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Introduction to Auditing, Public Practice, and Professional Responsibilities

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PART 1 Introduction to Auditing, Public Practice, and Professional Responsibilities

CHAPTER 1

Introduction to Auditing

Chapter 1 is an introduction to auditing, especially financial statement auditing. Other accounting courses helped you learn the principles and methods of accounting, but here you will begin to study the ways and means of auditing—the verification of accounting and other information.

Throughout this text, each chapter will open with an episode of the EcoPak Inc. case study. This case study will provide you with a practical context to examine perspectives on how audits are actually performed and to study the important role of the financial statement audit. The EcoPak Inc. case study is a fictional case based on a composite of real events and issues that arise in financial reporting for a growing business.

EcoPak Inc.

Kam and Mike have been best friends since high school. While at university, Kam went to business school, and Mike studied environmental engineering, but they both ended up finding jobs with Waterfalls Inc., a large 100-year-old public company in the paper and packaging industry. After a few years spent working their way up Waterfalls's corporate ladder, both Kam and Mike are doing quite well. Often, though, when they meet up for lunch, the two of them reminisce about all the ideas they had had years before for businesses they could start up. Kam's aunt, Zhang, is a very successful entrepreneur in the recycled-paper industry, and Kam had always hoped to follow her path.

One day while golfing with Georges, Waterfalls's chief financial officer, Kam learns that Waterfalls's board has decided to sell off the poorly performing manufacturing division, StyreneTech Inc., Waterfalls's 100%-owned subsidiary producing polystyrene-foam packaging products for the food services industry. According to Georges, StyreneTech's poor performance is due to changes in demand for styrene-foam packaging, environmental regulations favouring other materials, and a major fraud in which a purchasing manager was diverting shipments of ethylene raw material to another factory, of which he was part owner. Georges hints to Kam that Waterfalls's board would favour a management buyout "to avoid having a lot of venture capitalists sniffing around."

Kam tells Mike about this right away, and the wheels start turning. Mike meets with the StyreneTech's operations manager and, from their conversation, sees a huge opportunity to move the StyreneTech packaging business into the 21st century by converting its production over to new biomass-based materials, which are biodegradable and made from renewable resources. This would address the environmental concerns and costs that have been dragging StyreneTech's performance down. Once Kam gets his Aunt

LEARNING OBJECTIVES

After completing this chapter, you will be able to do the following:

LO1 Explain the importance of auditing.
LO2 Distinguish auditing from accounting.
LO3 Explain the role of auditing in information risk reduction.
LO4 Describe the other major types of audits and auditors.
LO5 Provide an overview of international auditing and its impact on Canadian auditing standards.

CHAPTER APPENDICES

Appendix 1A: How to Become a PA in Canada *(online)*
Appendix 1B: Alternative Theories of the Role of Auditing in a Society *(online)*

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Zhang interested in the investment, things move quickly. Kam and Mike start looking into the financial side of buying out the StyreneTech business. A large investment from Zhang is needed to come up with the amount Waterfalls wants for the StyreneTech shares.

Since Waterfalls owns 100% of StyreneTech, it must present its shareholders with audited consolidated financial statements (i.e., statements that include the accounts of StyreneTech). Waterfalls's auditors are Grand & Quatre, Public Accountants (G&Q), and they provided an opinion that Waterfalls's consolidated financial statements were fairly presented at its last fiscal year-end. Georges gives Kam a copy of ST's most recent stand-alone–entity financial statements and tells him that, while these financial statements have been "reviewed for accuracy" by Waterfalls's internal auditor, they are only needed for tax purposes so Waterfalls does not pay to have G&Q audit them.

Zhang, however, demands audited financial statements for StyreneTech before she will invest. Kam took just a couple of accounting courses in business school, and Mike does not know anything about financial statements at all, so they are beginning to feel overwhelmed, not really understanding why Zhang wants audited financial statements or how they would get them. Luckily, Mike's sister Nima is a professional accountant working for a mid-sized public accounting firm as an audit manager. Nima agrees to come in on weekends to help them with their finance and accounting, in exchange for shares in the company if they ever get it going. They ask Nima about the audited financial statements. Mike knows about CRA tax auditors—if the StyreneTech financial statements were done for tax reasons, wouldn't that mean they have been audited by a government auditor, someone famous like Sheila Fraser, maybe? And what about the internal auditor—why isn't Zhang satisfied with the internal auditor's review of the StyreneTech financial statements?

Nima explains that the StyreneTech financial statements should be audited by independent public accountants, such as G&Q, because this will give all the prospective investors assurance that the most reliable information about StyreneTech's financial condition and performance is presented. Because G&Q will be independent of Waterfalls's management, and it will perform an examination of Waterfalls's records to support their opinion that the financial information is reliable, this can lessen the investors' concerns that management may be biasing the results upward to get a higher selling price. While Zhang, Kam, and Mike do not have access to StyreneTech's financial information, nor do they have the expertise to assess its reliability, the auditor will do it on their behalf and thus reduce the risk that they are getting biased or inaccurate information.

This makes sense to Kam and Mike—it would be too risky to buy the shares of StyreneTech without getting the audited financial statements. Kam relays this to Georges, who sighs and says, "Okay, we were going to have to do that eventually anyway, to sell it to venture capitalists, so we will get G&Q to audit the StyreneTech financial statements and get them to you within four weeks."

INTRODUCTION: THE CONCEPT OF AUDITING

LO1 Explain the importance of auditing.

Auditing is a field of study that has received considerable media attention lately. In the business press, audit-related issues are mentioned daily. Headlines such as "Auditors: The Leash Gets Shorter," "The Betrayed Investor," "Dirty Rotten Numbers," and "Accounting in Crisis" indicate that the attention has not all been positive. This reality arises from the fact that auditing is critical to the proper functioning of capital markets, and if audits are perceived to fail, then capital markets can do the same. Without effective audits, modern capital markets cannot fulfill their role as efficient economic systems leading to high living standards. An example of an effective auditor is shown in the box below.

AN EFFECTIVE AUDITOR

Molex Incorporated is a $2.2 billion electronics manufacturer headquartered in Chicago. In late 2004 Molex's auditor, Deloitte & Touche, complained that CEO J. Joseph King and his chief financial officer had not disclosed that they allowed a bookkeeping error worth 1% of net income into the audited results. When the auditor demanded on Nov. 13 that King be removed from office, the board initially stood behind the CEO with a unanimous vote.

Then Deloitte did something unexpected: It quit. Two weeks later the firm wrote a blistering and detailed account of the affair for public disclosure at the SEC. That virtually assured that no auditor would work for Molex again as long as King was in charge. Within 10 days the directors had eaten crow: They ousted King, promised to hire a new director with financial expertise for their audit committee, and agreed to take training classes in proper financial reporting.

Source: "The Boss on the Sidelines," *BusinessWeek,* April 25, 2005, p. 94.

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The preceding example illustrates the work of effective auditors in the new business environment of the 21st century. In modern business, the role of auditing is so critical that references can be made to **audit societies**. In audit societies, economic activities (and other politically important ones) are extensively monitored to ensure market efficiency. In these societies, auditors also monitor the effectiveness and efficiency of government. For example, the political uproar surrounding Canada's Gomery commission inquiry (www.gomery.ca) in 2005 was the result of an audit of questionable sponsorship payments that yielded "no value" for taxpayer money spent. As a result of this and similar events, auditing is increasingly recognized as part of a broader process of social control. This expanding role is at the heart of the audit society concept.[1]

audit societies: the term coined by Michael Power for societies in which there is extensive examination by auditors of economic and other politically important activities

But what is auditing, exactly? Simply put, **auditing** is the verification of information by someone other than the one providing it. Since there are many types of information, there are many types of audits. Most of this text focuses on audits of financial statement information, or *financial statement auditing* for short. Before describing auditing in more detail, we will try to make financial statement auditing more intuitive through a simple illustration.

auditing: the verification of information by someone other than the one providing it

A Simple Illustration of the Importance of Auditing

Assume you have always wanted to run your own business—say, a Thai food restaurant. After some searching, you find an owner who wants to retire and is willing to sell his busy restaurant in a choice location of a major metropolitan area for $3 million. One of the first things you ask yourself is whether the business is worth the $3 million asking price. How can you answer that?

You could find out the price of similar properties—comparison shop. But, ultimately, you must decide on the value of this particular business. Accounting information is useful in answering these types of questions: What is the business's net worth (Assets − Liabilities)? What is its profitability?

The owner of the restaurant may claim annual profits of $600,000. First, you want to reach an agreement on how that profit is calculated: on a cash basis? before tax? after tax? under generally accepted accounting principles? Those are the criteria you might use in measuring the profitability (earnings) of the business.

Having decided on the criteria for measurement, you need to use a decision rule with your measurement. Businesses are frequently valued on some multiple of earnings. For example, if you are willing to pay five times current earnings (calculated using your agreed-upon criteria) and the current owner reports $600,000 in earnings annually, you would be paying five times $600,000 or $3 million for the business. You need accounting information to establish that $600,000 is the current earnings number.

But the owner prepares the accounting records. How do you know they are accurate? There may be errors or, worse, the owner might inflate earnings to get a higher price than the business is worth. For example, if the owner is overstating the earnings and they are only $500,000, the most the business is worth to you is five times $500,000, or $2.5 million, rather than $3 million. In other words, you are concerned about the risk of overpaying for your investment.

What can you do to minimize this risk and give yourself assurance? Hire an auditor! The auditor can help you by verifying that the $600,000 figure reported by the current owner is accurate. The earnings can be calculated on whatever basis you agree to, usually **generally accepted accounting principles (GAAP)**. The auditor can independently and competently verify the earnings so that you will have more confidence (assurance) in the numbers upon which you base your decision. The auditor increases the reliability, or reduces the risk, of using inaccurate information in your decision making. For example, if the auditor finds that earnings are really $400,000, you would be unwilling to pay more than five times $400,000 or $2 million for the restaurant. The difference between the

generally accepted accounting principles (GAAP): those accounting methods that have been established in a particular jurisdiction by formal recognition by a standard-setting body, or by authoritative support or precedent such as the accounting recommendations of the *CICA Handbook*

1 M.P. Power, *The Audit Society* (New York: Oxford University Press, 1997).

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original asking price ($3 million) and what you should actually pay ($2 million) is the value of the audit—in this case $1 million. If the audit fee is under $1 million you would, therefore, be better off having an audit.

This simplified example illustrates the value of auditing in investment decision making. But it also shows how auditing can provide other, more general, social services. For example, the restaurant owner can retire with a fair price for his business, and you can achieve your dreams of owning a restaurant and being your own boss. These are accomplished by using a fair exchange price based on reliable (accurate, trustworthy) information.

The transaction entries that you learn in your accounting courses are part of the raw data auditors deal with. The summarization of all the transactions over a period is achieved through financial statements. When auditors verify the reliability of this information, they reduce the information risk associated with financial statements. Now, imagine this illustration extended to all investors contemplating even partial ownership of a business—for example, investors in the stock market—and you will have some idea of how auditing can facilitate efficient economic activities by reducing financial information risk. And when auditors fail to do a proper job of verification (i.e., fail to reduce information risk), the type of headlines noted at the beginning of this section can result.

When you make an investment, you agree to enter into a contract to purchase from another party. The auditor can be called the first party and the seller the second party. Notice, however, that there is a third party—you, the investor. The auditor is an independent party hired to verify information provided by the second party. The auditor is hired because you, the third party do not trust the information provided by the second party. You feel the information risk is too high; therefore, the first party will provide you with independent verification. We refer to this relationship throughout the text as **three-party accountability**.

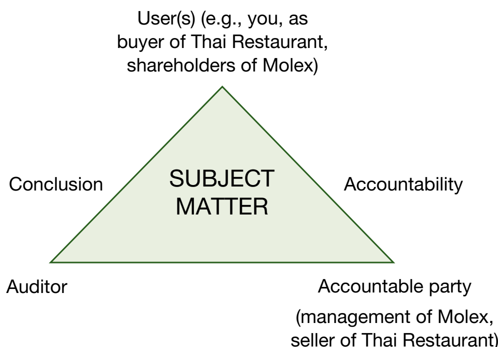
three-party accountability: an accountability relationship in which there are three distinct parties (individuals): an asserter, an assurer, and a user of the asserted information

accountability relationship: a relationship in which at least one of the parties needs to be able to justify its actions or claims to another party in the relationship

In an audit society, three-party accountability is so institutionalized that regulators require certain second parties to pay for the audit. In particular, companies whose shares are traded on regulated stock exchanges (public companies) are required to hire an independent auditor to verify the annual financial statements. The accountability is still three party because the audit's purpose is to reduce information risk for the third party, but the public company, the second party, pays the audit fee. It is important to remember that three-party accountability is not determined by who pays the fee.

Exhibit 1–1 indicates how three-party accountability applies to the Molex and Thai restaurant examples. In the exhibit, accountability is represented as a triangle with the auditor of the financial information, the management preparing the financial information, and the users of the financial information at the apexes. The triangle reflects an **accountability relationship**

EXHIBIT 1–1 Three Parties Involved in an Auditing Engagement (Three-Party Accountability)



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because management is accountable to the users. However, the users cannot rely on financial statements, as they do not trust management sufficiently; they demand that financial statements be verified by a competent, independent auditor. Thus, the auditor is also accountable to the user. Three-party accountability is an important distinguishing feature of auditing.

Note that the concept of three-party accountability means that the auditor is expected to act in the interests of the user of financial statements. If the owner of the Thai restaurant gives you an audited set of financial statements, you are entitled to assume that the auditor has not misled you. This is an important point because if you could not assume the auditor is trustworthy, the relevance of the audit would largely disappear, leaving little, if any, role for the audit in society. Thus, it is extremely important to the audit profession that the auditor be perceived as acting in the interests of the financial statement users (i.e., the third parties), also referred to as **acting in the public interest**. Later in this text, you will see how the public interest is reflected in the objectives of the audit engagement, in auditors' legal liability, and in the professional rules of conduct that determine the auditor's professional role.

acting in the public interest: acting in the interests of the users of the financial statements; also, more generally, fulfilling the social role expected of the professional

Three-party accountability is also important because it distinguishes the type of services that only licensed practitioners can provide (in some parts of Canada) from other services, such as tax work and business-advisory services, which anyone can provide. Audits are part of a broader class of services called *assurance engagements* that are licensed to professionals (in some parts of Canada). Three-party accountability applies to all assurance engagements. We will clarify these important concepts throughout the rest of the text. For now, think of three-party accountability as reducing the risk on information created by the second party, the preparer of the information. Reducing information risk is synonymous with improving the credibility of, or providing assurance on, information produced by the second party.

Agency Theory and Accountability

Three-party accountability is a special case of the agency problem of economic theory. Whenever a task is delegated by one party (the principal) to another (the agent), it can create a potential "agency problem." Agency problems occur when three conditions are present in an agency relationship: (a) the agent has objectives that are different from those of the principal, (b) the agent has more information than the principal does, and (c) the contract between the two is incomplete in that not every possible contingency can be anticipated.

Agency theory is the study of how contracts can be designed to mitigate the agency problem. Various solutions to this problem are discussed in Appendix 1B. The basic relationships are illustrated in Exhibit 1–2. The arrows indicate the direction of accountability in the basic agency relationship between the management (agent) and the shareholder/owner (principal) of a firm. Management is the party accountable to the owners, and one way it satisfies this accountability is by the preparation of financial statements. Financial statements are one way of monitoring how well management is doing in terms of running the firm. However, there is a potential problem in that management may bias its statements, making financial statements less credible. The auditor comes in as an outside, independent accounting expert to verify the accuracy of financial statements, thereby adding credibility to the statements. The auditor, thus, helps monitor management. The important thing to note about Exhibit 1–2 is that the auditor is primarily accountable to the principal (owner or capital provider) and not to management which, acting on behalf of the company, has historically hired and authorized payment for audit services. This fact can create a **conflict of interest** problem for the auditor that affects the auditor's independence in verifying the accuracy of management's statements. The auditor cannot help monitor management if the auditor is not independent of management. This helps explain the importance of auditor independence that is stressed throughout this text, an importance that arises from the need to meet third-party needs. Auditor independence and third-party needs also greatly shapes ethical reasoning in an audit context, as we will see in Chapter 3. Later in this text, you will learn how corporate governance changes have the strengthened three-party accountability

conflict of interest: A situation faced by a professional accountant in which there may be a divergence between the interests of two (or more) parties for whom the professional accountant undertakes a professional activity (e.g., clients), or between the interests of the professional and the interests of such parties, that could create a threat to the professional's objectivity or other fundamental ethical principles

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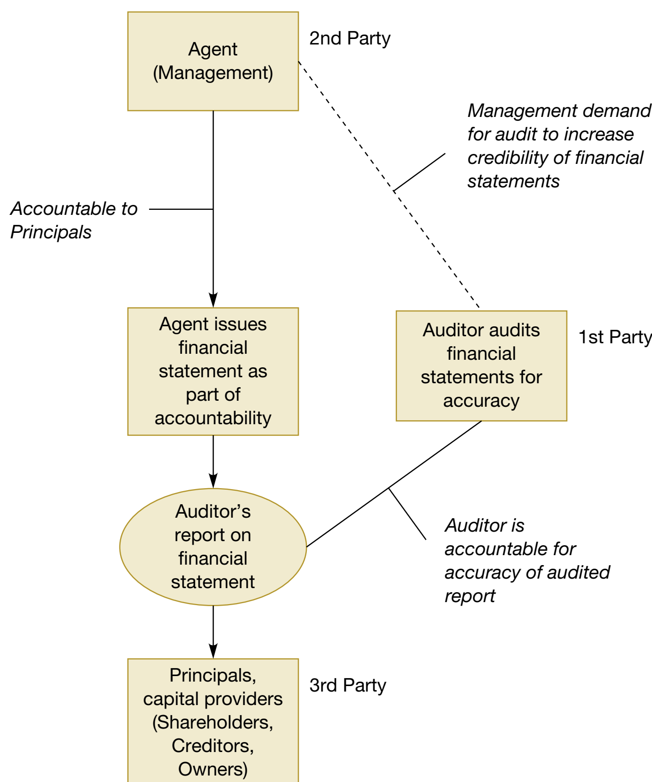
EXHIBIT 1–2 Agency Theory and Accountability



by separating various functions that used to be centralized in top management. For now, the important point is that third-party capital providers do not have access to the same information as management, something referred to in the next section as the "remoteness" of accounting information to third-party users.

We hope you have found the preceding illustrations useful. Next, we further clarify the roles of accounting and auditing in the financial reporting environment.

USER DEMAND FOR RELIABLE INFORMATION

Accounting

LO2 Distinguish auditing from accounting.

The following three underlying conditions affect users' demand for accounting information:

1. *Complexity.* A company's transactions can be numerous and complicated. Users of financial information are not trained to collect and compile it themselves. They need the services of professional accountants.
2. *Remoteness.* Users of financial information are usually separated from a company's accounting records by distance and time, as well as by lack of expertise. They need to employ full-time professional accountants to do the work they cannot do for themselves.
3. *Consequences.* Financial decisions are important to the state of investors' and other users' wealth. Decisions can involve large dollar amounts and massive efforts. The consequences are so important that good information, obtained through the financial reports prepared by accountants, is an absolute necessity.

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Accounting is the process of recording, classifying, and summarizing into financial statements a company's transactions that create assets, liabilities, equities, revenues, and expenses. It is the means of satisfying users' demands for financial information that arise from the forces of complexity, remoteness, and consequences. The function of **financial reporting** is to provide statements of financial position (balance sheets), statements of results of operations (income statements), cash flows statements, and accompanying disclosure notes (footnotes) to outside decision makers. A company's accountants are the producers of such financial reports. In short, accounting tries to record and summarize economic reality for the benefit of economic decision makers (the users).

Because of advances in **information technology (IT)**, the form and location in which accounting records are stored has changed dramatically over the past few decades. Although these changes have affected the form of audit evidence, the basic role of verification for users and their decision-making needs has not changed.

The goal of GAAP, which you study in your financial accounting courses, is to yield financial statements that represent as faithfully as possible the economic conditions and performance of a company. This is why GAAP are the most common criteria used in preparing financial statements. However, as illustrated in the introduction, auditors are independent financial reporting experts who are frequently asked to verify that these goals are met.

accounting: the process of recording, classifying, and summarizing into financial statements a company's transactions that create assets, liabilities, equities, revenues, and expenses

financial reporting: broad-based process of providing statements of financial position (balance sheets), statements of results of operations (income statements), statements of results of changes in financial position (cash flow statements), and accompanying disclosure notes (footnotes) to outside decision makers who have no internal source of information such as the management of the company has

REVIEW CHECKPOINTS

1-1 Explain how the auditor can help you in your investment decision making.

More on Auditing

Financial decision makers usually obtain their accounting information from companies wanting loans or selling stock. This is a potential conflict of interest, a condition that leads to society's demand for audit services. Users need more than just information; they need reliable, error-free information. Preparers and issuers (directors, managers, accountants, and others employed in a business) might benefit from giving false, misleading, or overly optimistic information. The potential conflict is real enough to generate a natural skepticism on the part of users. Thus, users depend on **external auditors**, professional accountants who serve as objective intermediaries and to add credibility to financial information. This "adding of credibility" is also known as **providing assurance**, and external auditing of financial statements is described as an **assurance engagement**.

Auditing does not include financial-report production. That function is performed by a company's accountants under the direction of management. Auditors determine whether the information in the financial statements is reliable, and they communicate this conclusion to the users by reporting that the company's presentation of financial position, results of operations, and cash flows statement are in accordance with GAAP, or some other disclosed basis of accounting. This is the assurance provided by the assurance function, as it relates to the traditional financial statements. Assurance requires three-party accountability, as discussed previously. To achieve three-party accountability, auditors must not be involved in production of the information audited. Such external auditors can provide a range of services in addition to audits, causing them to be referred to frequently as *public accounting (PA) firms.*

External auditors work for clients. A **client** is the person (company, board of directors, agency, or some other person or group) who retains the auditor and pays the fee. In financial statement audits, the client and the auditee are usually the same economic entity. The **auditee** is the company or entity whose financial statements are being audited. Occasionally, the client and the auditee are different entities. For example, if Conglomerate Corporation hires and pays the auditors to audit Newtek Company in connection with a proposed

information technology (IT): the hardware and software needed to process data

external auditor: an auditor who is an outsider and independent of the entity being audited

providing assurance: the "adding of credibility" to financial information by objective intermediaries

assurance engagement: an engagement in which the auditor adds either reasonable (high) or moderate (negative) levels of assurance

client: the person or company who retains the auditor and pays the fee

auditee: the entity (company, proprietorship, organization, department, etc.) being audited; usually it refers to the entity whose financial statements are being audited

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acquisition, Conglomerate is the client and Newtek is the auditee. In practice, these two terms are used interchangeably, possibly because the auditee is usually the one paying the auditor.

As explained previously, reliable financial information helps make capital markets efficient and helps people understand the consequences of a wide variety of economic decisions. External auditors practising the assurance function are not, however, the only auditors at work in the economy. Bank examiners, Canada Revenue Agency auditors, provincial regulatory agency auditors (e.g., auditors with a province's Commissioner of Insurance), internal auditors employed by a company, and the Office of the Auditor General of Canada (or a provincial equivalent) all practise auditing in one form or another. There are many acronyms associated with various auditing associations and auditors. The acronyms are part of the jargon of the profession.

professional judgment: the application of relevant training, knowledge, and experience, within the context provided by auditing, accounting, and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement

critical thinking: the process of justifying one's conclusion or decision by providing good or acceptable reasons

Professional judgment is a widely used concept in accounting and auditing. It is defined in Canadian Audit Standard (CAS) 200, paragraph 13(k) as "the application of relevant training, knowledge, and experience, within the context provided by auditing, accounting, and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement." Professional judgment includes consideration of key principles and concepts of disciplines underlying the professional standards, such as economics, psychology, law, finance, statistics, philosophy, and other social sciences. This integration of diverse areas helps explain why a university education is now required of external auditors. Specialized concepts and language integrate the disciplines in order to provide appropriate justification for audit decisions. We refer to the basic concepts and principles of justification as **critical thinking**. Auditors have to provide justification for their decisions, and this includes questioning or critical thinking about management's justifications. Critical thinking concepts are covered in some of the more difficult exercises throughout the book, and aspects of it are applied in cases analyzed at the end of most chapters.

REVIEW CHECKPOINTS

1-2 What is auditing? What condition creates demand for audits of financial reports?

1-3 What is the difference between a client and an auditee? What are the three parties in three-party accountability?

1-4 What is the difference between auditing and accounting?

1-5 What conditions create demand for financial reports, and who produces financial reports for external users?

DEFINITIONS OF AUDITING

Definitions of Auditing

In 1971, the American Accounting Association (AAA) Committee on Basic Auditing Concepts prepared a comprehensive definition of auditing as follows:

> Auditing is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between the assertions and established or suitable criteria and communicating the results to interested users.

This definition contains several ideas important in a wide variety of audit practices. The first and most important concept is the perception of auditing as a systematic process that is purposeful, logical, and based on the discipline of a structured approach to decision making. Auditing is not haphazard, unplanned, or unstructured.

The audit process, according to this definition, involves obtaining and evaluating evidence consisting of all the influences that ultimately guide auditors' decisions, and it relates

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to assertions about economic actions and events. When beginning an audit engagement, an external auditor receives financial statements and other disclosures by management that are management's assertions about economic actions and events (assets, liabilities, revenues, expenses). Evidence is then gathered to either substantiate or contradict these management assertions.

