

Your1040Return.com

Evaluating eBusiness Revenue Recognition, Information Privacy, and Electronic Evidence Issues

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INSTRUCTIONAL OBJECTIVES

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| [1] To illustrate business risks for Internet-only business models. | [5] To help students identify privacy issues associated with Internet-based business models. |
| [2] To help students develop skills related to identifying internal control responses to eBusiness risks. | [6] To illustrate audit implications when transaction audit trails are solely electronic. |
| [3] To highlight revenue recognition issues related to eBusiness transactions. | [7] To expose students to the benefits of cloud computing |
| [4] To illustrate unique accounting issues associated with Internet web site banner advertisements. | [8] To help students recognize threats to eBusiness strategies. |

KEY FACTS

- ff* Your1040Return.com is a leading provider of online income tax preparation and filing services for individual taxpayers.
- ff* The company was founded two years ago by Steven Chicago who realized individuals may be frustrated with the need to purchase tax preparation software upgrades each year to ensure their tax software reflects recent changes in the tax code.
- ff* Your1040Return.com's strategy is to provide up-to-date tax preparation software that can be accessed through the Internet by individuals who pay membership fees for that access.
- ff* In essence, Your1040Return.com's customers "rent" access to tax preparation software packages that are continually kept up-to-date with the latest tax law changes. Customers can also use Your1040Return.com's services to electronically file an already prepared paper-based tax return.
- ff* Customers can use Your1040Return.com to file both state and federal tax returns.
- ff* Your1040Return.com customers select from one of three service packages: Silver, Gold, or Platinum.
- ff* Silver package customers can access electronic copies of tax forms, schedules, and publications and can enter tax return information directly onto those forms and schedules. Your1040Return.com will also file the completed return electronically to the appropriate regulatory agency. *ff*
- In addition to the Silver package services, Gold package customers have one-year access to a commercially developed and continually maintained tax preparation software package that assists customers in the preparation of their individual returns.
- ff* Platinum package customers have access to the premium level of services, which allow customers to have multi-year access to the tax preparation software and personalized attention and realtime tax support from qualified income tax specialists.

The case was prepared by Mark S. Beasley, Ph.D. and Frank A. Buckless, Ph.D. of North Carolina State University and Steven M. Glover, Ph.D. and Douglas F. Prawitt, Ph.D. of Brigham Young University, as a basis for class discussion. Your1040Return.com is a fictitious company. All characters and names represented are fictitious; any similarity to existing companies or persons is purely coincidental.

- ff* Revenue recognition differs for each product offered by Your1040Return.com.
- ff* Your1040Return.com's business is seasonal with its highest demand from early February through April 15th each year. The company experiences peaks in demand during periods surrounding extension deadlines.
- ff* Tax payments and refunds are not funded by Your1040Return.com. Rather, tax refunds are remitted directly from the IRS or state agency to the individual. Tax payments are charged by the IRS or state agency to the individual's credit card account.
- ff* Your1040Return.com also engages in ad swapping with a number of major Internet companies. In exchange for providing electronic advertisements on the Your1040Return.com web site, the company receives free banner ads on other web sites.
- ff* Servers located at Your1040Return.com's offices support the tax preparation software. The servers are in facilities with physical access securities and are protected logically by firewalls and access passwords.
- ff* The company hires several tax experts to monitor tax code changes and to help ensure the underlying tax software is accurate. The company contracts with a software design firm to develop the online tools. Two of Chicago's nephews oversee the operations of the IT platform; each has less than 5 years of relevant work experience.
- ff* The company's CFO joined the company after three years of audit experience with a Big Four international accounting firm.
- ff* The company does not have an official customer privacy policy. The company has been approached by marketing executives who are interested in purchasing Your1040Return.com's customer lists.
- ff* As part of a recent line of credit arrangement with the local bank, Your1040Return.com's financial statements must now be audited.

