sales taxes collected from customers from net sales in its Statement of Operations.

Cost of Sales and Selling, General and Administrative Expenses – The following table illustrates the primary costs classified in each major expense category:

Cost of Sales	Selling, General and Administrative Expenses
• Cost of merchandise sold; • Freight costs associated with moving merchandise from our suppliers to our distribution center; • Costs associated with the movement of merchandise through customs; • Costs associated with the fulfillment of online customer orders; • Depreciation related to merchandise management systems; • Sample development costs; • Merchandise shortage; and • Client shipping costs.	• Payroll, bonus and benefit costs for retail and corporate associates; • Design and merchandising costs; • Occupancy costs for retail and corporate facilities; • Depreciation related to retail and corporate assets; • Advertising and marketing costs; • Occupancy and other costs associated with operating our distribution center; • Freight expenses associated with moving merchandise from our distribution center to our retail stores; and • Legal, finance, information systems and other corporate overhead costs.

Advertising – Costs associated with the production of advertising, such as printing and other costs, as well as costs associated with communicating advertising that has been produced, such as magazine ads, are expensed when the advertising first appears in print. Costs of direct mail catalogs and postcards are fully expensed when the advertising is scheduled to first arrive in clients' homes.

Leases and Deferred Rent Obligations – Retail stores and administrative facilities are occupied under operating leases, most of which are non-cancelable. Some of the store leases grant the right to extend the term for one or two additional five-year periods under substantially the same terms and conditions as the original leases. Some store leases also contain early termination options, which can be exercised by the Company under specific conditions. Most of the store leases require payment of a specified minimum rent, plus a contingent rent based on a percentage of the store's net sales in excess of a specified threshold. In addition, most of the leases require payment of real estate taxes, insurance and certain common area and maintenance costs in addition to the future minimum lease payments. Rent expense under non-cancelable operating leases with scheduled rent increases or free rent periods is accounted for on a straight-line basis over the initial lease term beginning on the date of initial possession, which is generally when the Company enters the space and begins construction build-out. Any reasonably assured renewals are considered. The amount of the excess of straight-line rent expense over scheduled payments is recorded as a deferred liability.

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Construction allowances and other such lease incentives are recorded as deferred credits, and are amortized on a straight-line basis as a reduction of rent expense beginning in the period they are deemed to be earned, which often is subsequent to the date of initial possession and generally coincides with the store opening date. The current portion of unamortized deferred lease costs and construction allowances is included in "Accrued tenancy", and the long-term portion is included in "Deferred lease costs" on the Company's Balance Sheets.

Cash and Cash Equivalents – Cash and short-term highly liquid investments with original maturity dates of 3 months or less are considered cash or cash equivalents. The Company invests excess cash primarily in money market accounts and short-term commercial paper.

Merchandise Inventories – Merchandise inventories are valued at the lower of average cost or market, at the individual item level. Market is determined based on the estimated net realizable value, which is generally the merchandise selling price. Merchandise inventory levels are monitored to identify slow-moving items and broken assortments (items no longer in stock in a sufficient range of sizes) and markdowns are used to clear such merchandise. Merchandise inventory value is reduced if the selling price is marked below cost. Physical inventory counts are performed annually in January, and estimates are made for any shortage between the date of the physical inventory count and the balance sheet date.

Store Pre-Opening Costs – Non-capital expenditures, such as rent, advertising and payroll costs incurred prior to the opening of a new store are charged to expense in the period they are incurred.

Property and Equipment – Property and equipment are recorded at cost. Depreciation and amortization are computed on a straight-line basis over the following estimated useful lives:

Building...40 years

Leasehold improvements ....10 years or term of lease, if shorter

Furniture, fixtures and equipment...............................2-10 years

Software ....5 years

Accounting for the Impairment or Disposal of Long-Lived Assets - The assessment of possible impairment is based on the Company's ability to recover the carrying value of the long-lived asset from the expected future pre-tax cash flows (undiscounted and without interest charges). If these cash flows are less than the carrying value of such assets, an impairment loss is recognized for the difference between estimated fair value and carrying value. The primary measure of fair value is based on discounted cash flows. The measurement of impairment requires management to make estimates of these cash flows related to long-lived assets, as well as other fair value determinations.

Goodwill and Indefinite-lived Intangible Assets – The Company performs annual impairment testing related to the carrying value of the Company's recorded goodwill and indefinite-lived intangible assets.