External auditors generally begin work with explicit representations from management—assertions of financial statement numbers and information disclosed in the notes to financial statements. When these assertions are made explicit in writing by the accountable party (the asserter), the resulting audit engagement is referred to as an **attest engagement**. Financial statements are an example of written assertions, and thus the audit of financial statements is an attest engagement. Not all auditors are provided with such explicit representations. An internal auditor, for example, may be assigned to evaluate the cost-effectiveness of the company's policy to lease rather than purchase equipment. A governmental auditor may be assigned to determine whether the goal of creating an environmental protection agency has been met by the agency's activities. Often, these latter types of auditors must develop the explicit standards of performance for themselves. This type of engagement is called **direct reporting engagement**.

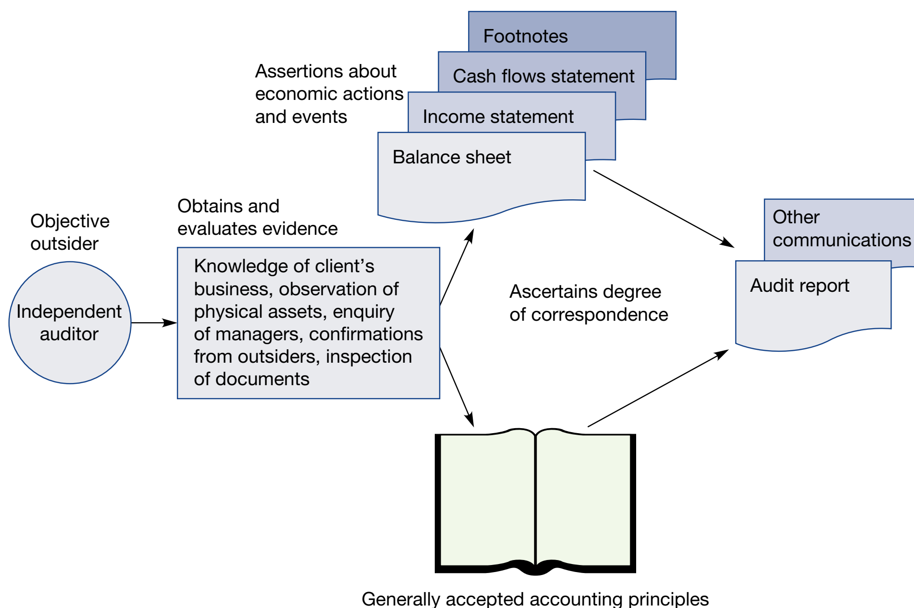
attest engagement: when a public accountant is hired to perform procedures and issue a report resulting from those procedures that affirms the validity of an assertion; also known as an *attestation engagement*

direct reporting engagement: a type of assurance engagement in which the assertions are implied and not written down in some form

The purpose of obtaining and evaluating evidence is to determine the degree of correspondence between the assertions and suitable criteria. The findings will ultimately be communicated to interested users. To communicate in an efficient and understandable manner, there must be a common basis, or suitable criteria, for measuring and describing financial information. These suitable criteria appear in a variety of sources. For external auditors, government auditors, and Canada Revenue Agency inspectors, the criteria largely consist of GAAP. Canada Revenue Agency inspectors also rely heavily on criteria specified in federal tax acts. Government auditors may rely on criteria established in legislation or regulatory agency rules. Bank examiners and provincial insurance board auditors look to definitions and rules of law. Internal and governmental auditors rely extensively on financial and managerial models of efficiency and economy, as well as on GAAP. All auditors rely to some extent on the elusive criteria of general truth and fairness.

Exhibit 1–3 depicts an overview of financial statement auditing.

EXHIBIT 1–3 Overview of Financial Statement Auditing



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Audit Objective and the Auditor's Report

Canadian Institute of Chartered Accountants (CICA): the professional body of chartered accountants in Canada

The AAA definition of auditing is broad and general enough to encompass external, internal, and governmental auditing. In Canada, the CASs, as issued by the **Canadian Institute of Chartered Accountants (CICA)**, set forth the main objective of a financial statement audit as follows:

> The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.[2]

The CICA statement of objective restricts auditing interest to external auditors' audit of the traditional financial statements and accompanying notes. However, as the needs of users change, new audit objectives and reports are created to meet them. Thus, the *CICA Handbook* also offers guidance on such divergent topics as reporting on control procedures at service organizations, solvency issues, and examining a financial forecast in a prospectus. A set of evolving "assurance standards" provides a framework governing a wide range of assurance services, including audit services. These expanding standards indicate a corresponding demand for new types of audits and an expanded social role for auditing. This is consistent with an evolving audit society. Historically, the demand for an expanded role for auditing has grown faster than standard setters' ability to meet these public expectations. As a result, an **expectations gap** has developed between what the public expects of auditors and what auditors can actually deliver. For example, historically, the public has expected auditors to take on more responsibility for fraud detection than the standards required.

expectations gap: the difference that can arise between what the public expects of the auditor's social role and what the professional standards and practice deliver

The auditor's opinion on financial statements is expressed in the last paragraph of the audit report. This is the culmination of the auditor's work, and almost everything that you will be studying in this text is geared to supporting this conclusion. Hence it is very important!

A standard report is shown in Exhibit 1–4. Chapter 3 explains this and other audit reports in more detail. For now, we highlight some key features of it, beginning with the end of the report. The key words in the last paragraph, the opinion paragraph, make reference to "financial statements present fairly, in all material respects, . . ." This is the auditor's conclusion, and it is intended for the users of financial statements. What do you think it means? See the discussion in the application case at the end of the chapter. The second to last paragraph, the one that begins with "We believe . . . ," tells the user on what basis the auditor reached the conclusion. It tells the user of financial statements that there is a link between the opinion and the audit evidence, something that you will be covering in most of this book. The link supports the conclusion, and it explains why you gather audit evidence! The fourth paragraph describes what type of evidence constitutes audit evidence. The third paragraph summarizes the objectives of the audit and highlights the importance of meeting professional ethics requirements. All this is made public to the user in the report so that as a good auditor you had better adhere to the claims in the report that you are responsible for!

Canadian Auditing Standard (CAS): the audit standard in Canada using the equivalent International Standard on Auditing (ISA) and the same numbering system as the ISAs

In this book, we refer to a **Canadian Auditing Standard (CAS)** as a CAS. Unless otherwise indicated, the equivalent International Standard on Auditing (ISA) is the same number as the CAS number. For example, CAS 700 and ISA 700 refer to the same standard, except for some minor variations explained later. We refer to each CAS by the number associated with it and also give the equivalent, original *CICA Handbook* Recommendation number in parentheses. For example, CAS 700 is the equivalent of the original Recommendation 5400, so we present it as CAS 700 (5400).

EXHIBIT 1–4 Independent Auditor's Report

To the Shareholders of . . . . .

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flows statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

2 Canadian Audit Standard (CAS) 200.03, "General Objective of the Independent Auditor." The Canadian Audit Standards of the *CICA Handbook* are the authoritative CICA pronouncements on auditing theory and practice.

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EXHIBIT 1–4 Continued

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Canadian generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

[Auditor's signature]

[Date of auditor's report]

[Auditor's address]

Source: *CICA Handbook—Assurance*, CAS 700, "Forming an Opinion and Reporting on Financial Statements."

A Definition of Auditing Relating to "Risk Reduction"

LO3 Explain the role of auditing in information risk reduction.

Although it is sometimes difficult to distinguish between a definition and a theory, most statements of theory begin with a definition. The theory that auditing is a "risk-reduction activity" is gaining popularity, and the following definition supports this view:

> Auditing in financial reporting is a process of reducing (to a socially acceptable level) the information risk to users of financial statements.

Economic activity takes place in an atmosphere of **business risk**. Business risks result from significant conditions, events, circumstances, or actions that might adversely affect the entity's ability to achieve its objectives and execute its strategies (CICA Assurance Handbook, CAS 700, Forming an Opinion and Reporting on Financial Statements). Auditors do not directly influence a company's business risk, but they are responsible for ensuring proper disclosure of these risks by the auditee in the financial statements. As the business world becomes more complex, auditors are finding that they must increasingly focus on understanding the client's business risks in order to judge whether the financial statements reflect them properly. It is emphasized in auditing that risk is an important part of economic substance that should be reflected in financial reporting. A good illustration of the effects of business risks related to the economic crisis that began in 2008 is given in the following box.

business risk: the probability that significant conditions, events, circumstances, or actions might arise that will adversely affect the entity's ability to achieve its objectives and execute its strategies

ACCOUNTING BLAMED FOR GLOBAL CREDIT CRISIS

Wall Street executives and lobbyists say they know what helped push the nation's largest financial institutions over the edge in recent months. The culprit, they say, is accounting.

Companies including American International Group Inc., the insurer that accepted $85 billion in a U.S. takeover, have said the rule by the U.S. Financial Accounting Standards Board requires them to record losses they don't expect to incur. Financial service companies have reported more than $520 billion in write-downs and credit losses since last year. Supporters of the rule say companies seeking the exemption are citing fair value as a way to cover their poor performance.

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Fair value "is an accounting issue that's too important to be left just to accountants," former SEC Chairman Harvey Pitt said in an interview today. Economists, academics and regulators from outside FASB, in addition to accountants, should be involved in considering a new approach to fair value, he said.

"What the banks are telling everyone is that the accounting has caused the problem," former SEC chief accountant Lynn Turner said. "The only thing fair-value accounting did is force you to tell investors you made a bunch of very bad loans."

". . . The banking lobby is also confusing the role of accounts. These should simply be a true and fair record of management's stewardship of the business. How the owners, regulators, and tax authorities that read accounts choose to interpret them is their choice. Complaining about what the accounts show, when we're talking about a system supported by such users of accounts as investors and regulators, is akin to blaming a torch for shining a light on the mess in your cupboard."

As an example of recent accounting challenges, analysts cite Merrill Lynch's sale of $30.6 billion of collateralized debt obligations, or pools of mortgage-linked assets, to the investment company Lone Star Funds for only 22 cents on the dollar in July. Jessica Oppenheim, a spokeswoman for Merrill, which this month agreed to be purchased by Bank of America, declined to comment.

Advocates for leading financial institutions, including the Financial Services Roundtable and the American Bankers Association, have been raising the issue with government officials in Washington and New York for months. Arizona Sen. John McCain, the GOP presidential candidate, mentioned fair-value accounting as a problem in a recent stump speech.

Lobbyists have been seeking temporary relief from the accounting measure, which they say establishes bargain-basement prices for assets that would be valued far higher during more normal trading conditions. The events of last week raised fresh concerns among industry executives who fear that investments sold to the government as part of the $700 billion bailout plan will set a bargain-basement precedent for the rest of the market.

Banks also have been fighting their auditors, some of which have reasoned that downmarket conditions have persisted for so long that assets are no longer "temporarily impaired" but now require write-downs and capital infusions. Banking trade association officials are scheduled to meet with SEC regulators this week to discuss the issue, which could prompt some banks to attract new capital to meet regulatory requirements.

"The accounting rules and their implications have made this crisis much, much worse than it needed to be," said Ed Yingling, president of the bankers' association. "Instead of measuring the flame, they're pouring fuel on the fire."

Sources: Excerpts from *Washington Post,* Sept. 23, 2008: D01 (Carrie Johnson); Bloomberg.com, Ian Katz, Sept. 23, 2008; and jennifer.hughes@ft.com, www.ft.com/accountancy, *The Financial Times* Limited, 2008.

information risk: the possible failure of financial statements to appropriately reflect the economic substance of business activities

Information risk refers to the possible failure of financial statements to appropriately reflect the economic substance of business activities, including risks and uncertainties. It thus includes failure to properly disclose business risk. For example, if a company fails to disclose that it plans to file for bankruptcy, the risk of bankruptcy is a business risk, and failure to disclose it is an information risk. Note that information risk is influenced by the evidence of bankruptcy gathered by the auditor and by the rules (i.e., GAAP) for appropriately disclosing this.

materiality: amount of misstatement that would likely affect a user's decision

Information risk from the auditor's perspective is the risk (probability) that the financial statements distributed by a company will be materially false and misleading. **Materiality**, as used in auditing, means the same thing as it does in your accounting courses. Basically, a material misstatement is one that would affect user decision making.

Financial analysts and investors depend on financial reports for stock purchase and sale decisions; creditors (suppliers, banks, and so on) use them to decide whether to give trade credit and bank loans; labour organizations use them to help determine a company's ability to pay wages; and government agencies and Parliament use them in preparing analyses of the economy and making laws concerning taxes, subsidies, and the like. All these users cannot determine whether financial reports are reliable and, therefore, low on the information risk scale. They do not have the expertise, resources, or time to enter thousands of companies to satisfy themselves about the veracity of financial reports. Auditors assume the social role of attesting to published financial information, offering users the valuable service of assurance that the information risk is low. This role of auditors has been institutionalized through laws and regulations.

audit risk (account level): the probability that an auditor will fail to find a material misstatement that exists in an account balance

accounting risk: the part of information risk due to incorrectly predicting future events, especially in accounting estimates

It is important to be aware that, from the auditor's perspective, there are two major categories of information risk. One is the risk of insufficient evidence being gathered on the facts concerning the client's (auditee's) economic circumstances. This is referred to as **audit risk (account level)**. The other category is the risk that errors associated with forecasts used in GAAP accounting estimates are not properly disclosed. We refer to this second category of information risk as **accounting risk**. Forecasts are the distinguishing feature of GAAP that separates GAAP accounting from cash basis accounting. Accounting risk is primarily the

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responsibility of accounting standards. Accounting risk is becoming increasingly important with the increasing use of fair value accounting and the adoption of International Financial Reporting Standards (IFRS) in 2011. You can see the challenges for auditors in deciding whether fair value accounting "present fairly" in particular circumstances from the preceding box! However, while the term *audit risk* is a key part of auditing standards, accounting risk is dealt with only indirectly in accounting standards. You likely did not encounter the accounting risk concept in your financial accounting courses because accounting theory is not as risk oriented as auditing theory currently is. This makes controlling information risk in financial reporting a major challenge for auditors. The accounting risk concept used in the more advanced parts of this text, especially Chapter 19, Part II (available on Connect), dealing with the audit of accounting estimates, helps address this key challenge of professional judgment in auditing.

The risk-reduction definition may appear very general. As your study of auditing continues, you will find that the primary objective of many auditing tasks is reducing the risk of giving an inappropriate opinion on financial statements. Auditors are careful to work for trustworthy clients, to gather and analyze evidence about the data in financial statements, and to take steps to ensure audit personnel report properly on the statements when adverse information is known. Subsequent chapters will have more to say about these activities. We begin the process with the Application Case and Analysis discussion at the end of this chapter.

For now, consider the following box for a current illustration of a call for an audit that may have global repercussions.

IS THERE ANY GOLD INSIDE FORT KNOX? AN EXAMPLE OF A BURGEONING DEMAND FOR AN INDEPENDENT EXTERNAL AUDIT

Protected by a 109,000-acre U.S. Army post in Kentucky sits one of the Federal Reserve's most secure assets and its only gold depository: the 73-year-old Fort Knox vault. Its glittering gold bricks, totalling 147.3 million ounces (that's about $265 billion as of August 10, 2011), are stacked inside massive granite walls topped with a bombproof roof. Or are they?

For several prominent investors and at least one senior U.S. congressman it is not the security of the facility in Kentucky that is a cause of concern: it is the matter of how much gold remains stored there—and who owns it. They are worried that no independent auditors appear to have had access to the reported $265 billion stockpile of brick-shaped gold bars in Fort Knox since the era of President Eisenhower. After the risky trading activities at supposedly safe institutions such as AIG, they want to be reassured that the gold reserves are still the exclusive property of the U.S. and have not been used to fund risky transactions.

"It has been several decades since the gold in Fort Knox was independently audited or properly accounted for," said Ron Paul, the Texas congressman and former Republican presidential candidate, in an email interview with *The Times.* "The American people deserve to know the truth."

"We're taking the President at his word," said Chris Powell, of the Gold Anti-Trust Action Committee (GATA). "If you go online you can find out how to build a nuclear weapon but you won't find any detailed records on central gold reserves."

A month after President Nixon resigned over the Watergate affair, Congress demanded to inspect the contents of Fort Knox but the trip to Kentucky was dismissed by critics as a photo opportunity. Three years earlier Mr Nixon brought an end to the gold standard when France and Switzerland demanded to redeem their dollar holdings for gold amid the soaring cost of the Vietnam War.

Many gold investors suspect that the U.S. has periodically attempted to flood the market with Fort Knox gold to keep prices low and the dollar high—perhaps through international swap agreements with other central banks—but facts remain scarce and the U.S. Treasury denies that any such meddling has gone on for at least the past decade.

Pressure for more openness is mounting after the collapse of the global banking system and renewed interest in a return to the simpler era of the gold standard—a subject that is likely to be raised at the G20 summit next week. China and Russia are calling for the creation of a new world reserve currency amid fears that the Federal Reserve's quantitative easing policy—essentially printing money—might cause hyperinflation, then collapse.

Sources: Chris Ayres in Los Angeles, from *The Times,* March 28, 2009, and Constance Gustke, January 20, 2010, http://moneywatch.bnet.com/economic-news/article/is-there-gold-in-fort-knox/385523/#ixzz1RqjMgxrG.

The preceding box illustrates how demand for an audit can arise. Basically, people stop believing the reporting by the report preparer, in this case a government's assertions about the quantity of gold at Fort Knox.. So an independent audit is demanded to add credibility. On the other hand, the Royal Canadian Mint announced in June, 2009, that 17,500 ounces of Mint gold had been lost or stolen. This disappearance was confirmed during an audit

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of the Mint by Deloitte & Touche, CAs, under the direction of the Auditor General of Canada. The question asked by U.S. commentators is, if Canada audits its gold, why doesn't the United States?[3] This lack of an independent audit, especially over lengthy periods of time, can raise credibility questions, as you can see from the box.

A related issue to consider at this point is how might you audit something like the quantity of gold? The obvious answer is to go see if it exists! That means actually going to Fort Knox and counting the gold bars. In fact, in auditing, the existence assertion that you will learn about later in this text specifies the need to verify the accuracy of the actual count. Not exactly rocket science! Somebody has to do it, and that somebody is the independent external auditor.

What other things would you need to do? Think of the questions being raised by the doubters of the contents of Fort Knox. It is important for you as an auditor to be aware of the concerns that users of your report may have. First, you would need to count the gold bars and check the accuracy of what is recorded at Fort Knox. Further tests could include checking serial numbers against records for accuracy, determining who owns the gold, and perhaps randomly testing the gold bars for purity. (One conspiracy theory is that the gold in Fort Knox is fake. Search "Is the gold in Fort Knox fake?" on Google to see what we mean.) While some of the conspiracy theories are far-fetched, an independent external audit would likely end much of the speculation. This is an example of how the demand for audits can grow spontaneously and why we are evolving toward an audit society.

REVIEW CHECKPOINTS

1-6 What would you say if asked by an anthropology major, "What do auditors do?"

1-7 What is the essence of the risk-reduction definition of auditing?

KINDS OF AUDITS AND AUDITORS

LO4 Describe the other major types of audits and auditors.

The AAA, the CICA, and the risk-reduction definitions apply to the financial statement audit practice of independent external auditors who practice in public accounting firms. The word *audit,* however, is used in other contexts to describe broader kinds of work.

The variety of audit work performed by different kinds of auditors causes problems with terminology. Hereafter in this text, the terms independent auditor, external auditor, chartered accountant (CA), certified general accountant (CGA), certified management accountants (CMA), and **public accountant (PA)** refer to people doing audit work with public accounting firms. In governmental and internal contexts, auditors are identified as governmental auditors, operational auditors, and internal auditors. While many of these are chartered accountants or certified general accountants, in this text, the initials PA, CA, CGA, and CMA will refer to auditors in public practice. We will use the neutral term PA as much as possible.

public accountant (PA): individual doing audit work with a public accounting firm; includes Chartered Accountants (CA), Certified General Accountants (CGA), Certified Management Accountants (CMA)

Internal and Operational Auditing

The Institute of Internal Auditors (IIA) defines **internal auditing** and its purpose as follows:

> Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.[4]

internal auditing: verification work performed by company employees who are trained in auditing procedures; mainly used for internal control purposes, but external auditors can rely on internal audit work if certain criteria are met

3 See http://news.goldseek.com/goldseek/1248373722.php.

4 See www.theiia.org.

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Internal auditing is practised by auditors employed by organizations such as banks, hospitals, city governments, or industrial companies. Some internal auditing activity is known as operational auditing. **Operational auditing (performance auditing or management auditing)** is the study of business operations in order to make recommendations about the economic and efficient use of resources, effective achievement of business objectives, and compliance with company policies. The goal of operational auditing is to help managers discharge their management responsibilities and improve profitability.

operational auditing (performance auditing or management auditing): auditors' study of business operations for the purpose of making recommendations about economic and efficient use of resources, effective achievement of business objectives, and compliance with company policies

Internal and operational auditors also perform audits of financial reports for internal use, much as external auditors audit financial statements distributed to outside users. Thus, some internal auditing work is similar to the auditing described elsewhere in this text. In addition, the expanded-scope services provided by internal auditors include (1) reviews of control systems for ensuring compliance with company policies, plans, procedures, and laws and regulations; (2) appraisals of the economy and efficiency of operations; and (3) reviews of program results in comparison with their objectives and goals.

Internal auditors need to be independent of the organization's line managers, much like the external auditors need to be independent of the company management. Independence helps internal auditors be objective and achieve three-party accountability. As noted earlier, you, as a user of audited information, expect the auditor to be unbiased and impartial, as well as competent, in verifying the accuracy of the information you rely on in making your decision. Internal auditors can recommend correction of poor business decisions and practices, and they can praise good decisions and practices. If they were responsible for making the decisions or carrying out the practices themselves, they would hardly be credible in the eyes of upper-management officers they report to. Consequently, the ideal arrangement is to have internal auditors whose only responsibilities are to audit and report to a higher level in the organization, such as a financial vice-president and the audit committee of the board of directors. This arrangement offers an independence that enhances the appraisal function (internal audit) within a company.

Internal audit can be an important aspect of auditee internal controls, as they monitor auditee operations year round. When such internal independence exists, external auditors may also be able to rely quite a bit on internal audit work as a valuable source for evidence. In the environment of the influential Sarbanes-Oxley Act (SOX) legislation passed in the United States, internal auditor reports to independent audit committees are increasingly viewed as indispensable for good corporate governance. In addition, in the SOX world, if an external auditor performs internal audit functions, he or she is deemed to be insufficiently independent and prohibited from auditing for external reporting. Again, this helps preserve external auditor independence.

Public Sector (Governmental) Auditing

The Office of the Auditor General of Canada (OAG) is an accounting, auditing, and investigating agency of Parliament, headed by the Auditor General. In one sense, OAG auditors are the highest level of internal auditors for the federal government. Many provinces have audit agencies similar to the OAG, answering to provincial legislatures and performing the same types of work as we describe in this section. In another sense, the OAG and equivalent provincial auditors are really external auditors with respect to government agencies they audit, because they are organizationally independent.

Many government agencies have their own internal auditors and inspectors: for example, federal ministries such as the Department of National Defence or Canada Revenue Agency and provincial education, welfare, and controller agencies. Well-managed local governments (cities, regions, townships) also have internal audit staff. Activities of all levels of government are frequently referred to as the **public sector**.

public sector: activities of all levels of government

Internal and public sector auditors have much in common. The OAG and internal auditors share elements of expanded-scope services. The OAG, however, emphasizes the accountability of public officials for the efficient, economical, and effective use of public funds and other resources. The CICA sets accounting and auditing standards for all public sector audit engagements, including those of the federal, provincial, and local levels of government.

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In the public sector, you can see the audit function applied to financial reports, and a compliance audit function applied with respect to laws and regulations. All government organizations, programs, activities, and functions were created by law and are surrounded by regulations governing the things they can and cannot do. For example, in some provinces, there are serious problems of health card fraud by ineligible persons. A hospital cannot simply provide free services to anyone as there are regulations about eligibility of tourists and visitors from other countries. A compliance audit of services involves a study of the hospital's procedures and performance in determining eligibility and treatment of patients. Nationwide, such programs involve millions of people and billions of taxpayers' dollars.

value-for-money (VFM) audit: audit concept from public sector that incorporates audits of economy, efficiency, and effectiveness

Also, in the public sector you see **value-for-money (VFM) audits**, a category that includes economy, efficiency, and effectiveness audits. Government is always concerned about accountability for taxpayers' resources, and VFM audits are a means of improving accountability for the efficient and economical use of resources and the achievement of program goals. VFM audits, like internal auditors' operational audits, involve studies of the management of government organizations, programs, activities, and functions. The following box indicates the range of activities that VFM audits can cover.

SOME EXAMPLES OF RECOMMENDATIONS BASED ON VALUE-FOR-MONEY AUDITS CONDUCTED BY THE ONTARIO OFFICE OF THE PROVINCIAL AUDITOR

Health care. Stronger efforts are needed in using available data to identify pharmacies overcharging the Ontario Drug Benefit Plan. Ontario is unprepared for a flu pandemic despite 44 deaths from the 2003 SARS crisis.