USE OF CASE

This case assignment provides students the opportunity to recognize that while the Internet and related innovative uses of technology offer opportunities for new avenues for conducting business, there are unique risks and related accounting issues that must be considered. This case exposes students to issues associated with a relatively new eBusiness enterprise that provides tax-related services via the Internet. This case explores several issues that arise with an Internet-based business model.

First, the case highlights how the Internet provides innovative ways for businesses to deliver value added services to consumers. As a result, this case exposes students to issues different from those associated with traditional "brick and mortar" businesses. And, because the underlying service relates to tax preparation software for customers, accounting students can easily understand the main components of Your1040Return.com's service offering to consumers.

Second, the structure of the three levels of product service offerings (Silver, Gold, and Platinum) provides a nice opportunity to engage students in an analysis and class discussion of the accounting implications related to revenue recognition. This analysis helps students see how operational decisions about product and service offerings create different accounting issues for each offering. In addition, the use of bartering for the ad banner transactions exposes students to a unique accounting issue for many Internet based businesses.

Third, the case illustrates basic business decisions that start-up companies must make. For example, the case highlights the practical aspects and related implications of attracting and hiring affordable employees with the necessary job skills. It also highlights the difficult realities of maintaining basic business operations with limited resources and talents, such as Your1040Return.com's limited IT system and lack of ideal data and system backups. Finally, the case illustrates tradeoffs business owners must make by highlighting the ethical dilemmas associated with the potential decision to sell private customer information to external marketing agencies.

This case could be used in either an undergraduate or graduate auditing or accounting information systems course to highlight unique business risks, internal controls, and audit evidence issues associated with Internet-based businesses. The questions related to revenue recognition may be effective for use in an undergraduate intermediate accounting course.

Students can complete the case individually or in groups as an in-class or out-of-class assignment. Because the case is relatively short, students can read the case during the class period to prepare for an in-class discussion of several of the questions. Other questions, however, may be better suited as an out-of-class assignment (e.g., see question 1.g and 1.i) that students complete before an in-class discussion is held.

This assignment can be broken down into several sub-assignments that can be completed at various points during a quarter or semester. Students should particularly enjoy this case, given that it exposes them to broader business issues associated with Internet-based businesses.

PROFESSIONAL STANDARDS

References to AU-C sections have been updated to reflect the new codification of ASB clarity standards. PCAOB standards are referenced by standard number. Relevant professional standards for this assignment are:

AICPA ASB Standards: Relevant professional standards for this assignment include AU-C Section 315 “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement,” AU-C Section 330, “Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained,” and AU-C Section 540, “Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures.”

PCAOB Standards: AS5, “An Audit of Internal Control over Financial Reporting That is Integrated with an Audit of Financial Statements,” AS 8, “Audit Risk,” and AS12, “Identifying and Assessing Risks of Material Misstatement.” (Note: PCAOB Standards are relevant from an informational perspective, but are not required since Your1040Return.com is not a public company.)

QUESTIONS AND SUGGESTED SOLUTIONS

[1] *You are an audit senior with Gooch & Brown CPA, LLP, a local accounting firm specializing in audits of information systems and financial statements. Your1040Return.com engaged your firm to perform its financial statement audit. You have been asked by the partner to perform the following tasks:*

[a] *Why does Your1040.com need to have its financial statements audited? How might understanding the reasons for the audit of the financial statements inform the auditor about potential audit risk?*

The bank that has provided Your1040.com with a bank line of credit has requested that Your1040.com submit audited financial statements annually as part of the financing arrangement. Knowledge about the main reasons for Your1040.com to engage your firm to conduct the audit provides important insight about potential users of the audited financial statements and how they might be using the audited information to assess the creditworthiness of Your1040.com. Awareness of the reasons for the audit are also informative to the auditor's assessment of the risks of material misstatements, including the risk of fraud. Management of Your1040.com would have incentives to preserve the line of credit to help manage cash flows of their business. That incentive, if excessive, may pressure management to present financial information that portrays a favorable perception of Your1040.com's financial strength. Thus, remaining aware of that possible risk would be important to the audit of the financial statements.

