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Decision Making in a Public Accounting Firm: An Instructional Case in Risk Evaluation, Client Continuance, and Auditor Independence within the Context of the Sarbanes-Oxley Act of 2002

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ABSTRACT: The purpose of this case, loosely based on an actual auditor-client situation, is to study decision making by auditors in public accounting firms regarding risk management (business, engagement, and audit risk), client continuance, and auditor independence. Audit partners often face difficult decisions for which they must balance the business objectives of the firm with their professional objective of satisfying the public interest. While most studies and cases focus on client-acceptance decisions (e.g., Johnstone 2000; Gendron 2002; Knapp and Knapp 2004), an equally important decision for public accounting firms in the Sarbanes-Oxley era is whether to keep a current client. This case encourages students to consider the decision with respect to client continuance, auditor independence, and risk evaluation.

INTRODUCTION

From the early 1970s until the early 2000s, public accounting firms focused more on the growth of the firm and not as much on professional values (Zeff 2003). Audit and tax partners were under considerable pressure to generate revenue by finding new clients, retaining existing clients, and cross-selling consulting services to both. Penalties for not achieving growth targets were severe, including possible dismissal from the firm. Unfortunately, some of these business practices had negative consequences.

In particular, many media reports drew attention to the fraud that occurred at Enron, WorldCom, Global Crossing, and other large firms. Such accounting scandals and business failures at large corporations in the United States caused legislators to enact the Sarbanes-Oxley Act of 2002 (SOX).[1] In an attempt to preclude such egregious wrong-doing in the future, Section 404 of SOX (implemented by rules from the SEC) requires management of

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[1] Many sources are available to learn more about the Sarbanes-Oxley Act of 2002. Some of the websites that offer this information include: http://cpcaf.aicpa.org/Resources/Sarbanes+Oxley/, http://www.sarbanes-oxley.com, http://www.theiia.org/iia/guidance/issues/sarbanes-oxley.pdf, and http://www.sec.gov/spotlight/sarbanes-oxley.htm. A book on the topic has been written by Lander (2004).

public companies to establish and maintain adequate internal control over financial reporting. To satisfy this requirement, management of a firm must have an effective internal control system and is required to report to shareholders regarding the effectiveness of its controls over financial reporting. This assessment must be accompanied by an attestation to that report by the company's independent public accounting firm. Other important provisions in the SOX legislation include: (1) restrictions on certain services that public accounting firms may provide to audit clients; (2) specific requirements regarding interactions between public accounting firms and audit committees; (3) explicit requirements regarding audit committee members; and (4) rules for mandatory partner rotation.

Indeed, in the wake of SOX, the issue of risk assessment has taken on a much more important role. Due to the demise of Arthur Andersen, the remaining Big 4 accounting firms have reassessed their risk with respect to their clients. Subsequently, the Big 4 firms have dropped hundreds of clients whose accounting practices were too aggressive or who were unwilling to pay premiums for the risk they represented (Hindo 2003; Johnstone and Bedard 2004).

This case enables students to study client continuance policies, risk-containment issues, and auditor independence within the organizational context of a CPA firm. According to Power (1995), very little is known about auditing in its organizational setting with respect to the audit firm and its clients. Hopwood (1996) maintains that, despite a number of major research initiatives, the audit process and context remain obscure for too much of the practice, and the task of auditing remains unknown. While most studies and cases focus on client acceptance decisions (e.g., Johnstone 2000; Gendron 2002; Knapp and Knapp 2004), an equally important decision in the Sarbanes-Oxley era is whether to keep a current client. This concern is just as important to regional accounting firms as it is for the Big 4 accounting firms.

Over the past several decades, standard setters have implemented rules to deal with auditor independence, client-continuance issues, and the ever-increasing level of risk in business. The AICPA issued Statements on Quality Control Standards and the Standards for Performing Peer Reviews. The AICPA also issues periodic Audit Risk Alerts. More recently, the Public Company Accounting Oversight Board (PCAOB 2006), formed as a result of SOX, has issued four auditing standards, and has adopted (on an interim basis) the AICPA's auditing standards, attestation standards, quality control standards, and ethics/independence standards contained in the AICPA (2005) *Code of Professional Conduct* (the Code).

Several possible frameworks are available as decision aids to help public accounting firms assess risks associated with the client-continuance decision. For example, Johnstone and Bedard (2004) propose a framework for the client-acceptance decision that includes an assessment of financial risk, audit risk, and auditor business risk, and then balances this assessment against the potential billing rate for the client. If the balance between risk and return is acceptable, then the decision would be to accept the prospective client (or continue with a current client).

Another framework that is described in much greater detail is an actual auditor decision aid (KRisk) that one public accounting firm developed to make more consistent client-continuance risk assessments across the firm (Bell et al. 2002). Examples of client-continuance risk factors in this decision aid include: entity and engagement information, third-party information/due diligence, quantitative and qualitative information, entity's organization and operations, entity's financial reporting, and recent audit results. Some of the qualitative issues auditors might want to research include the maturity of the industry, competitors in the industry, barriers to entry, profit margins, and ability to control costs.