Archives. Hundreds of historically significant items, including a valuable Group of Seven painting, have gone missing. Inventory control practices need to be strengthened.

Education. Ontario university buildings are in need of $1.6 billion in repairs. Capital asset management systems need to be enforced.

Environment. Monitoring of hazardous waste shipment has been lax. Hundreds of tonnes of hazardous waste have gone missing. The ministry's own standards need to be better enforced.

Transportation. New drivers are more likely to be involved in collisions if they take the province's beginning driver education course than if they do not. Inappropriate handling of driver education certificates by unscrupulous driving schools is suspected. Systems and procedures for assuring the public's money is properly spent are inadequate.

Criminal law. Several hundred names are missing from the sex offender registry. Amendments to legislation are needed.

Source: 2007 annual report by the Office of the Provincial Auditor of Ontario as summarized by the authors.

The above list of audits illustrates the huge range of activities that can be audited and important areas of society that are affected. Audits can go well beyond financial statement reporting.

comprehensive governmental auditing: auditing that goes beyond an audit of financial reports to include economy, efficiency, and effectiveness audits

Comprehensive governmental auditing involves financial statement auditing, compliance auditing, and VFM auditing. It goes beyond an audit of financial reports and compliance with laws and regulations to include economy, efficiency, and effectiveness audits. The public sector standard on the elements of comprehensive auditing is similar to the internal auditors' view. Public sector standards do not require all engagements to include all types of audits. The scope of the work is supposed to be determined by the needs of those who use the audit results. Auditors' reputations are highest when they meet these needs.

Judging by the favourable media attention they receive, Canadian public sector auditors probably have the best reputation of any auditors in the world. For example, Christina Blizzard, a columnist for *The Toronto Sun,* stated in a 2002 column discussing a provincial auditor's report, "How come this province is run by politicians, and not by people who can add, subtract, and oh yes, negotiate a deal with the private sector that doesn't rip off taxpayers? What a pity politicians aren't better auditors—and auditors don't run the province."[5] Also, see the interview with now-former Auditor General Sheila Fraser entitled "Patron Saint of Auditors." Awareness of the value of public sector audits has now spread to countries such

5 Christina Blizzard, *The Toronto Sun,* Dec. 4, 2002.

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as China where the National Audit Office of the People's Republic of China has become increasingly active in monitoring China's financial system and exposing bribery, corruption, fraud, capital embezzlement, and inappropriate accounting in state owned or state controlled enterprises. Public sector auditors are helping make state capitalism a viable option in China. These public sector auditor roles are outstanding examples of evolving audit societies.

SHEILA FRASER: PATRON SAINT OF AUDITORS?

Auditor General Sheila Fraser laughs heartily when asked what it's like to be a celebrity.

"I've never really thought of myself as a celebrity, quite honestly. I mean, I'm an accountant. So accountants don't expect to get a lot of public recognition." Still, she adds, as her voice quietly trails off, "It has been an amazing time."

Indeed, it has.

In a decade during which Canadians have had three prime ministers—Jean Chrétien, Paul Martin and Stephen Harper—one thing in Ottawa has always been constant. Fraser, the country's top spending watchdog, was there to keep an eye on the politicians and their bureaucrats. To keep them honest.

She has been—odd as it may sound for an auditor general—a rock star to the Canadian people. Her nonpartisan credibility is unimpeachable. Her audits have been fair but uncompromising. The media love her. The bureaucrats respect and fear her. The politicians don't dare criticize her. And now she is leaving. Her 10-year term is up. Monday is her last day on the job.

In a wide-ranging and candid interview with *Postmedia News*, Fraser discussed her tenure and whether bureaucrats trembled when they heard she was headed their way. "Quite frankly, no one likes to be audited. None of us. It's like when Revenue Canada phones you and says they're going to audit your tax return. None of us jump up with joy. "I'm sure there is a bit of apprehension, but I would hope that they recognize that we are fair and we have a very rigorous process that we go through to ensure that our audits' conclusions are balanced and based on fact."

Fraser's office has conducted hundreds of audits—some routine, others headline-grabbing. She put a spotlight on the cost of the firearms registry, questionable spending by privacy commissioner George Radwanski and prisons ombudsman Ron Stewart, rebate cheques sent to thousands of dead people for home heating costs, shoddy background checks for passport applications, inadequate national emergency response plans, and the shortcomings of public sector integrity commissioner Christiane Ouimet.

But the two audits for which she will be remembered relate to the Quebec sponsorship program. The first was released in May of 2002. She reviewed $1.6 million in contracts awarded by Public Works to a Montreal-based firm, Groupaction, and found the government "did not obtain all of the services for which it paid."

Then came the quote for which she is famous. Fraser blasted senior public servants for breaking "just about every rule in the book." There was an "appalling lack of documentation" and a violation of rules and policies on financial transactions. "This is a completely unacceptable way for government to do business," she said at the time. "Canadian taxpayers deserve better." Strong words for an auditor general. The Mounties began an investigation for possible criminal violations.

It didn't end there. Fraser's instincts were razor sharp. She began a broader audit of all government advertising and sponsorship programs. In February, 2004, that audit was released. It was a bombshell. She found Liberal-friendly communications firms collected millions of dollars in commissions for little, if any, work. "This is such a blatant misuse of public funds," said Fraser. "It is shocking." It was the catalyst for a string of events that would change Canadian history. It led to the Gomery commission of inquiry into political kickbacks and, eventually, criminal convictions against some involved in the sponsorship scheme. Ultimately, it contributed to a souring of public support for the governing Liberals and their defeat in the 2006 election by Stephen Harper's Conservatives.

Auditor General Sheila Fraser is leaving her post with a blunt warning for the federal government: Canadians need to be told much more about the looming costs of the aging population, climate change and this country's deteriorating infrastructure . . .

On Wednesday, she acknowledged that the sponsorship audit was the most heavily covered by media and perhaps the most "sensational of the audits that we did." She said it led to an increase in her office's independence and an expansion of its mandate. The Quebec-born accountant is considered one of the most trustworthy and respected public officials—elected or otherwise—in Ottawa. Fraser was the third "most trusted Canadian" in a *Reader's Digest* poll published this month (behind environmentalist David Suzuki and building contractor Mike Holmes).

Sources: Mark Kennedy (*Canada Post,* May 25, 2011); Bruce Cheadle (*Canadian Press,* May 25, 2011); *HuffPost Canada Politics*, "Sheila Fraser as Auditor General: Her Greatest Hits and Reports," August 9, 2011, http://www.huffingtonpost.ca/2011/06/09/sheila-fraser-the-auditor-general_n_871980.html.

Regulatory Auditors

For the sake of clarity, other kinds of auditors deserve separate mention. You probably are aware of tax auditors employed by the Canada Revenue Agency. These auditors take the "economic assertions" of taxable income made by taxpayers in their tax returns and audit

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these returns to determine their correspondence with the standards found in the *Income Tax Act*. They also audit for fraud and tax evasion. Their reports can either clear a taxpayer's return or claim that additional taxes are due.

Federal and provincial bank examiners audit banks, trust companies, and other financial institutions for evidence of solvency and compliance with banking and other related laws and regulations. In 1985, these examiners as well as external auditors made news with the failures of two Alberta banks—the first Canadian bank failures in over 60 years.

Fraud Auditing and Forensic Accounting

fraud: an attempt by one party (the fraudster) to deceive someone (the victim) for gain

Fraud is an attempt by one party (the fraudster) to deceive someone (the victim) for gain. Fraud falls under the Criminal Code and includes deception based on manipulation of accounting records and financial statements. Recently, auditor responsibilities to detect fraud have significantly increased. Financial statement auditors are now responsible for detecting material financial reporting fraud. They can no longer presume that management is honest. The PA needs to look for fraud risk factors. Some firms are beginning to screen clients before any wrongdoing is even suspected. The screening is done by specialist auditors who may do sensitive interviews or review unusual transactions and suspicious circumstances. In a normal audit, the procedures are diagnostic, not investigative. This is a distinction we will make clear later in the text.

fraud auditing: a proactive approach to detect financial frauds using accounting records and information, analytical relationships, and an awareness of fraud perpetration and concealment efforts (ACFE)

Fraud auditing is a separate engagement that might be done on behalf of the audit committee—a special in-depth investigation of suspected fraud by those with specialized training, and often involving a specialist auditor. It is a proactive approach to detecting financial statement deception using accounting records and information, analytical relations, and awareness of fraud perpetration and concealment in developing investigative procedures.

forensic accounting: application of accounting and auditing skills to legal problems, both civil and criminal

Fraud auditing and forensic accounting are huge growth areas for PA firms in today's world. The main reason for this is that white-collar crime is one of the fastest-growing areas of crime, and police and regulators need the expertise of auditors to carry out these investigations. But there are other factors, and these relate to the broader category of forensic accounting. **Forensic accounting** includes fraud auditing and uses accounting and/or auditing skills in investigations involving legal issues. The legal issues might be criminal (e.g., fraud) or civil (e.g., commercial disputes). Common examples of civil legal disputes are insurance claims for business losses of various types and valuation of spousal business assets in a divorce proceeding.

Two specialist designations are available for investigative engagements. One for CAs is referred to as CA-IFA for investigative and forensic accounting. See the website at www.rotman.utoronto.ca/difa for details. There is also an older association of certified fraud examiners (CFEs) providing training for an internationally recognized designation that does not require any other accounting designation. See its website at www.cfenet.com for details.

Some people feel all PAs should take more responsibility to detect fraud, especially financial statement fraud, and that this may be the main reason for the existence of the profession. The controversies generated by the economic crisis of 2008/2009 may strengthen this perspective. Appendix 1B on Connect discusses this increasingly influential view in more detail. Chapter 21 (available on Connect) also gives more details on forensic accounting and fraud auditing.

REVIEW CHECKPOINTS

1-8 Distinguish between forensic accounting and fraud auditing.
1-9 What is fraud?
1-10 What is operational auditing?
1-11 What are the elements of comprehensive auditing?
1-12 What is compliance auditing?
1-13 Name some other types of auditors in addition to external, internal, and governmental auditors.
1-14 Are financial statement audits intended to find fraud?

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PUBLIC ACCOUNTING

The Accounting Profession

There are professional accounting associations at the national and international levels. For example, in Canada, there are the Canadian Institute of Chartered Accountants (CICA), the Certified General Accountants Association of Canada (CGA-Canada), and the Society of Management Accountants of Canada (SMAC). Internationally, there is the International Federation of Accountants (IFAC), and in the United States, there is the American Institute of Certified Public Accountants (AICPA), whose members are referred to as Certified Public Accountants, or CPAs.

Within a single country, there may be a number of professional designations representing auditors. For example, in Canada there are provincial chapters of the Institute of Chartered Accountants (known in Quebec as the Order of Chartered Accountants of Quebec), the Certified General Accountants Association, the Society of Management Accountants, and the Institute of Internal Auditors. Each of these organizations has developed its own professional designation as follows: Chartered Accountants (CAs), Certified General Accountants (CGAs), Certified Management Accountants (CMAs), Certified Internal Auditors (CIAs), and Certified Fraud Examiners (CFEs). The requirements for obtaining these various designations vary greatly, so it is best to consult each organization for the details. A list of websites with education and certification requirements is provided in Appendix 1A on Connect.

Each designation has its distinguishing features. CAs are oriented to providing auditing and related public accounting services for large companies. CMAs primarily aim to provide private management and internal accounting services. CIAs provide private internal audit services to larger organizations, and CGAs aim to provide all types of services. In virtually all provinces, CGAs can be public accountants such as CAs, but they tend to service smaller audit clients. There is considerable overlap among all these accounting professionals. They all provide accounting, tax, and management advisory work, with CAs and CGAs largely providing these services to the public, whereas CMAs and CIAs provide these services to their full-time employer companies.

CGAs and CMAs have public practice rights throughout Canada, therefore making it appropriate to refer to public accountants as PAs rather than CAs in a text about external auditing. Although we use the more generic term PA throughout the text, many of our illustrations are based on standards set by the CICA, as these standards have legal standing in the courts through the various federal and provincial Corporation Acts, and through regulatory policy statements. In addition, when CGAs and CMAs practise public accounting, their guides refer to the *CICA Handbook* standards.

Public Accounting Firms

Many people think of public accounting in terms of the “big” accounting firms. As of 2012, there are four such firms, often referred to as the “Big Four”: Ernst & Young, Deloitte & Touche, KPMG, and PricewaterhouseCoopers. Notwithstanding this perception, public accounting is carried out in hundreds of practice units ranging in size from sole proprietorships (individuals who “hang out a shingle”) to international firms employing thousands of professionals. Many students look upon public accounting as the place to begin a career; they gain intimate knowledge of many different business enterprises for the first three to ten years, and then they select an industry segment to pursue their interests in. Public accounting experience is an excellent background to almost any business career.

Public accountants do business in a competitive environment. They perform audit services in the public interest, but they also need to make a living at it, so they have a profit motive just like other professionals. This duality—profit motive and professional responsibility—creates tensions in their work. As a result of increased litigation against them in the 1990s, the profession lobbied for legislation making it harder to sue professional accounting firms.

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limited liability partnership (LLP): a company whose partners' liability is limited to the capital they have invested in the business

In 1995, in the United States, legislation was passed allowing public accounting firms to take on the **limited liability partnership (LLP)** form of organization. The LLP structure, which will be covered in Chapter 3, is now commonplace in Canada and around the world.

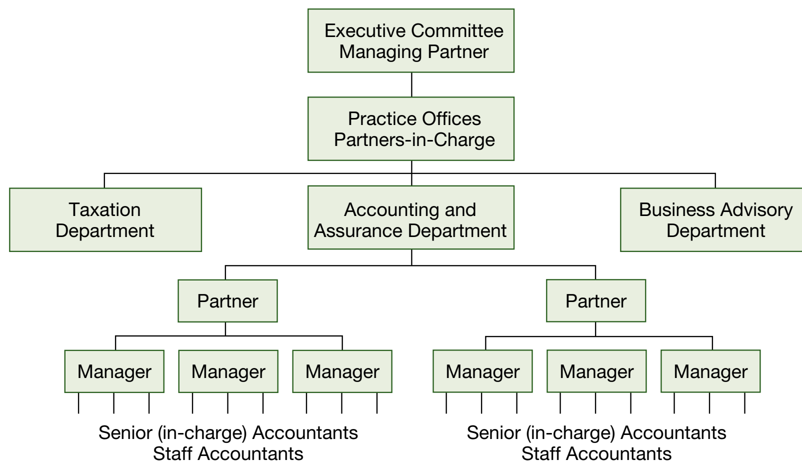
The United States and Canada went through an economic boom in the second half of the 1990s. This was also a time of unprecedented growth in nonaudit services for the public accounting firms. However, by the late 1990s, this growth had led to concerns about the independence of audit services provided by accounting firms that also engaged in extensive, possibly conflicting nonaudit services for the same client. Many cite this lack of independence as the primary cause of the profession's problems in today's world.

Public accounting services involve many PAs employed in assurance, tax, and consulting work. Although structures will differ, Exhibit 1–5 shows the organization of a typical larger PA firm. Some firms include additional departments, such as small-business advisory or compensation consulting departments, while others might have different names for their staff and management positions.

In Exhibit 1–5, you see the various staffing levels within a PA firm. A recent graduate will most likely start work as a staff accountant. This typical entry-level position involves working under the supervision of more senior people. As auditors need to verify virtually everything the auditee claims in his financial reporting, there is much mundane work to be done verifying the math and the extensions of financial data, and reconciling the physical amounts with recorded amounts. How does a user know the balance sheet balances? Someone needs to verify the seemingly obvious, and that someone is the auditor. One should look upon this experience as a form of apprenticeship. In most firms, your responsibilities will increase quickly once you demonstrate your reliability.

Depending on the firm, there may be several levels of staff accountants. Individuals who have just passed the professional exams are usually the most senior staff accountants and are ready to be promoted to manager once they have had a few years of experience and demonstrated leadership potential. Leadership means having people-management skills that are successful with both clients and staff accountants. Technical skills alone are usually not sufficient for a manager. The ability to expand the firm's practice becomes increasingly important. Getting along comfortably with client personnel is a high priority, as otherwise it is difficult to get the information an auditor needs. These personal dynamics become more important at the higher levels in a PA firm. Keep this context in mind as you read descriptions of the various procedures in subsequent chapters. Managers supervise most of the details of the audit engagement as explained throughout this text. They are the backbone of the audit at the technical level.

EXHIBIT 1–5 Typical Organization of a PA Firm



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Partners, working closely with managers, take overall responsibility for the audit and lead meetings with auditee's management and audit committee. Partners usually have at least ten years' experience and are the only permanent employees in a PA firm. About 5% of those with a PA designation become partners, while the rest go into industry or other PA firms. For more information on these positions, career opportunities, and the latest salary trends for PAs in North America, see the websites at www.mcintyre-smith.com and www.roberthalffinance.com.

Assurance Services

Audits of traditional financial statements are the most frequent type of assurance services for public companies and for most large and medium nonpublic companies. Auditing amounts to 20–60% of the business of larger PA firms. Audit fees make up about 10% of revenues for smaller PA firms, and the reporting standards tend to be based on either private entity GAAP or public sector GAAP. Most of this text is about the audit of traditional financial statements using some form of GAAP.

Accounting and review services are the "nonaudit" or other services performed frequently for medium and small businesses and not-for-profit organizations. A great deal of nonaudit work is done by small public accounting practice units. PAs can be associated with clients' financial statements without giving the standard audit report. They can perform compilations, which consist of writing up the financial statements from a client's books and records, without performing any evidence-gathering work. They can perform reviews, which are lesser in scope than audits but include some evidence-gathering work. (Compilation and review standards are explained in more detail in Chapter 17.)

Assurance services are also performed on information in presentations other than traditional financial statements. Since assurance is the adding of credibility by an independent party (assurer, auditor) to representations made by one person or organization to another, demand for a greater variety of PA engagements has grown. Public accountants provide assurance to vote counts (e.g., for the Academy Awards), to dollar amounts of prizes claimed to have been given in lottery advertisements, to investment performance statistics, and to claims made about the capabilities of computer software programs. These nontraditional services are governed by professional standards.

In this text, we reference three sets of professional standards—Canadian, international, and, to a lesser extent, American—which all influence each other. For example, the CICA's Auditing and Assurance Standards Board influences international standards by providing commentary on exposure drafts of new international standards. Once a new international standard is adopted, the CICA issues an exposure draft of any unique-to-Canada modifications that must be made before they can be incorporated into the CICA standards. Other countries follow similar processes, and increasingly, the trend is convergence to a common set of standards. For example, the CICA has adopted international standards with minor modifications in 2011. The Canadian Auditing Standards (CAS) are the main professional standards we refer to in this text.

Convergence is a defining characteristic of today's auditing and makes it more important to be aware of the similarities as well as the differences among the standards. International standards reference IFAC's **International Standards on Auditing (ISAs)**. American Public Company Accounting Oversight Board (PCAOB) standards are referenced to the PCAOB's **auditing standards**.

International Standards on Auditing (ISAs): the auditing standards of the IFAC

auditing standards (ASs): the subset of assurance standards dealing with "high" or "reasonable" levels of assurance in assurance engagements

Taxation Services

Local, provincial, national, and international tax laws are often called "full-employment acts" for accountants and lawyers; they are complex, and PAs perform tax planning and tax return preparation services in the areas of income, sales, property, and other taxation. A large proportion of small accounting firm work is tax practice. Tax laws change frequently, and tax practitioners have to spend considerable time in continuing education and self-study to keep current.

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Consulting or Management Advisory Services (MAS)

All accounting firms handle a great deal of consulting and management advisory services (some firms refer to these as *management ancillary services*). These are the great "open end" of public accounting practice that puts accountants in direct competition with the non-PA consulting firms. The field is virtually limitless, and no list of consulting activities could possibly include all of them. Indeed, accounting firms have created consulting units with professionals from other fields—lawyers, actuaries, engineers, and advertising executives, to name a few. Until the Enron scandal in 2001/2002, many of the large accounting firms had tried to become "one-stop shopping centres" for clients' auditing, taxation, and business advice needs. However, through the chilling effect of corporate scandals at the beginning of the century, these activities have been greatly restricted whenever the engagement includes assurance services.

Nevertheless, consulting work for nonaudit clients may continue to expand to new non conflicting areas such as eldercare, where PAs provide a package of services ranging from assurance to consulting, bill paying, and financial planning for the elderly. In large PA firms, the consulting department is quite often independent from the auditing and accounting departments, performing engagements that do not directly interact with the audits. PA firms are greatly restricted in the types of consulting or business advisory services they can provide to audit clients, particularly for publicly listed companies, but there are no such restrictions for nonaudit clients.

INTERNATIONAL AUDITING

LO5 Provide an overview of international auditing and its impact on Canadian auditing standards.

International Federation of Accountants (IFAC): an organization dedicated to developing international auditing standards

international harmonization: international convergence of national accounting and auditing standards with IFRSs and ISAs, including going concern, fraud, and the audit risk model

Many of the large public accounting firms are worldwide organizations that grew rapidly in the last few decades, in parallel with the increased economic integration of their global clientele. Developments such as the North American Free Trade Agreement (NAFTA), the evolution of the European Economic Union and other free trade zones, and the pervasive effects of technological change are all contributing to increased global harmonization of auditing and accounting standards. Following this trend, the **International Federation of Accountants (IFAC)**, formed in 1977, is creating, through its independent standard setting board (IAASB), international standards by publishing its own handbook on auditing standards that recommends International Standards on Auditing (ISAs). ISAs cover basic principles of auditing, auditor's reports, professional independence, reliance on other auditors abroad, and professional qualifications.

ISAs are increasingly becoming the dominant standards worldwide. The CICA's policy is to adopt ISAs as is, unless Canadian conditions require a different standard. The sources of auditing standards in Canada are the *CICA Handbook,* whose standards were traditionally referred to as *Handbook* Recommendations, and the Audit Guidelines (AuGs), which provide additional guidance on implementing the standards. The CICA adopted the revised and redrafted ISAs as well as the International Standard on Quality Control on December 15, 2009, effective for fiscal periods after December 14, 2010. In 2011, the CICA adopted IFRS. It will decide at a future date what, if any, other international standards it will adopt. We provide more details in later chapters. The goal of convergence, or **international harmonization** as it is frequently called, is a key focus of Canadian standard setters in the new century.

As the world becomes more interdependent, many concepts and terms used in other countries will become increasingly accepted in Canadian practice. Indeed, many large firms already use manuals and training materials reflecting international practice. This text makes use of those terms and concepts and does not restrict itself to those used in the *CICA Handbook* or CASs.

REVIEW CHECKPOINTS

1-15 What is the IAASB, and how do its standards affect auditing standards in Canada?

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APPLICATION CASE WITH ANALYSIS

THE AUDITOR'S MOST IMPORTANT QUALITY

DISCUSSION CASE

Review the box entitled "Is There Any Gold Inside Fort Knox?" This box illustrates the fundamental social role of the auditor and how it arises. Based on this box, what do you think is the most important personal characteristic of the auditor?

ANALYSIS

You might think that the most important characteristics of the auditor are to be able to count and to perform other audit procedures. But it should be clear in this case that virtually anybody could figure out the most basic procedures which need to be performed. In fact, let us assume that the U.S. government has performed these and all necessary procedures to keep an accurate record of the gold at Fort Knox, and yet this is what it reports. So there must be something more even more important than just having the knowledge and skill to perform audit procedures competently. The issue here is one of who effectively performs the audit procedures; it is not a government audit that is being demanded, it is an *independent external* audit.

The key words are *independent* and *external*. The external auditor is expected to be more objective than the government auditor, and the independence criterion is necessary to ensure that there is no conflict of interest—in this case, a bias toward the government. There should not be the appearance of a conflict of interest, but neither should there be in the auditor's actual thought processes as well. If the external auditor were not independent, or perceived to not be independent, then the purpose of having an external auditor would be defeated. The auditor's lack of independence from the government would not result in the assurance which users expect. Lack of independence prevents the auditor from being effective to third-party users—users are no better off than if there had been no audit.

The need for independence arises from third-party accountability. If the third-party users are to trust the auditor's work, then the auditor must preserve independence. A further complication for the auditor is that this preservation of independence needs to be toward parties who do not pay the auditor. The party who pays the auditor is the auditee (in this case, the U.S. government). The auditor must be especially concerned about independence from the auditee since it is the auditee who is demanding the audit (see Appendix 1B). This importance of independence extends to managing the image of the auditor so that there is not even the appearance of lack of independence.

The significance of independence, essentially an aspect of the auditor's character, is reflected in its extensive coverage in the rules of professional ethics for auditors (Chapter 3), and in the quality control practices of the auditor's accounting firm (Chapter 2).