Deferred Financing Costs – Deferred financing costs are amortized using the effective interest method over the term of the related debt.

Self Insurance – The Company is self-insured for certain losses related to its employee point of service medical and dental plans, its workers' compensation plan and for short-term disability up to certain thresholds. Costs for self-insurance claims filed, as well as claims incurred but not reported, are accrued based on management's estimates, using information received from plan administrators, third party activities, historical analysis, and other relevant data. Costs for self-insurance claims filed and claims incurred but not reported are accrued based on known claims and historical experience.

Income Taxes – The Company accounts for income taxes using the asset and liability method. Under the asset and liability method, deferred tax assets and liabilities are recognized, and income or expense is recorded,

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for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases.

Treasury Stock Repurchases – The Company repurchases common stock from time to time, subject to market conditions and at prevailing market prices, through open market purchases or in privately negotiated transactions. Repurchased shares of common stock are recorded using the cost method.

Stock-based Compensation – The Company uses the modified prospective method to record stock-based compensation. The calculation of stock-based compensation expense requires the input of highly subjective assumptions, including the expected term of the stock-based awards, stock price volatility, and pre-vesting forfeitures. The Company estimates the expected life of shares granted in connection with stock-based awards using historical exercise patterns, which is assumed to be representative of future behavior. The volatility of common stock at the date of grant is estimated based on an average of the historical volatility and the implied volatility of publicly traded options on the common stock. In addition, the expected forfeiture rate is estimated and expense is only recorded for those shares expected to vest. Forfeitures are estimated based on historical experience of stock-based awards granted, exercised and cancelled, as well as considering future expected behavior.

Savings Plan – Substantially all employees of the Company and its subsidiaries who work at least 30 hours per week or who work 1,000 hours during a consecutive 12 month period are eligible to participate in the Company's 401(k) Plan. Under the plan, participants can contribute an aggregate of up to 75% of their annual earnings in any combination of pre-tax and after-tax contributions, subject to certain limitations. The Company makes a matching contribution of 100% with respect to the first 3% of each participant's contributions to the 401(k) Plan and makes a matching contribution of 50% with respect to the second 3% of each participant's contributions to the 401(k) Plan.

Other Liabilities – Other liabilities includes liabilities associated with borrowings for the purchase of fixed assets and obligation for excess corporate office space.

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Anne Aylor, Inc.	Reference:	G 3
Memo: Analysis of Performance First Quarter	Prepared by:	DF
Year Ended: January 31, 2015	Date:	6/14/15
	Reviewed by:	

Net sales for the first quarter of fiscal 2015 increased 1.5 percent from the first quarter of fiscal 2014. Comparable store sales for the first quarter of fiscal 2015 increased 0.5 percent, compared to a comparable store sales decrease of 0.2 percent in the first quarter of fiscal 2014. Despite soft customer traffic across the industry, the Company saw improvement in same store sales as a result of a targeted promotional strategy and improved product offerings that helped drive increased traffic to Company stores. Based on their current strategy and performance to date, the company expects to achieve net sales growth of approximately 5 percent for the 2015 fiscal year compared to 3.5 percent for fiscal 2014. Net sales growth for the company's market sector is expected to be approximately 3 percent for the 2015 fiscal year.

Gross margin as a percentage of net sales increased to 51.5 percent in the first quarter of fiscal 2015, compared to 51.0 percent in the first quarter of fiscal 2014. The increase in gross margin as a percentage of net sales for the first quarter of fiscal 2015 as compared to the comparable fiscal 2014 period was due primarily to higher full price sales as a percentage of total sales coupled with higher margin rates achieved on both full price and non-full price sales at stores. This performance was the result of improved product offerings and effective targeted marketing initiatives.

Selling, general and administrative expenses as a percentage of net sales decreased to 47.2 percent, in the first quarter of fiscal 2015, compared to 48.0 percent of net sales in the first quarter of fiscal 2014. The decrease in selling, general and administrative expenses as a percentage of net sales was primarily due to improved operating leverage as a result of higher net sales, tenancy related savings associated with the store remodel program, and continued focus on cost savings initiatives. The decrease in selling, general and administrative expenses was partially offset by higher marketing and performance-based compensation expenses.