- [b] *Describe to Stephen Chicago why it is important for your firm to have an understanding of Your1040Return.com's business model.*

Auditing standards require that the auditor obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. A thorough understanding of the client's business model is essential for doing an adequate audit. The nature of the client's business operations and industry directly affects client business risks and the risk of material misstatements in the financial statements. The auditor uses the knowledge about these risks to determine the appropriate extent of audit evidence to be obtained through further audit procedures. Without an adequate understanding of the underlying client business models, auditors may fail to adequately identify relevant business risks. That failure will likely result in audit procedures inadequately designed to detect material misstatements in the financial statements.

The auditor should understand factors such as major sources of revenue, key customers and suppliers, sources of financing, and competitors, among other matters, related to the client's core business operations. Through such an understanding, the auditor may be more likely to identify business risks arising from unique incentives and pressures or deficiencies in internal controls created by that business model structure that increase opportunities for misstatements in the financial statements. Additionally, knowledge about core business models gives auditors a better understanding of the client's business and industry to provide value-added services to those clients.

- [c] *Identify Your1040Return.com's major business risks and describe how those risks may increase the likelihood of material misstatements in Your1040Return.com's financial statements.*

Because Your1040Return.com's main business model involves the provision of software and other services accessed through the Internet, the company faces different issues from traditional "brick and mortar" businesses. Here is an overview of several business risks that Your1040Return.com faces:

- **Customer Demand.** Because the business model is solely based on services delivered through the Internet, there may be individuals who are uncomfortable using the Internet to use the online tax services. Certain customers may be reluctant to submit personal tax related financial information over the public Internet. As a result, the customer base in the online marketplace may be limited. That may put pressure on management to generate future revenues to maintain profitability goals and targets. That pressure may provide incentives for management to aggressively account for revenue and expense transactions to achieve those profitability goals. In some cases, management may select options that are not in compliance with generally accepted accounting principles.
- **Software Technical Accuracy.** One of the main selling features for Your1040Return.com is access to an up-to-date popular tax software package. There is some risk that the tax preparation software contains errors in the interpretation and application of the complicated federal and state tax codes, which in turn may cause customers to file incorrect returns. If that risk is realized, Your1040Return.com may create contingencies related to potential liabilities associated with litigation claims from customers. In addition, as information about errors in the tax software packages becomes public, customers may be reluctant to continue subscribing to the online services offered, which will lead to decreased revenues. The revenue pressure may lead to incentives to engage in aggressive accounting to maintain profitability goals.

- **Service Availability.** Because Your1040Return.com's core business is based on services delivered via the Internet, the company faces the risk that customers may not be able to access the tax preparation software if there is a failure in the Internet link to the services. Any system failures with Your1040Return.com's computer servers would prevent the company from providing services for its customers, unless reliable and quick backup access is consistently maintained. If the service access is unavailable for a significant amount of time, the company may lose customers, which would create pressures for management to maintain its profitability. In addition, the lack of access to services may create revenue recognition problems given that the company has not fulfilled its service obligations for customers who have already paid for unlimited access to the software services.
- **Inadequate Staff.** Currently, key staff positions related to system support and the accounting functions have limited experience. As Your1040Return.com's business continues to grow, the size and complexities associated with company growth may present issues that the current staff is unable to adequately handle. The lack of experience of the current staff may result in errors in judgment that lead to misstatements in the financial statements.
- **Electronic Only Evidence.** Your1040Return.com engages in all transactions electronically, with backups of that data performed daily. There is some risk that the data may be lost or temporarily not accessible, which may increase the difficulty of managing the business and creating (and auditing) accurate financial statements.
- **Customer Privacy.** Because customers access Your1040Return.com's services to complete their individual tax returns, Your1040Return.com has access to highly sensitive personal financial and other demographic data. There is a risk that some of that information might be inadvertently given to or accessed by external parties. If that occurs, Your1040Return.com may face contingencies associated with litigation and other claims filed by customers affected that would need to be disclosed in the financial statements.

