Experimental Instrument

Appendix A – Qualtrics screenshots of Experimental Instrument (with differences across experimental conditions, and notes to reviewers, ***in italics***)
Appendix B – Background Information (Audit Case that auditors in all conditions view)
Appendix C – Prior Year Workpapers (auditors in all conditions view)

APPENDIX A

Qualtrics Screenshots of Experimental Instrument

Welcome

To begin the study, please use the arrow button below.

You will have approximately 40 minutes to complete the study. Below is the breakout of how much time you should spend on each section of the task:

- **Task Instructions, Guidance, and Background Information:** 10-15 minutes.
- **Risk Assessment Task:** 15-20 minutes.
- **Concluding Questions:** 10 minutes.

Thank you for your participation!

Audit Task Instructions

Please assume that you work for Smith & Co. Audit Firm. You are on the audit team for Company A, and your manager at Smith & Co. has asked you to prepare a risk assessment for Company A. In a moment you will be asked to complete this task. However, first it is important to introduce you to the study materials.

Background Information
You will find this document in hard copy form where you are seated. This document will provide information about Company A, which you will use when performing the risk assessment task. All of this information is considered credible. You may refer back to this document as much as you would like while completing the risk assessment task. You may also write on this document for your own reference.

<< Before continuing, please make sure you have a printout of this document. >>

Prior Year Risk Assessment
You will next open a PDF document called "Prior Year Risk Assessment." This document includes the risk assessment performed by the audit team in the prior year (i.e., this is last year's risk assessment workpaper). You may refer back to this document as much as you would like while completing the risk assessment for the current year.

*<< Please click on this **LINK** now to open the "Prior Year Risk Assessment" document.*
***Download this document to your desktop now, to ensure that you have access to it throughout the study**. >>*

Task Example
We will begin by showing you a few examples related to the risk assessment task you will perform for the current year audit. Specifically, the risk assessment task requires numerical risk ratings and written evidence. The examples relate to risk factors that you will not be evaluating as part of your work. For each risk factor below, we are providing you with the prior year's risk rating and evidence, along with the current year's risk rating and evidence. Note that the prior year's information is similar to the prior year workpaper in the PDF file that you will use for your actual work; however, for your convenience, the prior year information for these examples is displayed on the same screen.

Description of Examples:
The first column displays the relevant risk factor (in bold). The second column displays the auditor's prior year numerical risk rating for this risk factor. The third column displays the auditor's prior year risk assessment evidence for this risk factor. This is the evidence used by the audit team to support the prior year numerical rating.

Note: The Background Information and Prior Year Risk Assessment are in Appendix B and Appendix C, respectively.

This is the example of the prior year's risk rating and evidence:

Part I: Regulatory Factors (Prior Year Example)

	Risk Rating					Evidence for Risk Rating
	Low		Medium		High	
	1	2	3	4	5	
1. Are there any legislations or regulations that could significantly affect the Company's operations?	○	●	○	○	○	We are unaware of any legislations or regulations that would significantly affect Company A's operations.
2. Are there any government policies that could affect the conduct of the Company's business?	○	○	○	●	○	We recently became aware of a proposed government policy from the EPA that would affect Company A's
3. Are there any new accounting principles or industry-specific accounting practices that will impact the nature of the Company's reporting?	●	○	○	○	○	No changes in accounting principles or industry-specific practices noted.

This is the example of the current year's risk rating and evidence:

Part I: Regulatory Factors (Current Year Example)

	Risk Rating					Evidence for Risk Rating
	Low		Medium		High	
	1	2	3	4	5	
1. Are there any legislations or regulations that could significantly affect the Company's operations?	○	○	○	○	●	There was food contamination this year. Company A is facing several related lawsuits.
2. Are there any government policies that could affect the conduct of the Company's business?	○	●	○	○	○	The proposed government policy from the EPA that would affect Company A's environmental compliance
3. Are there any new accounting principles or industry-specific accounting practices that will impact the nature of the Company's reporting?	●	○	○	○	○	No changes in accounting principles or industry-specific practices noted.

Before you begin the audit risk assessment task, we would like you to read the following materials:

- Professional guidance related to risk assessment – i.e., a resource you would use when completing such a task in practice.
- Please note that in this study (unlike in practice), you will not be able to navigate back to this guidance once you begin the risk assessment task. At this time, please begin reading the guidance.

PCAOB Auditing Standard 2110: *Identifying and Assessing Risks of Material Misstatement*

Objective

.03 - The objective of the auditor is to identify and appropriately assess the risks of material misstatement, thereby providing a basis for designing and implementing responses to the risks of material misstatement.

Performing Risk Assessment Procedures

.04 - The auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for identifying and assessing the risks of material misstatement, whether due to error or fraud, and designing further audit procedures.

.05 - Risks of material misstatement can arise from a variety of sources, including external factors, such as conditions in the company's industry and environment, and company-specific factors, such as the nature of the company, its activities, and internal control over financial reporting. For example, external or company-specific factors can affect the judgments involved in determining accounting estimates or create pressures to manipulate the financial statements to achieve certain financial targets. Also, risks of material misstatement may relate to, e.g., personnel who lack the necessary financial reporting competencies, information systems that fail to accurately capture business transactions, or financial reporting processes that are not adequately aligned with the requirements in the applicable financial reporting framework. Thus, the audit procedures that are necessary to identify and appropriately assess the risks of material misstatement include consideration of both external factors and company-specific factors. This standard discusses the following risk assessment procedures:

- Obtaining an understanding of the company and its environment (paragraphs .07-.17);
- Obtaining an understanding of internal control over financial reporting (paragraphs .18-.40);
- Considering information from the client acceptance and retention evaluation, audit planning activities, past audits, and other engagements performed for the company (paragraphs .41-.45);
- Performing analytical procedures (paragraphs .46-.48);
- Conducting a discussion among engagement team members regarding the risks of material misstatement (paragraphs .49-.53); and
- Inquiring of the audit committee, management, and others within the company about the risks of material misstatement (paragraphs .54-.58).

Note: This standard describes an approach to identifying and assessing risks of material misstatement that begins at the financial statement level and with the auditor's overall understanding of the company and its environment and works down to the significant accounts and disclosures and their relevant assertions.