Net income as a percentage of net sales increased to 2.6 percent in the first quarter of fiscal 2015, compared to 1.8 percent in the first quarter of fiscal 2014. The increase in net income as a percentage of net sales is due to improved full price selling at Company stores and improved operating efficiencies. Based on their current strategy and performance to date, the company expects to achieve net earnings before taxes growth of approximately 23 percent for the 2015 fiscal year compared to 18 percent for fiscal 2014.

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Anne Aylor, Inc.
Memo: Current Events/Issues
Year Ended: January 31, 2015

Reference:	G 4
Prepared by:	DF
Date:	6/14/15
Reviewed by:	

The company plans to focus on optimizing store productivity and enhancing the in-store environment of existing stores. Last year the Company remodeled 4 stores with updated aesthetics and reducing the square footage 30-40%. The Company intends to remodel an additional 25 stores during fiscal 2015 following the remodeled prototype developed last year. The remodeling will be funded with operating cash flows.

On March 18, 2015 the Company entered into the credit facility with First Bank and a syndicate of lenders, which amended its existing $150 million senior secured revolving credit facility which was due to expire in October 2015. The credit facility provides the Company with an option to increase the total facility and the aggregate commitments thereunder up to $200 million, subject to the lenders' agreement to increase their commitment for the requested amount. The credit facility expires on September 30, 2020 and may be used for working capital, letters of credit and other general corporate purposes. Should certain liquidity and other requirements not be met, as defined in the credit facility, no additional funds can be borrowed and any outstanding borrowings may become immediately payable. The credit facility requires that the Company maintain a working capital balance of $125 million and quick ratio of 0.65. Additionally, the Company is only allowed to repurchase common stock up to $100,000 in any fiscal year.

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Anne Aylor, Inc.	Reference:	G 5
Planning Materiality Assessment	Prepared by:	
Year Ended: January 31, 2015	Date:	
	Reviewed by:	

Primary Users of Financial Statements (list):

Materiality Bases (in thousands):

Base	Fiscal 2014 Actual Financial Statement Amounts	Fiscal 2015 Projected Financial Statement Amounts	Planning Materiality Levels: Lower Limit — Percent	Lower Limit — Dollar Amount	Upper Limit — Percent	Upper Limit — Dollar Amount
Income Before Taxes			2		7	
Net Revenues			0.5		2	
Current Liabilities			2		7	
Current Assets			2		7	
Total Assets			0.5		2	

Planning Materiality (in thousands): $

Explanation:

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Anne Aylor, Inc.
Performance Materiality Assessment
Year Ended: January 31, 2015

Reference: G 6
Prepared by: ________
Date: ________
Reviewed by: ________

Likelihood of Management Fraud (check one):

____ Low Likelihood of Management Fraud
____ Reasonably Low Likelihood of Management Fraud
____ Moderate Likelihood of Management Fraud

Performance Materiality (in thousands):

Planning Materiality:	$
Multiplication Factor (0.75 if low likelihood of management fraud, 0.50 if reasonably low likelihood of management fraud, and 0.25 if moderate likelihood of management fraud).	X
Performance Materiality (in thousands)	$

Specific Accounts Requiring Lower Performance Materiality:

Account	Performance Materiality
Explanation:	
Explanation:	
Explanation:	
Explanation:	
Explanation:	
Explanation:	

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Anne Aylor, Inc.
Planning Materiality Financial Information
Year Ended: January 31, 2015

Reference:	G 7
Prepared by:	
Date:	
Reviewed by:	