[d] *Indicate what Your1040Return.com should do to improve its internal control?*

Below are suggestions designed to strengthen Your1040Return.com's internal controls:

- **Revenue Recognition Controls.** Your1040Return.com should evaluate the adequacy of internal controls surrounding its revenue recognition. Currently, Your1040Return.com recognizes revenue differently for the three levels of service. For the Platinum service, revenue for the first year of service is recognized completely at the point the customer requests the service. Revenue recognition is not spread across the year of service and is not contingent on the filing of a return. However, revenue for the Gold service is treated differently. A portion of the revenue is recognized when service is activated with the remainder not recognized until the customer files the return. Management needs to evaluate internal controls over revenue recognition to ensure that the treatment is consistent with generally accepted accounting principles for all levels of service (For further information regarding revenue recognition see solution to question 1.g).
- **Backup and Contingency Controls.** Your1040Return.com's ability to generate revenues is dependent on the availability of customer access through the Internet to Your1040Return.com's servers and databases. The company needs to evaluate the adequacy of the backup and contingency controls in the event there is a server failure. Backup files should be made frequently (at least daily) and stored off site in secure environments. Alternative servers fully loaded with software and necessary backup data files should be available so that service can be provided in the event of a system failure. These backup and contingency controls should be regularly tested.

- Privacy Controls. Because Your1040Return.com has access to highly sensitive customer financial and other demographic information, Your1040Return.com should develop a formal customer privacy policy that identifies how private customer information is maintained and protected. Without a formal policy, sensitive information may be inadvertently released, which may expose Your1040Return.com to significant liabilities. In addition, the company should ensure that policies related to security controls (i.e., firewalls and passwords) are continually evaluated for adequacy.
- Controls Over Advertising Arrangements. Because contracts associated with banner advertising can often contain complex revenue provisions (i.e., ad revenues can often be a function of the number of hits to the banner ads and the extent of subsequent drill downs on the advertiser's web site), Your1040Return.com needs to develop controls to ensure the company correctly understands and accounts for revenue transactions generated from offering banner advertisements.

- [e] *Explain what audit implications arise if you decide that the controls over electronic records at Your1040Return.com are inadequate to ensure that records have not been altered?*

Given that all transactions are documented solely in electronic form, there is no alternative paper trail to serve as evidence supporting financial statement transactions and accounts. If the auditor is unable to determine that electronic records have not been altered, there may be no reliable evidence for the auditor to examine when evaluating the fair presentation of account balances and transactions. In certain cases, the lack of reliable electronic or other alternative evidence may cause the auditor to conclude that the entity is un-auditable (see AU-C 500, "Evidential Matter"). In that case, the auditor may be unable to accept the audit engagement or may have to withdraw at a later date. Thus, Your1040Return.com's management needs to establish effective internal controls to ensure that adequate evidence is maintained to support accounts and transactions in the financial statements.

- [f] *Steven Chicago has indicated that he is exploring upgrades to the company's IT systems. Your audit partner would like you to explore whether cloud computing is an option that your firm might recommend for consideration by Steven. Perform research to explain what cloud computing is and why it might offer benefits to Your1040.com.*

COSO's thought paper, *Enterprise Risk Management for Cloud Computing*, defines cloud computing as "a computing resource deployment and procurement model that enables an organization to obtain its computing resources and applications from any location via an Internet connection." Depending on a particular cloud solution, all or parts of the organization's hardware, software, and data might reside on servers in data centers managed by the cloud service provider. One of the most significant benefits of this cloud solution for Your1040.com is the fact that the hardware supporting the tax return preparation software and related data storage would be managed by a third-party IT service provider that is in the business of maintaining and securing IT platforms. Thus, the level of infrastructure support and security surrounding Your1040.com's systems would most likely be significantly strengthened. Additionally, given Your1040.com's business model is seasonal, the cloud option most likely would provide Your1040.com the ability to scale up operations during peak times and then scale down operations in off-peak times. The cloud option would also be more likely to support any significant growth in Your1040.com's business, given the scalability options of cloud-based IT solutions.