The Committee of Sponsoring Organizations (COSO) of the Treadway Commission released an Enterprise Risk Management (ERM) framework in 2004 to help organizations better manage risk throughout the organization. This framework includes eight interrelated components: internal environment, objective setting, event identification, risk assessment, risk response, control activities, information and communication, and monitoring. Arens et al. (2006) believe that an effectively implemented ERM system will be beneficial to auditors as they assess client business risks.

Auditors in professional accounting firms are facing unprecedented levels of business risk, engagement risk, and audit risk.[2] At the same time, firms' professionals are confronted with a highly competitive and very litigious business environment. Auditors must apply experience and judgment as they adopt strict client-acceptance/-continuance policies to help control risk within the firm. In addition, the growth of professional accounting firms must be controlled so that neither the firm nor its clients are exposed to unreasonable liability risk. According to Statements on Quality Control Standards, the firm must appropriately consider the risks associated with providing any professional services (AICPA, QC 20.15).

Regarding auditor independence, the Code clearly identifies "responsibility to the public" as a distinguishing characteristic of a profession. For the public accounting profession, its public includes clients, creditors, regulators, investors, and the business and financial community at large. The public relies on accountants to be objective and honest in maintaining the orderly functioning of commerce (AICPA, ET 53.01). The attribute of objectivity implies that CPAs are impartial, intellectually honest, and free from conflicts of interest. CPAs are also required to avoid relationships that may impair their independence, both in fact and appearance, when providing audit services (AICPA, ET 55.01–.03). The first Quality Control Standard also addresses the requirement of auditor independence, integrity, and objectivity (AICPA, QC 20.07).

Statements on Quality Control Standards include guidance regarding acceptance/continuance of clients and engagements, as well as engagement performance (AICPA, QC 20.07). Accordingly, a firm must establish policies and procedures to provide reasonable assurance that it undertakes only those engagements that the firm can reasonably expect to complete with professional competence. The Statements on Auditing Standards, issued by the AICPA and adopted on an interim basis by the PCAOB, contain additional responsibilities/functions of the independent auditor. However, other than detailed guidance on internal controls in a financial statement audit, auditing standards offer few guidelines for making continuance decisions.

CASE: PART I

The Firm

As of March 2005, Johnson Keith Niemeyer LLP (JKN), a large, regional public accounting firm, had offices in 45 U.S. cities in the West and Midwest, as well as several international affiliations. Firm headquarters are located in the Midwest, and the professional staff at the headquarters provide outstanding support to the local offices. JKN has a total of 225 partners and approximately 2,000 supporting professionals and administrative staff. U.S. offices of the firm generally are staffed with 3–10 partners and 20–100 supporting

[2] For this case, *business risk* for the audit firm is the overall risk that the firm will suffer economic loss due to inappropriate business strategy or other business decisions. *Engagement risk* is the risk that the audit firm will suffer harm because of a client relationship, even though the audit report issued to the client was correct. *Audit risk* is the risk that the auditor may fail to appropriately modify the opinion issued to the client, even though the financial statements are materially misstated.

professional accountants and administrative personnel. The firm provides a full array of audit, tax, and consulting services for its clients; these are mostly privately held, owner-managed companies with revenues ranging from $1 million to $50 million, although JKN also serves approximately 80 public companies.

JKN has a reputation for being very conservative in its audit practice. Management has been very careful in its client acceptance and continuance policies. Before submitting proposals to perform audit services, prospective engagement partners must obtain extensive information about the potential client to make an informed decision about whether to accept or reject the engagement. If the prospective engagement partner's decision is to accept a client, then at least one additional audit partner must agree with the decision to accept the client. In the course of evaluating prospective clients, JKN personnel assess their potential exposure from being associated with a particular client or engagement (engagement risk). JKN's acceptance procedures allow the acceptance of high-risk clients only if the risk can be controlled. That is, the engagement team must have relevant expertise and experience to manage the risk, as well as adequate compensation for the risk assumed. Potential clients are evaluated for integrity, industry competence, management experience, and financial condition.

If the prospective client is a public company, then additional due diligence procedures are required. These procedures include evaluating underwriters and legal counsel, performing background checks on members of management and the board of directors, and evaluating the financial viability of proposed transactions and investor returns. In these situations, firm policy requires the approval of the partner responsible for firm-wide audit and accounting policy, as well as the approval of a concurring partner.

Engagement partners re-evaluate existing audit clients on an annual basis to determine whether any events since completion of the last audit might cause the firm to discontinue its relationship with the client. If an existing client is planning a public offering of its securities, then additional due diligence procedures are necessary. In addition to a planned public offering, the re-evaluation of existing clients requires concurrence by another audit partner when certain events or circumstances occur. These events include: a change in majority ownership or management, management's refusal to sign a representation letter, discovery of fraud or other misrepresentations, a client's unwillingness to pay fees, and regulatory investigations.