.06 - In an integrated audit, the risks of material misstatement of the financial statements are the same for both the audit of internal control over financial reporting and the audit of financial statements. The auditor's risk assessment procedures should apply to both the audit of internal control over financial reporting and the audit of financial statements.

Obtaining an Understanding of the Company and Its Environment

.07 - The auditor should obtain an understanding of the company and its environment ("understanding of the company") to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement. Obtaining an understanding of the company includes understanding:

- Relevant industry, regulatory, and other external factors:
- The nature of the company;
- The company's selection and application of accounting principles, including related disclosures;
- The company's objectives and strategies and those related business risks that might reasonably be expected to result in risks of material misstatement; and
- The company's measurement and analysis of its financial performance.

Selected Guidance from Other PCAOB Documents

Professional skepticism is essential to the performance of effective audits under Public Company Accounting Oversight Board standards. It is the responsibility of each individual auditor to appropriately apply professional skepticism throughout the audit, including in identifying and assessing the risks of material misstatement, performing tests of controls and substantive procedures to respond to the risks, and evaluating the results of the audit.

Applying professional skepticism involves, among other things, considering what can go wrong with the financial statements, performing audit procedures to obtain sufficient appropriate audit evidence rather than merely obtaining the most readily available evidence, and critically evaluating all audit evidence. When properly applied, professional skepticism indicates that the auditor uses his or her knowledge, skills, and ability called for by the profession of public accounting to diligently perform the gathering and objective evaluation of evidence as a reasonable basis for the auditor's opinion. Gathering and objectively evaluating audit evidence requires the auditor to consider the competency and sufficiency of the evidence; since evidence is gathered throughout the audit process, professional skepticism should be exercised throughout the audit process. It is not sufficient for auditors merely to rely on their perceived knowledge of the industry or information obtained from prior audits or other engagements for the company.

Certain circumstances can impede the appropriate application of professional skepticism. Audit firms and individual auditors should be alert for these circumstances and take appropriate measures to assure that professional skepticism is applied appropriately throughout all audits performed under PCAOB standards. If the audit is conducted without professional skepticism, the value of the audit is impaired.

Viewed by Auditors in the General Guidance condition only.

Selected Guidance from Other PCAOB Documents

Professional skepticism is essential to the performance of effective audits under Public Company Accounting Oversight Board standards. It is the responsibility of each individual auditor to appropriately apply professional skepticism throughout the audit, including in identifying and assessing the risks of material misstatement, performing tests of controls and substantive procedures to respond to the risks, and evaluating the results of the audit.

By its nature, risk assessment involves looking at internal and external factors to determine what can go wrong with the financial statements. When properly applied, the risk assessment approach set forth in PCAOB standards should focus auditors' attention on those areas of the financial statements that are higher risk and thus most susceptible to misstatement. The evidence obtained from the required risk assessment procedures should provide a reasonable basis for the auditor's risk assessments. It is not sufficient for auditors merely to rely on their perceived knowledge of the industry or information obtained from prior audits or other engagements for the company.

Certain circumstances can impede the appropriate application of professional skepticism in risk assessment. Audit firms and individual auditors should be alert for these circumstances and take appropriate measures to assure that professional skepticism is appropriately applied in risk assessment. For example, an inappropriate application of skepticism could be focusing more on risk factors that would support a lower risk of material misstatement rather than a critical assessment of all factors, including those they may indicate a higher risk of material misstatement exists. Inappropriate identification or assessment of risks of material misstatements can lead the auditor to overlook relevant risks, and to perform inadequate audit procedures to address these risks.

Viewed by Auditors in the Task-Specific Guidance condition only.

Now that you have finished reading the guidance, please click the arrow below to begin the risk assessment task.

Audit Task

- Now you are ready to move on to your risk assessment task. Your work during this task is anonymous.
- Note that you will see **four screens** during the risk assessment task, and you may click between these screens as much as you would like (both forward and backward). You may also change your numerical ratings and descriptions of evidence throughout your work on the task.
- For each item, you must select a numerical risk rating in the second column and include a description of evidence in the text box of the third column (all fields must contain something). The numerical risk rating that you select could be higher than, lower than, or the same as the prior year numerical rating. This is entirely up to you, and we would like you to use your professional judgment to decide.
- Because there are multiple people working on this assignment individually, we are not able to take questions. If you feel that you do not understand something, please do the best you can.
- Please keep in mind that it is essential that you do not discuss this task with anyone else until all participants have completed the study.
- We truly value your work on this auditing task, and thank you for your participation today!

When you are ready to begin the task, please click on the arrow below.

Thank you again!

First, read the "Background Information" handout at your seat. As a reminder, you may write on this document for your own reference.

When you are finished reading the "Background Information", please click on the arrow below to continue the task.

Note: The Background Information is displayed in Appendix B.

On the next screen, you will see the first of four screens in the risk assessment task.

Consistent with Auditing Standards No. 1215 and 2110, you have been provided the prior year's work paper containing the numerical risk ratings and documentation of evidence. Auditing Standard No. 1215, regarding Audit Documentation requirements, allows auditors to use "the prior year's documentation to understand the work performed as an aid in planning and performing the current engagement." Also, Auditing Standard No. 2110, regarding Identifying and Assessing Risks of Material Misstatement, specifically states that auditors should consider information from prior audits when performing the risk assessment task.

To be consistent with these standards, Smith & Co. has provided you with access to the prior year's risk assessment work paper. As a reminder, this is available in the PDF document you opened and saved to your computer desktop ("Prior Year Risk Assessment").

Also note, however, that prior year's numerical risk rating and evidence have been copied over into the current year's work paper. This is consistent with Smith & Co.'s policy on how auditors should access prior year work papers. Senior leadership in the audit quality group at Smith & Co. chose this policy because they believe it strikes the right balance between audit effectiveness and efficiency in performing the audit.

Note: Auditors in the Non-Prepopulation condition view this screen, except they read "Also note, however, that prior year's numerical risk rating and evidence have not been copied over…"

These workpapers are for auditors in the Prepopulation condition. Auditors in the Non-Prepopulation condition view the same workpapers, but the workpapers are blank (i.e., do not contain the prior year risk ratings and evidence). Note that auditors in all experimental conditions have access to these prior year risk ratings and evidence (in the Prior Year Risk Assessment file, displayed in Appendix C).