- [g] *Authoritative literature provides guidelines for proper revenue recognition policies for transactions such as those discussed in the case. Analyze Your1040Return.com's revenue recognition policies for the three package services. Provide appropriate citations to authoritative literature.*

As summarized in the case materials, Your1040Return.com recognizes revenues differently for each of the three service packages.

Your1040Return.com's Revenue Recognition Policies

For the Silver package, customers pay for access to tax forms, schedules, and publications. And, Silver package customers can submit tax forms electronically. Access is only allowed for one year. Your 1040.com recognizes revenue on the Silver package when the customer submits the tax return to the IRS or state agency.

Gold package customers can access the tax preparation software to complete and submit the return. Access is allowed for one year. Your1040Return.com recognizes a portion of the revenue when the customer accesses the tax software package for the first time. Your1040Return.com recognizes the remaining portion of the revenues when the customer submits the return.

Platinum package customers pay to access the tax software on a multi-year contract basis. Customers can access the tax software package year round to update their tax information and they can receive personalized attention and real-time tax support from qualified income tax specialists. Your1040Return.com recognizes revenues for each year immediately after the customer selects the Platinum service.

At a minimum, Your1040Return.com needs to evaluate their revenue recognition policies to ensure they are applying revenue recognition criteria correctly and consistently across all three products. In addition, Your1040Return.com needs to evaluate implications of their cancellation policy to determine whether they need to record an accrual for the cancellation expense.

Guidance Relevant to Revenue Recognition

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) recently completed a joint project to develop a common revenue standard for U.S. GAAP and IFRS to improve revenue recognition practices and to remove inconsistencies and weaknesses in revenue requirements. The updated guidance is contained in the Accounting Standards Codification as Topic 606, "Revenue from Contracts with Customers." In order to record revenue transactions, ASC 606, "Revenue from Contracts with Customers," describes the core principle for revenue recognition as follows: "...the entity should recognize revenue to depict the transfer of promised goods or services to customers in the amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services." To achieve that core principle, ASC 606 notes that the entity should apply the following steps:

- Step 1: Identify the contract(s) with a customer.
- Step 2: Identify the performance obligations in the contract.
- Step 3: Determine the transaction price.
- Step 4: Allocate the transaction price to the performance obligations in the contract.
- Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

For Your1040Return.com, all three packages (Silver, Gold, and Platinum) grant customers access to the web site for a contracted period of time. For the Silver and Gold memberships,

customers have access for a full year. For the Platinum service, customers contract for multiple year service. Because the services allow customers access for a period of time, one may argue that Your1040Return.com should recognize revenues for the Silver and Gold services evenly over the 12-month contractual period. For the Platinum service, revenues should be spread evenly over the number of months contracted in the multi-year package selected.

While all of the revenues for the Silver package and a portion of the revenues for the Gold package are not recognized until the customer files the tax return, one could argue that Your1040Return.com is prematurely recording a portion of the revenue. Even though the tax return has been filed by the customer, both the Silver and Gold packages allow customers access to the web site information to file amendments to their already filed returns. Thus, Your1040Return.com promises access to services beyond the tax return filing date. As a result, Your1040Return.com has an obligation to its customers for the entire one-year period. Thus, revenues are not fully realized until the 12 months expire.

Your1040Return.com's revenue recognition policy appears most aggressive for the Platinum package. Fees for each year's service are recognized as revenue immediately after the customer selects the Platinum option. Because the customer is paying for access to the software and tax specialists for an entire year, revenues from the Platinum service should be earned proportionately over the entire contract period. Thus, Your1040Return.com should modify its revenue recognition policy for the Platinum service to ensure that it is not prematurely recording revenues.

Your1040Return.com needs to evaluate the extent that customers have cancelled previously paid for services during the contract period, as allowed by its cancellation policy. Management needs to perform this evaluation to provide a basis for developing an estimate for the cancellation expense and related liability that should be recorded to reflect this cancellation expense in the financial statements. Your1040Return.com should also determine whether the cancellation policy should be modified to clearly communicate cancellation options for customers during the contract period.