SUMMARY

- This chapter began by illustrating and defining auditing, distinguishing it from accounting. The practice of public accounting is rooted in the history of auditing. The accounting profession has been undergoing radical changes since the bankruptcy of Enron in December 2001. These changes are being accompanied by broad corporate governance and regulatory reforms.
- Auditing is practised in numerous forms by various practice units, including PA firms, the Canada Revenue Agency, the OAG, companies' internal audit departments, and several types of regulatory auditors. Fraud examiners, many of whom are internal auditors and inspectors, have found a niche in auditing-related activities.
- Many auditors aspire to become CGAs, CAs, CPAs, CIAs, CFEs, or CMAs; this involves passing rigorous examinations, obtaining practical experience, and maintaining competence through continuing professional education. Each of these groups has a large professional organization that governs the professional standards and quality of practice of its members.
- This chapter has given you a broad overview of auditing. Being aware of the bigger picture of the context of auditing is increasingly important for effective auditing. This is the main reason the concept of critical thinking in professional judgment is being introduced in this text. We end this introduction with a brief overview of what you can expect from this text. Part I, consisting of the first four chapters, introduces you to the most

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fundamental concepts you will need to consider as an auditor. Part II introduces you to evidence-based concepts and refines the important concept of internal control. In Part III, you will learn to apply the concepts studied thus far to the various accounts in the financial statements. This part concludes with the opinion that ends the audit report and reflects an evaluation of financial statements as a whole. Part IV covers other assurance engagements and specialized types of auditors and auditing.

When you begin a study of auditing, you may be eager to attack the nitty-gritty of financial statement audit work. Although this text will enable you to learn about auditing, instructors are seldom able to duplicate a practice environment in a classroom setting. You may feel frustrated about not knowing "how to do it." This frustration is natural, because auditing is done in the field under pressure of time limits and in the surroundings of client personnel, paperwork, and accounting information systems. Part IV covers at a more advanced level professional ethics, legal liability, audit of accounting estimates, and specialized assurance and related services.

KEY TERMS

accountability relationship
accounting
accounting risk
acting in the public interest
assurance engagement
attest engagement
audit risk (account level)
audit societies
auditee
auditing
auditing standards (ASs)
business risk
Canadian Auditing Standard (CAS)
Canadian Institute of Chartered Accountants (CICA)
client
comprehensive governmental auditing
conflict of interest
critical thinking
direct reporting engagement
expectations gap
external auditor
financial reporting
forensic accounting
fraud
fraud auditing
generally accepted accounting principles (GAAP)
information risk
information technology (IT)
internal auditing
International Federation of Accountants (IFAC)
international harmonization
International Standards on Auditing (ISAs)
limited liability partnership (LLP)
materiality
operational auditing (performance auditing or management auditing)
professional judgment
providing assurance
public accountant
public sector
three-party accountability
value-for-money (VFM) audit

EXERCISES AND PROBLEMS

EP 1-1 Controller as Auditor. LO2 The chair of the board of Hughes Corporation proposed that the board hire as controller a PA who had been the manager on the corporation's audit performed by a firm of independent accountants. The chair thought that hiring this person would make the annual audit unnecessary and consequently save the company the fee paid to the auditors. The chair proposed giving this new controller a full staff to conduct such investigations of accounting and operating data as necessary. Evaluate this proposal.

EP 1-2 Controller as Auditor. LO2 Put yourself in the position of the person hired as controller in the above situation. Suppose the chair of the board moves to discontinue the annual audit because Hughes Corporation now has your services on a full-time basis. You are invited to express your views to the board. Explain how you would discuss the nature of your job as controller and your views on the discontinuance of the annual audit.

EP 1-3 Logic and Method. LO3 Identify four major factors affecting information risk that make the need for independent audits important in today's business world. Give two examples for each.

EP 1-4 Logic and Method. LO3 Auditors must have a thorough knowledge of generally accepted accounting principles (GAAP) if they are to properly perform an audit of the financial statements of a company. Explain why this is so. Use capital leases as an example of the need for this knowledge.

EP 1-5 Operational Auditing. LO4 Bigdeal Corporation manufactures paper and paper products and is trying to decide whether to purchase and merge Smalltek Company. Smalltek has developed a process for manufacturing boxes that can replace other containers that use fluorocarbons for expelling a liquid product. The price may be as high as $45 million. Bigdeal prefers to buy Smalltek and integrate its products, while leaving the Smalltek management in

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charge of day-to-day operations. A major consideration is the efficiency and effectiveness of the Smalltek management. Bigdeal wants to obtain a report on the operational efficiency and effectiveness of the Smalltek sales, production, and research and development departments.

Required:
Who can Bigdeal engage to produce this operational audit report? Several possibilities exist. Are there any particular advantages or disadvantages in choosing among them?

EP 1-6 Auditor as Guarantor. LO1 Your neighbour invited you to lunch yesterday. Sure enough, it was no "free lunch," because he wanted to discuss the annual report of the Dodge Corporation. He owns Dodge shares and has just received the report. He says, "PricewaterhouseCoopers prepared the audited financial statements and gave an unqualified opinion, so my investment must be safe."

Required:
What misconceptions does your neighbour seem to have about the auditor's role with respect to Dodge Corporation?

EP 1-7 Identification of Audits and Auditors. LO4 Audits may be characterized as (a) financial statement audits, (b) compliance audits—audits of compliance with control policies and procedures and with laws and regulations, (c) economy and efficiency audits, and (d) program results audits. The work can be done by independent (external) auditors, internal auditors, or governmental auditors. Below is a list of the purposes or products of various audit engagements.

1. Render a public report on the assumptions and compilation of a revenue forecast by a sports stadium/racetrack complex.
2. Determine the fair presentation in conformity with GAAP of an advertising agency's financial statements.
3. Report on how better care and disposal of vehicles confiscated by drug enforcement agents might save money and benefit law enforcement.
4. Determine the costs of municipal garbage pickup services compared with the same service subcontracted to a private business.
5. Audit tax shelter partnership financing terms.
6. Study a private aircraft manufacturer's test pilot performance in reporting on the results of test flights.
7. Conduct periodic examination of a bank for solvency.
8. Evaluate the promptness of materials inspection in a manufacturer's receiving department.

Required:
Prepare a three-column schedule showing: (1) each of the engagements listed above; (2) the type of audit (financial statement, compliance, economy and efficiency, or program results); and (3) the kind of auditors you would expect to be involved.

EP 1-8 Analysis and Judgment. LO6 As part of your regular year-end audit of a publicly held client, you must estimate the probability of success of its proposed new product line. The client has experienced financial difficulty during the last few years and, in your judgment, a successful introduction of the new product line is necessary for the client to remain a going concern.

There are five steps, all of which are necessary for successful introduction of the product: (1) successful labour negotiations between the building trades unions and the construction firms contracted to build the necessary addition to the present plant, (2) successful defence of patent rights, (3) product approval by the Health Branch, (4) successful negotiation of a long-term raw material contract with a foreign supplier, and (5) successful conclusion of distribution contract talks with a large national retail distributor.

In view of the circumstances, you contact experts who have provided your firm with reliable estimates in the past. The labour relations expert estimates that there is an 80% chance of successfully concluding labour negotiations before the strike deadline. Legal counsel advises that there is a 90% chance of successfully defending patent rights. The expert on Health Branch product approvals estimates a 95% chance of approval. The experts in the remaining two areas estimate the probability of successfully resolving the raw materials contract and the distribution contract talks to be 90% in each case. Assume these estimates are reliable.

Required:
What is your assessment of the probability of successful product introduction? (*Hint:* You can assume the five steps are independent of each other.)

EP 1-9 Role of Auditing Questions. LO3 What do you think management certification of financial statements means? Has management's responsibility changed since the inception of SOX? Why do we need auditors if management "certifies" its financial statements? Discuss in class.

EP 1-10 The audit society. LO3 Identify a major finding from the auditor general of your province in 2012. How extensively was it reported in the news media? Identify the three-party accountability in these engagements. Do you think that the media reports reflect well on the auditor? Discuss in class.

EP 1-11 The audit society. LO3 Identify a report on a major investigation of the Auditor General of Canada in 2012 that led to a major embarrassment for the federal government. How extensively was this reported in the media? Identify the three-party accountability in these engagements. Do you think that the media reports reflect well on the auditor? Discuss in class.

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CHAPTER 2

Auditors' Professional Roles and Responsibilities

Chapter 2 describes the audit environment, layers of standardization, and professional self-regulation that have evolved to uphold the quality of audits. These layers of control over auditors' work can be viewed as a reflection of the importance of auditing to society and our economy, and of auditors' responsibility in protecting the public interest.

EcoPak Inc.

While they are waiting for the audited StyreneTech's financial statements, Kam and Mike start looking over Waterfalls Inc.'s consolidated financial statements with Nima. The statements are in a big, glossy document titled "The Annual Report," which also includes the auditor's report, a report on internal control effectiveness and corporate governance, a managements' discussion and analysis report, and a corporate environmental and social responsibility report. Nima explains that Waterfalls Inc. is a large public company, so it has to provide a lot more details about its management and governance than a smaller entity like StyreneTech does.

When the audited StyreneTech financial statements are received, Kam and Mike note the auditor's report is exactly the same wording as the Waterfalls one, which makes them a bit suspicious. Both reports say the audits were done in accordance with "standards," and that they provide reasonable assurance. How do they know the PAs at Grand & Quatre LLP (G&Q) did good-quality work? Nima tells them that as Public Accountants, the auditors at G&Q must follow generally accepted auditing standards to ensure that their work is of a high quality. As an auditor of public companies, G&Q is also subject to securities regulations and inspections of the quality of their audit work, so Kam and Mike can expect the same quality level for the StyreneTech audit.

When they pass the audited StyreneTech financial statements along to Zhang, who has looked over hundreds of audited financial statements, she is, initially, quickly satisfied with the auditor's report because it is "unmodified." Then, however, her eyes zoom right to the disclosures in the notes, where she finds a

LEARNING OBJECTIVES

After completing this chapter, you will be able to do the following:

LO1 Describe the current audit environment, including developments in regulatory oversight and provincial regulation of public accountants in Canada.

LO2 List the various practice standards for independent audits of financial statements.

LO3 Outline the ethical, examination, and reporting standards that make up generally accepted auditing standards (GAAS) as set out in the CICA's Canadian Auditing Standards (CAS).

LO4 Explain the importance of general assurance standards, using examples of assurance matters.

LO5 Explain how requirements of quality control standards are monitored for PA firms.

CHAPTER APPENDIX

Appendix 2A: Generally Accepted Auditing Standards (GAAS) of the United States *(online)*

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note about a contingent liability to some former employees who have developed serious health problems. These former employees have launched a lawsuit against StyreneTech claiming that StyreneTech did not provide adequate protection from the fumes in the factory, which led to their illness. This contingency did not appear in the unaudited financial statements, and in Waterfalls notes it was combined with some other legal claims but not specifically identified. Based on these audited statements, Zhang tells Kam and Mike that she is not willing to invest in the StyreneTech shares because of that contingent liability. She is only willing to invest in shares of a new corporation that will buy the operating assets of StyreneTech rather than its shares.

When Nima hears about Zhang's decision, she tells Kam and Mike, "Now you see why Zhang wanted those audited statements—they are much more complete because the auditors look for things like contingent liabilities and make sure that all the requirements of GAAP are followed. Zhang is very wise!"

Kam and Mike are very impressed, and they continue to consider things. They have heard that StyreneTech petroleum-based polystyrene-foam production process releases pollutants that are controlled substances, meaning that the emissions volumes need to be measured and reported to a government agency. They ask Nima if it is possible to have G&Q audit StyreneTech pollution emissions to see if they comply with the government's limits. Nima says they probably could, since big accounting firms such as G&Q often have environmental auditors on staff, or there are other consulting firms that provide assurance on information other than financial statements, such as pollution volumes. But it could be costly, and it's unlikely that Waterfalls would pay for it, so Kam and Mike would need to really think about why they want that information audited and how much they are willing to pay for it.

Kam and Mike decide to take the plunge and become packaging entrepreneurs. When they tell Nima, she responds by saying, "Congratulations! I know you will both succeed brilliantly! But for now, you really need to get a lawyer to help you start up the new corporation and get you going on acquiring StyreneTech assets. I can recommend a few good ones."

THE CURRENT ENVIRONMENT OF AUDITING

LO1 Describe the current audit environment, including developments in regulatory oversight and provincial regulation of public accountants in Canada.

The audit environment has undergone profound changes as a result of spectacular corporate failures, such as Enron and WorldCom, starting in 2001. Until 2002, the accounting profession was largely self-regulating. By **self-regulation** we mean that the profession itself established the rules governing audit practice and monitored compliance with them. This reliance on self-regulation changed with the perceived failure of the profession to detect the problems leading to the corporate scandals of 2002/2003. The crucial role of auditing in well-functioning capital markets became clear as never before. This process of rapid change continued with the economic crisis of 2008/2009. The integrity of capital markets is being questioned all over the world. WorldCom's failure in 2002 led to the passage of the most drastic legislation affecting the accounting profession since 1933. This section briefly summarizes these changes in the current audit environment. Later chapters explain the significance of these changes in more detail.

self-regulation: a situation where a professional group is given the power to monitor and discipline its members by the government

The *Sarbanes-Oxley Act*

On July 30, 2002, President Bush signed the *Sarbanes-Oxley Act* (SOX) into law. This legislation began its progress through Congress after the fall of Enron, and the WorldCom failure catalyzed the legislative process and guaranteed quick passage and approval by Bush. For auditors of public companies, SOX created a five-member **Public Company Accounting Oversight Board (PCAOB)** with the authority to tighten quality control of audit practices and report on the results of inspections of audit firm practices. Key features of SOX include the following:

Public Company Accounting Oversight Board (PCAOB): a five-member board created through the *Sarbanes-Oxley Act* (SOX) to oversee the auditors of public companies in the United States

- Increased oversight of auditors, including audit standard setting by PCAOB
- Increased penalties for corporate wrongdoers
- More timely and extensive financial disclosures
- More timely and extensive disclosure on the way the firm is governed
- New options of recourse for aggrieved shareholders, including increased legal liability for auditors

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Canadian companies listed on the American stock exchanges, as well as their auditors, are subject to these SOX rules. SOX and the financial disasters that preceded it have had a huge impact on corporate governance and the regulation of accounting and auditing around the world. For example, in Canada, the CICA helped organize the creation of its own **Canadian Public Accountability Board (CPAB)** to oversee the auditors of public companies. The CPAB also tightens quality control of audit practice and reports on inspections of audit firm practices. In addition, several of Canada's largest pension and mutual funds banded together in 2002 to form the **Canadian Coalition for Good Governance**. This organization controls $400 billion in assets and monitors executives, audit committees, auditors, and boards of directors in corporate Canada for compliance with what they consider good corporate governance and financial reporting practices. However, in Canada, for the time being at least, the profession is largely self-regulating. The big exceptions are regulation of PA education and practice in Ontario and Quebec. The Public Accountants Council of Ontario (PAC) allows only licensed PAs to practise public accounting in Ontario. See www.pacont.org for PAC's standards, regulations, and handbook regarding education and licensing of PAs in Ontario. A similar system exists in Quebec. Through SOX, in the United States, the profession there is regulated in many other ways under the PCAOB.

Canadian Public Accountability Board (CPAB): the board organized to monitor the auditors of public companies in Canada

Canadian Coalition for Good Governance: a group of the largest pension and mutual funds, whose purpose is to monitor executives and boards of directors to comply with good corporate governance and financial reporting practices

The PCAOB's composition was finalized in April 2003. Its first actions included the following: (1) conducting an inspection of the Big Four accounting firms, (2) creating a registry system for PA firms, (3) conducting a review of existing audit standards, and, most importantly, (4) taking on the task of setting future audit standards in the United States. The last action is noteworthy as it represents the first time American auditing standards are not set by its professional institute, the **American Institute of Certified Public Accountants (AICPA)**. The AICPA, however, still sets audit standards for nonpublic companies whose shares are not traded on the stock markets.

American Institute of Certified Public Accountants (AICPA): the professional organization of independent external auditors in the United States

The corporate failures, the fall of Arthur Andersen, and the resulting passage of SOX dramatically changed the corporate environment. We refer to this changed world as the twenty-first century audit environment. The PCAOB's actions reflect the dramatically increased regulation of the profession. The Canadian, American, and other accountability boards around the world will likely make this second-guessing of professional judgment a fixture of the post-Enron world. That world is now more complicated for auditors and the profession, and the implications will become more clear as it unfolds. However, auditing will likely become more important to accounting firms and to society. Specific effects evident through 2012 are included in this text.

But this increased attention came at a price; the extensive impact on the markets of the profession's perceived failures means it is no longer acceptable to leave monitoring of the profession to the professionals themselves. The stock markets hit multi-year lows in 2002, coinciding with WorldCom's bankruptcy and resultant speedy passage of the SOX legislation with its increased external monitoring and control of the profession. The monitoring process now involves groups representing the broader public interest as well as government, but the exact mix of monitors depends on the country. Since most of the corporate failures prompting the changes took place in the United States, America tends to lead in promoting new ways of providing oversight of auditors, and the instrument of the changes is SOX.

SOX's impact can be seen throughout the world, but it also had consequences for broader areas of corporate activities. Following is a quick overview of its main impact on auditors:

- Management certification of all its publicly issued financial statements
- Evaluation of internal control in statements made by management
- Closer regulation of the profession, including regular monitoring of its activities
- Greater responsibilities assigned to client audit committees
- Increased importance of the role of the internal auditor

internal control: the system of policies and procedures needed to maintain adherence to a company's objectives; especially, the accuracy of recordkeeping and safeguarding of assets

audit committees: monitor management's financial reporting responsibilities, including meeting with the external auditors and dealing with various audit and accounting matters that may arise

Internal control statements deal with the reliability of the system or process that creates the financial statements.[1] **Audit committees** monitor management's financial reporting

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responsibilities, including meeting with the external auditors and dealing with various audit and accounting matters that may arise during an audit. In Canada, we have weaker and less costly requirements regarding disclosures, which some have dubbed SOX North. Under SOX North, client firms disclose as part of "Management Discussion and Analysis (MD&A)" only any weaknesses in the design of internal control systems. There is no requirement that the internal controls be tested for effectiveness. There is also no requirement that these disclosures be certified by management, or that the disclosures be audited. Nevertheless, there is some evidence that these less-costly, self-reported disclosures are credible in capital markets.[2] We will discuss audit committees and the evolving concept of internal control in much greater detail throughout the rest of this text.

Perhaps the most important result of SOX for the auditor has been the increased monitoring of the profession, in the form of accountability boards. The board in Canada has authority and responsibilities that are different from those of its American counterpart, as the legal systems and political institutions of the two countries are different.

In the United States, the PCAOB has nationwide legislative backing for its monitoring and enforcement activities. PCAOB has final authority on auditing, ethical, and independence standards, as well as on the quality control criteria that will be used to monitor the profession. Detailed monitoring reports identifying specific audit firms are available to the public at www.pcaob.org/inspection. In Canada, on the other hand, the CPAB does *not* have legislative backing. This means that if an accounting firm claims the legal privilege of client confidentiality, the CPAB cannot review those client documents. This constrains the CPAB's monitoring activities. Also, the CPAB is directly funded by the audit firms, leading to questions about its independence from the profession itself. In contrast, the PCAOB is directly funded by the Securities and Exchange Commission (SEC). Finally, the CPAB uses the profession's auditing, ethics, independence, and quality control standards in performing its monitoring. However, like the PCAOB, the CPAB issues reports on its monitoring that are made public at www.cpab-ccrc.org.

The first two consequences of SOX identified above relate to management's increased responsibility for financial reporting and the requirement of an external audit of management's internal control statement. Management's certification of financial reporting means that it must state in writing that it is not aware of any factual errors or omissions of facts that would make the financial and internal control statements misleading. These are all best summarized as attempts to strengthen the system of corporate governance. **Corporate governance** describes how well a company is run in the interests of shareholders and other stakeholders. Corporate governance principles are covered in Chapter 6, Appendix 6E. Audit committees and internal auditing are also covered in more detail later.

corporate governance: the ways in which the suppliers of capital to corporations assure themselves of getting a return on their investment; more generally, under the corporate social responsibility view, corporate governance is the system set up to hold a corporation accountable to employees, communities, the environment, and similar broader social concerns, in addition to being accountable to the capital providers

Canadian regulations, especially those in Ontario, have been influenced by the SOX requirements. There is now greater emphasis on more timely disclosures of material information and more disclosure of corporate governance practices. Management is now required to disclose its conclusions about the effectiveness of internal control in the management discussion and analysis (MD&A) section of the annual report. In Canada, it is not required that this disclosure on internal control be audited. In contrast, the SEC requires audits of internal control disclosures by registrant companies. In Ontario, the Toronto Stock Exchange (TSX) companies do not need to follow best corporate governance practices, but failure to do so by the largest companies must be disclosed. The Ontario Securities Commission (OSC) specifies the duties and authority of audit committees, including providing a definition of independence of its members.

1 We clarify official terminology by always referring to "reports" as auditor prepared and "statements" as management-prepared communications.

2 H. Lu, G. Richardson, and S. Salterio. "Direct and indirect effects of internal control weaknesses on accrual quality: Evidence from a unique Canadian regulatory setting," *Contemporary Accounting Research*, CAAA, Summer 2011: 675–707.

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REVIEW CHECKPOINTS

2-1 What is meant by self-regulation? How is self-regulation for the profession being affected in the post-Enron environment?

2-2 What are the differences between Canadian and U.S. accountability boards? Compare the differences in their monitoring reports. Which ones do you think are better?

REGULATION OF PUBLIC ACCOUNTING

Regulation of public accounting in Canada, as with most professional groups, is a provincial matter. Most provinces have laws, public accountancy Acts, that specify who is allowed to practise public accounting in the province. For example, for many years, Ontario's *Public Accounting Act* licensed only CAs to perform assurance engagements. However, as part of the post-Enron reform process, this legislation was amended in 2004 to allow any accounting organization meeting the Public Accountants Council (PAC) of Ontario's educational and experience standards to perform what they describe as public accounting functions that meet the public interest. (See their website at www.pacont.org for more details on their activities and requirements.) For PAC, the public interest is effectively represented by the third-party users of the financial statements. These reforms were linked to the creation of the new CPAB, incorporated under the *Canada Corporations Act*, which provides oversight of all PAs auditing public companies in Canada.

CGAs, CMAs, and CAs are allowed to practice public accounting throughout Canada. The goal is to increase accessibility to reasonably priced public accounting services while maintaining standards. Public interests, particularly those of vulnerable third parties, must be protected. Quality control standards and CPAB monitoring implemented in recent years to ensure this are further explained later in this chapter.

In addition to the system of regulation outlined previously, other factors greatly influence the profession. These include the legal system the profession operates in (discussed in Chapter 3) and the impact of regulators on practising auditors. Regulators include, at the federal level, the Superintendent of Financial Institutions, whose prime responsibility is regulating the financial services industry under the jurisdiction of the *Federal Bank Act*. At the provincial level, there are the securities commissions with responsibility for investor protection and for ensuring the fairness and efficiency of the province's capital markets. There are securities commissions in every province and territory, but because of the division of powers between the provinces and the federal government, there is no national-level securities commission in Canada comparable with the SEC in the United States. However, since 1999, the Joint Forum of Financial Market Regulators, consisting of provincial securities commissioners and various national regulators, has coordinated and streamlined the regulation and services in Canadian financial markets through voluntary agreement between participants.

The Ontario Securities Commission (OSC) has responsibility for the biggest and most developed capital markets in Canada. We will use it here to illustrate the impact a regulator can have on public accounting. Three principal activities of the OSC ensure the orderly functioning of capital markets within its jurisdiction, such as the Toronto Stock Exchange:

1. Registering issuers, dealers, and advisers trading in securities and commodity futures contracts
2. Monitoring the full extent of reporting requirements, including those related to prospectuses, takeovers, and continuous disclosure of material information
3. Enforcing the provisions of the *Securities Act* and the *Commodity Futures Act*

prospectus: set of financial statements and disclosures distributed to all purchasers in an offering registered under Securities Law

A **prospectus** is the information, usually including financial information, about a firm that accompanies any new issuance of shares in a regulated securities market. The staff of

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the OSC includes the chief accountant and a chief forensic accountant who work under the director of enforcement. The Office of the Chief Accountant is responsible for formulating financial reporting policy and for monitoring the application of accounting principles and auditing standards by report issuers and their auditors. Financial statements are reviewed on a selective basis, and up to one-quarter of companies reviewed receive comment letters relating to inadequacies in their financial reports. The companies' auditors are also informed of problems. If the financial reporting problems are severe enough, the Enforcement Branch is notified. In 2001, the OSC found revenue recognition to be a significant problem area for high-tech firms.

An example of an Enforcement Branch action affecting an auditor who will testify as a witness is given in the following box. This OSC action followed an investigation of Nortel's accounting launched in April 2004 by the SEC and the OSC. Nortel, then one of Canada's premiere high-tech companies in the telecommunications industry, had to restate its financial results for quarterly periods going back through 2003, 2002, and 2001. The restated 2003 results reduced earnings by 41%. By January 2005, Nortel's stock price had gone down to the $4 range from a July 2000 high of $124. The earlier 2003 earnings had triggered millions of dollars of bonus payments to management. Twelve senior executives agreed to return $10.4 million of these bonuses, but Nortel is still seeking repayment of 2003 bonuses from managers fired in April 2004.

NORTEL FRAUD TRIAL LAUNCHES WITH NOT-GUILTY PLEAS, ALLEGATIONS OF A COOKIE JAR CULTURE

The fraud trial of former Nortel Networks Corp. executives began Monday with the prosecution alleging a "cookie jar" culture in which accounting reserves were repeatedly manipulated to meet thresholds and trigger bonus payouts.

"They set their targets," chief prosecutor Robert Hubbard said in his opening remarks before Superior Court Justice Frank Marrocco. "Then they went about doing whatever needed to be done to meet those targets."

