Solution Manual for Auditing and Accounting Cases Investigating Issues of Fraud and Professional Ethics 4th Edition Thibodeau Freier 0078025567 9780078025563

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Case 1.1 Waste Management: The Matching Principle

I. Technical Guidance

To maximize a student's knowledge acquisition of this material, this book has been designed to be read in conjunction with the post–Sarbanes-Oxley technical audit guidance. All of the PCAOB Auditing Standards that are referenced in this book are available for free. In addition, a summary of the provisions of the SarbanesOxley Act of 2002 is available for free on the book'.

II. Recommended Technical

Knowledge **<u>Conceptual Framework</u>**

The Expense Recognition Principle (sometimes referred to as the Matching Principle)

<u>PCAOB Auditing Standard No. 5</u>

Paragraph #2

<u>PCAOB Auditing Standard No. 15</u>

Paragraphs #5-6

III. Classroom Hints

This case provides students with an opportunity to appreciate the difficulty

that can be associated with auditing the application of depreciation rules to different types of assets at an audit client. Since the computation of depreciation expense requires management to estimate the salvage value and the estimated useful life for each asset depreciated, an auditor is often forced to evaluate a number of subjective factors when completing his/her procedures. To properly do so, students are able to see that an auditor must first understand the true economic substance of management's estimates for both salvage value and the estimated useful life. After gaining this understanding, the auditor must then determine whether the client has properly calculated and recorded depreciation expense in accordance with the economically appropriate estimates. Of course, each of these judgments must be made based on sufficient and competent evidence. In addition, the case provides a mechanism to illustrate the importance of identifying relevant financial statement assertions and identifying the related control activities that are designed to prevent and/or detect fraud in the post-Sarbanes audit environment. Finally, the case provides an opportunity for instructors to highlight the responsibility of management and the board of directors for an effective internal control system in the post-Sarbanes audit environment.

We believe it is essential for students to carefully read over the recommended technical knowledge, along with this case reading. The educational psychology literature suggests that the acquisition of technical/factual type knowledge increases dramatically when such knowledge can be applied in a realistic context.

This case assignment will work best if it is used at the time when instructors cover the purchasing process, the fixed asset process or the audit of depreciation expense. Alternatively, the case can be used when instructors cover the audit evidence topic or when instructors discuss the ways in which a management team can perpetrate a fraud. Indeed, because of the subjectivity associated with the estimate of an asset's useful life and salvage value, the account can be used by management as a mechanism to help smooth earnings and/or perpetrate fraudulent activity. As a result, we recommend that instructors spend time in class reviewing the impact that an increase in salvage value and/or an increase in depreciable life can have on reported earnings. This discussion should help students conceptualize how the application of depreciation rules can be used as a mechanism to perpetrate fraudulent activity.

Importantly, the goal of the previous discussion is not necessarily to make sure that students are experts in auditing recorded depreciation expense at an audit client with significant investments in fixed assets. Rather, we believe that it is important to point out to students that they will encounter difficult financial statement accounts to audit in their role as an auditor. Therefore, when such an account is encountered, students must take the time to fully understand the nature and economic substance of the account. The professional judgment that is involved in auditing a difficult financial statement account also provides an opportunity for instructors to remind students of the importance of being unbiased and objective when making their audit judgments. Indeed, we believe that it is helpful to consistently remind students of their responsibility to maintain an attitude of professional skepticism throughout the audit process. Indeed, one of the primary goals of the Sarbanes-Oxley Act of 2002 was to take steps to improve the independence and objectivity of the audit process (e.g., Section 201). As such, we encourage instructors to take this opportunity to remind students of their responsibility.

This case also provides an opportunity for instructors to highlight the increased responsibility that management now has for effective internal controls under the Sarbanes-Oxley Act of 2002 (SARBOX). Under Section 404 of SARBOX, management is responsible for establishing and maintaining an effective internal control system that is designed to support reliable financial statement reporting. In addition, management must undertake a process whereby they assess the effectiveness of their own internal control system each year. Given this increased responsibility, it is amazing for students to see that the management team and Board of Directors at Waste Management actually ignored the recommendation made by Arthur Andersen to conduct a site by site analysis of their landfills. In the post-Sarbanes environment, this is clearly a process that would have to be in place to insure reliable financial reporting.

Finally, this case provides an opportunity to highlight the importance of identifying the relevant financial statement assertions about a significant financial statement account, a critically important task in the post-Sarbanes environment. The discussion of student responses to question #3 provides instructors with an opportunity to discuss this point. In addition, the discussion of student responses to question #3 provides an opportunity for instructors to highlight the importance of being able to identify an internal control activity that is explicitly designed to support reliable financial statement reporting for a particular financial statement assertion. Once again, the knowledge required to link an internal control activity to the financial statement assertion is essential in the post-Sarbanes audit environment. Thus, we encourage instructors to take the time to make this linkage explicit for students in the present context.