- [h] *Explain how you can obtain evidence that ad swapping actually occurred between the Your1040Return.com and Amazon.com? Describe accounting issues that arise when Internet-based companies swap ad services and identify relevant authoritative literature.*

Your1040Return.com and Amazon should have entered into formal contracts regarding the exchange of advertising services on each company's web sites. The auditor would want to obtain copies of the contracts for the audit files to determine the terms of the arrangements and obligations each company has to provide advertisements. Reviews of those contracts would help the auditor determine whether there are underlying accounting issues related to recognizing revenues for advertisements provided on the Your1040Return.com web site or expenses related to Your1040Return.com advertisements at Amazon.com's web site.

The web site systems can be designed to track the time and date advertisements are programmed to appear on the respective web sites. Reports or logs from these systems could be reconciled back to the ad contracts for compliance. Based on information obtained from the review of the ad contracts, the auditor could also visit the respective web sites at those scheduled times to determine if the ads actually appear as stipulated in the contracts.

Because neither Your1040Return.com nor Amazon.com actually pay each other for the advertising services, both companies have actually entered into a non-monetary barter transaction. While currently there is no formal pronouncement from the FASB specifically addressing the accounting for web site advertising arranged on a barter basis, there is relevant

guidance for accounting for non-monetary transactions. Accounting Standards Codification No. 845, *Nonmonetary Transactions*, states that *"the accounting for nonmonetary transactions should be based on the fair values of the assets (or services) involved, which is the same basis as that used in monetary transactions. Thus, the cost of a nonmonetary asset acquired in exchange for another nonmonetary asset is the fair value of the asset surrendered to obtain it, and a gain or loss shall be recognized on the exchange. The fair value of the asset received shall be used to measure the cost if it is more clearly evident than the fair value of the asset surrendered."* ASC No. 920, *Entertainment - Broadcasters*, contains guidance related to bartering of advertising in the broadcast industry that may be analogous to Your1040Return.com's use of bartering for banner related advertising. Paragraph 30-1 of ASC No. 920 states that *"All barter transactions except those involving the exchange of advertising time for network programming shall be reported at the estimated fair market value of the product or service received."*

As a result of these accounting provisions, Your1040Return.com needs to gather information to determine the fair market value of the revenues related to advertising it provides for Amazon.com on the Your1040Return.com web site. And, management needs to gather information to determine the fair market value of the expenses related to advertising Your1040Return.com incurs for advertisements on the Amazon.com web site. In addition, information in the contract may provide useful information about the timing of the banner advertisements to determine if there are related receivables and payables that should be reflected in Your1040Return.com's balance sheet.

- [i] *Address a memo to Steven Chicago detailing the appropriate contents for a customer privacy policy. (You may want to visit other company web sites, such as www.amazon.com, to see an example of a privacy policy.) Why is it important for Your1040Return.com to have an explicit privacy policy? How might the lack of a policy affect Your1040Return.com's financial statements in the future?*

Online privacy policies should focus on protecting the privacy of personal information an organization may collect from its customers through its electronic commerce systems. The AICPA/CICA's *Trust Services Principles and Criteria* provide useful guidance about the importance of online privacy protection for customers engaging in Internet-based businesses that could be pointed out in a memo to Steven Chicago. You could note that the following concepts are commonly used to facilitate the creation and implementation of privacy policies and practices:

- ☐ *Notice.* An entity should inform customers about its privacy policies and practices at or before the time information is collected or as soon as practicable thereafter. The notice should describe the purpose for which personal information is collected and how it will be used.
- ☐ *Choice and Consent.* The entity should describe the choices available to individuals and obtain consent from them with respect to the collection, use, disclosure, and retention of personal information.
- ☐ *Collection.* The entity should limit the collection of personal information to that which is necessary for the purpose described in the notice.
- ☐ *Use and Retention.* The entity should limit the use of personal information to the purposes described in the notice and for which the individual has provided either implicit or explicit consent. The entity should retain personal information for only as long as necessary for the fulfillment of the stated purposes, or as required by law or regulation.
- ☐ *Access.* Customers should have access to their own personal or sensitive information for the purposes of correction, update and deletion.