All amounts are in thousands	1/31/2015 Projected	2/1/2014 Actual
Net sales	$ 1,305,600	$ 1,243,788
Cost of sales	596,700	573,727
Gross margin	708,900	670,061
Selling, general and administrative expenses	604,600	585,225
Operating income/(loss	104,300	84,836
Interest income	700	636
Interest expense	1,100	1,009
Income/(loss) before income taxes	103,900	84,463
Income tax provision/(benefit)	41,400	33,686
Net income/(loss)	$ 62,500	$ 50,777
Assets		
Current assets		
Cash and cash equivalents	$ 124,200	$ 115,845
Accounts receivable	13,900	12,892
Merchandise inventories	148,600	137,647
Refundable income taxes	4,500	4,165
Deferred income taxes	17,900	16,572
Prepaid expenses and other current assets	38,000	35,199
Total current assets	347,100	322,320
Property and equipment, net	275,500	254,475
Deferred income taxes	4,100	3,790
Other assets	13,700	12,670
Total assets	$ 640,400	$ 593,255
Liabilities		
Current liabilities		
Accounts payable	$ 62,800	$ 58,165
Accrued salaries and bonus	27,800	25,779
Accrued tenancy	23,800	22,014
Gift certificates and merchandise credits redeemable	30,600	27,654
Accrued expenses and other current liabilities	60,200	55,768
Total current liabilities	205,200	189,380
Deferred lease costs	102,100	94,593
Deferred income taxes	-	21
Long-term performance compensation	9,600	8.877
Other liabilities	33,800	31,339
Total liabilities	350,700	324,210
Stockholders' equity		
Common stock and paid in capital	466,300	432,080
Retained earnings	483,000	447,556
Accumulated other comprehensive loss	(1,800)	(1,652)
Treasury stock	(657,800)	(608,939)
Total stockholders' equity	289,700	269,045
Total liabilities and stockholders' equity	$ 640,400	$ 593,255

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CASE 8.3

Burlingham Bees

Using Analytical Procedures as Substantive Tests

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

[1] Use analytical procedures to develop expectations for revenue accounts

[2] Appreciate the degree of professional judgment involved in evaluating differences between expected and reported account balances

[3] Recognize factors that lead to precise expectations of account balances

[4] Understand the audit planning implications of using analytical procedures as substantive tests of account balances

BACKGROUND

Burlingham Bees, an independent, minor league baseball team, competes in the Northwest Coast League. The team finished in second place in 2014 with an 92-52 record. The Bees' 2014 cumulative season attendance of 516,783 spectators set a new record high for the team, up more than 8% from the prior season's attendance.

Bank-loan covenants require the Bees to submit audited financial statements annually to the bank. The accounting firm of Hickman and Snowden, CPAs, has served as the Bees' auditor for the past five years.

One of the major audit areas involves testing ticket revenues. Ticket revenues reached nearly $3.95 million in 2013. In 2014 the unaudited ticket revenues are reported to be $4,292,970 with net income before tax of $731,845. In prior years, the audit plan called for extensive detail testing of revenue accounts to gain assurance that reported ticket revenues were fairly stated.

Michelle Andrews, a new audit manager, just received the assignment to be the manager on the 2014 audit. Michelle worked previously on the Bees' prior-year audits as a staff auditor. When she learned she would be managing the current-year engagement, she immediately thought back to all the hours of detailed testing of ticket sales she performed. On some of her other clients, Michelle has been successful at redesigning audit plans to make better use of analytical procedures as substantive tests. She is beginning to wonder if there is a more efficient way to gather effective substantive evidence related to ticket revenues on the Bees' engagement.

In her first meeting with Bees' management for the 2014 audit, Michelle learned that the Bees now use an outside company, Tickets R Us, to operate ticket gates for home games. The terms of the contract require Tickets R Us to collect ticket stubs so that it can later report total tickets collected per game. While Tickets R Us does not break down the total ticket sales into the various price categories, Michelle thinks there may be a way to develop an analytical procedure using the independently generated total ticket numbers and data from prior audits. To investigate this possibility, Michelle asked a staff person to gather some information related to reported sales.

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. Burlingham Bees is a fictitious team. All characters and names represented are fictitious; any similarity to existing teams, companies or persons is purely coincidental.

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Here is the information the staff person gathered from the records of the client, Tickets R Us, and prior-year audit files:

2014 Park Attendance (all games)

Total park attendance	516,783

2014 Number of Games

Weekday games	44
Weekend games	28

Information from prior-year audit files indicates a similar number of home games in total, although in the prior year there were 26 weekend games. The audit file indicates that average per-game attendance for weekend games was 20% higher than average per-game attendance for weekday games.

2014 Per-Game Ticket Prices

Club seats		$ 12
Box seats		$ 10
General seats:	Adult	$ 6
	Child (Senior Citizens)	$ 4

Comparison of 2013 ticket prices to 2014 ticket prices reveals an average increase of 9% between the two years.

Sales Mix	**Weekday**	**Weekend**
Club seats	25%	26%
Box seats	30%	29%
General seats:		
Adult	23%	24%
Child (Senior Citizens)	22%	21%

Information from prior-year audit files shows that sales mix has remained fairly constant over the last several years.