IV. Assignment Questions & Suggested Answers

1. **Consider the principles, assumptions and constraints of Generally Accepted Accounting Principles (GAAP). Define the *expense recognition principle (sometimes referred to as matching principle)* and explain why it is important to users of financial statements.**

According to the expense recognition principle, costs need to be matched to the revenues that they helped to generate. A key point is that expenses should not necessarily be recognized when the work is completed or a product is produced. Rather, the costs should be recognized when the costs can be "matched" to revenue that has been recorded. If a connection cannot reasonably be made between a cost and revenue that has been recognized, an accountant still has a responsibility to try to determine whether there is some type of relationship between the cost and revenue generated. The absolute goal is to try as hard as possible for an accountant to provide the best measure of the profitability and performance of a company. As a result, accountants should attempt to identify as best as possible, how much it cost to generate revenue. This is the basis of the expense recognition principle.

2. **Based on the case information provided, describe specifically how Waste Management violated the expense recognition principle. In your description, please identify a journal entry that may have been used by Waste management to commit the fraud.**

GAAP requires that depreciation expense be determined by allocating the historical cost of assets over the useful life of the asset less the salvage value. When the management team at Waste Management made changes to the estimated useful life and salvage value of several assets, they effectively reduced the depreciation expense, ultimately resulting in overstated income. The reduction of depreciation expense in the current year essentially defers depreciation expense to a future year. The expense recognition principle requires the depreciation expense of an asset to be recognized over its useful life so that the associated expense is recorded in the year in which related income is earned. The arbitrary changes made to the estimated useful lives and salvage values directly violated the matching principle because the depreciation expense recognized in future years would now be unrelated to the production of income in those related future years.

In essence, increases to the useful life of assets have the effect of writing up the value of an asset and reducing expenses. This change can have a material impact on the financial statements. These types of changes, that affect the way a user of financial statements values Waste Management, must be properly disclosed as required by GAAP under the full disclosure principle. This principle requires management to disclose sufficient information to allow the user to make a judgment about the financial position of Waste Management.

3. **Consult Paragraph 2 of PCAOB Auditing Standard No. 5. Do you believe that Waste Management had established an effective system of internal control over financial reporting related to the depreciation expense recorded in its financial statements? Why or why not?**

According to Paragraph #2 of PCAOB Auditing Standard No. 5, "effective internal control over financial reporting provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes." Waste Management did not have an effective system of internal control over financial reporting related to the depreciation expense recorded in its financial statements. Stated simply, Waste Management's internal control system did not provide reasonable assurance that the transactions were recorded fairly, accurately, and in accordance with GAAP.

4. **Consult Paragraphs 5–6 of PCAOB Auditing Standard No. 15. As an auditor, what type of evidence would you want to examine to determine whether Waste Management's decision to change the useful life and salvage value of its assets was appropriate under GAAP?**

A company is allowed to change the useful life and/or the salvage value of its fixed assets under GAAP if events or circumstances reveal additional information that indicates that a change to the useful life and/or salvage value will more accurately depict the current market situation. Stated simply, there should be a legitimate basis to make any changes to these variables. In addition, according to the SEC, changes to the variables used in estimating depreciation and the resulting impact to investors should be disclosed in the financial statements to be in accordance with GAAP.[1]

Paragraphs #5-6 of PCAOB Auditing Standard No. 15 specifically highlight that an auditor must obtain sufficient and appropriate evidence. Sufficiency "is the measure of the quantity of evidence" needed. The quantity of evidence needed will depend upon the risk of material misstatement and the quality of evidence obtained. The appropriateness of evidence refers to whether the evidence obtained by the auditor is both relevant and reliable "in providing support for the conclusions on which the auditor's opinion is based." In this situation, an auditor should examine relevant information about comparable useful lives used in the industry and monitor the company's actual experience for similar assets in the past to determine if the firm's decision to change the useful life and salvage value of its assets was appropriate under GAAP. Overall, the rationale for changes must be well supported and reasonable. In making this determination, interviews with managers and other relevant personnel would be essential, as each of these estimates are subjective. Ultimately, the events or circumstances resulting in the

[1] U.S. Securities and Exchange Commission. (26 March 2002). "Securities and Exchange Commission vs. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen."

need for the changes would have to be critically evaluated and corroborated with sufficient and competent evidence by the auditors. After considering all of the available evidence, if the auditors are still unsure about the decision, they could use an independent third party to evaluate the changes to the useful life and/or salvage value that are proposed.

5. **Visit the PCOAB website, search for the "tip and referral center" and review the guidelines. Can you report a violation to the PCAOB anonymously? Assuming that the employee knew that the consolidating entries in the fourth quarter recorded by upper management were fraudulent, do you believe that the employee had a responsibility to report the behavior to the audit committee? Why or why not?**

Yes, according to the website, the PCAOB does allow you to report a violation in an anonymous manner. However, according to the website, if you so wish to stay anonymous, the PCAOB asks "that you please contact us again, within 24 hours, so that we may ask any important follow-up questions in response to your tip or referral."

Clearly, there are a number of allowable answers to the second part of this question. The absolute key is for a student to try and justify his or her position. Consider the following acceptable sample answer from a student:

Yes, the employee should have reported the fraudulent behavior to the audit committee. Consistent with the notion that ethical behavior is that which conforms to moral rules and principles, the moral action to be taken would have been to report the fraudulent behavior. In fact, when an employee is thinking through his/her ethical decision process, he/she should realize that in the long run, they may be held responsible for their role in helping to prepare fraudulent financial statements. Clearly, the moral action is for the employee to tell the audit committee about the fraudulent entries.