Instructions: Use the scale (in column 2) to complete your **current year** numerical rating and the text box (in column 3) to document your **current year** evidence.

1. Factors related to the Company's business risk (business objectives and strategies)

	Risk Rating					Evidence for Risk Rating
	Low		Medium		High	
	1	2	3	4	5	
1. Evaluate the Company's industry developments for possible risks. Consider demand, market capacity, and competition.	○	●	○	○	○	The industry is strong but has shown little growth in recent years. The industry faces some competition but no
2. Are there any expected changes in the entity such as large acquisitions, reorganizations, or other unusual events?	○	●	○	○	○	Company A continues to expand with some acquisitions. But the acquisitions are all relatively small; no single
3. Has the Company made any changes to its business model (e.g., new product offerings, initiatives, changes to stores)?	○	○	●	○	○	Company A has begun to expand business by introducing several new product lines, such as ready-made meals and
4. Has the Company expanded its operations into any new locations or competitive markets?	●	○	○	○	○	Company A has strong organic growth. Company A has not expanded into any new markets or regions. Company
5. Have there been any significant changes in the IT environment?	○	○	●	○	○	There have been some discussions about upgrading IT systems, but the project is not scheduled for the current
6. Does the company engage in any highly complex transactions (e.g., use of derivatives)?	○	○	○	●	○	In the current year, the company has begun hedging their fuel costs. Given the lack of expertise in the Company for
7. Evaluate the complexity of the Company's revenue recognition policies.	○	●	○	○	○	Revenue recognition always presents a risk of misstatement due to error or fraud. However, there are no

Instructions: Use the scale (in column 2) to complete your **current year** numerical rating and the text box (in column 3) to document your **current year** evidence.

2. Factors related to the Company's internal controls

	Risk Rating					Evidence for Risk Rating
	Low		Medium		High	
	1	2	3	4	5	
1. Is the board of directors active and qualified? Are the audit committee members independent from the Company?	○	●	○	○	○	Board is active and has one financial expert on the audit committee. We have a private meeting with audit
2. Are sound integrity and ethical values from top management developed and understood?	○	○	○	●	○	CEO supports established procedures and encourages his top executives to set an appropriate ethical tone that
3. Does the Company have an objective and competent internal audit function?	○	●	○	○	○	Company A's internal audit function is objective. Several important mechanisms related to objectivity are in place.

Instructions: Use the scale (in column 2) to complete your **current year** numerical rating and the text box (in column 3) to document your **current year** evidence.

3. Factors related to the Company's financial health (e.g. performance measures)

	Risk Rating					Evidence for Risk Rating
	Low		Medium		High	
	1	2	3	4	5	
1. Evaluate the Company's current year performance (e.g., operating income, cash flows from operations, performance trends).	●	○	○	○	○	Company A has strong performance. Company A continues to have trends of increasing sales, operating
2. Evaluate the Company's key financial statement ratios, and compare to industry peers.	○	○	●	○	○	Most key financial statement ratios, such as gross profit margin and debt to equity, are consistent with industry
3. Evaluate pressure on management to meet earnings targets.	○	●	○	○	○	Several analysts follow Company A and forecast Company A's earnings. This creates pressure for management to

Instructions: Use the scale (in column 2) to complete your **current year** numerical rating and the text box (in column 3) to document your **current year** evidence.

4. Factors related to the nature of the entity

	Risk Rating					Evidence for Risk Rating
	Low		Medium		High	
	1	2	3	4	5	
1. Evaluate the organization's structural characteristics (e.g., size, complexity, geographic dispersion), including any changes.	○	○	●	○	○	Company A is a large, publicly traded company. It holds 20 percent of the market share. Company A operates in
2. Evaluate the Company's top management team, including any changes in key executives.	●	○	○	○	○	All executives seem to have adequate skills necessary to successfully complete their jobs. No changes in
3. Evaluate the competency of the Company's accounting staff.	○	●	○	○	○	Company A's accounting staff are competent and most of the are quite experienced and knowledgeable. The
4. Evaluate the source, nature and profitability of the Company's revenue sources.	○	●	○	○	○	Company A's revenue sources are consistent, profitable, and are in line with industry standards. No concerns
5. Evaluate key third parties, including the Company's significant customers, as well as any union contracts.	○	○	○	○	●	Company A's customer base is steady. It also has many union workers. When relationships with unions are
6. Evaluate the Company's related party transactions for business rationale, disclosure, and proper approval.	○	●	○	○	○	Company A does not engage in very many related party transactions. Any related party transactions are

Reaching this screen signifies that you have completed the Risk Assessment Task.

To confirm:

- If you have not completed the Risk Assessment Task, please click the backward arrow button to navigate back to the task and continue working.
- If you have completed the Risk Assessment Task, please click on the forward arrow button below to continue on with the research study. **Note, you will not be able to return to the task after you click on the forward arrow button.**

You have completed the Risk Assessment Task.

Now we would like to ask you questions about the task and about yourself. We estimate that it will take you approximately 10 minutes to answer these remaining questions, and then you will have completed the study. Your input on these questions is very valuable to us, and we greatly appreciate your careful consideration of the remaining questions.

Consistent with the entire study, your answers to these questions are anonymous as well. Please click the arrow below to continue.

Please indicate the number on the scale that best represents your answer to the following statements. Read each statement as if it begins with the following phrase:

The manner in which Smith & Co. gave me access to prior year's workpapers was done to...

	Strongly Disagree 1	2	3	Neither Agree or Disagree 4	5	6	Strongly Agree 7
...promote effectiveness in the audit.	○	○	○	○	○	○	○
...promote efficiency in the audit.	○	○	○	○	○	○	○
...fulfill the PCAOB documentation requirements.	○	○	○	○	○	○	○
...help train new auditors.	○	○	○	○	○	○	○
...reflect the fact that most of its clients' risks change little from year to year.	○	○	○	○	○	○	○

Have you ever performed a risk assessment task during an audit before?

○ Yes

○ No

Now, think back on the risk factors from the audit client in this case that you thought may have **increased** from the prior year, and indicate the number on the scale that best represents your thoughts about the following statements.