Traditionally, audit and tax services have been the core business of the firm. However, for the past five years, JKN management has not been satisfied with the firm's financial results, and its new strategy focuses on nonaudit services, primarily management consulting and personal financial services. Therefore, JKN now promotes itself as a business services firm and as a "one-stop shop" for its clients' business needs. Recently, the firm formed alliances with other financial service providers around the country and is aggressively promoting its ability to help with retirement plan administration, insurance, wealth management, and information systems needs for small- and medium-sized, closely held businesses and their owners.

The Briarwood City Office

The Briarwood City office of JKN is located in the Pacific Northwest and is one of the oldest offices in the firm. Three partners, 30 professional staff (mostly CPAs), and five administrative staff make up the Briarwood City team. The partners all graduated from highly rated accounting programs in the U.S. Their areas of specialization/responsibility are as follows:

- *Andrew (Andy) Stevens:* office administration and attest services, including small audits, reviews, and compilations. Andy is very much in tune with the current JKN strategy and is actively involved in promoting nonaudit services and establishing alliances with other professional service providers. Andy joined the firm 20 years ago and has been a partner for ten years.
- *Frank Clement:* attest services consisting of large and small audits, reviews, and litigation support. Frank also serves as a regional quality control resource, conducting concurring reviews for other offices and serving four publicly listed clients from Briarwood City. Frank moved to Briarwood City 18 years ago, after eight years with a national firm in its Chicago office.
- *Bernard (Bernie) Richards:* tax services. Bernie is known as one of the firm's best tax partners. He has excellent corporate and individual client relationships and is one of the most sought-after instructors at firm-wide training sessions. Bernie has been with the firm for 27 years.

Frank and Bernie are very proud of their long careers as audit and tax partners and the firm's rich history providing these services. However, both men have a number of concerns about the future of the firm. They are not very pleased with the firm's new strategy to be a business services firm. In addition, they are very concerned about living up to the firm's responsibilities under SOX. On the other hand, Andy is trying his best to follow the firm strategy of being a one-stop financial service provider, despite the high chargeable hour goals and pressure to grow the practice in his respective area. Mark Grumbles, the regional managing partner for JKN, is very supportive of the firm's strategy and frequently reminds everyone about the need to grow the firm and to sell nontraditional services.

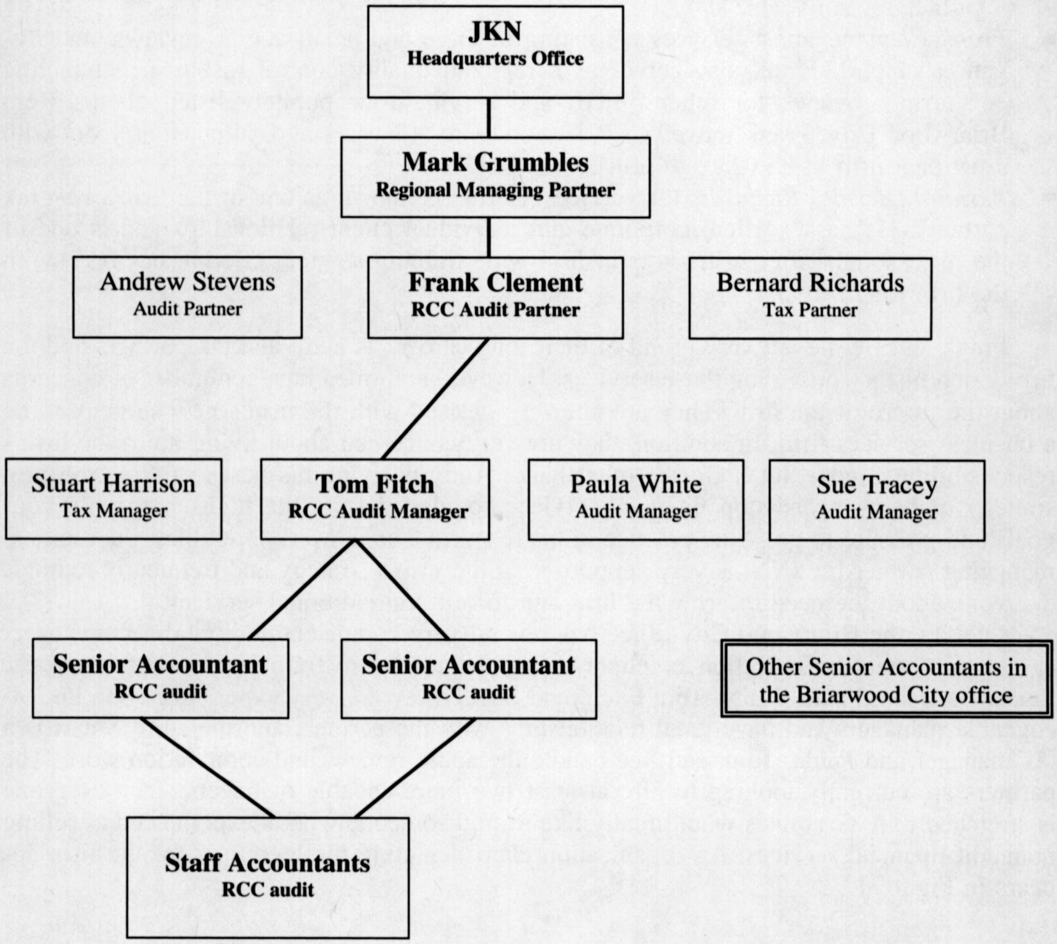
Luckily, the Briarwood City office has several very competent audit and tax managers to assist in the administration of client engagements and to train junior staff members. Stuart Harrison, Paula White, Tom Fitch, and Sue Tracey are very experienced and knowledgeable managers and have great relationships with the partners and the staff. Stuart is a tax manager and Paula, Tom, and Sue handle the audit, review, and compilation work. The partners are currently looking to hire at least two more capable managers since everyone is stretched thin. Grumbles would really like to find someone who is experienced at selling nonaudit financial services. An organization chart depicting the hierarchy for the firm appears in Figure 1.