The accused, former Nortel chief executive Frank Dunn, former chief financial officer Douglas Beatty and ex-Nortel corporate controller Michael Gollogly, were fired by Nortel for cause in 2004 amid allegations of financial mismanagement. The RCMP laid fraud charges against the three men in 2008. They are accused of manipulating Nortel's financial reporting to trigger multi-million-dollar bonus payouts linked to the networking company's return to profitability. All three men entered pleas of not guilty at the start of the trial that a spokesman for the Ontario Ministry of the Attorney General said could last more than six months.

Source: Michael Lewis, "Nortel fraud trial launches with not guilty pleas, allegations of a cookie jar culture," *The Toronto Star,* January 16, 2012. Reprinted with permission of Torstar Syndication Services.

An independent review by Nortel's audit committee concluded that the corporate culture encouraged financial manipulation through weak internal controls. In January 2005, the board of directors went through a major reorganization, with half of the board members leaving. In addition, a high-profile ethics watchdog and compliance officer was hired to help change the corporate culture. The ongoing saga of lawsuits and investigations at Nortel that continued is covered in subsequent chapters. This example illustrates why good corporate governance principles need to be followed. (Corporate governance principles are explored in more detail in Appendix 6E.)

The OSC also monitors auditing and accounting standards setting of the CICA, and it provides input on emerging issues as well as commentary on proposed standards. In addition, since 1989, the OSC has issued Staff Accounting Communiqués (SACs) intended to explain the OSC staff's views on specific reporting issues. Although the SACs have no official OSC approval, OSC staff are likely to challenge any treatment that is inconsistent with an SAC. By publishing the results of its monitoring program, by filing complaints to provincial disciplinary committees, and through its representation on CICA standard-setting boards, in recent years the OSC has made a significant, ongoing impact on the profession.

There are other regulators affecting the profession. For example, the Canadian Investor Protection Fund sponsored by the Toronto and the Montreal stock exchanges,

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the Canadian Venture Exchange, the Toronto Futures Exchange, and the Investment Dealers Association of Canada is a trust established to protect customers from the financial failure of a member firm (any member of a sponsoring organization and some American bond dealers that trade in Canada). In recent years, Fund staff has taken a more active supervisory role by overseeing regular monthly, quarterly, and annual reporting, paying surprise visits to offices of member firms and conducting at least one financial questionnaire a year. The Fund can fine or set sanctions against a member firm that violates capital, reporting, or other requirements. It develops policy statements that address standards for internal control within member firms. Auditors must be aware of these standards when auditing member firms. Internal control reports are discussed in more detail in Chapter 21 (available on Connect).

Securities and Exchange Commission (SEC): the main U.S. government agency regulating then securities markets in the United States

initial public offering (IPO): first time offering of a corporation's shares to the public

Another regulator, the **Securities and Exchange Commission (SEC)**, affects Canadian auditors whose client firms have dealings with U.S. securities markets. In recent years, many Canadian companies have gone to American and other international markets to raise cash through **initial public offerings (IPOs)**. Because they need to file regulatory documents in each province, which increases the cost of financing, many Canadian companies are finding it cheaper to raise money through public markets in other countries. Canada's Department of Finance has for a number of years explored the idea of creating a national securities regulator (such as the SEC in the United States) or some national coordinator of provincial securities commissions, to improve the quality and competitiveness of Canadian securities markets.[3] The impact of the SEC on auditors is discussed in more detail in Chapter 20 (available on Connect).

An important development in the regulation of the Canadian accounting profession was the creation of the CPAB on July 17, 2002. The Board represents the public interest through being dominated by non-CA members (seven of the eleven Board members are to be non-CAs). The Board monitors audit practice and conducts annual inspections of accounting firms to assess their ability to protect the public interest. It has the power to sanction any auditor that fails to protect the public interest, and is viewed as the first in a series of major structural reforms to protect the integrity of Canada's financial accounting systems. However, the CPAB does not create audit standards. That is left to the CICA, which as a matter of policy has adopted the international standards that we cover in this text. Other steps include the CICA's evolving standard for auditor independence and the creation of provincial boards to oversee the professional conduct and peer-review systems.

Finally, there are regulators, such as provincial ministries of the environment and natural resources, which indirectly impact the profession by placing restrictions on activities that the clients themselves may need to disclose as part of the client's business risk.

It should be clear from this brief review that the profession is facing an increasingly complex regulatory environment and that auditors must be sensitized to regulatory concerns in order to do a proper audit. Auditors also need to be concerned with meeting the demands of regulators in different countries. One part of the solution is using worldwide standards whenever feasible.

REVIEW CHECKPOINTS

2-3 Identify several types of professional accountants and their organizations.

2-4 What are some examples of assurance services rendered on representations other than traditional financial statements?

2-5 What are the three major areas of public accounting services?

2-6 Locate Nortel's audit committee report on the Internet. Is the OSC or the SEC Website more user-friendly for investors?

3 A. Freeman and K. Hawlett, "Keep IPO's at home: Martin," *The Globe and Mail,* March 8, 1996, B1.

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PRACTICE STANDARDS

LO2 List the various practice standards for independent audits of financial statements.

Practice standards are general guides for the quality of professional work, and the accounting and auditing profession has many sets of standards to choose from. This chapter deals directly with four sets: (1) generally accepted auditing standards (GAAS), issued by the CICA Auditing and Assurance Standards Board; (2) assurance standards, as suggested by section 5025 of the *CICA Handbook* (and the current proposal to replace this with ISAE 3000 of the *Handbook of International Standards on Auditing, Assurance, and Ethics Pronouncements*); (3) the CICA's General Standards of Quality Control for Firms Performing Assurance Engagements (CSQC-1); and (4) quality control standards as reflected in firm peer reviews and provincial institutes' practice inspection manuals. Several countries have created accountability boards in the post-Enron world. These boards can influence standards through monitoring public company audits and identifying weaknesses in them. In most countries, public companies are those listed on stock exchanges. As noted in above, the PCAOB can set its own standards for public companies; other standards are covered later in this text. The rules of professional ethics are also discussed later in this chapter and in Chapters 3 and 18, and the CICA Recommendations for compilation and review services are explained in Part IV, Chapter 17.

You will find relatively few references to the accounting Recommendations in this text. The CICA issues accounting standards, but this text concentrates on auditing and the practice of accounting, not on the accounting rules themselves. An overview of generally accepted auditing standards is provided in the next section.

GENERALLY ACCEPTED AUDITING STANDARDS (GAAS)

LO3 Outline the ethical, examination, and reporting standards that make up generally accepted auditing standards (GAAS) as set out in the CICA's Canadian Auditing Standards (CAS).

The CICA's **generally accepted auditing standards (GAAS)** were first written as a short statement of eight standards. Since 1975, these eight have been augmented by additional explanations and requirements in the assurance Recommendations of the *CICA Handbook,* section 5100. Beginning in 2010, *CICA Handbook* section 5100 was largely replaced by CAS 200 (5100, 5021, 5090, and 5095), and professional ethical requirements of the relevant professional accounting organizations were added. These changes are in line with convergence to international standards. CAS 200 is entitled "Overall Objective of the Independent Auditor, and the Conduct of the Audit in Accordance with Canadian Auditing Standards." CAS 200 establishes auditors' overall responsibilities when conducting an audit in accordance with CAS standards. It lists the objectives of the audit and a series of principles and concepts fundamental to financial statement auditing, as they are shown in Exhibit 2–1.

generally accepted auditing standards (GAAS): those auditing recommendations that have been established in a particular jurisdiction by formal recognition by a standard-setting body, or by authoritative support or precedent such as the auditing and assurance recommendations of the *CICA Handbook*

The importance of GAAS is that they identify the objectives and key principles of the financial statement audit. Every CAS is written so that it identifies the subject and objectives of the standard, provides new definitions wherever applicable, states the requirements for meeting the objective, and provides further explanation for carrying out those requirements. This may include examples of procedures that are appropriate in specific contexts. As we will see in Chapter 3, organizing the standards in this way more closely parallels the concepts of critical thinking within professional judgment. The goal is to have a more logically organized set of standards, and to communicate the reasoning behind these to the auditor.

If a relevant CAS objective cannot be achieved in an audit, the auditor has to consider whether the overall objectives of the audit, as stated in CAS 200, can be met. The CASs are issued from time to time, and the objective of each is consistent with the overall objective of CAS 200. For all practical purposes, this consistency of objectives makes all CASs part of GAAS. Any financial statement auditor who does not follow *Handbook* CASs can be judged as performing a deficient audit.

The auditing standards literature also includes a series of Canadian Audit Practice Statements (CAPSs) or **Audit Guidelines (AuGs)**. Although officially considered less authoritative and less binding than the CAS standards, auditors still must justify any departures from them. For the most part, the guidelines give technical help.

Audit Guidelines (AuGs): the part of the *CICA Handbook* that provides procedural guidance on implementing GAAS

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EXHIBIT 2–1 Generally Accepted Auditing Standards (Summarization of CAS 200, 300, and 315)

Objective of an Audit of Financial Statements

The overall objective of the audit is to enable the auditor to express an opinion on whether the financial statements are prepared, in all material respects, with an applicable (acceptable) financial reporting framework. Most of this text deals with fair presentation frameworks.

General Standard

The auditor should comply with relevant professional ethical requirements relating to audit engagements.

Examination Standards

1. The auditor should conduct an audit in accordance with Canadian Audit Standards (CAS).
2. In determining the audit procedures to perform in accord with CAS's "scope of an audit," the auditor should comply with each CAS relevant to the audit.
3. The auditor should obtain reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether due to fraud or error.
4. The auditor should plan and perform an audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit.

Reporting Standards

1. The report should identify the financial statements and distinguish between the responsibilities of management and the responsibilities of the auditor.
2. The auditor should determine whether the financial reporting framework adopted by management in preparing the financial statements is acceptable.
3. The auditor should refer to CAS 700, 705, and 706 when expressing an opinion on a complete set of general purpose financial statements prepared in accordance with a financial reporting framework that is designed to achieve fair presentation.

Skepticism

The auditor should plan and perform an audit with an attitude of professional skepticism, recognizing that circumstances may exist that cause the financial statements to be materially misstated or misleading to third parties.

Source: Adapted from the *CICA Handbook—Assurance,* CAS 200, 300, and 315.

Appendix 2A (available on Connect) lists the GAAS used in the United States. Note the similarities to GAAS of Exhibit 2–1.

auditing standards (ASs): the subset of assurance standards dealing with "high" or "reasonable" levels of assurance in assurance engagements

Auditing standards (ASs) are audit-quality recommendations that remain the same over time and for all audits. Auditing procedures, on the other hand, are quite different and include the particular and specialized actions auditors take to obtain evidence in a specific audit engagement. Audit procedures may vary, depending on the complexity of an accounting system (whether manual or computerized), the type of company, and other situation-specific factors. These differences explain why audit reports refer to an audit "conducted in accordance with generally accepted auditing standards," rather than "in accordance with auditing procedures." As such, considerable judgment is required to apply audit procedures in specific situations.

GAAS: Objectives of the Audit of Financial Statements

The overall objective of a financial statement audit is to enable the auditor to express an opinion as to whether the financial statements are prepared, in all material respects, in conformity with an applicable framework. Note how this objective implies three-party accountability. Statements are prepared, and an auditor expresses an opinion on whether the statements conform to an applicable, also known as *acceptable framework*. The CICA and international standards view the terms "applicable" and "acceptable" as equivalent, but "acceptable" better reflects both the need for the reporting to be appropriate to third parties and the evaluative component in auditor professional judgment.

CAS 200 offers a very broad financial reporting framework. In this book, we focus primarily on Canadian generally accepted accounting principles (GAAP) as the reporting framework. This reporting includes a balance sheet, income statement, cash flows statement, statement of retained earnings, and notes made up of a summary of significant accounting policies as well as any other explanations.

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GAAS: Ethical Requirements Relating to an Audit of Financial Statements

This section of GAAS relates to the personal integrity and professional qualifications of auditors. Until 2009, section 5100 included what was called a *general standard*. This general standard has been replaced by the rules of professional ethics that are covered in Chapter 3. For now, we will summarize these under four headings.

Competence

The rules of professional ethics require competence—adequate technical training and proficiency—in auditors. This competence begins with an education in accounting, since auditors hold themselves out as experts in accounting standards and financial reporting. It continues with on-the-job training in developing and applying professional judgment in real-world audit situations. This stage provides practice in performing the assurance function, in which auditors learn to (1) recognize the underlying assertions being made by management in each element (account) in the financial statements, (2) decide which evidence is relevant for supporting or refuting the assertions, (3) select and perform procedures for obtaining the evidence, and (4) evaluate the evidence and decide whether management assertions correspond to reality and GAAP. Auditors must be thoughtfully prepared to encounter a wide range of judgments on the part of management accountants—judgments varying from the truly objective to the subjective, and occasional deliberate misstatement within either extreme.

Objectivity and Independence

The ethics rules also require that auditors have an objective state of mind—that is, intellectual honesty and impartiality. Auditors must be unbiased with respect to the financial statements and other information they audit. They are expected to be fair not only to the companies and executives who issue financial information, but also to the outside persons who use it. This type of objectivity in assurance services is achieved by maintaining professional independence, in appearance as well as in fact. The appearance of independence—avoiding financial and managerial relationships with auditees—is important because this is what public users of audit reports can see. They cannot see an auditor's state of mind or attitude. Independence must be carefully guarded because the public will only recognize the professional status of auditors if they perceive them to be independent. Note that this stress on independence arises primarily from the need to get the trust of the third-party users of the financial statements. Independence in appearance is addressed in more detail in Chapters 3 and 18.

Some critics of the public accounting profession find it undesirable that auditors are paid by their auditees. They argue that it is impossible to be independent from the party paying the fee. The alternative would be some form of public or government control of accounting fees, and very few PAs want government involvement. Auditing is unique in that, although a company pays the auditor, the real clients are the third-party users of financial statements. This concept of public interest increasingly guides standard setting and regulators in all aspects of the audit environment. An auditor, therefore, needs to differentiate between responsibilities to the company and responsibilities to third parties. Addressing such ethical conflicts in a competent manner is part of what makes public accounting a profession. (See Chapter 3 for more details.)

Due Professional Care

The exercise of due professional care requires observance of the rules of professional ethics and GAAS. Auditors must be competent and independent, exercising proper care in planning and supervising the audit, in understanding the auditee's control structure, and in obtaining sufficient appropriate evidence. Their training should include computer auditing techniques because of the importance and pervasiveness of computers in the business world.

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Many social science theories incorporate the idea of a prudent professional practitioner; for example, the "economic person" of economic theory and the "reasonable person" in law. The qualities of a "prudent auditor," as summarized by Mautz and Sharaf, might be used to demonstrate the concept of due care in an audit:

> A prudent practitioner [auditor] is assumed to have a knowledge of the philosophy and practice of auditing, to have the degree of training, experience, and skill common to the average independent auditor, to have the ability to recognize indications of irregularities, and to keep abreast of developments in the perpetration and detection of irregularities. Due audit care requires the auditor to acquaint himself with the company under examination, the accounting and financial problems of the company . . . to be responsive to unusual events and unfamiliar circumstances, to persist until he has eliminated from his own mind any reasonable doubts he may have about the existence of material irregularities, and to exercise caution in instructing his assistants and reviewing their work.[4]

Due professional care is a matter of what auditors do and how well they do it. A determination of proper care must be reached based on all facts and circumstances in a particular case. When an audit firm's work becomes the subject of a lawsuit, the question of due audit care is frequently at issue (as you will see in Chapter 3).

REVIEW CHECKPOINTS

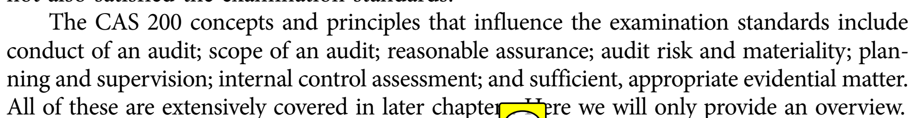
2-7 What is the difference between auditing standards and auditing procedures?

2-8 By what standard would a judge determine the quality of due professional care? Explain.

GAAS Examination Standards

The examination standards are covered by CAS 315 and CAS 300, as well as by CAS 200. These standards set general quality criteria for conducting an audit and also relate to the sufficiency and appropriateness of evidence gathered to support the audit opinion. Auditors cannot effectively satisfy the general standard requiring due professional care if they have not also satisfied the examination standards.

The CAS 200 concepts and principles that influence the examination standards include conduct of an audit; scope of an audit; reasonable assurance; audit risk and materiality; planning and supervision; internal control assessment; and sufficient, appropriate evidential matter. All of these are extensively covered in later chapters. Here we will only provide an overview.



Conduct of an Audit of Financial Statements

In order to meet the overall objective of the audit of financial statements, the auditor in Canada must comply with the CAS and the Canadian Audit Practice Statements (CAPS). While this might seem to state the obvious, it serves to make the requirement explicit so that there are no excuses for failing to comply.

Scope of an Audit of Financial Statements

This principle refers to exercising professional judgment when deciding, based on CAS, on the type and extent of audit procedures to perform in the particular circumstance. The procedures performed must be documented during the audit engagement.

Reasonable Assurance

The evidence gathered during the audit procedures should allow the auditor to have reasonable assurance that the financial statements as a whole are free of material misstatements, whether

4 R. Mautz and H. Sharaf, *The Philosophy of Auditing* (American Accounting Association, 1961) p. 140.

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due to fraud or error. Reasonable assurance means the same as high assurance; that is, assurance should not be too low for an audit engagement. On the other hand, it does not mean certainty or absolute assurance. If assurance were represented as the degree of confidence in the audit opinion, then a range of 90–99% confidence, with 95% being the most common, would be normal. Reasonable assurance is closely related to the concepts of audit risk and materiality.

Audit Risk and Materiality

The risk that an auditor expresses an inappropriate audit opinion when the financial statements are materially misstated is audit risk. As introduced in Chapter 1, this risk relates to evidence gathering. The most serious form of audit risk is failing to detect a material misstatement. These misstatements would affect the decisions of third-party users of the financial statements. Reasonable or high audit assurance can only be obtained when audit risk is acceptably low. Thus, the objective of the audit is only achieved when audit risk is reduced to an acceptably low level. This is done through performing effective audit procedures—the means auditors use to obtain evidence for their opinion. The audit opinion must be supported by sufficient appropriate evidence. This is the only acceptable way to meet the overall audit objective. An important means of controlling audit risk is through proper training, planning, and supervision. As noted in Chapter 1, the focus of audit standards is controlling audit risk, whereas how the accounting standards are applied affects the accounting risk.

Planning and Supervision

CAS 300 of the *Handbook* contains several considerations for planning and supervising an audit. They are all concerned with (1) preparing an **audit plan** and supervising the audit work, (2) obtaining knowledge of the auditee's business, and (3) dealing with differences of opinion among the audit firm's own personnel.

audit plan: the set of audit programs to be executed in an audit engagement

audit program: a list of the audit procedures auditors need to perform to produce sufficient, competent evidence as the basis for good audit decisions

Written audit programs are required. An **audit program** lists the audit procedures the auditors will perform to produce the evidence needed for good audit decisions. The procedures in an audit program should include enough detail to instruct the assistants about the work to be done. (You will see detailed audit programs later in this text.)

An understanding of the auditee's business is an absolute necessity. An auditor must be able to understand the events, transactions, and practices that are characteristic of the business and its management and that may have a significant effect on the financial statements. This knowledge helps auditors identify areas for special attention (the places where errors, irregularities, or frauds might exist), evaluate the reasonableness of accounting estimates made by management, evaluate management's representations and answers to enquiries, and make judgments about the appropriateness of accounting principles chosen.

Where does an auditor get this understanding of a business? By being there; working in other companies in the same industry; conducting interviews with management and other auditee personnel; reading extensively—accounting and audit guides of various accounting bodies, the practice manuals of the various accounting organizations, industry publications, other companies' financial statements, business periodicals, and textbooks; getting a thorough familiarization presentation from the partner in charge of the audit before beginning the engagement; and being observant and letting on-the-job experience sink into long-term memory. Auditors are increasingly building their understanding of the auditee's business through knowledge-acquisition frameworks from strategic management. These frameworks (covered in more detail in Chapters 5 and 6) provide a structured approach to gaining deep knowledge of the auditee's business and industry.

There is no guarantee that the auditors on an audit team will always agree among themselves on audit decisions, which range from inclusion or omission of procedures to conclusions about the fair presentation of an account or the financial statements as a whole. When differences of opinion arise, audit personnel should consult with each other and with

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experts in the firm to try to resolve the disagreement. If resolution is not achieved, the audit firm should have procedures allowing an audit team member to document the disagreement and to dissociate himself or herself from the matter. Particularly where there are disagreements, the basis for the final audit decision on the matter should be documented in the working papers for later reference.

Timing is important for audit planning. To have time to plan an audit, auditors should be engaged before the auditee's fiscal year-end. An early appointment benefits both auditor and auditee. The audit team may be able to perform part of the audit at an **interim date**, a date some weeks or months before the fiscal year-end, and thereby make the rest of the audit work more efficient. It could include preliminary analytical procedures, preliminary assessment of internal control risk, testing the controls, and auditing some account balances. Advance knowledge of problems can enable auditors to alter the audit program so that year-end work (performed on and after the fiscal year-end date) can be more efficient. Advance planning for the observation of physical inventory and for the confirmation of accounts receivable is particularly important.

interim date: a date before the end of the period under audit when some of the audit procedures might be performed, such as control evaluation and testing

TOO LATE

FastTrak Corporation was angry with its auditor because the partner in charge of the engagement would not agree to let management use the operating lease accounting treatment for some heavy equipment whose leases met the criteria for capitalization. FastTrak fired the auditors ten weeks after the company's balance sheet date, then began contacting other audit firms to restart the audit. However, the audit report was due at the OSC in six weeks. Every other audit firm contacted by FastTrak refused the audit because it could not be planned and performed properly with such a tight deadline.

Internal Control Assessment

The examination standard CAS 315, paragraphs 12–23, requires an understanding of the auditee's internal control. This consists of a company's control environment, accounting system, and control procedures. The existence of a satisfactory internal control system reduces the probability of errors and irregularities in the accounts. Auditors need to know enough about the auditee's control system to assess the control risk. Control risk is the probability that a material misstatement (error or irregularity) could occur and not be prevented or detected on a timely basis by the internal control structure, as is discussed in CAS 200.

The primary purpose of control risk assessment is to help the auditors develop the audit program. This standard presumes two necessary relationships: (1) good internal control reduces the control risk, minimizing the extent of subsequent audit procedures; (2) conversely, poor internal control produces greater control risk, increasing the necessary extent of subsequent audit procedures. If auditors saw no relationship between the quality of controls and the accuracy of output, then an assessment of control risk would be pointless. Audit efficiency would be lost in many cases. (Chapters 6 and 9 explain the work involved in control risk assessment.)

Sufficient Appropriate Evidential Matter

Examination standard CAS 200 recognizes that evidence is the heart of audits of financial statements and it requires auditors to obtain enough to justify opinions on those statements. Evidence is the influence on auditors that ultimately guides their decisions. It includes the underlying accounting data and all available corroborating information as discussed in CAS 330 and CAS 500. Appropriate—that is, reliable and relevant—evidence may take many forms: quantitative or qualitative, objective or subjective, absolutely compelling or mildly persuasive. The audit team's task is to collect and evaluate sufficient appropriate evidence in order to afford a reasonable and logical basis for audit decisions.

The standard refers to sufficient rather than absolute evidence. In most cases, not all of a company's transactions and events are audited, and audit decisions are made by

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CONTROL LAPSE CONTRIBUTES TO DUPLICATE PAYMENTS

All Points Trucking processed insurance claims on damages to shipments in transit on its trucks, paying them through a self-insurance plan. After payment, the claim documents were not marked "paid." Later, the same documents were processed again for duplicate payments to customers, who kicked back 50% to a dishonest All Points employee. When the auditors learned that the claims were not marked as paid, they concluded that the specific control risk of duplicate payments was high and extended their procedures to include a search for duplicate payments in the damage expense account. They found the fraudulent claims and traced the problem to the dishonest employee. Embezzlements of $35,000 per year were stopped.

inference based on data samples. The standard gives broad outlines for procedures for gathering evidence—inspection, observation, enquiry, and confirmation. Chapter 8 gives a more thorough explanation of audit objectives and procedures.

REVIEW CHECKPOINTS

2-9 What three elements of planning and supervision are considered essential in audit practice?

2-10 Why does the timing of an auditor's appointment matter in the conduct of a financial statement audit?

2-11 Why does an auditor obtain an understanding of the internal control system?

2-12 Define audit evidence.

GAAS Reporting Standards

The ultimate objective of independent auditors—the report on the audit—is guided by the GAAS reporting standards. The three that are identified in CAS 200 deal with acceptability of the financial reporting framework, auditor and management responsibilities, and report content. Auditing standards dictate the use of a "standard report" when the auditor is expressing an opinion on a complete set of general purpose financial statements prepared to achieve fair presentation. Detailed guidance on these reports is given in CAS 700 and 705. These standards cover audit reports using a fair presentation reporting framework, as well as audit reports using a compliance financial reporting framework. Special considerations for reporting on special purpose financial statements, or financial information other than a full set of financial statements, are covered in CAS 800 and 805. In this chapter, we provide an overview of the CAS 700 audit report on fair presentation for a set of general purpose financial statements. Chapter 4 gives more in-depth coverage.

