Joly Dogs – Operational Profit Manipulation

Joly Dogs was a very large manufacturer and wholesaler of hot dog wieners and other beef products. They purchased beef sides and froze them until ready to process.

The owner was a well-known figure in the community and his investors always marvelled how his forecast profits always came in exactly on target, especially when he was dealing in a commodity where prices fluctuated. The auditors were aware of this and were somewhat skeptical. However in previous years they had not identified any concerns about profit manipulation.

This year's senior auditor was very smart. She took more than a cursory look at the accounting system – especially relating to inventory. When checking the physical inventory in the freezer (not a popular job) she noted that each side of beef was tagged with purchase date, total price and price per kilo. She also noted that the prices were significantly higher than in the previous year's count. She checked beef prices and could not find justification for this.

When she asked about the accounting, she was told that as each side of beef was put into production, the actual cost of that side of beef was used. This seemed logical and precise to the accounting staff. However, when she enquired into how each side of beef was chosen she discovered that it was the CFO who did the selection. This seemed odd until she realised how profit could be manipulated using this approach. If profits were to be suppressed, expensive sides were taken from inventory and if profits were to be boosted cheap ones were chosen. Since the pressure had been to increase profits for some time all the cheaper sides had now been taken from inventory – hence the high value of those left.

The auditors asked the client to account for inventory on an average cost basis and the result was quite devastating. A large write down was required and although the client was mad at the auditors there was no more cheap inventory on hand and profits would have taken a big hit anyway in the future. There was no question of fraud – just "imaginative accounting", as the partner put it. But without the smart senior, it would not have come to light until the following year and not even then if the price of beef came down.

In the end, the owner did not want to be thought of as in any way dishonest and agreed to switch to average cost accounting. He didn't fire his CFO because he had not in any way falsified records.

Questions:

1. Why did good profits heighten the auditors' professional skepticism in this case?
2. Were the audit senior's actions indicative of abnormal professional skepticism? If so, how?
3. What should the auditor consider when an accounting method is permissible but misleading in the circumstances?
4. The CFO determining items to be removed from inventory should trigger what kind of reaction from a skeptical auditor?
5. Why is persistence such an important value for auditors?

Source: Professional Skepticism Case Collection for Professional Accountants, University of Toronto Professional Accounting Centre, 2023, PAC website https://www.utm.utoronto.ca/pac/case-collections/enhancing-professional-skepticism-case-collection.