The Client

Riverside Communications Company (RCC) commenced business operations in 1925 as a local exchange telephone service provider in the southwestern part of the state. In 1958, RCC conducted its initial public offering (IPO), and many local residents in its service area became shareholders. Later, in 1980, a second public offering was conducted, and subsequently the RCC common stock was listed on NASDAQ. The primary business of RCC still consists of local exchange (or wireline services) to customers in the southwestern part of the state. However, over the past ten years, RCC has significantly expanded its local territory. Furthermore, passage of the Telecommunications Act of 1996 (targeted at increasing competition in the industry) encouraged RCC to increase its coverage area and the services offered to its customers.

Through its various wholly owned subsidiaries and nonconsolidated equity investees, RCC provides the following services: local telephone service (wireline), cellular and paging communications services (wireless), cable television services, telecommunications equipment sales, leasing of a fiber-optic cable network and tower space, financing services, and

FIGURE 1
Organization Chart for Johnson Keith Niemeyer LLP
(Riverside Communications Company Audit)



The diagram portrays the line of responsibilities at JKN for the RCC engagement only. Responsibilities in the firm vary for each client situation. Five staff accountants are assigned to the RCC audit and work directly under the supervision of the two senior accountants.

directory assistance services. RCC has a history of successful operations and has a long history of paying dividends. Financial information for the past five years is presented in Table 1. During that period, revenues have increased due to RCC's continued growth into new lines of business; at the same time, net income has declined mainly because of investments required for the startup of these new lines of business.

Key personnel of RCC are as follows:

- *Warren England,* Chief Executive Officer (CEO): Warren is a CPA and has been with RCC for 20 years. He started working at RCC as the Chief Financial Officer (CFO) after spending 13 years in a national public accounting firm, the last three as a partner.

TABLE 1
Recent Financial Results for Riverside Communications Company
(in thousands)

	2004	2003	2002	2001	2000
Total Assets	$300,808	$238,115	$219,338	$212,883	$210,376
Shareholders' Equity	174,924	144,227	137,223	136,777	135,316
Total Revenues	120,724	107,162	90,816	77,055	66,245
Net Income	9,502	11,476	18,323	14,977	12,750

- *Larry Cashman,* CFO: Larry has an M.B.A. and was hired as the CFO ten years ago. At the time he was hired at RCC, he had over 20 years of experience as either a controller or a CFO for public companies in other industries.
- *Greg Lowman,* Controller: Greg is a CPA and was hired five years ago from JKN after serving as the audit senior on the account for four years.

Additional information and firm characteristics of RCC may be found in Table 2.

History of the Auditor-Client Relationship

JKN has been serving the audit and tax needs of RCC since the 1950s when the firm assisted the Company with its IPO. The relationship between JKN and RCC has been very good over the years. Because of its good reputation in the community and because of the prestige of performing audit and tax services for this client, JKN has been able to attract other sizable clients, including three other small public companies. One of these public clients is also a telecommunications company with lines of business similar to RCC. There are no other significant telecommunications company clients in any office of the firm. Frank Clement has been handling the audit partner responsibilities on RCC for each of the three years, ending December 31, 2004. Tom Fitch has just completed his second year as the engagement manager.

Total fees from RCC have averaged approximately $250,000 per year for the past three years under a fixed-fee arrangement for the annual and quarterly audit and tax services, exclusive of services required in connection with the attestation reporting on internal controls beginning in 2004, as required by Section 404 of SOX and for which an additional $75,000 was billed. The total RCC fees represent approximately 4 percent of total fees for the Briarwood City office of JKN, placing RCC in the top five of all clients based on total fees billed and collected.

TABLE 2
Firm Characteristics and Selected Data for Riverside Communications Company

	2004	2003	2002	2001	2000
Earnings per share—diluted	$0.75	$0.87	$1.40	$1.10	$0.97
Cash dividends per share	$0.67	$0.65	$0.62	$0.60	$0.58
Average common shares outstanding—diluted	12,670,000	13,191,000	13,088,000	13,615,000	13,144,000
Number of employees	1,331	1,067	792	724	686
Number of shareholders	3,888	3,816	3,724	3,502	3,216

Occasionally, Larry Cashman will call with questions about how to handle the accounting entries and reporting for nonroutine or unusual transactions. In these special situations, Frank Clement often consults with Michael Bryan, who has performed the concurring review of the RCC audit for the past three years. When Frank submits a bill to the audit committee for these extra services, a minor argument or "negotiation" often takes place between Frank and Larry regarding the size of the bill. Larry argues that these consultations should be covered in the fixed-fee audit as defined in their engagement letter with JKN.