An **unmodified opinion report,** or a report without reservation, means that the auditors are not calling attention to anything wrong with the audit work or the financial statements. The standard unmodified opinion audit report is shown in Exhibit 2–2, and you should review it in relation to the discussion that follows. A **modified opinion report** means that either the financial statements contain a departure from GAAP or the scope of the audit work was limited. (You will study modified opinion audit reports in Chapter 4.)

unmodified opinion report: an audit report in which the auditor is not calling attention to anything wrong with the audit work or the financial statements

modified opinion report: an audit report that contains an opinion paragraph that does not give the positive assurance that everything in the financial statements is in conformance with GAAP; includes qualified opinion, adverse opinion, and disclaimer of opinion reports

All standard unmodified opinion reports contain the following features:

1. **Title.** The title should refer to the auditor, thus indicating that the report is based on an audit examination and not some other types of engagement.
2. **Address.** The report is normally addressed to those it is prepared for; this may be the shareholders or those charged with governance of the auditee organization.
3. **Introductory paragraph.** This should identify the financial statements and declare that they were audited.

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4. **Responsibilities.** The second paragraph should state management's responsibility for the financial statements, and a third should describe the auditor's responsibility for the audit report.
5. **Description of the audit.** The fourth and fifth paragraphs should declare that the audit was conducted in accordance with GAAS and describe the principal characteristics of an audit. This covers what is traditionally referred to as the *scope of the audit*.
6. **Opinion.** The report's sixth paragraph should contain an opinion (opinion paragraph), stating whether the financial statements present fairly, in all material respects, . . . in accordance with GAAP.
7. **Signature.** The auditor should sign the report, manually or otherwise.
8. **Date.** The report should be dated no earlier than the date when the auditor obtained sufficient appropriate audit evidence supporting the auditor's opinion on the financial statements; this will be after those with recognized authority (e.g., board of directors) have taken responsibility for (i.e., approved) the financial statements. The engagement quality control review, discussed later in this chapter (CSCQ-1, CAS 220), also needs to be completed before the date of the auditor's report.
9. **Auditor's Address.** The report should name the location in the country or jurisdiction where the auditor practices.

Generally Accepted Accounting Principles (GAAP)

In the audit report, the opinion sentence shows the GAAP standard has been met: "In our opinion, the financial statements . . . present fairly in all material respects the financial position . . . and the results of operations and cash flows . . . in accordance with Canadian generally accepted accounting principles." Here, the auditors make a statement about their belief based on their evidence (opinion).

EXHIBIT 2–2 Independent Auditor's Report

To the Shareholders of.....

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity, and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Canadian generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

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EXHIBIT 2–2 Continued

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

[Auditor's signature]

[Date of auditor's report]

[Auditor's address]

Source: Copyright © *CICA Handbook—Assurance,* CAS 700.

However, determining the appropriate GAAP in a company's circumstances is not always easy. Students often think of the *CICA Handbook* Recommendations on accounting standards as the complete body of GAAP. This is not so, as GAAP actually consist of all the accounting methods and procedures that have substantial authoritative support. The *CICA Handbook* is only one source of such support, albeit the most powerful. It is widely recognized that the meaning of the expression "present fairly in accordance with GAAP" in the audit report establishes a hierarchy of authoritative support for various sources of GAAP.

The *Handbook* Recommendations cover many accounting issues and problems, and the standards for these are generally compelling. However, the *Handbook* does not cover all conceivable accounting matters. When a conclusion about GAAP cannot be found in the *Handbook* Recommendations, auditors follow a hierarchy to find the next highest source of support for an entity's accounting solution to a financial reporting problem. Reference can be made to positions taken by provincial securities commissions, international standards, authoritative pronouncements by other countries' standards boards, industry audit and accounting guides, consensus positions of the CICA's Emerging Issues Committee, and other accounting literature.

The unmodified opinion sentence contains implicit messages: (a) the accounting principles in the financial statements have general acceptance—that is, authoritative support; (b) the accounting principles used by the company are appropriate in the circumstances; (c) the financial statements and notes are informative of matters that may affect their use, understanding, and interpretation—that is, disclosures are complete; this last feature refers to both materiality and accuracy; (d) the classification and summarization in the financial statements is neither too detailed nor too condensed for users; and (e) the financial statements are accurate within practical materiality limits covered in CAS 320. Auditors and users do not expect financial account balances to be absolutely accurate, as accounting is too complicated and includes too many estimates to expect this. After all, many financial reports use numbers rounded to the thousands, even millions, of dollars! Financial figures are "fair" as long as they are not materially misstated—that is, misstated enough to make a difference in users' decisions. All of these issues in applying GAAP involve professional judgment, which can be defined very generally as making a decision using professional standards and other criteria while maintaining professional ethics responsibilities. (Chapter 3 covers auditors' professional ethics responsibilities.)

Consistency

The reporting standards call for explicit reporting in accordance with GAAP, except in special circumstances. Prior to 1991, all audit reports contained a sentence confirming that GAAP had been "consistently applied" when no changes in the application of accounting principles had been made. This sentence referred to a company's use of the same accounting procedures and methods from year to year. However, the *CICA Handbook (Accounting- Part II),* section 1506, governs the accounting and disclosure of a company's change of accounting principles. In 1991 the reporting standards were changed to allow the audit report to be silent—that is,

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implicit—about consistency when no accounting changes had been made or when any changes that were made were properly disclosed in the financial statements.

Adequate Disclosure

The reporting standards include a second implicit element. They require auditors to use professional judgment in deciding whether the financial statements and related disclosures contain all the important accounting information users need. It may be necessary to disclose information not specified in authoritative support sources; for instance, if there is an unusual fact situation not encountered before. Using this standard, auditors have latitude to determine what is important and what is not. Likewise, users of financial statements also have the right to claim that certain information is necessary for adequate disclosure. In fact, many lawsuits are brought forward on this issue, and auditors must show reasons for the lack of disclosure. As noted in Chapter 1, disclosures are an important means of dealing with accounting risk and a significant aspect of auditor professional judgment, as many aspects of implementing accounting and auditing standards are not covered by them.

When auditors believe that certain information is necessary for adequate disclosure but the company refuses to disclose it, a departure from GAAP exists. Usually, a qualified opinion is written, and the reason for the departure (missing disclosure) is described in the audit report. Sometimes the missing disclosure is added to the audit report itself.

Report Content

The reporting standard of CAS 700 and 705 states the requirements for an opinion. Two types of modifications to the report are relevant: those that affect the audit opinion and those that do not. In this section, we provide an overview of matters that affect the audit opinion. Chapter 4 provides more details on these and other modifications.

CAS 700 provides guidance for the standard audit report, while CAS 705 provides guidance on reservations in the auditor's report and requires that the report must contain either the opinion on the financial statements or an assertion that an opinion cannot be given. This means that there are two classes of opinion statements: all opinions on statements (i.e., unmodified, adverse, and qualified opinions) and the disclaimer of opinion. An **adverse opinion** is the opposite of an unmodified opinion. It states that the financial statements are not in accordance with GAAP. A **disclaimer of opinion** is an auditor's declaration that no opinion is given. The standard applies to financial statements as a whole; that is, the standard applies equally to the set of financial statements and footnotes and to each individual financial statement and footnote. According to CAS 705, an explanation is required whenever there is a report reservation. Thus, when an adverse opinion, qualified opinion, or disclaimer of opinion is rendered, all the substantive reasons for doing so must be given in an additional paragraph(s).

adverse opinion: states that financial statements are not in accordance with GAAP

disclaimer of opinion: auditor's declaration that no opinion is given on financial statements and the reasons why this is so, usually due to a scope limitation; also called a *denial of opinion*

Other reporting standards relate to auditor responsibilities and identifying the financial statements covered by the opinion. Every time PAs (even when acting as accountants associated with unaudited financial statements) are associated by name or by action with financial statements, they must report on their work and responsibility. The character of the work is usually described by the standard reference to an audit in accordance with GAAS. But if an audit has been restricted in some way or if the statements are simply unaudited the auditor must say so.

The "degree of responsibility" is indicated by the form of the opinion. Auditors take full responsibility for their opinion about conformity with GAAP when they give either an unmodified or an adverse opinion. They take no responsibility whatsoever when they give a disclaimer of opinion. When they give qualified opinions, they take responsibility for all matters except those that are the reasons for the qualification. (Qualified and adverse opinions and disclaimers of opinion are discussed more fully in Chapter 4.) These are part of the association rules that cover information the PA is associated with. The association rules will be covered in Chapter 4, after you have been introduced to other types of PA engagements.

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REVIEW CHECKPOINTS

2-13 What are the nine important features of a standard unmodified audit report?

2-14 Identify various authoritative supports for GAAP, with an indication of their ranking.

2-15 Do auditors take any responsibility for auditees' choices of accounting principles?

2-16 What four kinds of audit opinion statements are identified in this chapter? What is the message of each one?

2-17 What messages are usually implicit in a standard audit report?

ASSURANCE STANDARDS

LO4 Explain the importance of general assurance standards, using examples of assurance matters.

A special framework in the IFAC Handbook covers the international standards for assurance engagements. It was issued in 2005 and was heavily influenced by the *CICA Handbook,* section 5025. However, the International Standards Association (ISA) standards for some assurance engagements have not yet been integrated with its framework. As a consequence, the CICA continues to use its original assurance standard. Thus, the *CICA Handbook* assurance standard section 5025 is not part of CAS.[5]

In March 1997, the CICA issued section 5025, "Standards for Assurance Engagements." The standard, the first of its kind in the world, is significant because it is intended to provide an umbrella for all existing and future audit-type engagements, including many that do not involve financial statements. Section 5025 also contemplates different levels of assurance.

An *assurance engagement* is defined in paragraphs 5025.03–5025.04 as follows:

> An engagement where, pursuant to an accountability relationship between two or more parties, a practitioner is engaged to issue a written communication expressing a conclusion concerning a subject matter for which the accountable party is responsible. An *accountability relationship* is a prerequisite for an assurance engagement. An *accountability relationship* exists when one party (the "accountable party") is answerable to and/or is responsible to another party (the "user") for a subject matter, or voluntarily chooses to report to another party on a subject matter. The accountability relationship may arise either as a result of an agreement or legislation, or because a user can be expected to have an interest in how the accountable party has discharged its responsibility for a subject matter.

The assurance standard does not supersede audit and review standards, but it is influencing changes to other assurance standards. It is designed to provide guidance for expanding assurance services to subject matters not currently covered in the *Handbook*. For example, it is the assurance standard that introduced the three-party accountability concept. The general relationships in assurance engagements are given in Exhibit 2–3.

An assertion is a statement about some aspect of a subject matter—for example, that a building exists as of a certain point in time. The assurance standards in section 5025 are quite broad in that they can be applied to assertions that are only implied, a direct reporting engagement, as well as to written assertions, an attest (or attestation) engagement. The *Handbook* paragraphs 5025.05–5025.06 state the following:

> In an attest engagement, the practitioner's conclusion will be on a written assertion prepared by the accountable party. The assertion evaluates, using suitable criteria, the subject matter for which the accountable party is responsible. In a direct reporting engagement, the practitioner's conclusion will evaluate directly using suitable criteria, the subject matter for which the accountable party is responsible . . . . In these standards, the accountable party is referred to as management. Depending on the circumstance, the user could include a variety of stakeholders such as shareholders, creditors, customers, the board of directors, the audit committee, legislators, or regulators. The practitioner is the person who has overall responsibility for the assurance engagement.

5 Section 5025 is included in the *CICA Assurance Handbook* as an "Other Canadian Standard" or OCS.

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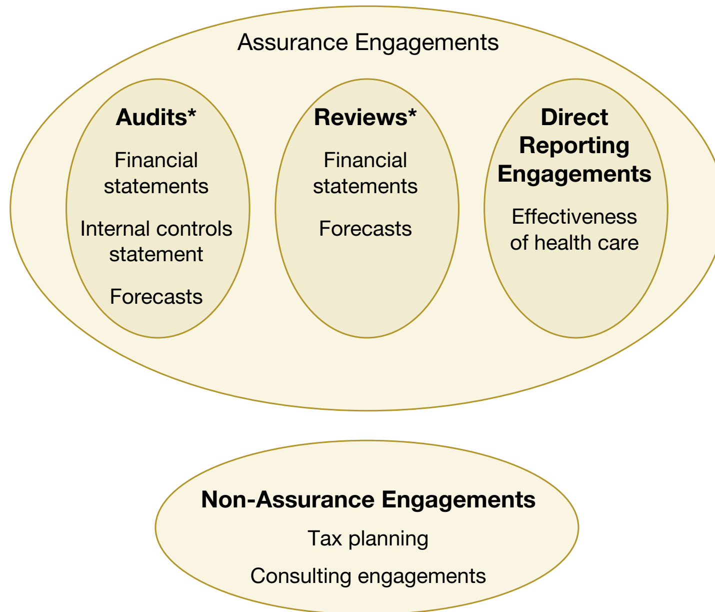
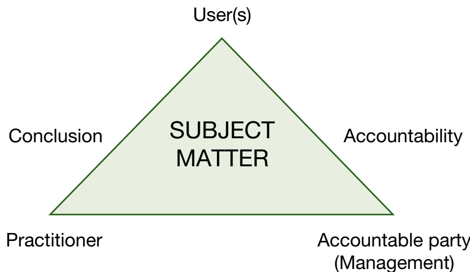
EXHIBIT 2–3 **Universe of PA Engagements**



*Audits and reviews are attest engagements.

These relationships are illustrated in Exhibit 2–4. For example, the practitioner in paragraph 5025.06 of the exhibit has traditionally been referred to as an *external auditor* in a financial statement assurance engagement. Since most of this text deals with financial statement audits, we will continue using this terminology. After we have become familiar with other assurance services in Chapter 21 (available on Connect), we will explain the assurance standards in more detail.

EXHIBIT 2–4 **Three Parties Involved in an Assurance Engagement (Three-Party Accountability)**



Source: Copyright © *CICA Handbook—Assurance,* paragraph 5025.07.

Reporting is different because assurance engagements on nonfinancial information do not depend upon GAAP. The assurance standards speak of "evaluation against suitable criteria" and "accordance with generally accepted criteria," and they leave the door open for assurance engagements on a wide variety of assertions. An illustration of how far assurance engagements can go is provided in an article in *The Wall Street Journal* entitled "Fore!" (see box below). Many people appreciate the value of auditors' assurance to historical financial statements, and they have found other representations for PAs to assure, as illustrated in the box "Other Examples of Assurance Engagements."

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FORE!

An interesting example of an assurance engagement subject matter is the distance a particular brand of golf balls can hit on a driving range. This type of assurance engagement was requested by Wilson Sporting Good Company to prove that amateur golfers could drive Wilson golf balls farther than competing brands of golf balls. The assurance engagement required PAs to measure the average distance of golf drives at 30 driving ranges. The PAs reported that Wilson's brand of golf balls could be hit farther by an average of 5.7 yards per drive. In addition to walking off the distances of the golf drive, the PA verified that all participants were amateurs, that the participants were not paid by Wilson, and that Wilson's records of the results were accurate.

OTHER EXAMPLES OF ASSURANCE ENGAGEMENTS

- Goods and Services Tax (GST) and real estate tax bases
- Political contributions and expenditures
- Financial feasibility of a rapid transit system
- Cost justification for a utility rate increase
- Regulator's questionnaire on business ethics and conduct
- Reliability of drinking water surveillance program
- Quality of nursing home care
- Effectiveness of student loan programs in meeting needs of students
- Effectiveness of research and development activities
- Labour data for union contract negotiation
- Newspaper and magazine audience and circulation data
- Integrity and security of a computer network
- Investment performance statistics
- Insurance claims data
- Pollution emissions data (e.g., greenhouse gas emissions)

An important assurance engagement now required by SOX in the United States is the audit of internal control statements prepared by management. Like audits of financial statements, these internal control audits verify the accuracy of management's internal control statement; the difference is the subject matter.

A main objective in developing the assurance standards is to provide a general framework for, and set reasonable boundaries around, the assurance services offered by public accountants. Whether these standards actually set boundaries remains to be seen. After all, before the assurance standards were published, PAs were using the GAAS audit standards as a point of departure for other assurance engagements. Now they must use the assurance standards as the point of departure.

Assurance standards are explained in more detail in Chapter 21 (available on Connect).

REVIEW CHECKPOINTS

2-18 What are the major differences between assurance standards and GAAS?

2-19 Define assurance engagements.

2-20 What is the theoretical essence of an assurance service?

2-21 **CRITICAL THINKING QUESTION:** In the "Fore!" feature, identify the assertion, the three parties to the engagement, and the criteria being used. Is a high level of assurance being provided? Explain.

QUALITY CONTROL STANDARDS

LO5 Explain how requirements of quality control standards are monitored for PA firms.

GAAS must be observed in each audit engagement conducted by a PA firm. Thus, PA firms need to observe GAAS in their entire audit practice. While GAAS relate to the conduct of each audit engagement, quality control standards govern the quality of a PA firm's audit practice as a whole. Quality control can be defined as actions taken by a public accounting firm to evaluate compliance with professional standards. And a "system of quality control" is designed to provide reasonable assurance of conforming to professional standards. Professional standards include GAAS, as covered in the *CICA Handbook,* as well as provincial rules of ethical conduct.

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Elements of Quality Control

The International Federation of Accountants (IFAC) has identified at least four basic elements of quality control. These are listed and explained briefly in Exhibit 2–5. In comparison, the AICPA has identified a more detailed set of nine basic elements of quality control: independence, assignment of personnel to engagements, consultation, supervision, hiring, professional development, advancement, acceptance and continuation of engagements, and inspection. These may be further refined by the PCAOB.

EXHIBIT 2–5 Elements of Quality Control

1. Quality control policies and procedures should be implemented both at the level of the audit firm and on individual audits.
2. The audit firm should implement quality control policies and procedures designed to insure that all audits are conducted in accordance with ISAs or relevant national standards of practices.
3. The firm's general quality control policies and procedures should be communicated to its personnel in a manner that provides reasonable assurance that the policies and procedures are understood and implemented.
4. The auditor should implement those quality control procedures which are, in the context of the policies and procedures of the firm, appropriate to the individual audit. In particular, delegated work should be properly directed, supervised, and reviewed.

Source: Extract from International Standard of Auditing 220 of the International Auditing and Assurance Standards Board, published by the International Federation of Accountants (IFAC), February 2006. Used with the permission of IFAC.

Both the 1978 Adams Report (*Report of the Special Committee to Examine the Role of the Auditor*) and the 1988 Macdonald Commission Report (*Report of the Commission to Study the Public's Expectations of Audits*) recommended the development of quality control standards to guide PA firms. More recently, several regulatory agencies initiated discipline for substandard performance by professional staff in PA firms and criticized the individual-level focus of the provincial disciplinary process. In response, provincial institutes are amending their bylaws to bring firms, as well as individuals, within the disciplinary process. This expanded disciplinary process will require new guidelines for evaluating systems of quality control. Increasing litigation is also putting pressure on firms to develop good systems of quality control so that they can demonstrate compliance with professional standards and thus minimize the loss from litigation. A CICA study entitled "Guide for Developing Quality Control Systems in Public Accounting" proposed detailed guidance based on five key components or areas: clients, personnel, engagement procedures, practice administration, and a quality control review program.

Exhibit 2–6 illustrates the implementation of a quality control system using the five key components included in the CICA study. The study proposed that the areas of client relationships (including independence from the clients) and engagement procedures be given top priority when implementing a system in stages. The right-hand columns in Exhibit 2–6 suggest priority in setting up a firm-wide quality control system. Note in Exhibit 2–6 that the five areas have each been subdivided into series of elements that allow firms to better articulate all the different aspects of quality control. While the exhibit framework is not a standard, it indicates where Canadian guidance may be headed. Note that tax and management advisory services could be included in the framework, but the extent to which they should be considered in the quality control system is controversial.

The International Federation of Accountants (IFAC) issued a standard on quality control, ISCQ-1. As a result, the CICA added to its *Handbook* the section, "Canadian Standard on Quality Control, CSCQ-1 (was CGSF-QC)," for firms performing assurance engagements. This standard is outlined in Exhibit 2–7. There are only minor differences between CSCQ-1 and the international equivalent ISCQ-1.

Firms can use the evolving quality control standards in developing their own policies and procedures, along with the related documentation. When peer or quality reviews are conducted, the reviewers "audit" the PA firm's policies and procedures designed to ensure compliance with the elements of CSQC-1, and perhaps additional criteria. The statements of policy and procedures

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may vary in length and complexity, depending on the size of the PA firm and the regulatory system affecting them. (Students who wish to know these policies and procedures in detail when interviewing for a job should ask for a copy of the firm's quality control document.)

EXHIBIT 2–6 Implementing a Quality Control System

QUALITY CONTROL AREA/ELEMENTS	FIRST PRIORITY	SECOND PRIORITY
A. Clients		
1. Independence and Objectivity	√	
2. Prohibited Investments	√	
3. Conflicts of Interest	√	
4. Confidentiality	√	
5. Acceptance and Continuance	√	
6. New Client Proposals		√
B. Personnel		
1. Hiring		√
2. Assignment		√
3. Performance Evaluation		√
4. Advancement		√
5. Continuing Professional Education	√	
6. Restriction of Professional Staff Activities	√	
C. Engagement Procedures		
1. Engagement Letters	√	
2. Planning and Execution	√	
3. Documentation	√	
4. Supervision and Review	√	
5. Resolution of Differences of Opinion		√
6. Consultation with Peers		√
7. Independent Review	√	
8. Management Letters	√	
D. Practice Administration		
1. Use of Firm Name		√
2. Access to Client Files	√	
3. Security of Confidential Information	√	
4. Retention of Files		√
5. Software Usage and Security		√
6. Technical Reference Materials	√	
7. Litigation and Professional Conduct		√
8. Advertising and Promotion		√
9. Solicitation of Clients	√	
E. Quality Control Review Program		
1. Internal Review		√
2. Monitoring Client Services		√
3. Monitoring Quality Control		√
4. Premerger Review		√
Total Elements	17	16

Source: Copyright © Exhibit 4–2 in CICA's *Guide for Developing Quality Control Systems in Public Accounting*, p. 35.

Accountability Boards Quality Control

Accountability boards have been created in Canada and the United States to help preserve the integrity of the financial reporting system. Most countries in the European Union were supposed to have equivalents of a CPAB by 2009, but many did not meet this deadline. The boards have been pressing for new rules in the monitoring of quality control and audit practice, most of these geared to improving auditor independence. These rules include five-year rotations of partners and strict limits on consulting services that have the potential to create conflicts of interest with the auditing role. The list of conflicting services would include valuation services, legal services, information technology systems design,

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and internal audits for auditees with more than $10 million in assets or market capitalization. In addition, the PCAOB is studying the requirements of audit firm rotation and the potential conflict created when audit firm personnel leave to work for auditees. These are primarily issues of professional ethics and are covered in more detail in Chapter 3.

EXHIBIT 2–7 CICA Canadian Standards on Quality Control for Firms (CSQC-1)

CSQC/ISCQ 1, 16-17
Elements of a System of Quality Control

16. The firm shall establish and maintain a system of quality control that includes policies and procedures that address each of the following elements:
    (a) Leadership responsibilities for quality within the firm.
    (b) Relevant ethical requirements.
    (c) Acceptance and continuance of client relationships and specific engagements.
    (d) Human resources.
    (e) Engagement performance.
    (f) Monitoring.
17. The firm shall document its policies and procedures and communicate them to the firm's personnel. (Ref: Para. A2–A3)

Source: *CICA Handbook—Assurance,* 2012.

In monitoring PA firm quality control practices, the boards would need to consider implementation controls. The quality control elements listed in Exhibits 2–5, 2–6, and especially 2–7 are examples of criteria that could be used to implement the monitoring. In the future, the accountability boards may issue their own standards for accounting firms' quality controls, including monitoring of ethics and independence, internal and external consulting on audit issues, audit supervision, hiring, development and advancement of audit personnel, client acceptance and continuance, and internal inspections.

The PCAOB has indicated that it will set future auditing independence and quality control standards. In contrast, the CPAB has indicated that it will let the profession decide on these standards. Hence, CPAB uses CSQC-1 as outlined in Exhibit 2–7 as its primary criteria.

Monitoring of Quality Control: Practice Inspection, Peer Reviews, and Quality Inspections

practice inspection: the system of reviewing and evaluating practice units' audit files and other documentation by an independent external party

Practice inspections, peer reviews, and quality inspections are "audits of the auditors." **Practice inspection** is the system of reviewing and evaluating practice units' audit files and other documentation by an independent external party. The main objective of practice inspection is to evaluate conformity of the work with the *CICA Handbook* and with the professional, ethical principles and rules of conduct (covered in Chapter 4). The practice unit can be an individual or an entire office, in which case the individual members of the office are evaluated relative to their level of responsibility. Provincial practice inspection programs apply to all members of the relevant institutes, orders, or associations and consist of several steps:

1. Selection of practice unit for inspection (can be a PA firm, an office of a firm, or a sole practitioner)
2. Completion of questionnaires to gather general information about the practice and quality control systems of the practice unit
3. Assignment of inspector
4. Inspection of a sample of engagement files
5. Report of inspection—each report focuses on an individual in a practice unit
6. Follow-up review of corrective actions, if applicable
7. A report to the professional conduct committee, if necessary[6]

There are some minor variations among provincial practice inspection programs relating to types of engagements reviewed and the way the inspection reports are prepared. The overall focus is on individual member's performance, and the orientation is more educational than

6 *Guide for Developing Quality Control Systems in Public Accounting* (CICA, 1993), p. 17.