	Strongly Disagree 1	2	3	Neither Agree or Disagree 4	5	6	Strongly Agree 7
I felt like Smith & Co. would want me to increase these risk ratings.	○	○	○	○	○	○	○
I worried about what would happen to audit efficiency if I increased these risk ratings (e.g., that hours might go over budget).	○	○	○	○	○	○	○
I worried about what would happen to audit effectiveness if I did not increase these risk ratings (e.g. that we might miss a misstatement).	○	○	○	○	○	○	○

Please estimate the time you last ate something.

- ◯ Less than 1 hour ago
- ◯ 1 to 2 hours ago
- ◯ 2 to 3 hours ago
- ◯ 3 to 4 hours ago
- ◯ 4 to 5 hours ago
- ◯ More than 5 hours ago

Please estimate the number of hours you slept last night.

- ◯ Less than 4 hours
- ◯ 4 to 5 hours
- ◯ 5 to 6 hours
- ◯ 6 to 7 hours
- ◯ 7 to 8 hours
- ◯ More than 8 hours

Now, think back on the risk factors from the audit client in this case that you thought may have **decreased** from the prior year, and indicate the number on the scale that best represents your thoughts about the following statements.

	Strongly Disagree 1	2	3	Neither Agree or Disagree 4	5	6	Strongly Agree 7
I felt like Smith & Co. would want me to decrease these risk ratings.	◯	◯	◯	◯	◯	◯	◯
I worried about what would happen to audit effectiveness if I decreased these risk ratings (e.g. that we might miss a misstatement).	◯	◯	◯	◯	◯	◯	◯
I worried about what would happen to audit efficiency if I did not decrease these risk ratings (e.g., that hours might go over budget).	◯	◯	◯	◯	◯	◯	◯

Please note how many months of audit experience you have (include any internship experience).

Now, think back on the risk factors from the audit client in this case that you thought may have **stayed the same** as the prior year, and indicate the number on the scale that best represents your thoughts about the following statement.

	Strongly Disagree 1	2	3	Neither Agree or Disagree 4	5	6	Strongly Agree 7
I felt like Smith & Co. would want me to keep these risk ratings the same.	○	○	○	○	○	○	○

How many undergraduate audit classes have you had?

- ○ 0
- ○ 1
- ○ 2

How many graduate audit classes have you had?

- ○ 0
- ○ 1
- ○ 2

Please indicate the number on the scale that best represents your thoughts about the following statements.

	Strongly Disagree 1	2	3	Neither Agree or Disagree 4	5	6	Strongly Agree 7
I felt mentally overloaded when trying to combine the current client information with the prior year's risk ratings.	○	○	○	○	○	○	○
It was easy to integrate the current year and prior year information.	○	○	○	○	○	○	○
I felt like I had to divide my attention between the current year and prior year information.	○	○	○	○	○	○	○
It was easy to remember prior year information when thinking about current year information.	○	○	○	○	○	○	○
I invested a lot of mental energy in considering prior year information when making current year decisions.	○	○	○	○	○	○	○
I had to stay very focused to use both prior year and current year information at the same time.	○	○	○	○	○	○	○
It was important to me to be accurate in my performance on the risk assessment task.	○	○	○	○	○	○	○

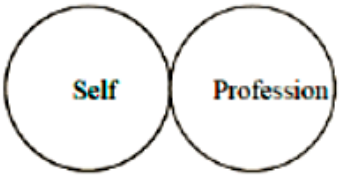
Please check all the degrees you have obtained:

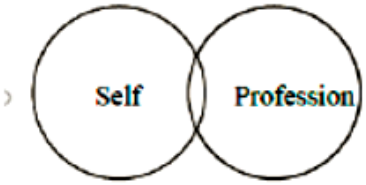
- ☐ Bachelors in Accounting
- ☐ Bachelors in Business (other than accounting)
- ☐ Masters in Accounting
- ☐ Masters in Business Administration (i.e., MBA)

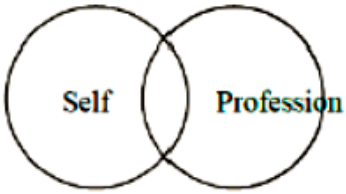
Please indicate the number on the scale that best represents your answer to the following statement.

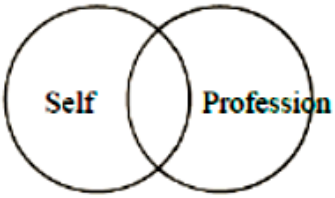
	...far more about efficiency than effectiveness	...equally about both efficiency and effectiveness	...far more about effectiveness than efficiency
	0 10 20 30 40 50 60 70 80 90 100		
In this study, *the manner in which Smith & Co. provided me access to prior year's workpapers* suggested that it seemed concerned...			

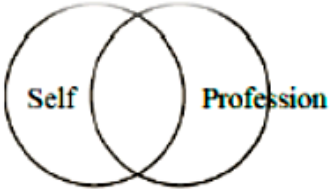
Select the picture below that best describes how your personal attributes, qualities, and values **align or overlap** with the attributes, qualities, and values of the accounting profession.