2014 Promotions: Number of Games

Weekday	8
Weekend	9

Information from prior-year audit files shows that attendance generally increases by 15% when there is a promotion (e.g., free baseball cap, poster, or special entertainment). In the prior year there were only 15 total promotional days.

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REQUIRED

[1] Research auditing professional standards and list the requirements related to developing an expectation and conducting analytical procedures when those procedures are intended to provide substantive evidence. What are the advantages of developing an expectation at a detailed level (i.e., using disaggregated data) rather than at an overall or aggregated level?

[2] Using the information provided, please develop a precise expectation (i.e., using the detailed or disaggregated data provided) for ticket revenues for the 2014 fiscal year.

[3] (a) What are the advantages of using analytical procedures as substantive tests? (b) If the engagement team decides to use analytical procedures for the Bees' audit, how will the audit plan differ from prior years? (c) Discuss whether you believe analytical procedures should be used as substantive tests for the Bees 2014 audit?

[4] (a) How close does the Bees' reported ticket revenue for 2014 have to be to your expectation for you to consider reported ticket revenue reasonable or fairly stated? (b) If reported ticket revenues were outside your "reasonableness range," what could explain the difference?

CASE 9.5

Morris Mining Corporation

Auditing Fair Value

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

[1] Understand common audit procedures used to audit fair value estimates

[2] Comprehend the challenges inherent in auditing fair value estimates

[3] Appreciate how estimation uncertainty and sensitivity to small changes in fair value inputs can affect reported values

[4] Understand and appreciate the degree of judgment required to formulate and audit Level 3 fair value estimates

INTRODUCTION

The Financial Accounting Standard Board's Accounting Standards Codification Topic 820, *Fair Value Measurement*, (ASC 820) provides a framework for measuring or estimating the fair value of certain assets and liabilities. It provides a hierarchy with three levels that are differentiated by the inputs used to derive estimates. Level 1 valuations are based on quoted prices in active markets for identical assets or liabilities. Level 2 valuations are based on directly or indirectly observable market data for similar or comparable assets or liabilities. Orderly transactions between market participants may not be observable at the valuation date; therefore, Level 3 valuations are based on management's judgments and assumptions about unobservable inputs. While standard setters and most users believe an appropriately developed Level 3 valuation provides valuable information and is better than the alternative (e.g., possibly irrelevant historical), some critics of Level 3 valuations refer to such valuations as being marked to "make believe."[1] There are a number of valuation models that are commonly used for Level 3 measurement: stock option pricing models (e.g., the Black Scholes model), discounted cash flows method, discounted dividend method, and others. Even though some inputs into these models could qualify for Level 1 or Level 2 treatment, the overall model and the related asset or liability being estimated would be considered a Level 3 model/valuation if any of the significant inputs are unobservable because the level of the asset or liability is determined based on the lowest level input.

In the next section you will find a dialogue between an audit manager and an audit senior discussing the fair value method and assumptions used by audit client Morris Mining Corporation to form a fair value estimate. Morris Mining, Corp., with a fiscal year-end of December 31, owns and operates mining facilities in the U.S. and Canada and distributes various extracted ores and minerals to customers throughout the world.

In January 2015, Morris Mining acquired another mining company called King Co. The acquisition is expected to be synergistic, as the location and nature of King's operations fit well with

1 Weil, J. "Mark-to-make-believe perfumes rotten bank loans," Bloomberg Opinion available at http://www.bloomberg.com/news/2010-11-18/mark-to-make-believe-perfumes-rotten-loans-commentary-by-jonathan-weil.html.

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

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Morris Mining's long-term strategy. The combined firm controls greater market share in key ores and minerals and some redundant overhead costs can be streamlined to improve overall profitability. According to valuation analyses conducted by Morris Mining and its advisors in preparation of the acquisition, the purchase price will exceed the value of identifiable net assets. As a result Morris Mining will record goodwill and the identifiable assets and liabilities of King Co. will be recorded on the books of Morris Mining at fair value.