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disciplinary, although serious deficiencies could lead to a complaint with a professional conduct committee, as is further explained in Chapter 18. Practice inspections are a useful complement to a firm's system of quality control. Their success is reflected in the fact that many countries have followed the Canadian model, including Ireland, Norway, China, and Australia.

A **peer review** is a practice inspection, usually done as a special engagement by another audit firm hired for the task by the firm reviewed. The reviewers issue a report on the firm's compliance with quality control standards and make recommendations for improvements to the audit practice.

peer review: study of a firm's quality control policies and procedures, followed by a report on a firm's quality of audit practice

A **quality inspection** is an examination and evaluation of the quality of the overall practice. They are thus aimed at the firm level rather than at individuals. A quality inspection involves an extensive study of a firm's quality control document and includes interviews with audit personnel as well as detailed study of quality of work, adherence to GAAS, and quality control standards on a selection of audit engagements. A quality inspection has the same objective as a peer review but is less extensive. They are usually requested by smaller PA firms.

quality inspection: examination and evaluation of the quality of the overall practice

The new accountability boards have taken on the job of regulating inspections of firms' audit operations to ensure compliance with the various quality control criteria outlined in the preceding section. The inspection reports for CPAB and PCAOB can be found at their websites, www.cpab-ccrc.org, and www.pcaobus.org, respectively. The PCAOB has been given the authority to create auditing standards; however, CPAB has not. CPAB monitors and enforces the application of the CAS, which are based on international auditing standards.

The first CPAB report dealt with inspections of the Big Four firms in Canada (issued October 6, 2004). The most common problems cited were lack of documentation for work said to have been done and independence violations. But the CPAB indicated that these problems did not represent negligent work. More recent reports have indicated that audit deficiencies in Canada have been reduced and that PAs are exercising greater skepticism in the conduct of audits. The concerns going forward are improving auditor communications with audit committees and others charged with corporate governance, focusing on the quality of audits of accounting estimates, and tracing the extent to which firms using sampling adhere to the new CAS 530 sampling requirements (presentation by Brian Hunt, CEO of CPAB, on June 13, 2011, at the International Symposium on Audit Research, Quebec City). These emerging issues are covered in this text.

The SEC requires that any litigation alleging audit deficiencies and involving public companies or regulated financial institutions or their personnel be reported to them by the auditors. The SEC obtains documents related to the litigation in order to determine whether the case has any bearing on quality control deficiencies in the PA firm. In Canada, sometimes a regulator such as the OSC will ask that a PA firm or individual be reviewed by the CPAB and a provincial institute reviewer. This is usually in response to a complaint, but it sometimes arises from regular monitoring of annual reports and filings submitted to the regulator.

The extent of work involved in practice inspections, peer reviews, or quality inspections is greatly influenced by the quality of documentation concerning the quality control system. Generally, if the quality control documentation is good and the reviewer can rely on extensive internal monitoring of quality control, less work is required than if documentation is poor and the reviewer must rely more on her own detailed inspection of files.

REVIEW CHECKPOINTS

2-22 Consider the following quality control policy and identify the quality control element it relates to: "Designate individuals as specialists to serve as authoritative sources; provide procedures for resolving differences of opinion between audit personnel and specialists."

2-23 What is a practice inspection, and what roles does it play in the quality control self-regulation of the profession?

2-24 Compare the quality inspection reports of the CPAB and PCAOB. Do the PA firms in the United States and Canada have similar quality control problems?

2-25 What is the meaning of quality control as it relates to a PA firm?

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APPLICATION CASE WITH ANALYSIS

WHICH GAAS IS MOST IMPORTANT?

DISCUSSION CASE

This chapter introduced you to GAAS. If you had to pick the one standard that is most important to the profession, which would it be?

ANALYSIS

A hint to the response for this question has already been provided to you in the Application Case for Chapter 1. At its most fundamental level, the answer is the need for *independence*. Let us review the independence concept now, using the objective of the audit of financial statements; that is, "to enable the auditor to express an opinion as to whether the financial statements are prepared, in all material respects, in conformity with an applicable framework." Note how this objective implies three-party accountability.

When the standard says "to express an opinion," it does not mean any opinion. It means an opinion that is truthful and, based on the evidence and the evaluation of the evidence, reflects the economic facts of the entity as portrayed by the acceptable framework. By "acceptable" we mean acceptable to the third-party users of financial statements. The second party, the auditee and its management, presumably know that it is acceptable because they take responsibility for having the financial statements prepared. The auditor determines whether the financial statements are acceptable through the gathering of audit evidence and his or her own knowledge of what is acceptable according to the reporting framework. This knowledge is what supports and justifies the audit opinion.

But how does the third-party user know whether the financial reporting is acceptable? The third party is the least knowledgeable and thus relies on the auditor to verify acceptability of the financial reporting. But the auditor cannot just be anybody who is competent. Management, after all, can be very competent in preparing the financial statements and does, in fact, accept responsibility for them. Thus, competence is a necessary condition, but it does not explain why there is a need for an auditor.

As explained in the Application Case and Analysis in Chapter 1, an indispensable characteristic of the auditor is independence. Without the independence, the auditor cannot provide the trustworthy opinion that third parties need in order to rely on the financial statements. Thus, to meet the overall objective of GAAS, the auditor must be independent. Independence is also what makes the rest of the GAAS standards relevant, because only with independence will third parties rely sufficiently on the financial reporting by the auditee. The less the third-party financial statement user trusts the first-party financial statement preparer, the more important the auditor independence becomes.

The importance of independence extends to the entire accounting firm. Many of the accounting firm quality control standards discussed in this chapter relate to independence. The concept of skepticism requires independence and minimization of conflicts of interest. Some current issues affecting conflicts of interest for accounting firms include mandatory rotation of audit firms every few years and further limits on the type of non-audit services that an audit firm can provide to the auditee.[7] Note that these constraints on audit firm activities all relate to improving at least the appearance of the audit firm's independence from the auditee.

The only way auditors can meet the unique ethical demands of putting priority of third-party users over the priority of the party who pays for the audit is to be independent of the auditee. This is quite a challenge from the ethical perspective, and is for auditors an ethical issue that is not faced by other professionals. These unique audit challenges are further discussed in Chapter 3, but they are fundamentally based on society's expectations that the auditors need to be independent in fulfilling their social role.

7 Tim Kiladze, "Auditors rethink industry rules post-crisis," *The Globe and Mail*, March 9, 2012.

SUMMARY

- The assurance standard is the general framework for applying assurance engagements to a wide range of subjects. They are the quality guides for general assurance work. Theoretically, they could serve as quality guides for independent audits of financial statements. However, they were created long after GAAS for audits of financial statements, and therefore, GAAS remains the predominant framework for most engagements.
- The profession is becoming increasingly regulated by outside bodies as a result of perceived audit failures and questionable accounting at the turn of the century.
- Financial statement auditors are most concerned with GAAS standards because they are the direct guides for the quality of everyday audit practice. The goal of the audit is to

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provide high assurance that the financial statements present fairly. The general standard consists of the code of professional ethics, and it sets requirements for auditors' competence, objectivity, and due professional care. The examination standards set requirements for planning and supervising each audit, obtaining an understanding of the auditee's internal controls, and obtaining sufficient appropriate evidence to serve as a basis for an audit report. The reporting standards cover the requirements for an acceptable framework of financial reporting (usually GAAP), auditor and management responsibilities, adequate disclosure, and report content. We briefly reviewed the financial statement audit process to show how GAAS concepts relate to this process.

- In all matters relating to financial statement audits, auditors are advised to have a sense of professional skepticism. This attitude is reflected in a "prove it with evidence" response to management representations, to answers for enquiries, and to financial statement assertions themselves. Critical thinking is a broader idea, covered in Chapter 3, that considers not only the evidence, but also related ethical issues and the effects of the reporting framework that should be applied. Critical thinking and skepticism consider how management's reporting may mislead users.

- While assurance standards and GAAS govern the quality of work on each individual engagement, the quality control elements guide a PA firm's audit practice as a whole. Quality control is the foundation of the self-regulatory system of peer review, practice inspection, and quality inspection. It also serves as the basis for monitoring by accountability boards. The elements of independence, assigning personnel, consultation, supervision, hiring, professional development, advancement, acceptance and continuance of audit engagements, and inspection are usually the objects of a firm's policies and procedures for assuring that GAAS are followed faithfully in all aspects of the firm's practice.

As an auditor, you must have a thorough understanding of these practice standards, especially GAAS. All practical problems can be approached by beginning with a consideration of the practice standards in question. Auditing standards do not exist in a vacuum. They are put to work in numerous practical applications. Practical applications of the standards will be shown in subsequent chapters on audit program planning, execution of auditing procedures, gathering evidence, and auditing decisions.

KEY TERMS

adverse opinion
American Institute of Certified Public Accountants (AICPA)
audit committees
Audit Guidelines (AuGs)
audit plan
audit program
auditing standards (ASs)
Canadian Coalition for Good Governance
Canadian Public Accountability Board (CPAB)
corporate governance
disclaimer of opinion
generally accepted auditing standards (GAAS)
initial public offering (IPO)
interim date
internal control
modified opinion report
peer review
practice inspection
prospectus
Public Company Accounting Oversight Board (PCAOB)
quality inspection
Securities and Exchange Commission (SEC)
self-regulation
unmodified opinion report

EXERCISES AND PROBLEMS

EP 2-1 Audit Independence and Planning. LO5 You are meeting with executives of Cooper Cosmetics Corporation to arrange your firm's engagement to audit the corporation's financial statements for the year ending December 31. One executive suggests the audit work be divided among three staff members to minimize audit time, avoid duplication of staff effort, and curtail interference with company operations. One person would examine asset accounts, a second would examine liability accounts, and the third would examine income and expense accounts.

Advertising is the corporation's largest expense, and the advertising manager suggests that a staff member of your firm, whose uncle owns the advertising agency handling the corporation's advertising, be assigned to examine the Advertising Expense account.

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The staff member has a thorough knowledge of the rather complex contact between Cooper Cosmetics and the advertising agency.

Required:

a. To what extent should a PA follow the auditee management's suggestions for the conduct of an audit? Discuss.

b. List and discuss the reasons why audit work should not be assigned solely according to asset, liability, and income and expense categories.

c. Should the staff member of your PA firm whose uncle owns the advertising agency be assigned to examine advertising costs? Discuss.

EP 2-2 Examination Standards. LO2 You have accepted the engagement of auditing the financial statements of the C. Reis Company, a small manufacturing firm that has been your auditee for several years. Because you were busy writing the report for another engagement, you sent a staff accountant to begin the audit, with the suggestion that she start with the accounts receivable. Using the prior year's working papers as a guide, the auditor prepared a trial balance of the accounts, aged them, prepared and mailed positive confirmation requests, examined underlying support for charges and credits, and performed other work she considered necessary to obtain evidence about the validity and collectability of the receivables. At the conclusion of her work, you reviewed the working papers she prepared and found she had carefully followed the prior year's working papers.

Required:

The opinion rendered by a PA states that the audit was made in accordance with generally accepted auditing standards.

List the three generally accepted standards of field work. Relate them to the above illustration by indicating how they were fulfilled or, if appropriate, how they were not fulfilled.

(ICAO adapted)

EP 2-3 Time of Appointment and Planning. LO5 Your public accounting practice is located in a town of 15,000 people. Your work, conducted by you and two assistants, consists of compiling clients' monthly statements and preparing income tax returns for individuals from cash data and partnership returns from books and records. You have a few corporate clients; however, service to them is limited to preparation of income tax returns and assistance in year-end closings where bookkeeping is deficient.

One of your corporate clients is a retail hardware store. Your work for this company has been limited to preparing the corporation income tax return from a trial balance submitted by the bookkeeper. On December 26, you receive a letter from the president of the corporation with the following request:

> We have made arrangements with the First National Bank to borrow $500,000 to finance the purchase of a complete line of appliances. The bank has asked us to furnish our auditor's certified statement as of December 31, which is the closing date of our accounting year. The trial balance of the general ledger should be ready by January 10, which should allow ample time to prepare your report for submission to the bank by January 20. In view of the importance of this certified report to our financing program, we trust you will arrange to comply with the foregoing schedule.

Required:

From a theoretical viewpoint, discuss the difficulties that are caused by such a short-notice audit request.

(AICPA adapted)

EP 2-4 Reporting Standards. LO3 PA Musgrave and his associates audited the financial statements of North Company, a computer equipment retailer. Musgrave conducted the audit in accordance with the general and field work standards of generally accepted auditing standards and therefore wrote a standard audit description in his audit report. Then he received an emergency call to fill in as a substitute tenor in his barbershop quartet.

No one else was in the office that Saturday afternoon, so he handed you the complete financial statements and footnotes saying, "Make sure it's OK to write an unmodified opinion on these statements. The working papers are on the table. I'll check with you on Monday morning."

Required:

In general terms, what must you determine in order to write an unmodified opinion paragraph for Musgrave's signature?

EP 2-5 GAAS in a Computer Environment. LO2 The Lovett Corporation uses an IBM mainframe computer system with peripheral optical reader and high-speed laser printer equipment. Transaction information is initially recorded on paper documents (e.g., sales invoices) and then read by optical equipment that produces a magnetic disk containing the data. These data file disks are processed by a computer program, and printed listings, journals, and general ledger balances are produced on the high-speed printer equipment.

Required:

Explain how the audit standard requiring "adequate technical training and proficiency" is important for satisfying the general and field work standards in the audit of Lovett Corporation's financial statements.

EP 2-6 Audit Report Language. LO3 The standard unmodified report contains several important sentences and phrases. Give an explanation of why each of the following phrases is used instead of the alternative language indicated.

1. Address: "To the Board of Directors and Stockholders" instead of "To Whom It May Concern."
2. "We have audited the balance sheet of Anycompany as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended" instead of "We have audited the attached financial statements."

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3. "We conducted our audit in accordance with generally accepted auditing standards" instead of "Our audit was conducted with due audit care appropriate in the circumstances."
4. "In our opinion, the financial statements referred to above present fairly . . . in conformity with generally accepted accounting principles" instead of "The financial statements are true and correct."

EP 2-7 Public Oversight of the Accountancy Profession. LO7 The Canadian Public Accountability Board (CPAB) and the Public Company Accounting Oversight Board (PCAOB) in the United States will provide oversight for public accountants who audit public companies. What are the objectives of these boards? What factors should these boards consider in assessing public accountants' work?

EP 2-8 Scope of an Audit, Requirement for Specialist Expertise. LO4 Consider the following two situations:

1. The auditor discovers during the audit that the auditee company has entered a complex legal contract that involves transferring assets to another company if that company performs certain future services by obtaining supplies from a foreign country. The auditor is unable to establish whether the contract imposes any financial liability or has any other financial impact on the auditee company.
2. The auditor learns that the auditee company is required to comply with environmental standards requiring it to monitor various emissions using complex scientific techniques. The amounts of the financial penalties that can be imposed by the government are determined by the nature and extent of noncompliance with these scientific standards.

Required:

Contrast these two situations in terms of the auditor's responsibility to perform audit procedures and issue a report. Include a recommendation on which form of report would be issued in each case, based on your analysis.

EP 2-9 Assurance Engagements, General Assurance Standards. LO5 A radio advertisement for a new software management product included the following statement: "According to ITR, Knovel's new software product will pay back in three months."

ITR is an information technology (IT) research firm that is hired by various companies in the IT industry to provide reports on IT usage and sales in the IT market. As soon as ITR's president heard the ad on his car radio, he immediately phoned Knovel and told them to stop using the ad.

Required:

Discuss whether ITR's statement is the result of an assurance engagement. Consider the parties involved, the subject matter, the accountability relationships, the nature of the report, and any other relevant aspects of the situation. Why do you think ITR's president wanted the ad stopped?

EP 2-10 Fair Presentation in Accordance with GAAP. LO3 The third reporting standard of GAAS states that the auditor's opinion on the financial statements should indicate whether they present fairly the financial position, results of operations, and changes in financial position in accordance with GAAP. The *CICA Handbook* Recommendations are an important source of GAAP. However, the Recommendations may allow for different interpretations and choices in how they are applied, or they may be silent.

Required:

a. How does the auditor assess whether financial statements are in accordance with GAAP when a conclusion on GAAP is not found in the *CICA Handbook* Recommendations? Give an example of an accounting issue that may not be covered in the Recommendations.

b. How does the auditor assess whether financial statements are in accordance with GAAP when the *CICA Handbook* Recommendations allow for different accounting methods to be acceptable? Give an example of an accounting issue for which alternative acceptable accounting treatments are provided in the Recommendations.

EP 2-11 Missing Disclosure Described in Auditor's Report. LO3 Bunting Technology Corporation is a large public company that manufactures the IXQ, a telecommunications component that speeds up Internet transmission over fibre-optic cable. Subsequent to its current year-end, but, before the audited financial statements are issued, a competitor of Bunting launches a new product that increases transmission speed one hundred times more than Bunting's IXQ and sells for one-tenth of the price. Bunting has approximately eleven months of inventory of the IXQ in inventory, based on the current year's sales levels.

Bunting's auditors, Ditesmoi & Quail (DQ), have determined that this subsequent event warrants a write-down of Bunting's year-end inventory to reflect technological obsolescence. Given that the IXQ is Bunting's main product, the write-down will be highly material. DQ argues that this development will result in a permanent change in Bunting's future earnings potential and cash flows, and it would be misleading users if it is not included in the current year financial statements.

Bunting's management refuses to record the inventory write-down, arguing that the event occurred after the year-end and therefore does not relate to the current year's results. Also, since the competitor's product is brand new, management argues that there is significant uncertainty about whether it will perform as well in actual use as the competitor claims. Thus, it is premature to assume it will have an impact on IXQ sales, and it is impossible to estimate a dollar amount of the impact. Management is also concerned that, by publicly reporting information about the competing product in Bunting's annual report, DQ will jeopardize several large sales contracts that Bunting is currently negotiating, and this may lower sales even more than if the information were withheld.

DQ issues a qualified audit report that spells out its estimate of the material impact of the technological obsolescence on Bunting's assets, net income, and retained earnings.

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Required:

Discuss the issues raised by DQ's decision to issue a qualified report in this situation. Consider the impact of DQ's audit report qualification on Bunting, on users of the audited financial statements, and on DQ as Bunting's auditor.

EP 2-12 Auditor's Professional Skepticism. LO4 Auditors are required to have professional skepticism, but an auditor must also rely on management representations in order to complete the audit. Discuss the inherent conflicts in these two requirements and how they may be resolved.

EP 2-13 Assurance Engagement other than Audit or Review. LO4 During 2002 and 2003, United Nations weapon inspectors entered Iraq to search for "weapons of mass destruction." These include chemical, biological, and nuclear weapons. It has been reported that these weapons and equipment for manufacturing them may be concealed in public buildings such as schools, hospitals, or apartment buildings.

Required:

Identify the subject matter and design an approach for assessing risks and probabilities of weapons existing, and for implementing the inspection. Use basic audit definitions and approaches from financial statement auditing. For example, compare the weapons inspectors' objectives to the approach to looking for a material understatement of a financial statement liability.

EP 2-14 Audit Weaknesses Found in CPAB Inspections. LO5 Access the CPAB website at www.cpab-ccrc.ca and find the most common weaknesses in Canadian audit practice as identified in their reports.

EP 2-15 Audit Expectations Gap. LO2 Some have proposed the idea of an "audit expectation gap" which is the difference between what the auditor accomplishes using GAAS and what third-party users expect from audited financial statements. Do you think there is an expectations gap? Discuss and identify potential sources of the gap.

EP 2-16 Private Sector versus Public Sector Auditing. LO4 Is there more of an expectations gap in private sector auditing or public sector auditing? Discuss. Explain any difference in terms of the independence characteristic. In particular, are public sector auditors more independent than private sector auditors? Discuss.

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CHAPTER 3

Auditors' Ethical and Legal Responsibilities

Chapter 3 describes the moral, professional, and legal responsibilities that the public expects auditors to meet, further demonstrating the importance society attaches to the auditor's role in protecting the public interest.

EcoPak Inc.

Two years ago, Kam and Mike started up a corporation called EcoPak Inc. to purchase the operating assets of the former StyreneTech company. They each own 45% of the EcoPak common shares, and Nima was given 10% of the common shares in return for her help in starting up the company. Zhang has invested in convertible preferred shares that can be converted to a 50% common share interest at any time.

Kam and Mike kept the styrene-foam production business going to generate cash flows and developed the materials and production processes for their new biomass product line. Kam has also been very busy in his role as head of business development, and EcoPak has obtained a big contract to supply hot-food containers to a national restaurant chain. If the food containers perform well, the chain will consider having EcoPak also provide all its coffee cups. Kam has several other large contracts very close to signing, and it is now necessary for EcoPak to expand its production capacity significantly.

Kam has attracted a lot of business media coverage. EcoPak's highly innovative production process, which makes use of agricultural waste by-products, produces zero pollutant emissions, and results in a completely biodegradable product. Consequently, an ethical investment management firm has approached Kam about investing in EcoPak, to help finance the expansion of its biomass production. This firm has asked EcoPak to provide an environmental report on its operations; it is their policy to invest based on an audited environmental report or by doing its own audit of the company's operations to assess its environmental sustainability and performance. But Kam and Mike are thinking of doing an environmental report solely on the new biomass business, leaving out any mention of the

LEARNING OBJECTIVES

After completing this chapter, you will be able to do the following:

LO1 Introduce the concept of auditor responsibilities.

LO2 Explain the importance of the study of ethics in helping define auditor responsibilities.

LO3 Outline the characteristics of professional skepticism and critical thinking.

LO4 Describe the purpose and contents of the codes of professional ethics established by the various professional accounting associations.

LO5 Explain the importance of an independence framework for auditors.

LO6 Outline auditor legal responsibilities.

LO7 Outline the various types of common law liability for PAs, citing specific case precedents.

CHAPTER APPENDIX

Appendix 3A: Framework for Critical Thinking *(online)*

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styrene-foam business. They are pretty sure a report on that pollution-emitting, petroleum-based process would send the ethical investors running! But how can they get it audited? Time to call Nima; she's a senior audit manager now, so maybe she can do it.

When Nima hears what Kam and Mike have in mind, she is upset: "First, since I own shares in EcoPak I cannot audit the company—I am not independent! But even if I could, your plan to report on just one half of your operations is misleading. I am a professional public accountant, and I can't associate myself with information that I know could be misleading to someone making an important decision based on it. AND, even if you do an environmental report presenting all of your operations, I am not an environmental expert so I have no competence to provide assurance on the report. Remember those professional standards we talked about when you were looking at StyreneTech's audited financial statements? I need to comply with those or my work won't have the quality the public expects. So, basically, what you are asking me to do would be totally unethical! And maybe it's time you two started thinking about the ethics of your own situation at EcoPak—taking a lot of credit for being so 'environmentally responsible' when half of your operations and most of your cash flows come from a really toxic process and a product that ends up littering the environment."

Kam and Mike fall over themselves apologizing to Nima. They realize they had not thought things through very well, and what she is saying makes a lot of sense. But they are also in real bind because without new financing and without the cash flow from the styrene-foam business, they cannot expand the biomass business! Nima suggests they work with the ethical investment firm; Kam should try to sell them on the idea that their investment in EcoPak will allow the company to not only expand the biomass material line but also to shut down the styrene-foam line very soon. They will be getting twice the bang for their ethical buck.

Kam and Mike decide to engage an engineering firm to do an environmental audit of EcoPak's operations. A big surprise is uncovered during the audit—all the land behind the factory has been contaminated by a large spill of a toxic material, benzene, that had occurred a couple of years before they took over StryreneTech's operations! The Ministry of the Environment had issued a cleanup order against ST, and the company had done the first phase of cleanup to just prevent the pollutant from spreading, but then the operating assets were sold to EcoPak. Since this is the land that will be used to expand their factory, EcoPak will need to complete the second cleanup phase—removal of the contaminated soil—before the expansion can occur. The cost of the cleanup is very high.

When Nima hears about this, she realizes that Grand & Quatre (G&Q) really missed a big issue in their audit, since this problem existed at the time of their audit work. She advises Kam and Mike to see a lawyer about suing G&Q for the cost of the cleanup, since it was a known liability of an estimable amount that should have been accrued in the StryreneTech financial statements: "At best, if G&Q was just sloppy and didn't ask the right questions, you should be able to show that their negligence resulted in your loss. But if G&Q knew about it, and let the Waterfalls Inc. management intimidate them into leaving it off the books because StryreneTech was being sold, that is a much more serious issue which will just kill G&Q's reputation should it become public!"

INTRODUCTION

LO1 Outline the concept of auditor responsibilities.

moral responsibilities: auditor responsibilities to conform to broad social norms of behaviour

professional responsibilities: the rules and principles for the proper conduct of an auditor in her work; necessary to obtain the respect and confidence of the public, achieve order within the profession, and provide a means of self-policing the profession; also known as *professional ethics*

As part of a privileged profession, auditors are responsible to society. This responsibility can be divided into three categories: moral, professional, and legal. Morality deals with character and "doing the right thing," as is determined largely by social norms. Morality deals with distinctions between right and wrong actions or behaviour. Auditors have a responsibility to conform to social norms. Auditors' **moral responsibilities** can be summarized as "public accountants should be upright, not kept upright." Ethics relates to proper conduct in life, and a study of ethics helps the auditor develop a set of principles by which to live.