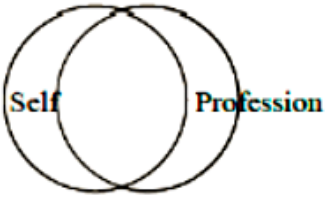






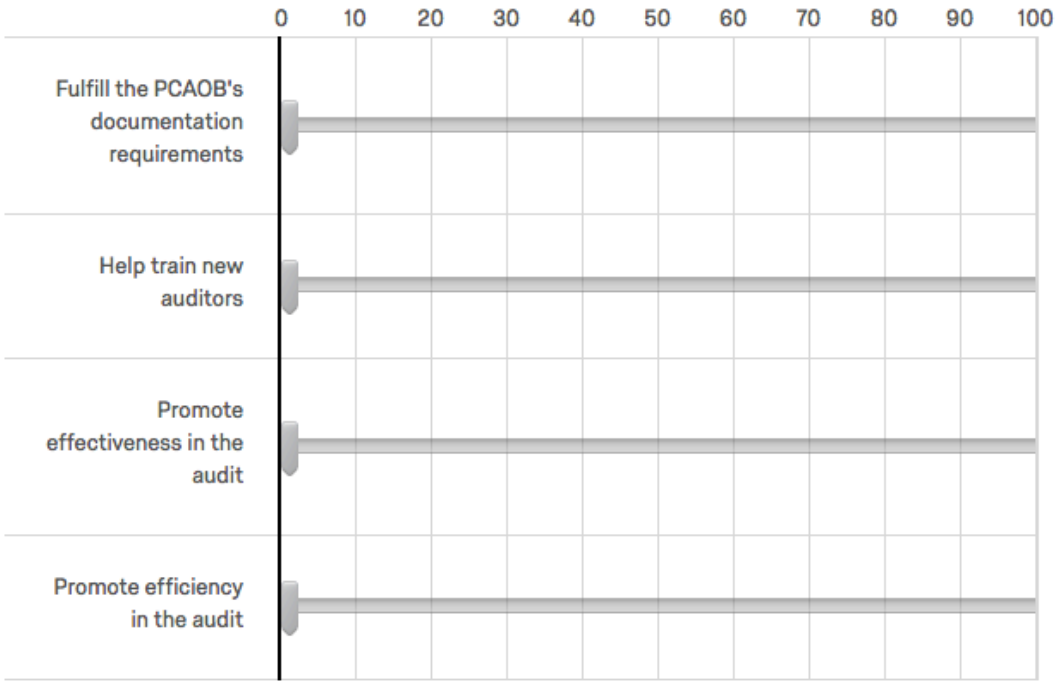






We are now interested in understanding your beliefs about why Smith & Co. decided on the workpaper structure (regarding how to provide prior year information).

That is, please allocate 100 possible points among the following potential reasons behind Smith & Co.'s workpaper structure choice (with the most points allocated to the most important reason, next most points allocated to the next most important reason, etc. with the least most important reason receiving the least points). To allocate points to a reason, please drag the bar beside that reason until you get to the number of points that you would like to allocate for that reason. Note that the total must sum to 100.



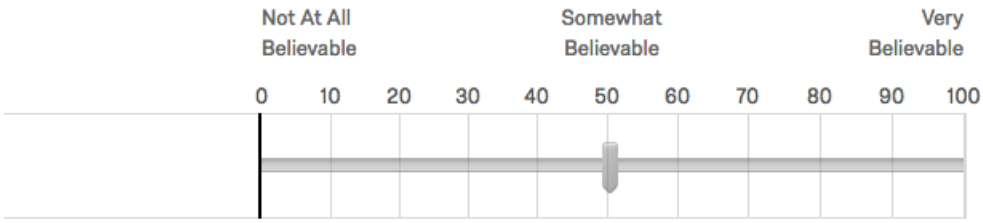
To confirm your understanding of the structure of the workpapers, were the prior year's numerical risk ratings and evidence documentation automatically copied over into your current year workpapers? Please click yes or no.

- ◯ Yes
- ◯ No

Please click the button below that corresponds to the guidance that you were given to read prior to completing the risk assessment task:

- ◯ PCAOB Auditing Standard 2110: *Identifying and Assessing Risks of Material Misstatement*
- ◯ PCAOB Auditing Standard 2110: *Identifying and Assessing Risks of Material Misstatement* **and** *Selected Guidance from Other PCAOB Documents*

In this study, Smith & Co. selected the workpaper structure (i.e., whether prior year risk ratings and evidence were automatically copied over into the current year workpapers). Did you find the fact that *Smith & Co. made this decision* believable?



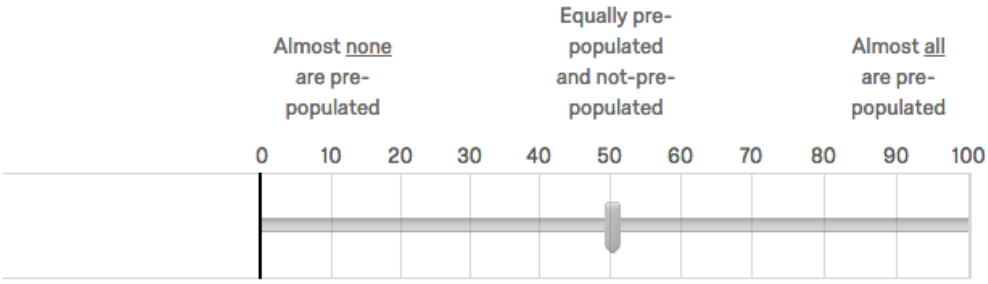
Current year workpapers can be pre-populated (i.e., have prior year documentation either automatically copied over or copied and pasted from prior year workpapers) or not pre-populated (i.e., be blank).

Please click the button that best corresponds to the workpapers that you work with on your audit engagements:

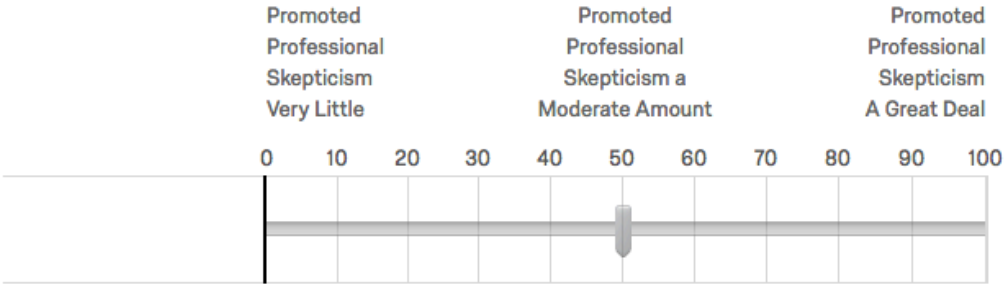
- ○ The workpapers on all of my engagements are pre-populated.
- ○ The workpapers on all of my engagements are not pre-populated.
- ○ The workpapers on some of my engagements are pre-populated, while the workpapers on some of my engagements are not pre-populated.

Note: the below question is displayed if the participant selects the third option above

Please indicate, on the scale below the extent to which workpapers on your engagements are pre-populated with prior year documentation.