Since RCC has a calendar year, the audit takes place during JKN's busy season (January and February). Although the firm prefers not to accept work for less than standard rates during this period, an exception is made for this client, whose fees average only 80 percent of standard rates. One of the main reasons for this exception is that the senior members of the RCC management team are very crafty negotiators. Warren England and Larry Cashman both realize that RCC is an important client to JKN. Warren, having been a partner in a public accounting firm, knows how to play the game. Therefore, because of the significant fee and the prestige of having this client, JKN makes an exception to its usual policy of demanding full rates for busy season work. Staff members enjoy working on this audit even though the timetable for fieldwork is tight and the hours are long. Working on this engagement presents a great opportunity to learn, and the audit is clean because of good internal controls and the competent management and accounting staff of RCC.

The audit is always completed on time with no material audit adjustments ever required. Client personnel prepare the annual report to stockholders and the Form 10-K for filing with the SEC; the JKN staff has had no problems with the adequacy or format of disclosures, or referencing the financial information in their workpapers. A management letter is prepared each year with suggestions for improvements in internal controls or for more efficient methods of handling operations. However, no reportable control structure conditions have ever been reported to management or to the audit committee of the board of directors pursuant to Statement on Auditing Standards No. 60. In addition, the attestation report on management's assessment of internal controls in 2004, as required by Section 404 of SOX, was unqualified.

Frank Clement and Tom Fitch meet with the audit committee twice each year, once before the audit to obtain their input and to discuss the audit plan, and once after completion of the fieldwork to discuss the audit findings and the management letter. Larry Cashman and Warren England are especially sensitive to the matters mentioned in the management letter and always insist that they see the letter before the audit committee meeting. Frank and Tom have no problem with that procedure because they want to be sure that the facts are correct and that their staff has reported everything correctly. However, sometimes these discussions are difficult. Larry and Warren sometimes object to certain information in the letter, claiming that the information is not significant enough to be communicated to the audit committee of the board of directors.

Requirements for PART I

1. Do you see any potential areas of risk that the partners in the Briarwood City office should consider regarding RCC? In your response, consider business risk to JKN, engagement risk, and audit risk. *Hint*: Your textbook and Bell et al. (2002, Table 1) should be helpful resources to answer this question.
2. Based on the information regarding the Briarwood City office of JKN and the history of the auditor-client relationship with RCC, can you identify any potential auditor independence issues related to this client? In your response, consider SOX, Sections 301 and 407, NASDAQ rules, and any AICPA guidance that you believe is relevant.

3. Review JKN's client acceptance and continuance policies. Do you believe there are any potential client continuance issues with RCC? Address both positive and negative characteristics of this client in your response.

CASE: PART II

Growth Strategy for RCC

It is now Spring 2005, and Frank Clement is presented with a series of transactions contemplated by Larry and Warren. RCC's management is eager to grow the company into one of the leading providers of wireless communications and Internet services in the Northwest. The overall economy and the stock market have been performing well for the past three years, and RCC stock has been trading at all-time highs, ranging from \$75–\$80 per share. Senior management and the board of directors have already met with officials from the investment banking division of Morton Stosch (MS), a very large Wall Street securities firm, and with Whipple Killjoy (WK), a large private equity firm from San Francisco, both of which appear to be excited to be part of an arrangement to grow RCC. The transactions contemplated involve, among other things, a series of mergers and acquisitions to be financed by various public and private debt and equity offerings. Briefly summarized, these transactions include:

1. Issue high-yield debt of \$550 million. \$275 million will be loaned by WK, and the remaining \$275 million will be underwritten by MS in a public offering.
2. Issue \$250 million convertible preferred stock. All of this stock will be issued to MS and to WK. In three years, the preferred stock will be convertible into common stock, and a secondary public offering will likely take place at that time so that the current financiers will be able to liquidate their investment.
3. Dispose of the directory assistance business for \$68 million. Although this business is profitable, it does not fit into the strategic plan as a core service. RCC has a company that is interested in buying the directory assistance business.
4. Acquire FirstCo, a wireless digital communications company, for \$650 million. Since the service area is only about 150 miles from RCC, it seems to fit with the strategy of expanding the company's "wireless footprint." This acquisition will also add 300 employees.
5. Acquire the remaining minority interests in two wireless unconsolidated subsidiaries for \$75 million. Currently, RCC is a 25 percent shareholder in each company and carries these as equity investments. Seven other telecommunications companies own the remaining 75 percent, with no one company owning more than 15 percent. The plan is to buy out the other seven shareholders.
6. Merge with A&D Telecommunications Company. A&D is a company that is very similar to RCC, but is only about 30 percent of the size of RCC, based on total revenues. A&D is privately owned by approximately 100 shareholders, mostly members of the Manley family, with Chris Manley as its CEO. The merger plan is to exchange 40 shares of RCC for each share of A&D. As added inducement for pushing this merger to the A&D shareholders, RCC is promising to make Chris Manley the Chief Operating Officer (COO) of RCC and to grant him a cash bonus of \$1.2 million if the transaction is approved.
7. "Buildout" the wireless system. This process requires the purchase of licenses and equipment, as well as the construction of towers.