One of the assets that will require fair value measurement is a patent that King Co. was granted two years ago. King Co. engineers developed and patented the design for a new mining machine that significantly improves mining efficiency. The patent obtained by King Co. gives the company the right to exclude others from commercial exploitation of the invention for a period of 20 years. King Co. developed some prototypes of the new mining machine, the "Extract-o-Matic 1000," and then entered into an agreement with a manufacturing firm called Build-IT, Inc. The agreement gives Build-IT the exclusive rights to manufacture and sell the Extract-o-Matic 1000 machines for a period of 12 years. In exchange, King Co. receives a yearly royalty payment in the amount of 10 percent of the revenue from sales of the Extract-o-Matic 1000. After acquiring King Co., Morris Mining is now the legal patent holder and as such is entitled to receive the royalty payments.

Sales of the Extract-o-Matic have gone well as the machines allow mines to significantly reduce the amount of waste during the mineral extraction process. In fact, Morris Mining purchased one of the machines before the acquisition, and it is performing as promised.

PHONE CONVERSATION ABOUT FAIR VALUE ESTIMATE

The following is a phone conversation between Rob, a new audit manager on the Morris Mining engagement, and Gabriela, the audit senior, regarding Morris Mining's accounting for the Extract-o-Matic patent.

[ROB] Gabriela, I understand you have tracked down more information on the valuation of the patent Morris obtained in the acquisition of King Co.

[GABRIELA] Yes, I did. I met with Morris Mining's CFO, Chris Carter, this morning, and he walked me through their thinking on developing a fair value estimate for the patent on the Extract-o-Matic 1000.

[ROB] Well, if the machine is as impressive as its name, it must really be something. I understand the equipment reduces waste and that the company is using the equipment in its operations. I also understand that the company has an agreement to receive yearly patent royalties from sales. Is that correct?

[GABRIELA] Right. The company is currently using the equipment and has 10 years left on a royalty agreement with Build-IT, Inc. Under the agreement, Build-IT has the exclusive right to manufacture and sell the Extract-o-Matic and Morris Mining receives a 10 percent royalty payment on the revenue from sales of Extract-o-Matics each year, paid annually at the end of each year. Sales growth in the first couple of years was significant and is expected to continue for at least another few years before leveling out and then declining for the remaining useful life of the patent. Reports back from customers are extremely positive—the Extract-o-Matics are reported to really reduce waste and improve overall yield. The fact that the equipment is performing well, on top of the granting of the patent and the agreement with Build-IT, really has the company excited about the potential royalty cash flows that Extract-o-Matic sales will generate over the next 10 years.

[ROB] Okay, the equipment is in production, there is already a track record on sales, and there is positive buzz in the marketplace—that is all good news and suggests the patent is a valuable asset. How is the company proposing to value the patent? I'm guessing no one else has a directly comparable product or patent.

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[GABRIELA] Correct. Certainly, there are other patents in the industry that we will want to consider in our evaluation of the company's estimate, but the Extract-o-Matic is definitely unique in the market. The company is using a discounted cash flow approach to estimate the fair value of the patent. Key inputs include: expected life of the asset, discount rate, royalties on sales, and expected sales growth. The machines are not cheap; they sell for about $2 million each.

[ROB] Okay, a discounted cash flow approach sounds reasonable. What other approaches did they consider? Did they compute the value using more than one approach?

[GABRIELA] The CFO did mention they considered other models before concluding that the discounted cash flow method is the most appropriate approach. As you know, for valuing assets, three common approaches are the market approach, cost approach, and income approach. The market approach would value the patent based on sales of similar assets or patents in the market. The problem with this approach is that patents are so unique that it becomes very difficult to find a comparable sale to base a value on. That's definitely the case with the Extract-o-Matic. There just doesn't appear to be a good comparison in the marketplace.

[ROB] Okay, makes sense. How about the cost approach?

[GABRIELA] The cost approach would measure the fair value of the patent based on the costs that would be necessary to replace it. But this method is generally not used because patents can't really be replaced like many other assets. Plus, capturing specific development costs is non-trivial, especially because King Co. did not track separately the development costs that led to the patent design. So it doesn't seem that a replacement cost approach is sensible. After discussing with the CFO, I agree with the use of the income or discounted cash flows approach.

[ROB] Yeah, that makes sense. The fair value of the patent is computed by estimating the present value of the estimated cash flows that will be earned in royalty payments. Based on past experience, applying the discounted cash flow approach requires a great deal of effort to ensure that inputs used in the model are reasonable and supportable. Fortunately, it sounds like the company has focused a lot of time and attention on formulating the estimate and providing support for its inputs. I appreciate you walking me through all this. So what amount have they computed for the fair value under the discounted cash flow method?