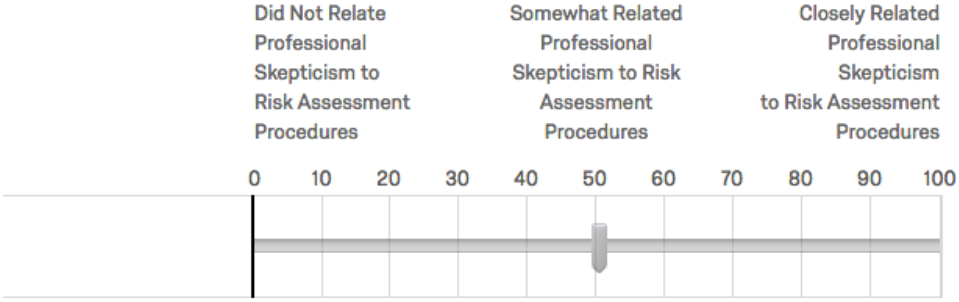


Recall that you were provided guidance to read before completing the risk assessment task. To what extent do you feel like the guidance you were provided promoted the importance of professional skepticism?



Note: the below question is viewed by auditors in the General and Task-Specific Guidance conditions

How closely do you believe the ***Selected Guidance from PCAOB Documents*** that you received (i.e., the guidance provided immediately before you began the risk assessment task) related professional skepticism to risk assessment procedures?



Please click on the arrow below to complete the study.

As a reminder, for this research, it is critical that you do not discuss this study with any other participants until after all participants will have completed the study.

Thank you again for participating in this study!

APPENDIX B

Background Information (Audit Case)

Background Information

Company A is a large, publicly traded company that operates in the grocery industry. Company A currently holds approximately 20 percent of the market for food sold through conventional food outlets (i.e., supermarkets). It operates in one country and has a significant presence in all Regions, except the Southern Region. It is the market leader in the Northern Region (33 percent), the Eastern Region (46 percent) and the Western Region (46 percent). Company A just started expanding into the Southern Region this year and currently has less than 1 percent of the market share.

The Grocery Industry

The grocery industry is competitive and dominated by eight major chains that hold approximately 75 percent of the traditional food distribution market. With sales of $11.01 billion and 70,000 employees, Company A is the market leader in the grocery industry.

The grocery industry has shown little growth in recent years. Starting this year, the grocery industry faces increased competition from companies in the retail industry such as warehouse clubs, drug chains, and mass merchandisers who are moving into the grocery business. A real threat to traditional grocers is the possibility that Big-Box, a new competitor, will move more broadly into the grocery business. Currently, Company A and Big-Box overlap only slightly. However, Big-Box is rolling out several full-fledged supermarkets to experiment with this new concept, and Big-Box recently expanded the food sections at some stores in the Northern Region. The addition of refrigerated grocery products has many believing that Big-Box will formally introduce a new "supercenter" format this year.

That is, Big-Box is expected to begin expanding its development of the supercenter (130,000 sq. ft.) concept. Big-Box is renowned for its technologically sophisticated distribution system and its ability to control its costs. Company A has anticipated the move by Big-Box. Should Big-Box decide to formally enter the grocery market in "a big way" by converting the majority of its stores to supercenters, Company A will be ready with plans for squeezing inefficiencies from its cost structure, especially in the area of distribution-related information systems and changing its product mix. However, according to analysts, Company A is struggling to find the correct response. Analysts are concerned that if Company A does not take a focused approach, it will lose market share to Big-Box. To encourage Company A's management to compete with Big Box, the compensation committee has added a new aspect to Company A's incentive package that will reward management for successfully competing with Big Box.

The Southern Region market that Company A entered this year is the largest and becoming the most competitive food retailing market in the country. In the past year, another company that had a strong presence in the Southern Region converted many of its stores to discount markets. The discount markets cut into the sales and margins of all competitors in the Southern Region.

In summary, the grocery industry is healthy, with high demand and as one reporter notes, "people will always have to eat." But the maturity of the industry, characterized by flat demand, combined with the growth aspirations of the dominant suppliers and the potential entrant of other players, makes the industry a competitive battleground.

Company A

Performance

Company A management is confident about the company's accomplishments and future prospects, as evidenced by this press release issued by Company A (note that Smith and Co. verified the numbers):

This year is an outstanding one for Company A by any measure. Sales increased to $11.01 billion, up 12 percent from the prior year, with operating income of $426 million, net earnings of $213 million and earnings per share of $0.88, all of which set new highs. Further, we have met or beat analyst forecasts each quarter this year, and we expect this trend to continue for the foreseeable future.

Sales are now increasing rapidly, year-on-year, with an estimated growth of $1 billion this year. In fact, sales are the "big story" in Company A. In total, the grocery industry is growing about 3 percent a year and our sales have grown by 20 percent in the last 2 years. We expect sales to match or beat these growth rates in the upcoming two years as well.

Company A maintains a significant program of reinvestment in and expansion of our existing markets. We are highly selective in acquisitions and continue to invest in products and technology. Company A seeks long term, stable growth, taking managed operating risks from a strong balance sheet position.

The auditor has determined that Company A's revenue sources, profitability, trends, and performance are in line with industry standards and show reasonable growth relative to prior year financial results.

Moreover, some key metrics have shown favorable trends this year. Especially noteworthy is Company A's sizeable increase since last year in inventory turnover, which is due to cutting edge technologies Company A management employed to increase efficiency of inventory management. These changes resulted in Company A having superior inventory turnover, compared to its key competitors, as well as to last year.

Also noteworthy is Company A's increase in Accounts Receivable Turnover since last year, which is due to Company A strengthening its credit granting terms for credit customers who purchase for resale store-brand products that Company A manufactures. Company A has determined this change in credit granting terms was a good strategic decision, as it improved collectability of receivables with customers without negatively impacting sales. This change also resulted in Company A's Accounts Receivable Turnover being consistent with key industry competitors.

Finally, Company A's gross profit margin has increased (and is now higher than industry

averages), due to new, long-term contracts made with suppliers for significant purchase discounts (that are exclusively for Company A and no other industry competitors).

Current Strategy

Company A has had strong organic (same store) growth and growth through acquisitions. Central to the company's growth strategy has been aggressive expansion of new stores and upgrades to its existing stores. Company A has opened new stores at a rate far exceeding that of its competitors. Similar expansion is planned for the next few years, especially in the highly competitive Southern Region. In the past few years, most acquisitions have been relatively small in size. However, in the current year, Company A acquired a very large regional grocery (its largest acquisition in the past five years). This purchase expands its footprint in the Southern Region, but, due to its large size, the acquisition will require significant work for Company A to assimilate this grocery chain into Company A's operations and structure.