- *Onward Transfer and Disclosure.* The entity should only disclose personal information to third parties for purposes described in the notice and for which the individual has provided either implicit or explicit consent, or as permitted by law or regulations. The entity should only disclose personal information to third parties who provide substantially equivalent privacy protection as the entity.
- *Security.* The entity that gathers, maintains, or uses personal information must take reasonable precautions to protect the information from loss, misuse, unauthorized access, disclosure, alteration, and destruction.
- *Integrity.* The entity should take reasonable care that the information it collects, whether personal or sensitive, be relevant for the purposes for which it is to be used.
- *Management and Enforcement.* The entity should provide procedures for assurance of compliance with its own privacy policies and independent recourse procedures to address any unresolved complaints and disputes. The entity should designate one or more individuals who are accountable for the entity's compliance with its privacy policies.

It is important for Your1040Return.com to consider developing an online privacy policy because it is important for consumers to have confidence that an entity takes appropriate steps to protect personal information, especially information as sensitive as that surrounding income and taxation. Because many consumers consider the use of private information about them to be an invasion of their privacy, it is important that entities inform their customers about the kinds of information that are collected about them, the uses of that information, customer options, and related matters. Additionally, some countries have implemented laws and regulations covering the privacy of information obtained through e-commerce.

Failure to develop a formal online privacy policy may lead to future issues that may have an impact on Your1040Return.com's financial statements. First, the lack of a policy may cause some customers to not purchase or renew tax preparation services from Your1040Return.com. Given that customers are using Your1040Return.com's services to prepare and submit highly-sensitive personal tax information, the lack of an adequate privacy policy may be of major concern to potential customers. That reluctance may put pressure on management to generate adequate revenues to be profitable. Second, the lack of an adequately stated privacy policy creates uncertainty as to how Your1040Return.com can use the information it collects from customers ordering tax services online. That lack of uncertainty may lead to inconsistent interpretations about the appropriate uses of the personal information. In some cases, customers may be offended by Your1040Return.com's decision to use the personal information it collects (e.g., decision to sell the customer lists to marketing agencies). Those customers may ultimately enter into litigation against Your1040Return.com to prevent further misuse. Any contingencies that arise related to the litigation may warrant disclosure and recording in the Your1040Return.com financial statements.

Delta Airlines' opening web page at www.delta.com contains an online link to its privacy & security policies. To examine the Delta privacy policy, visit this web site link:

http://www.delta.com/privacy_security/index.jsp

- [2] *Your1040Return.com's main business strategy involves the delivery of services via the Internet. What are some threats to the viability of Your1040Return.com's business strategy?*

Because Your1040Return.com's core business strategy involves the delivery of services to customers via the Internet, there are several issues that threaten the viability of successfully continuing this service. Below are examples of some of those threats (note that the answers to this question are similar to those for question 1-c):