[GABRIELA] Well, it is a pretty big number; the present value of the projected discounted cash flows is just over $25.7 million. Morris Mining obtained estimates from Build-IT regarding the expected future cash flows to be generated from sales of the Extract-o-Matic 1000. These cash flow estimates were then used to value the patent. Build-IT had $30 million in Extract-o-Matic sales last year and expects sales to increase 15 percent per year for the next four years, and then decline at 5 percent per year for three years, and finally decline 15 percent per year for the last three years of the agreement. Morris Mining obtained a 10-year discounted cash flow projection from Build-IT, and based on that they were able to compute the present value of the royalties that will be received each year for the life of the licensing agreement (see Appendix A). While the actual patent grants exclusive rights for up to 20 years, experience in the industry is that the patent will likely produce a competitive advantage for 12 years, as other competing technology will eventually come online. In this situation, the remaining useful life matches up with the 10-year remaining life of the agreement with Build-IT. I've looked at the model. They're using a discount rate of 10 percent and the expected sales trend provided by Build-IT.

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[ROB] Well, all of those numbers are estimates and they all will impact the fair value estimate and of course the future amortization. What do you think about the inputs, do they seem reasonable to you?

[GABRIELA] Well, I did some research, and based on relevant rate indices and industry norms, the discount rate seems to be reasonable, but you know how much rates have fluctuated in the past few years. Given a 10-year remaining useful life, I'm not sure 10 percent is the best rate to use in the valuation model. A reasonable range for the interest rate appears to be 8 to 11 percent, but it seems the lower end of the range is more likely and probably more supportable. They are at the higher end of that range, which decreases the net present value of the asset and thus the future amortization they will be recognizing. It also increases the amount recorded as goodwill, as compared to what it would be if they used a lower discount rate. As for the growth rate in the first four years, Chris tells me that the President of Build-IT doesn't believe the growth rate of 25 percent in the first couple of years is sustainable, but based on his experience with sales of equipment like this he is confident that they can achieve a 15 percent growth rate over the first four years. He also believes that sales will then start to decline because technological improvements in mining have limited useful lives.

[ROB] Well, I'm glad Chris and the President of Built-IT feel comfortable with the forecasts, but unfortunately it doesn't seem like there's enough support for us to buy-off on the estimated growth and subsequent decline projections. Do you or the company have any benchmark data for similar mining machinery that's been patented and sold in recent years?

[GABRIELA] I've done some research on that as well, and given my preliminary findings, I think the 15 percent growth rate that's been suggested for the first four years may actually be too conservative given the rapid growth in the first two years and the other information I found. Several years ago, another mining company in the western U.S. manufactured and sold newly patented equipment that represented a pretty big step over existing technology at the time. The company was quite successful in marketing and selling the equipment, and in the first few years averaged just over 22 percent growth, with the highest years at about 25 percent, which is about what Build-IT experienced in the first two years of sales. The decline in the middle and later years of the useful life seem reasonable, although in the last year or two I think it could drop more than 15 percent.

[ROB] We'll need to do some more research on this and we'll have to challenge the client to provide additional support for the expected pattern of cash flows in terms of initial growth and subsequent decline. The chosen discount rate and sales growth in the early years relative to what you have determined so far as reasonable ranges will tend to reduce the net present value of the cash flows. What do you think about the estimated length of the asset's useful life?

[GABRIELA] Their numbers seem reasonable in that regard. In researching footnotes of other mining companies' financials, it seems pretty common for patent assets to have a useful life of 10 to 12 years. In this case, it seems reasonable to estimate the remaining useful life at 10 years, which as I mentioned is the same as the term remaining in the royalty agreement with Build-IT. I also gathered more evidence from Chris on how they are supporting the estimated life.

[ROB] Gabriela, you've done a great job on the patent valuation so far. Thanks for your good work. Now we need to make sure we can get comfortable with the model and the inputs. To the extent we disagree with Morris on any of the inputs, we will want to compute our own estimated value and then look at the sensitivity of the estimated value to changes in inputs. We'll want to see how big the ranges are relative to materiality.

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[GABRIELA] Right. Even slight changes in the input estimates the Company is using could have a significant impact on the financial statements. I'll continue researching the projected growth rate and discount rate and I'll run some sensitivity analyses and keep you posted.