Last year, Company A initiated a new program to hedge its fuel costs. Analysts initially expressed concern last year that Company A might not have the in-house derivatives expertise in this area to successfully structure hedges and account for these complex transactions. However, Company A has been very successful with hedge accounting, in smoothing out volatility in earnings and guarding against exposure to changes in fuel costs. Further, Company A hired two in-house derivatives specialists at the beginning of this year – one who specializes in structuring hedges and one who specializes in hedge accounting. The audit team is confident in the specialists' objectivity and competence.

Information Systems

Due to growth via acquisitions, Company A has a large set of *ad hoc* information systems. The large acquisition in the current year increases information systems issues. There is concern by the auditors that the systems of the acquired company are old, have bad internal controls, and will not easily integrate into Company A's current IT system, which is undergoing upgrades.

To address the issues with the *ad hoc* systems, Company A is planning a large-scale systems conversion project. In fact, industry analysts have begun talking about perceived inadequacies in Company A's current information systems. However, while the audit team believes that there may be risk associated with the client's information systems, they are also concerned with the planned changes being started this year. The conversion will be challenging because Company A was forced to hire a new manager of information systems this year after the last one left to work at a competitor. It will take time for him to get up-to-speed, and there is additional concern with the competency of his team in successfully implementing the changes.

Responding to Consumer Preferences in Initiatives

Company A is a strong competitor because it can respond quickly to consumer spending patterns. For example, in response to increased demand during the current year, Company A has successfully expanded the availability of ready-prepared meals.

In addition, this year, Company A carefully invested in upgrading its stores. Stores in existing markets are enlarged and modernized regularly, but this year, Company A successfully upgraded

and modernized more stores than in prior years. Customers have clearly recognized these initiatives as successful, as tabulated results of customer surveys indicate that Company A's stores have never been viewed as favorably as they are now. Larger stores are generally more profitable than smaller stores because of the greater variety of nonfood items that can be offered, and they are better able to compete with Big-Box. Early this year, Company A implemented a new initiative to increase store sizes, and this initiative resulted in an increase in average store size of 36 percent. This initiative was viewed as cutting edge and favorable by Company A's industry peers.

Company A will begin to introduce restaurants (owned by a third party) into some of its stores, and based on industry practices, the auditor feels these new restaurants will be quite successful. They will earn rent revenues based on a combination of fixed fees as well as a portion of the restaurant's gross sales. The timing of the revenue recognition for these transactions is complex and could lead to issues in accurately applying revenue recognition policies.

Labor

Company A has a philosophy of developing its own personnel. For example, 30 corporate officers have an average of 13.5 years of service with the company. Further, Company A has a large number of unionized employees, approximately 55,700. Relationships with unions are important because Company A's success depends on the attitudes of its employees toward its customers, and these attitudes are better when union relations are favorable.

Last year, many union contracts were under negotiation and unsettled because some members of management wanted to take a harder stance against union negotiations. This created a lot of uncertainty with the union employees and caused customers to have less pleasant experiences in stores, due to less favorable employee attitudes. During the current year, however, the CEO was able to successfully renew all of the union contracts for a long-term period. The CEO was praised by the union for his efforts in negotiations.

Internal Audit Function

The auditor has observed that Company A's internal audit function is very objective, and Company A has consistently had mechanisms to enhance objectivity. For example, Company A's management has no control over the hiring or terminating of internal auditors; instead, Company A's Board of Directors has full control over this process. Further, the Chief Internal Auditor reports to the head of the audit committee. Half of Company A's internal audit group has CPA licenses, and the majority of internal audit personnel are certified with the Institute of Internal Auditors. All of Company A's internal auditors have accounting degrees from accredited universities.

Management and Accounting Personnel

The auditor has observed that Company A's top management are appropriately qualified, have the skills necessary to perform their duties, and typically make relatively conservative financial reporting decisions. The auditor has also verified that any non-routine journal entries have appropriate, documented support and have been approved by the audit committee. Further, Company A engages in very few related party transactions, and any related party transactions are

scrutinized and approved by the Board of Directors for proper business rationale and disclosure.

During the current year, the CEO established a new program for ethical training throughout the organization and an ethics hotline. These programs help all employees focus on sound ethical behavior. This had led some analysts to suggest he is currently the most forward thinking CEO on ethical topics in the industry.

The CFO resigned in May. Analysts were surprised to see his departure, and there have been various unsubstantiated rumors regarding the reasons, some of which were concerning. Company A has said little, except that he has left to pursue new opportunities. The new CFO is not a grocery expert. However, he does have large accounting firm experience within the retail industry.

The auditor has observed that most of Company A's accounting staff are quite experienced and knowledgeable. 20 of the 30 accounting staff have CPA licenses, and half of the staff regularly engage in accounting continuing education courses.

Corporate Governance

Company A's Board of Directors consistently exerts a significant monitoring influence on management. The composition of the Board of Directors has been the same over the past five years. The auditor believes the Board of Directors is qualified and involved. Company A's audit committee has one financial expert, who significantly influences Company A's accounting choices. The auditor has a private meeting with the audit committee every quarter, in which all members are engaged and a lively dialogue takes place. The audit committee members have also stayed the same over the past five years.