Warren and Larry explain that RCC is especially ready to take advantage of these "ripe" times in the telecommunications industry. The accounting department has assembled projections covering the next five years and, although large losses (as much as $90 million in one year) are projected in the years 2006–2010, the company expects a profit and positive cash flows in 2010. Borrowings will be sufficient to create cash reserves in the early periods to meet debt requirements.

Frank sees this project as a tremendous opportunity for the Briarwood office, although it will involve some very difficult accounting and reporting issues that will include filing several registration statements with the SEC. He will surely need the assistance of Michael Bryan from the headquarters office. Luckily, most of the immediate work will take place in the summer, which is usually slow; however, this work might also require individuals to postpone planned vacations. The fees from this type of high-risk work will be billed at premium rates, and they will provide an opportunity to make up for all those years at 80 percent of standard. Therefore, this work for RCC should contribute to great financial results in 2005 for the Briarwood City office.

The other two partners in the Briarwood office, Andy Stevens and Bernie Richards, are also excited about the opportunity. Grumbles is delighted. He has been pressuring Frank to sell some of JKN's value-added services, such as wealth management, to the RCC executives and board members. Grumbles comments that, after these transactions take place, RCC should be a prime candidate for the firm to provide other nonaudit services. This situation should also help the Briarwood office attract more audit clients.

Requirements for PART II

1. Discuss each aspect of RCC's growth proposal that might impact JKN's independence.
2. The growth strategy for RCC is very ambitious and aggressive. Should JKN continue with this client? What risks can you identify? In your response, address the following issues: RCC's increasing complexity, Morton Stosch and Whipple Killjoy, the industry, the size of RCC with respect to the other clients in the Briarwood office, JKN's client-continuance policies that were outlined in Part 1, and Section 404 of SOX.

CASE: PART III

The Project

The next few months are very busy for Frank, Tom, and several JKN staff people assigned to the project. Feelings in the office are mixed about the impact of RCC. Everyone wants to be in a successful environment, but not everyone is willing to be challenged by such a large project that involves overtime hours and postponing vacations. Frank and Tom work very well together and are very keen about the success of this project. In fact, they want to exceed RCC's expectations.

The project involves many meetings with the executive team from RCC and the underwriters from MS and WK, along with the professionals who represent their interests. Several meetings are held at the MS offices in San Francisco. Since MS is accustomed to working with very large national accounting firms, they are somewhat skeptical of JKN. However, since JKN has been the independent auditor for RCC during the years to be reported in the offering statements, no changes are feasible. Nevertheless, MS hires specialists from the mergers and acquisitions group of a national firm to monitor JKN's work. These specialists are expected to be heavily involved in the preparation of the pro forma financial information that will be included in the registration statements to be filed with the SEC as part of the planned transactions.

Frank and Tom are challenged like they never have been before. Not only are they involved with the RCC project, but they are also maintaining other client responsibilities, including a fraud investigation concerning another client with international operations that will require several trips to Asia in the coming months. Frank and Tom find themselves working weekends and nights and are frequently out of town at meetings.

Some tricky audit and accounting issues come up for the RCC project, such as business combinations, accounting for intangible assets, asset impairments, early debt extinguishments, revenue recognition, accounting for derivatives, and issuance of comfort letters to underwriters. Additionally, Frank and Tom discover that the financial statements of A&D must be restated because of errors in previous years that were not detected by the local CPA firm. Nevertheless, they receive help from Michael Bryan when needed, and they get through the project. During the period from May to November of 2005, RCC files ten Form 8-Ks, a Form S-3, a Form S-4, and two Form 10-Qs with the SEC. All of these steps require the involvement of JKN. Total billings for the project were approximately $1.2 million, an average of 110 percent of standard rates because firm policy is to bill high-risk SEC work at a premium.

Tom comments that he got more public company experience during this six-month period than he had in the entire eight years of his career prior to that time. Frank told the other partners in Briarwood City how lucky he was to have Tom on the project, because Tom really demonstrated his technical talent while gaining the respect of the other outside professionals on the project. Apparently, Larry Cashman and Greg Lowman felt the same way. On one occasion during a meeting at RCC, they hinted very strongly to Tom that they would certainly enjoy having someone with his skills on their team.

Requirements for PART III

1. In this section of the case, we can clearly see that the client relationship between RCC and JKN is changing in a number of ways. If you were Frank or Tom, what might be your primary concern for JKN in the next 12–18 months with respect to the RCC audit?
2. Based on the projected growth plans of RCC and the ongoing responsibilities of the partners in the Briarwood office of JKN, discuss any risk issues that you believe are relevant. Again, review Section 404 of SOX and Bell et al. (2002, Table 1).
3. Review the provisions of SOX, Section 206, and then discuss the requirements that would be placed on RCC and JKN if Tom decided to pursue the "invitation" to take a position on the RCC management team.