- **Customer Demand.** Because the business model is based solely on services delivered through the Internet, there may be individuals who are uncomfortable using the Internet to use the online tax services. Certain customers may be reluctant to submit personal tax related financial information over the public Internet. As a result, the customer base in the online marketplace may be limited. One of Your1040Return.com's comparative advantages is that it provides customers access to the most up-to-date tax preparation software. If providers of traditional tax preparation software purchased in retail stores make available easy access to updated software, there may be less demand for Your1040Return.com's online access to up-to-date software.
 - **Software Technical Accuracy.** One of the main selling features for Your1040Return.com is access to an up-to-date popular tax software package. There is some risk that the tax preparation software contains errors in the interpretation and application of the complicated federal and state tax codes, which in turn may cause customers to file incorrect returns. If that risk is realized, Your1040Return.com may lose its customer base.
 - **Service Availability.** Because Your1040Return.com's core business is based on services delivered via the Internet, the company faces the risk that customers may not be able to access the tax preparation software if there is a failure in the Internet link to the services. Any system failures with Your1040Return.com's computer servers would prevent the company from providing services for its customers, unless reliable and quick backup access is consistently maintained. If the service access is unavailable for a significant amount of time, the company may lose its core customer base.
 - **Customer Privacy.** Certain customers may be reluctant to submit personal tax related financial information over the public Internet because of concerns about the privacy of their highly sensitive tax information. As a result, the customer base in the online marketplace may be limited. Any breaches in customer privacy may cause a deterioration of Your1040Return.com's customer base.
 - **Competitors.** Given Your1040Return.com's success of offering online tax preparation software, other established tax preparers may decide to compete directly with Your1040Return.com. Tax preparers, such as H&R Block and national CPA firms, may decide to offer similar online tax preparation software services. To some extent, the IRS already competes with the Silver service package, given that individuals can access electronic copies of tax schedules, forms, and publication via the IRS web site (<http://www.irs.gov/>).
- [3] *When customers register for the Platinum package, they have online access to tax professionals who are paid on a contract basis. If you were in Steven Chicago's shoes, how would you compensate those professionals for their services? What controls could Your1040Return.com implement to ensure that the company does not overpay for those professional services?*

Currently, the tax professionals who provide online tax consulting to Platinum service customers are compensated on a contract basis. Most likely, Steven Chicago would compensate those individuals on an hourly basis for the work they perform. Perhaps a small set of those professionals may be contracted on a retainer basis to perform a minimum number of hours of service each month or quarter of the year for Your1040Return.com customers. Each month (or quarter) the tax professionals could submit a detailed time analysis of the work performed to determine if the minimum number of hours have been worked in accordance with the retainer agreement. In the event the number of hours worked exceed the contracted amount, the tax professionals would be paid for the additional work performed on an hourly rate basis.

Your1040Return.com should design adequate controls to ensure that the tax professionals perform legitimate tax consulting services in exchange for their pay. Perhaps, the

Section 2: Understanding the Client's Business and Assessing Risk

Your1040Return.com web site could be designed to capture information when the customer clicks on a link to activate the instant messenger program that allows communication between the Platinum customer and the tax professional service. The web site could be designed such that pertinent information is captured (e.g., time, date, customer number, question asked) automatically by Your1040Return.com's server. The server could also be designed to capture information about the tax professional (e.g., contractor id) who responds to the customer's inquiry. That information captured automatically could then be reconciled to the monthly time analysis submitted by the tax professional that indicates the services performed for the customer. The tax professional's time analysis would be set up to "charge" hours worked to each customer number serviced by that professional. Your1040Return.com could also require the tax professional to retain electronic or paper copies of the responses provided to the customer via the internet messenger program as backup of all services performed. Your1040Return.com could selectively "audit" charges submitted by the tax professionals back to these files on a periodic basis.

Thinking about the issues Your1040Return.com faces in paying its tax consultants is a valuable exercise that will bring students face-to-face with the challenging issues brought about by the unique e-business models made possible by the Internet. Thus, the specific content of student answers to this question is less important than the depth of their thinking and the quality of their insights.

- [4] *Auditing standards provide guidance for auditors when evaluating electronic evidence. What are the implications for an auditor when a client's accounting system produces and stores transaction evidence only electronically?*

Paragraph A134 of AU-C Section 315, "Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatement", summarizes the implications as follows:

"When such routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures in relation to the risk. For example, the auditor may consider this to be the case when a significant amount of an entity's information is initiated, authorized, recorded, processed, or reported only in electronic form, such as in an integrated system. In such cases

- audit evidence may be available only in electronic form, and its sufficiency and appropriateness usually depend on the effectiveness of controls over its accuracy and completeness.*
- the potential for improper initiation or alteration of information to occur and not be detected may be greater if appropriate controls are not operating effectively."*