APPENDIX C

Prior Year Risk Assessment

1. Factors related to the Company's business risk (business objectives and strategies)

	Risk Rating					Evidence for Risk Rating
	Low		Medium		High	
	1	2	3	4	5	
1. Evaluate the Company's industry developments for possible risks. Consider demand, market capacity, and competition.		●				The industry is strong but has shown little growth in recent years. The industry faces some competition but no large threats. Despite competition, Company A continues to grow and gain market share. They have responded well to industry changes and those changes in strategies are not too aggressive. Therefore, while there is a higher than normal risk in the industry, we deem the risk low to moderate for Company A given their current stance in the industry.
2. Are there any expected changes in the entity such as large acquisitions, reorganizations, or other unusual events?		●				Company A continues to expand with some acquisitions. But the acquisitions are all relatively small; no single acquisition is material to the Company A as a whole. Prior acquisitions have been assimilated without concerns. There were no restructurings in current year.
3. Has the Company made any changes to its business model (e.g., new product offerings, initiatives, changes to stores)?			●			Company A has begun to expand business by introducing several new product lines, such as ready-made meals and more fresh produce. Company A also has been increasing the size of current stores. The larger stores are offering greater selection of goods. We are unsure of how successful these initiatives will be.
4. Has the Company expanded its operations into any new locations or competitive markets?	●					Company A has strong organic growth. Company A has not expanded into any new markets or regions. Company A's key competitors have stayed consistent.
5. Have there been any significant changes in the IT environment?			●			There have been some discussions about upgrading IT systems, but the project is not scheduled for the current year. Company A has a large number of ad-hoc systems due to acquisitions. The ad-hoc systems create some operating and financial reporting risks. We rank this as a moderate risk.
6. Does the company engage in any highly complex transactions (e.g., use of derivatives)?				●		In the current year, the company has begun hedging their fuel costs. Given the lack of expertise in the Company for this activity, there is increased risk to this area.
7. Evaluate the complexity of the Company's revenue recognition policies.		●				Revenue recognition always presents a risk of misstatement due to error or fraud. However, there are no specific issues noted during the current year. Company A's revenue recognition policies are in line with the industry standards, and have stayed consistent.

2. Factors related to the Company's internal controls

	Risk Rating (Low 1, 2, Medium 3, 4, High 5)	Evidence for Risk Rating
1. Is the board of directors active and qualified? Are the audit committee members independent from the Company?	2	Board is active and has one financial expert on the audit committee. We have a private meeting with audit committee, where all members have been actively engaged. In addition, all topside adjustments have appropriate, documented support and have been appropriately approved. However, the audit team does note that the Board of Directors and audit committee membership has stayed the same over the past five years. Bringing in a new member or two could provide some beneficial "fresh eyes".
2. Are sound integrity and ethical values from top management developed and understood?	4	CEO supports established procedures and encourages his top executives to set an appropriate ethical tone that organization appears to follow. However, Company A is missing some key initiatives that are important to promoting sound ethical values from top management. For example, the organization does not have an ethics hotline or a program for ethical training. Our audit team recommended they implement these items as soon as possible.
3. Does the Company have an objective and competent internal audit function?	2	Company A's internal audit function is objective. Several important mechanisms related to objectivity are in place. The Chief Internal Auditor reports to the head of the audit committee and has no direct reporting channels to management. The Board of Directors, as opposed to management, hires and terminates internal auditors. Company A's internal function is relatively competent. All internal auditors have accounting degrees from accredited universities; however, only half of internal audit has CPA licenses. The majority of the internal audit group is certified with the Institute of Internal Auditors.

3. Factors related to the Company's financial health (e.g. performance measures)

	Risk Rating (Low 1, 2, Medium 3, 4, High 5)	Evidence for Risk Rating
1. Evaluate the Company's current year performance (e.g., operating income, cash flows from operations, performance trends).	1	Company A has strong performance. Company A continues to have trends of increasing sales, operating income, and net earnings. The performance trends are all positive and the increases are reasonable with expectations given the steady growth in operations.
2. Evaluate the Company's key financial statement ratios, and compare to industry peers.	3	Most key financial statement ratios, such as gross profit margin and debt to equity, are consistent with industry peers, but Company A's inventory turnover and accounts receivable turnover lag behind industry peers. This is because Company A has looser credit terms than their industry peers and also is not as efficient with inventory management.
3. Evaluate pressure on management to meet earnings targets.	2	Several analysts follow Company A and forecast Company A's earnings. This creates pressure for management to meet analysts' estimates. Company A consistently meets or beats analysts' estimates. While we have found no direct issues, this inherent pressure to continue a trend of meeting earnings targets causes us to maintain a low to moderate risk. In addition, manager incentive packages are in line with industry standards, reviewed by BOD and contain reasonable performance targets.

4. Factors related to the nature of the entity

	Risk Rating					Evidence for Risk Rating
	Low		Medium		High	
	1	2	3	4	5	
1. Evaluate the organization's structural characteristics (e.g., size, complexity, geographic dispersion), including any changes.	○	○	●	○	○	Company A is a large, publicly traded company. It holds 20 percent of the market share. Company A operates in multiple geographical regions (Northern, Eastern, and Western) but all in one country. Company A has strong organic growth and growth through acquisitions but the risk is low because Company A has not entered into any new markets. Company A maintains a regional focus but overall the organizational complexity is low risk. Given the size of the company and the number of users relying on the financial statement (e.g., investors and analyst following), we rate the risk as moderate.
2. Evaluate the Company's top management team, including any changes in key executives.	●	○	○	○	○	All executives seem to have adequate skills necessary to successfully complete their jobs. No changes in executives for the current year. Area deemed low risk.
3. Evaluate the competency of the Company's accounting staff.	○	●	○	○	○	Company A's accounting staff are competent and most of the are quite experienced and knowledgeable. The accounting staff consistents of 30 staff, and 20 of these 30 staff members have CPA licenses. Approximately half of the group participates in continuing education accounting courses on a regular basis.
4. Evaluate the source, nature and profitability of the Company's revenue sources.	○	●	○	○	○	Company A's revenue sources are consistent, profitable, and are in line with industry standards. No concerns identified. Their gross profit margin is consistent with industry peers.
5. Evaluate key third parties, including the Company's significant customers, as well as any union contracts.	○	○	○	○	●	Company A's customer base is steady. It also has many union workers. When relationships with unions are favorable, this leads to better customer relations because employees are happier and provide customers with a better in-store experience. Many of the union contracts expired this year and were not yet renewed; negotiations are currently taking place. There was also some discussion that some executives of Company A may take a harder stance with unions in current negotiations. It is unknown as to how this union negotiation may affect relations with Company A's customers. Therefore, we are ranking this a higher risk area in the current year.
6. Evaluate the Company's related party transactions for business rationale, disclosure, and proper approval.	○	●	○	○	○	Company A does not engage in very many related party transactions. Any related party transactions are evaluated by the Board of Directors for business purpose and proper disclosure, and also must be approved by the Board of Directors. However, related party transactions are an area that requires scrutiny for fraud, so there is always a degree of risk involved.