CASE: PART IV

Year-End Audit

In November 2005, when it came time to plan the year-end audit, Larry asked Frank and Tom to prepare a fee estimate, knowing that the audit would take on a new dimension because of the recent transactions. Larry also told Frank that RCC would seek proposals from several national accounting firms.

Frank had already given RCC's expansion some thought, and realized that JKN would probably have to compete with the national firms for continued business with RCC. However, Frank also had other business concerns. For example, there was the impact of the client on office morale. Now, RCC would be the largest and most complex client for the Briarwood City office. No longer would fees averaging 80 percent of standard be appealing; on the other hand, there was still a profit margin. As to staff attitudes and morale, some staff would rather not be involved in such a complex pressure situation; conversely, the more ambitious staff would be disappointed if they could not participate in such an important assignment.

Finally, after discussions with Grumbles, Stevens, and Richards, Frank quotes a fee of $750,000 for the 2005 audit and tax work, including $200,000 applicable to the attestation report on internal controls as required by Section 404 of SOX. Frank and Tom estimate that this fee will result in 100 percent of standard rates, but they cannot be as sure of themselves as in the past because of the uncertainty about how the new RCC will function. The proposal is sent to the RCC audit committee; very soon thereafter, Larry calls Frank and tells him to reduce the quote. Frank agrees to reduce the quote to $700,000, but no more. He believes that 93 percent of standard rates will still be acceptable, assuming an accurate estimate.

After all of the fee quotes are in, which includes JKN and two of the national firms, Frank receives a call from Warren England, the CEO at RCC, who mentions that he would really like to see JKN continue as auditors, but explains the pressure from the new investors, who have a representative on the audit committee. Warren also says the JKN quote is substantially higher than the competition's quotes and wants to know if this quote really reflects bottom-line pricing. Frank is sure that the larger firms are attempting to "buy the business," but he also realizes that they have substantially greater resources and are in a better position to negotiate. Nevertheless, he agrees to reduce the estimate once more, this time to $650,000.

Requirements for PART IV

With respect to the appropriate sections of SOX, the complexity of the RCC audit (internal controls and possible going-concern issues), and the expertise in the Briarwood office (i.e., Quality Control Standards), identify any concerns you have regarding:

1. JKN's willingness to negotiate its fee estimate to RCC.
2. JKN's ability to successfully complete the year-end audit for RCC.
3. JKN's ability to continue with this client.

CASE LEARNING OBJECTIVES AND IMPLEMENTATION GUIDANCE

Learning Objectives

The purpose of this case is to help students understand some of the difficult business and professional issues encountered that inform firms' decisions to continue working with clients. Throughout the case, students are asked to deal with this decision within the context of regulations placed on auditors and public companies by the Sarbanes-Oxley Act of 2002 (SOX). The case has several junctures that raise issues related to client continuance that impact both auditor independence and audit risk containment. One of the marks of a successful professional is to recognize these issues as they arise and to deal with them professionally and fairly. Doing so requires knowledge and experience in applying professional standards, balancing professional and business priorities, using critical-thinking skills, and exercising skillful communication and negotiation skills.

Implementation Guidance

The case has been divided into four parts and may be used in part or in its entirety in an auditing course. The case is straightforward enough to be used effectively in an undergraduate, introductory auditing course, yet sufficiently rich in detail and context so that it may also be used in a graduate level course as an individual or group project. However, group dynamics better simulate actual practice conditions. As with Knapp and Knapp's (2004) case, this case offers an excellent opportunity for a series of in-class, role-playing exercises.

The case should be used in connection with chapters of an auditing textbook that deal with auditor independence, averting legal liability, audit planning, understanding a client's business and industry, assessing a client's business risk, ethical dilemmas, assessing inherent risk, and assessing internal control risk. Throughout the Teaching Notes, we refer to specific chapters and pages in Arens et al. (2006) as an aid to the instructor. Although we only refer to this auditing textbook, the topics covered in the case may readily be mapped to other auditing texts.

The case has been used by three professors at three universities. Two of the professors teach auditing classes at two large southeastern state universities with AACSB-accredited accounting programs. The third professor teaches two different auditing classes at a smaller private northeastern college, also with AACSB accreditation. The instructors at the large universities used a group study format, giving the groups several weeks to study the case and prepare a report with their findings. An entire class period was used to discuss the groups' responses to the questions posed in the case material. The instructor at the private college used each part of the case at different points during the semester concurrent with his discussion of the relevant topics, and the students studied and reported on the case individually.