REQUIRED

[1] What is the definition of fair value according to ASC 820? Do you believe the discounted cash flow method is capable of computing an estimate that would be considered a reasonably reliable fair value for the patent held by Morris Mining? Why or why not?

[2] Should Gabriela and Rob be concerned about the fair value estimate Morris Mining has computed? Why? What incentive does the company likely have in terms of valuing the patent (over or understatement)? Explain your answer.

[3] Research auditing standards and describe the typical procedures that an auditor would perform in auditing a fair value estimate such as the value of Morris Mining's patent. Is the patent a Level 1, Level 2, or Level 3 fair value asset? Why?

[4] Examine the 10-year discounted cash flow analysis provided by the client in Appendix A and also available electronically at www.pearsonhighered.com/beasley and verify that the model is producing a mathematically sound fair value estimate based on the inputs used by Morris Mining. Assuming planning or performance materiality for Morris Mining is $10 million, answer the following questions:

[a] How sensitive is the fair value estimate to changes in the discount rate? How much would the discount rate estimate have to change for it to have a material impact on the financial statements?

[b] How sensitive is the fair value estimate to changes in the estimated growth rates? How much would the estimated growth percentages have to change to have a material impact on the fair value estimate? Do rate changes in early years or later years have a larger impact? Why?

[5] Now, assuming planning or performance materiality at Morris Mining is $600,000, answer the following questions. (Note: as indicated earlier, you can obtain an electronic copy of the 10-year discounted cash flow analysis at www.pearsonhighered.com/beasley)

[a] How sensitive is the fair value estimate to changes in the discount rate? How much would the discount rate estimate have to change for it to have a material impact on the financial statements?

[b] How sensitive is the fair value estimate to changes in the estimated growth rates? How much would the estimated growth percentages have to change to have a material impact on the fair value estimate? Do rate changes in early years or later years have a larger impact? Why?

[6] What are the most significant audit risks associated with the fair value estimate of the patent? Assuming performance materiality of $600,000, what additional steps can the auditor take to improve the sufficiency and appropriateness of the evidence gathered to support the fair value estimate for the patent?

PROFESSIONAL JUDGMENT QUESTION

It is recommended that you read the Professional Judgment Introduction found at the beginning of this book prior to responding to the following question.

[7] A great deal of judgment often is required when estimating fair values, and sometimes a "reasonable range" for the possible estimate value is very large relative to materiality. Considering the sensitivity highlighted in question 4, what implications do the estimate's sensitivity to small changes in input values, and the related judgments and potential biases, have when it comes to auditing fair value estimates?

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APPENDIX A

Royalty Discounted Cash Flow Analysis

Prepared by Chris Carter, Morris Mining CFO

2014 Revenue	$ 30,000,000	**Growth Rates:**	
		Years 1 - 4	15%
Discount rate:	10%	Years 5 - 7	-5%
Royalty rate:	10%	Years 8 - 10	-15%

Year	1	2	3	4	5	6	7	8	9	10
Morris Mining, Corp.	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Extract-o-Matic Revenues	$ 34,500,000	$ 39,675,000	$ 45,626,250	$ 52,470,188	$ 49,846,678	$ 47,354,344	$ 44,986,627	$ 38,238,633	$ 32,502,838	$ 27,627,412
Patent Royalty (10%)	3,450,000	3,967,500	4,562,625	5,247,019	4,984,668	4,735,434	4,498,663	3,823,863	3,250,284	2,762,741
Present Value of Cash Flow from Royalty	3,136,364	3,278,926	3,427,968	3,583,784	3,095,087	2,673,029	2,308,525	1,783,860	1,378,438	1,065,156
Total Present Value of Cash Flow from Royalty	**$ 25,731,137**									
Patent Royalty (10%)	3,450,000	3,967,500	4,562,625	5,247,019	4,984,668	4,735,434	4,498,663	3,823,863	3,250,284	2,762,741
Amortization per year	2,573,114	2,573,114	2,573,114	2,573,114	2,573,114	2,573,114	2,573,114	2,573,114	2,573,114	2,573,114
Annual Net Royalty Income	**$ 876,886**	**$ 1,394,386**	**$ 1,989,511**	**$ 2,673,905**	**$ 2,411,554**	**$ 2,162,321**	**$ 1,925,549**	**$ 1,250,750**	**$ 677,170**	**$ 189,628**

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