Department of Accounting
College of Commerce
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Ph.D. Qualifying Exam- Auditing
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PART 1

(1) The following was a news posted at the Washington Post's website on March 29, 2007:

> **Dell to delay filings, investigation finds misconduct**
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> An internal investigation at Dell Inc. has found evidence of misconduct and accounting errors, forcing the company to delay filing its annual earnings report with stock market regulators, it said Thursday after the U.S. stock market closed.
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> *Ben Ames*
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> Thursday, March 29, 2007; 5:32 PM
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> An internal investigation at Dell Inc. has found evidence of misconduct and accounting errors, forcing the company to delay filing its annual earnings report with stock market regulators, it said Thursday after the U.S. stock market closed.
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> Once the world's largest sellers of notebook and desktop PCs, Dell has stumbled in recent quarters, watching profits fall as the company struggled with an accounting investigation by the U.S. Securities and Exchange Commission (SEC). In January, founder Michael Dell ousted his successor Kevin Rollins and returned as CEO in an attempt to reverse the company's fortunes. Now Michael Dell will face an even tougher challenge. One of his first moves was to win a reprieve when the NASDAQ stock exchange threatened to de-list the company's stock because it had missed three deadlines for filing its quarterly earnings reports with the SEC. The company now says it will miss the extended date, as well. Dell will delay filing its Form 10-K for the fiscal year ending Feb. 2 beyond the original deadline of April 3 and the extended deadline of April 18.
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> Dell did not say what sort of misconduct it had found or who had committed it. In a brief statement, the company said only that an audit committee it had assigned to investigate the SEC charges was not yet finished with its task, but had "identified a number of accounting errors, evidence of misconduct, and deficiencies in the financial control environment." Dell management has not yet determined whether prior earnings will have to be restated to correct those errors, the statement said.
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> One hint to the nature of the misconduct may come from a lawsuit filed Jan. 31 by shareholders, alleging that a small circle of executives arranged for Dell to accept payments from Intel Corp. in exchange for using only Intel processors in Dell PCs. The lawsuit also said the managers had used inside information to reap multimillion dollar profits by selling stock options at auspicious times. The lawsuit was filed in U.S. District Court in Austin, Texas.

Identify as many auditing issues as possible from the above news and discuss prior empirical studies that address these issues. Please organize your answers in a structured format. (24 points)

(2) Audit quality has been emphasized by both the auditing profession and the accounting academics for many years. For auditing to serve its social role of attesting the creditability to firms' financial statements, audit quality becomes a major concern to the capital markets and regulators. David Landsittel indicates in the AAA 2000 Auditing Section Midyear Conference (January 14, 2000) that earnings management is one major challenge facing the public accounting profession in improving its audit quality.

(A) How did auditing researchers empirically measure (capture) managers' earnings management behavior (except the discretionary accruals)? What are the potential problems associated with these measurements? Please cite prior studies to justify your answers. (8 points)

(B) How did auditing researchers measure (capture) audit quality (except the discretionary accruals)? What are the potential problems associated with these measurements? Please cite prior studies to justify your answers. (10 points)

(C) During the past two decades, discretionary accruals (DA) have been extensively used in capital market research as a proxy for managers' earnings management behavior. Recently, auditing research also adopts DA as the measure of audit quality. Conceptually speaking, since earnings management reflects *managers*' opportunistic behavior whereas audit quality reflects *auditors*' capability of detecting material misstatements and propensity to report such misstatements, DA should not be a proxy for both players' behavior *simultaneously*. Is there anything wrong (or missing) in the literature? What is the fundamental logic reasoning underlying these two lines of research? Do you agree that DA can capture both earnings management and audit quality at the same time? Why or why not? (8 points)