Instructor Feedback

The professors at the large universities each believed the full class period that they allotted to discussion was adequate. The professor at the private college allocated 15–20 minutes per part because of time constraints; however, he thought that 30 minutes per part would have been better. All of the instructors used the case in undergraduate auditing classes and, in their opinion, believed that the case was more suitable for undergraduates than for graduate students. They also indicated that the case contained sufficient information for meaningful discussion with the students. The professors at the large universities gave students two weeks to prepare for the assignment and required written reports. The groups then made in-class presentations and facilitated classroom discussion. A professor from one of the large universities assigned a significant portion of the course grade (15 percent of the total points) to the assignments associated with the case. The professor at the private college integrated case study assignments with other relevant chapter assignments from the text used for the course. He did not grade the case study assignments independently. Other comments from the instructors are as follows:

> "Overall, the case was very helpful and the students found it a very appropriate tool to relate theoretical concepts to practical situations. I was impressed by the amount of enthusiasm the case generated; we had a very lively discussion."
>
> "I thought it was a good example—very real. I will probably use it again."
>
> "I received very positive feedback from the students with regard to how much the case enhanced their understanding of the particular auditing principles the case dealt with."

Student Feedback

Students expressed positive satisfaction with the case materials both verbally (by being enthusiastic and participative in class) and in writing. Written student responses were obtained by use of a survey instrument (Appendix, Panel A). We also include the mean scores for each of the questions for each class (Appendix, Panel B). The following is a representative list of student comments from question eight on the survey instrument:

> "The case allowed me to think from the client's perspective as well as the firm perspective."
>
> "The case study allowed us to actually apply some of what we've learned to situations. I found this to be extremely helpful to get a better understanding of topics discussed in class."
>
> "I looked forward to coming to class because I knew it was going to be discussed."
>
> "More cases such as this would enhance understanding."
>
> "It helped better understand what we learned. There should be mini-cases like this for each chapter."
>
> "Brought together points from the book and helped me gain a better understanding. Not a bad exercise. Enjoyed and learned from it a great deal."
>
> "Overall, it was rather interesting and was not filled with jargon and information that would lose the reader. The cases were short, sweet, and to the point, which made answering/understanding the questions better."
>
> "A real-world outlook on current topics in accounting provides for a glimpse into what a young accountant will face once with a firm. Good questions and discussions about the case are as important as the case itself."
>
> "Very good case—added value to the learning experience."
>
> "It was interesting to see the problems that might pop up for an auditor."

APPENDIX

Panel A: Student Feedback Questionnaire

Please answer the following questions by marking a vertical line through the number that corresponds with your belief about that item. There are no "right" answers; we are interested in your opinion. Thank you!

1. The JKN case provides a realistic business situation.

0 10 20 30 40 50 60 70 80 90 100
|– – –|– – –|– – –|– – –|– – –|– – –|– – –|– – –|– – –|– – –|
Strongly Disagree — Disagree — Neutral — Agree — Strongly Agree

2. I enjoyed working on the JKN case.

0 10 20 30 40 50 60 70 80 90 100
|– – –|– – –|– – –|– – –|– – –|– – –|– – –|– – –|– – –|– – –|
Strongly Disagree — Disagree — Neutral — Agree — Strongly Agree

3. Completing the JKN case was a good lesson in teamwork skills.

0 10 20 30 40 50 60 70 80 90 100
|– – –|– – –|– – –|– – –|– – –|– – –|– – –|– – –|– – –|– – –|
Strongly Disagree — Disagree — Neutral — Agree — Strongly Agree

4. The JKN case added to my textbook knowledge and helped me to better understand the "real world" issues faced by auditors when dealing with client continuance issues.

0 10 20 30 40 50 60 70 80 90 100
|– – –|– – –|– – –|– – –|– – –|– – –|– – –|– – –|– – –|– – –|
Strongly Disagree — Disagree — Neutral — Agree — Strongly Agree

5. The JKN case helped me to better understand "real world" independence issues that might confront auditors.

0 10 20 30 40 50 60 70 80 90 100
|– – –|– – –|– – –|– – –|– – –|– – –|– – –|– – –|– – –|– – –|
Strongly Disagree — Disagree — Neutral — Agree — Strongly Agree

6. The JKN case helped me to better understand risk containment issues that auditors must consider as they deal with clients.

0 10 20 30 40 50 60 70 80 90 100
|– – –|– – –|– – –|– – –|– – –|– – –|– – –|– – –|– – –|– – –|
Strongly Disagree — Disagree — Neutral — Agree — Strongly Agree

7. I believe I would learn more and would be better prepared for the business world if my accounting professors would use more case studies like the JKN case.

0	10	20	30	40	50	60	70	80	90	100
Strongly Disagree			Disagree		Neutral			Agree		Strongly Agree

8. Do you have any other comments regarding the JKN case study?

Panel B: Mean Responses for Student Feedback Questionnaire

	University #1	University #2	Private College (Class 1)	Private College (Class 2)
Question #1	85.5	82.5	84.3	74.7
Question #2	79.3	76.3	75.6	57.1
Question #3	72.1	72.5	NA	NA
Question #4	85.8	86.3	84.4	70.7
Question #5	88.6	85.0	85.2	73.6
Question #6	85.7	83.8	81.3	68.6
Question #7	83.6	71.3	81.8	64.3

TEACHING NOTES

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