Case 16-5

Skeptical Lens

Professional skepticism is at the core of ultimately performing a quality audit. Below are three case studies that will focus your attention on what it takes to be a skeptical auditor when performing journal entry testing.

The specific facts and circumstances of each case are described below.

Case Study A — Not Just a Trivial Item

I joined a Big Four accounting firm straight out of college a few years ago as a staff accountant. My first assignment on an audit engagement was a learning experience I would never forget; it was a practical lesson perhaps even more valuable than my newly minted accounting degree.

On our way to the client, Susan, a senior accountant and one of my new colleagues, cautioned me about the CFO:

“He has a bit of a reputation,” she said, adding, “Let me know if you have problems. And don’t let him browbeat you!” That comment, as an introduction to my brand-new career, was just a little unsettling.

I was given what seemed to be a nice, safe task: testing routine journal entries, which involved selecting items from the population and examining the supporting evidence. I asked a clerk for some reconciliations and a little later, to my surprise, I got a call from the CFO himself to ask why we were working on “trivial items,” as he called it.

“We hired you for the big picture, not this kind of stuff,” was his terse comment, and he hung up before I could respond.

We were under a tight deadline to get the audit completed, and after several days there was no sign of the reconciliations I’d requested. I talked to Susan and later Mike, the engagement partner.

When I finally received the reconciliations and tested them, I noticed a high volume of journal entries that even to my inexperienced eyes seemed a little out of the ordinary.

Case Study B — Journal Entries Reveal a Puzzling Pattern

For several years, I’ve been a senior audit manager on a subsidiary of a foreign entity. We conduct the annual audit, with no review of quarterly financial information.
One year, a few months before we started fieldwork, the client hired a new controller and made some other personnel changes to the finance team. When we began our work, we found more small errors than usual, specifically in revenue and accounts receivable.

We attributed the errors to the change in personnel and were not overly concerned, but we modified our procedures for testing revenue and looked for journal entries made to revenue with offsets to unusual accounts.

We soon noticed a trend: entries to revenue often had an offset to atypical accounts. The pattern was puzzling because the entries both increased and decreased revenue during the course of the year, so it was difficult to understand any potential reasoning.

As the reporting deadline approached, the partner and I sat down with the controller to ask for an explanation.

In response to our questions, the controller produced a spreadsheet and showed us that all the topside entries netted out to a minimal effect on the final full-year results. He indicated that the entries were made with the agreement of the CEO.

Since we were performing an annual audit of the financial statements on which these entries had little effect, the controller evidently felt our questions were satisfied.

“But what was the purpose of the entries?” our partner asked. “We need to understand why these topside entries have been made,” he persisted.

There was a long, uncomfortable pause. Finally, the controller sighed and said, “Well, you may not like the answer. Let me ask the CEO to join us.”

They explained that they tried to make the quarterly results approximate the budgeted amounts, solely for the purpose of reporting to the foreign parent. This was intended to avoid having to explain unfavorable quarterly variances, a normal part of this company’s business cycle. The CEO added that his team fully understood their business, and they were confident that the full-year results would approximate the budget.

**Case Study C — You Just Don’t Understand Journal Entries**

I was a first-year senior assigned to the audit of a large client. I welcomed the challenge and the learning experiences I was sure would come with it.

Every year the engagement team deliberately varied the nature, timing, and extent of audit procedures, and this year the team planned to test an account balance that didn’t vary much year to year and was seen as a low-risk.

However, as we began testing the account balance, we realized it would involve a lot more work than we expected. It seemed that there was a large volume of journal entries posted to the account representing allocations and expenses from nearly every location across the United States.
We needed to make requests of entity personnel at various locations to understand the nature and purpose of the journal entries that had been posted to the account. Of those personnel, relatively few had ever interacted directly with an external auditor.

Initially, entity personnel were more than willing to help, but no one person seemed to know the whole story. We were constantly being directed from one person to another, and each person could offer only partial explanations for the journal entries we were inquiring about.

Soon it became routine for us to be on a call with eight or ten entity personnel from the various groups involved in the journal entries, trying to gain a full understanding of the purpose of the journal entries and underlying allocations and expenses.

As our work continued, the frustration of both parties increased, and we noticed a distinct change in the tenor of the calls.

Instead of focusing on answering our questions, the entity personnel believed that we were wasting their time, and they became defensive.

“It’s been done this way forever,” “you’re spending way too much time on insignificant items,” and “you just don’t understand the way we handle expenses,” were some of the comments that fell on my inexperienced ears. To be honest, at times I felt uncomfortable, and sometimes it was a bit intimidating. But I knew we had a job to do.

As we neared the completion of our fieldwork, explanations and support for several of the journal entries remained open and unresolved, prompting some rather pointed internal questions from the partner in charge of the audit engagement.

**Required:**

1. Formulate a definition of professional skepticism.
2. Why is professional skepticism important?
3. What are the barriers to applying professional skepticism?
4. Read each case study and evaluate what you would do next.
5. Given the knowledge gained from these case studies, what are the key elements to applying professional skepticism?