Professional responsibilities refer to the more formal ethical responsibilities of auditors. Ethics is the philosophical study of morality. The emphasis on philosophy means that ethics is a more formal study and analysis of morality. These responsibilities (or *professional ethics*) are the rules and principles for the proper conduct of an auditor in her work. Professional ethics are necessary for a number of reasons: to obtain the respect and confidence of the public, to distinguish the professional from the general public, to achieve order within the profession, and to provide a means of self-policing the profession. All of these

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are meant to help meet the expectations of society as to the auditor's role. However, social norms and social expectations of auditors change, and a study of ethics is helpful in preparing for lifelong adaptation. For example, auditors are increasingly viewed as a key component of well functioning capital markets. The first half of this chapter will focus on ethics that are particular to accountants and auditors in relation to their responsibilities of the profession.

Legal responsibilities are the risks auditors accept in a court of law while practising public accounting. The legal system is a chief means of regulating the social and professional responsibilities of auditors. These include the risks that arise from failing to use due care in the conduct of the audit. There is an interaction between legal and professional responsibilities, and they both relate to significant violations of society's expectations of the social role of the auditor.

GENERAL ETHICS

LO2 Explain the importance of the study of ethics in helping define auditor responsibilities.

A pervasive sense of proper ethical conduct is critical for professional accountants. Two aspects of ethics operate in the professional environment: general ethics (the spirit or principles) and professional ethics (the rules). Mautz and Sharaf have contributed the following thoughts to the link between general and professional ethics:

> The theory of ethics has been a subject of interest to philosophers since the beginnings of recorded thought. Because philosophers are concerned with the good of all mankind, their discussions have been concerned with what we may call general ethics rather than the ethics of small groups such as the members of a given profession. We cannot look, therefore, to their philosophical theories for direct solutions to our special problems. Nevertheless, their work with general ethics is of primary importance to the development of an appropriate concept in any special field. Ethical behaviour in auditing or in any other activity is no more than a special application of the general notion of ethical conduct devised by philosophers for men generally. Ethical conduct in auditing draws its justification and basic nature from the general theory of ethics. Thus, we are well advised to give some attention to the ideas and reasoning of some of the great philosophers on this subject.[1]

Overview

What is ethics? Wheelwright gives a more complete definition of ethics as "that branch of philosophy which is the systematic study of reflective choice, of the standards of right and wrong by which it is to be guided, and of the goods toward which it may ultimately be directed."[2] In this definition, you can detect three key elements of ethics: (1) It involves questions requiring reflective choice (decision problems); (2) it involves guides of right and wrong (moral principles); and (3) it is concerned with the consequences of decisions.

What is an ethical problem? A problem exists when you must make a choice among alternative actions and the right choice is not absolutely clear. It is an ethical problem because the alternative actions affect the well-being of other people. An **ethical dilemma** is a problem that arises when a reason to act in a certain way is offset by a reason to not act that way. The way to resolve such dilemmas is to rely on the primary ethical principle underlying the action. This can be influenced by the context of the dilemma. The process of identifying the primary ethical principle is a major reason we introduce **critical thinking** in this chapter. The process of identifying the primary accounting, auditing, as well as ethical principles to be relied upon in a particular situation, with all the principles being consistent, is a one way to characterize critical thinking in professional judgment.

ethical dilemma: a problem that arises when a reason to act in a certain way is offset by a reason to not act that way

critical thinking: the process of justifying one's conclusion or decision by providing good or acceptable reasons

What is ethical behaviour? There are two standard philosophical answers to this question: (1) It is that which produces the greatest good; and (2) it is that which conforms to moral rules and principles. Problem situations arise when two or more rules conflict or when a rule and the criterion of "greatest good" conflict. Some examples of these are given later in this chapter.

1 R. K. Mautz and H. A. Sharaf, *The Philosophy of Auditing* (American Accounting Association, 1991). [Emphasis added.]

2 P. Wheelwright, *A Critical Introduction to Ethics,* 3rd ed. (Indianapolis, IN: Odyssey Press, 1959).

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Why does an individual or group need a code of ethical conduct? While it has been said that a person should be upright and not kept upright, a code serves as a useful reference or benchmark and specifies the criteria for conduct of a profession. Society changes, and this creates challenges in adhering to general principles. For example, it is not always obvious what constitutes proper professional conduct in social networking sites. Thus, codes of professional ethics provide some solutions that may not be available in general ethics theories, it allows individuals to know what the profession expects, and it publicly declares the profession's principles of conduct so these standards can be enforced.

A Variety of Roles and Conflicts

The decision maker role does not fully describe a professional person's entire ethical obligation. Each person acts as an individual, a member of a profession, and a member of society. Hence, accountants and auditors are also spectators (observing the decisions of colleagues), advisers (counselling with co-workers), instructors (teaching accounting students or new employees on the job), judges (serving on disciplinary committees of provincial associations), and critics (commenting on the ethical decisions of others). All of these roles are important in the practice of professional ethics. In addition, public accountants (PAs) work as consultants, tax advisors, as well as auditors, and there can be conflicts of interest in serving these professional roles. Also, within the auditing role, there can be conflicts between the preparers and users of financial information. Finally, there can be conflicts between the different users of financial information, and auditors must be ready to act as a type of accounting referee.

An Ethical Decision Process

Your primary goal in considering general ethics is arriving at a set of acceptable methods for making ethical decisions. Consequently, you will only behave according to the rules of professional conduct if you understand the general principles of ethics. Essentially, ethics is principles based.

In the previous definition of ethics, one of the key elements was reflective choice. This involves an important sequence of events, beginning with recognizing decision problems. Collecting evidence, in the ethics context, refers to thinking about rules of behaviour and outcomes of alternative actions. The process ends with analyzing the situation and taking an action. Ethical decision problems almost always involve projecting yourself into the future to live with your decisions. Professional ethical decisions usually turn on these questions: What written and unwritten rules govern my behaviour? What are the possible consequences of my choices? Principles of ethics can help you think about these two questions in real situations.

TO TELL OR NOT TO TELL?

In your work as an auditor, you discover that the cashier, who has custody over the petty cash fund, has forged several payment records in order to cover innocent mistakes and make the fund balance each month when it is replenished. Your investigation reveals that the amount involved during the year is $240. The cashier is a woman, age 55, and the president of the company is a man who tolerates no mistakes, intentional or otherwise, in the accounting records. In fact, he is unyielding in this respect. He asks you about the results of your audit. Not doubting that the cashier would be fired if the forgeries were known, should you remain silent or the truth?

Philosophical Principles in Ethics

A discussion of ethical theories would be unnecessary if we accepted a simple rule: "Let your conscience be your guide." Such a rule is appealing because it calls on an individual's own judgment, which may be based on wisdom, insight, or adherence to custom or an authoritative code. However, it might also be based on self-interest, caprice, immaturity, ignorance, stubbornness, or misunderstanding.

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In a similar manner, relying on the opinions of others or a social group is not always enough, as they may perpetuate a custom or habit that is wrong (e.g., smoking). Adhering blindly to custom or group habits is abdicating individual responsibility. Titus and Keeton summarized this point succinctly: "Each person capable of making moral decisions is responsible for making his own decisions. The ultimate locus of moral responsibility is in the individual."[3] Ethical principles provide some guidelines for taking individual decisions and actions. The earlier illustration (To Tell or Not to Tell?) and the one that follows (Conflicting Duties) demonstrate some ethical problems that, for most people, would present difficult choices. Consider them in light of the ethical principles discussed following the box.

CONFLICTING DUTIES

Because of your fine reputation as a public accountant, you were invited to become a director of a local bank and were pleased to accept the position. While serving on the board for a year, you learned that a bank director is under a duty to use care and prudence in administering the affairs of the bank, and that failure to do so in such a way that the bank suffers a financial loss means that the director(s) may be held liable for damages. This month, in the course of an audit, you discover a seriously weakened financial position in a client who has a large loan from your bank. Prompt disclosure to the other bank directors would minimize the bank's loss, but since the audit report cannot be completed for another three weeks, such disclosure would amount to divulging confidential information gained in the course of an audit engagement (prohibited by confidentiality principles). You can remain silent and honour confidentiality principles (and fail to honour your duty as a bank director), or you can speak up to the other directors (thus violating confidentiality principles). Which should you choose?

Ethical theories can be subdivided into two types: monistic and pluralistic. **Monistic theories** assume that universal principles apply regardless of the specific facts. **Pluralistic theories**, on the other hand, assume that there are no universal principles and that the best approach is to use the principles that are most relevant in a particular case.

There are a number of monistic theories. The most important are deontological (or duty based) theories dominated by the ideas of Immanuel Kant and utilitarianism. **Deontological (Kantian) ethics** assumes that there are universal principles (**imperatives**) such as the biblical Ten Commandments that must always be followed regardless of the consequences. Kant maintained that motive and duty alone define a moral act, not the consequences of the act.

Some object to the imperative principle because so-called universal rules always turn out to have exceptions. Others respond that if the rule is stated properly to include the exceptional cases, then the principle is still valid. But the human experience is complicated, and the rules would be very complex if they had to cover all possible cases.[4] This problem is not unique to ethics, as identifying the universal or primary principles and concepts of anything is a challenge for anyone trying to justify some action or conclusion. Universal principles are generally easier to identify in mathematics and the physical sciences than they are in social sciences such as accounting and auditing. Nevertheless, auditors must try to give the best reasons they can for their professional judgments and conclusions (claims). These reasons must also be based on the audit evidence.

Another major problem with duty-based ethics is that duties can conflict; one then needs to sort out which duty is most important, depending on the specific context. The professional rules of conduct for accountants have been greatly influenced by duty-based Kantian ethics and can be viewed as duties. But there is also a potential conflict of professional rules, most notably the rules of confidentiality and of not being associated with misleading information. This ethical dilemma was illustrated in the preceding box, and the related rules are discussed later in this chapter and in Chapter 18.

monistic theories: ethical theories that assume universal principles apply regardless of the specific facts of a situation

pluralistic theories: ethical theories that assume that there are no universal principles and that the best approach is to use the principles that are most relevant in a particular case

deontological (Kantian) ethics: the moral theory that an action is right if it is based on a sense of duty or obligation

imperatives: universal principles assumed by monistic moral theories

3 H. H. Titus and M. Keeton, *Ethics for Today,* 4th ed. (New York: American Book-Stratford Press, 1966), p. 131.

4 Several rules of professional conduct to be discussed shortly are explicitly phrased to provide exceptions to the general rules (e.g., Rules 210 and 204 of the ICAO Rules of Professional Conduct). Imperative rules also seem to generate borderline cases, so the ethics divisions of PA professional bodies issue interpretations and rulings to explain the applicability of the rules.

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consequentialism: a moral theory that the choice of action is made based solely on the consequence; that is, that it maximizes utility; note that economics and business are based on this theory

utilitarianism: a moral theory that the right choice is the one which results in the greatest good for the greatest number of people

Another monistic theory is **consequentialism**, that is, base the decision on the consequences of an action. Utilitarianism indicates that when we have a choice, we pick the one which results in the best outcome (that is, has the highest utility). **Utlitarianism** is a specialized case of consequentialism that chooses the action that maximizes the greatest good for the greatest number of people. A minority, however, might suffer as a consequence of this. Related difficulties with utilitarianism include deciding what is "good" and what is a "fair" distribution of the good. In other words, who decides how to measure utility in the particular circumstances. Addressing such complications requires more refined concepts, and these may be influenced by culture and ideology.

These monistic theories are not sufficient on their own to handle the complexities of most real-life ethical problems, including those of professional accounting ethics. Nevertheless, they can be important principles when providing reasons for a claim or decision. For example, standard economic theory is based on utilitarianism, the same theory used in cost-benefit analysis. However, exclusive reliance on one principle in all situations can lead to problems. The cost-benefit analysis approach was used by many PA firms in the 1990s when they decided to put more emphasis on developing the management consulting side of their practices rather than on auditing. In some cases, auditing was viewed as a "loss leader" in creating more lucrative consulting practices. At the time, the big PA firms were also the largest consulting firms in the world.[5] The resulting increase in consulting revenues was so large that the appearance of independence was affected. Many feel that overreliance on consulting led to Arthur Andersen's demise. This focus on utilitarianism

THE SIGNIFICANCE *OF UNITED STATES V. SIMON* (POPULARLY KNOWN AS THE *CONTINENTAL VENDING* CASE), 1969

The circumstances were judged to be evidence of willful violation of the Section 32 of the *Exchange Act.* Generally accepted accounting principles (GAAP) were viewed by the judge as persuasive but not necessarily conclusive criteria for financial reporting. Section 32 states the criminal penalties for violation of the *Exchange Act.* Like Section 24 of the *Securities Act,* the critical test is whether the violator acted "willfully and knowingly."

In affirming the conviction, the appeals court stated that it should be the auditor's responsibility to report factually whenever corporate activities are carried out for the benefit of the president of the company and when "looting" has occurred.

The significance of this case is that while the auditor was able to prove that the financial statements were in conformity with GAAP at the time, the auditor was nevertheless found guilty of committing fraud! This is because the accounting standards at the time did not require disclosure of material related-party transactions. While the auditor knew that the related-party transactions were material and presented in a misleading way, the auditor relied on technical conformity with GAAP to support his opinion. The courts disagreed. The court concluded that when the auditor uses the words "present fairly" in his report then that means more than mere conformity with GAAP. A higher-level principle comes into play that can be interpreted as meeting the needs of third parties. These needs include being understandable and not misleading to non-accountants. In essence, the courts said that auditors should use more "common sense" in deciding on user needs. An auditor cannot "hide behind GAAP" to avoid making informative disclosures and meeting third-party needs. Technical conformity with GAAP can be irrelevant in meeting user needs because the assumptions of an applicable reporting framework may not apply in particular circumstances. An auditor must look to broader-level principles and objectives of financial reporting in order to decide if the financial statements result in being "presented fairly" Put another way, "present fairly" is more principles based, whereas "in conformity with GAAP" or "in accordance with GAAP" is more rules-based accounting.[6]

The issue of principles-based accounting is becoming even more important with the distinctions made by CAS 200.13 between a "compliance" reporting framework and a "fair presentation framework." The use of the words "present fairly" now mean something. The auditor can use the words "present fairly" in the opinion paragraph only if a fair presentation reporting framework is used as defined in CAS 200.13. A fair presentation framework is one that is more principles based, allowing disclosures beyond and departures from more specific reporting requirements. This focus on broader principles, understanding user needs, and related concepts is a major reason for introducing the critical-thinking concept in this chapter.

Postscript: The auditors of Continental Vending were found guilty of criminal fraud in misleading investors despite the auditee's compliance (in accordance) with GAAP. The auditors were sentenced to go to jail but were pardoned by President Nixon. This case set the legal precedence for the importance of principles-based accounting.

5 For a good review of the history of the profession during this period, see A. R. Wyatt, "Accounting professionalism—They just don't get it!" *Accounting Horizons,* March 2004, pp. 45–54.

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thus caused the profession a great deal of grief. With the passage of SOX and other reforms, the pendulum is now swinging the other way—the focus on quality control puts emphasis on auditors' duties toward the public interest. Ethical reasoning is different from other types of reasoning because it includes consideration for the perspective of others.

The consequences of a decision for others and the ability to imagine their feelings about these must be part of ethical reasoning. This ability to imagine is frequently referred to as **moral imagination**. For example, a moral imagination helps in the understanding of user needs in financial reporting. This may be an important way of avoiding litigation as discussed in the box below. Had the CEO at Molex (the company described at the beginning of Chapter 1) used his moral imagination, he might not have been fired.

moral imagination: part of ethical reasoning where one has the ability to imagine others' feelings about the consequences of a decision

Professional Skepticism and Critical Thinking

LO3 Outline the characteristics of professional skepticism and critical thinking.

Professional skepticism, a phrase that appears frequently in auditing literature and speech, is an auditor's tendency to not believe management assertions but, instead, to find sufficient support for the assertions through appropriate audit evidence. Specifically, professional skepticism means recognizing that circumstances causing the financial statements to be materially misstated may exist (CAS 200.15). Note that to implement this concept of skepticism, the auditor first needs to define "misstatement" and "materiality" and then implement them in practice. You will see that doing this appropriately will present its own challenges.

professional skepticism: an auditor's tendency to question management representations and look for corroborating evidence before accepting them

Professional skepticism is inherent in applying due care in accordance with the general standards. The business environment that has seen errors and fraud in financial reports dictates this basic level of professional skepticism: "A potential conflict of interest always exists between the auditor and the management of the enterprise under audit." This follows from the fact that the auditor must add credibility to the financial statements by gathering his or her own evidence to support their conclusion on the truthfulness of the financial statements. Truthfulness, in turn, is a function of what the auditor actually says in the audit report in relation to what the auditor really knows, and this is another reason we introduce the critical thinking concept. The relationship between truthfulness, meaning, and the actual words used in the auditor's report and in the financial statements that are referenced in the report are all part of the auditor's critical thinking process. The auditor must make sure that the financial statements correspond with what the auditor says in her or his report. The difficulty and uncertainty in doing this is illustrated in the Continental Vending case discussed in the preceding box.

The belief that the potential for conflict of interest always exists causes auditors to perform procedures in search of misstatements and omissions that would have a material effect on financial statements. This tends to make audits more extensive and expensive. The extra work is not needed in the vast majority of audits where there are no material errors, irregularities, or frauds. Nevertheless, auditors approach all audits with a mindset framed by the actions of a minority of people, and they must be careful, therefore, to also control their professional skepticism. Once audit procedures give them evidence that financial misstatements are not misleading, the audit team must be willing to accept that fact and let go of their skepticism.

Still, due audit care does call for a degree of professional skepticism—an inclination to question all material assertions made by management, whether oral, written, or contained in the accounting records. However, this attitude must be balanced by a willingness to respect the integrity of management. Auditors should neither blindly expect that every management is dishonest nor thoughtlessly assume management to be totally honest. The key lies in auditors' objectivity and in the audit requirement of gathering sufficient appropriate evidence and evaluating financial statement disclosures to reach reasonable and supportable audit decisions. But what does reasonable and supportable mean? It means providing sufficient reasons (reasonable) that are also true (supportable) reasons. The critical thinking concept is introduced here to help understand this reasoning process better.

6 See R.M. Mano, M. Moritsen, and R. Pace, "Principles-based accounting," *CPA Journal*, February 2006, p. 60–63 for more discussion.

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With the adoption of international standards and their greater emphasis on the most basic principles of accounting and auditing, the role of critical thinking in professional judgment has become more important. For example, auditors now need to distinguish between "compliance" and "fairness of presentation" with an appropriate financial reporting framework. In addition, critical thinking and skepticism become more important when the auditor takes an equal responsibility for detecting fraud as he or she does for detecting unintentional errors. Critical thinking considers how the financial statements will be used in a particular engagement. This is necessary in evaluating the appropriateness of how the assertions are presented to third parties and how courts might view a situation in litigation. Critical thinking is especially important in evaluating the application of accounting principles using accounting estimates, as covered in Chapter 20 (available on Connect). As noted in Chapter 1, the economic crisis of 2008/2009 created new concerns about the limits of the audit process and the financial reporting that it verifies. When combined with new concepts like accounting risk, critical thinking can be used to help address these concerns. A framework for critical thinking is introduced in this section, and applications of different parts of it are illustrated in the exercises throughout the text.

Auditors cannot rely on standards for detailed rules in all possible situations. IFAC's international code of professional ethics recognizes that every engagement is unique, and consequently, auditors must tailor their moral imaginations to the specific circumstances of the engagement. It is part of being a professional rather than just a technician mechanically following standards and rules of conduct. It will not be sufficient to merely follow detailed rules of GAAP and GAAS and rules of ethics on an engagement in order to meet audit objectives, just as it does not work to rely too much on one broad principle of morality, such as utilitarianism, to resolve all ethical conflicts. The social and moral world is complicated and messy. People will disagree on how to measure utility and how to prioritize rights and duties.

A framework for structured thinking will better prepare you to deal with the ethical and other issues of professional judgment in the 21st century audit environment. A **critical-thinking framework** is one that consists of principles, concepts, and their application, and ethics is an important concept within the framework. In the end, the auditor must have good reasons other than that "it feels right" to support a position.

critical-thinking framework: principles and concepts to help structure your thinking so that your conclusions will be better justified

As illustrated in the *Continental Vending* box on page 60, reliance on detailed rules of GAAS and GAAP may not be enough for good professional judgment. Standards should not be seen as a recipe to memorize, and true professionalism means being aware of how and why the standards have evolved the way they have. Basic principles underlie all the standards and the standard-setting process. Some of these principles are more obvious than others, and critical thinking helps identify the less obvious ones. For example, Appendix 1B discusses the reasoning and theories behind the important concept of meeting the public interest. Ultimately, the auditor relies on the fundamental principles, such as fairness of presentation in the circumstances, meeting the public interest, and maintaining the reputation of the profession. There are no rules for achieving these in all situations, and the auditor must think through each case in a systematic way. A critical-thinking framework is a guide to helping achieve a well-supported conclusion.

A brief description of the framework follows in Exhibit 3–1, with more detail provided in Appendix 3A on Connect.

Critical thinking means involving principles in your analysis of an issue. These principles normally will have an important ethical component. In particular, note the principle of a questioning mind, or skepticism, which represents a mental attitude incorporating all the rest of the critical thinking principles. This principle is often referred to as the *ethics of virtue or character*. It addresses the question of what a person should be or become, rather than what a person should do. Many aspects of the detailed rules of conduct relate to the audit virtues such as skepticism, integrity, objectivity, due care, and independence. Critical thinking extends traditional audit virtues to a more holistic approach to judgment.

The goal of the critical-thinking framework reflects the ideal audit virtues. Doing the right thing and learning the truth is a way of summarizing the traditional audit virtues of objectivity, integrity, skepticism, professional competence, due care, independence,

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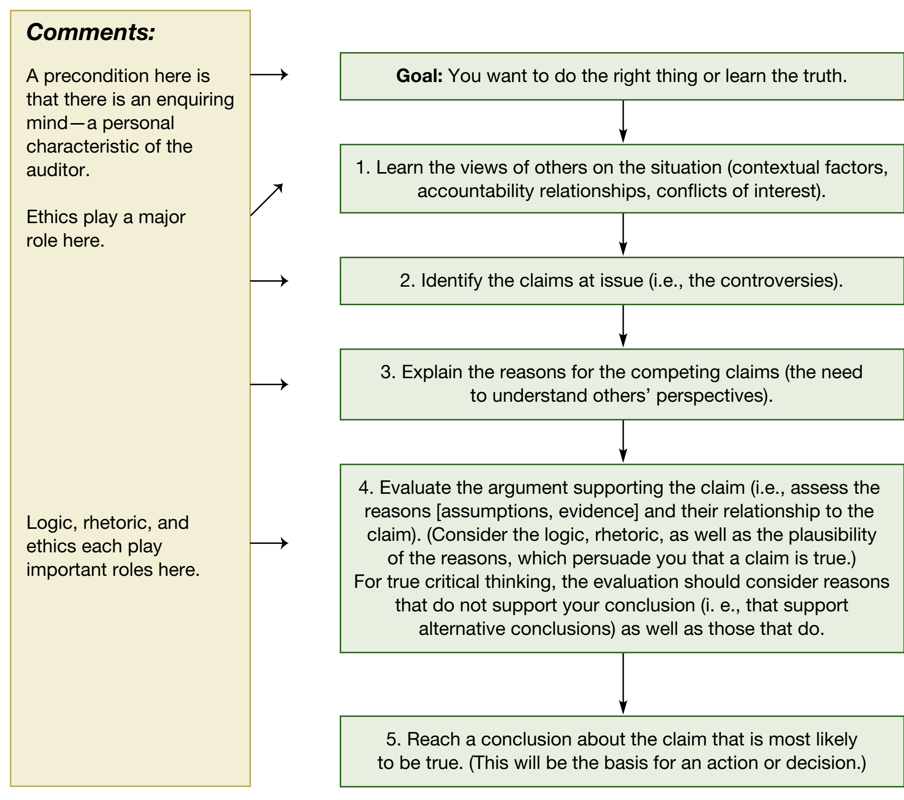
EXHIBIT 3–1 A Framework of Critical-Thinking Principles: Achieving a Goal with an Enquiring Mind



confidentiality and professional behavior (CAS 200, paragraph CA15). These virtues are needed to achieve the overall objective of serving the public interest. This overall objective is clarified via the terms of an engagement, as well as the accounting and auditing standards and their conceptual frameworks. The audit virtues are further clarified in the codes of professional ethics discussed in the next section.

Step 1 of the critical-thinking framework relates to clarifying the auditor's role in an engagement. For example, the auditor should identify the needs and responsibilities of the other parties in the three-party accountability relationship discussed in Chapter 2.

Step 2 relates to identifying what issues need to be resolved in the engagement. You will see in this text that audit standards already provide quite a bit of guidance on this, but this step also reminds us that there may be contentious financial reporting issues to resolve as well. For example, the auditor needs to decide if an accounting estimate is "reasonable" and "presented fairly." Such decisions cannot be reduced to a formula or checklist to be memorized. Instead, they involve considered judgment taking into account both quantitative and qualitative factors. The rest of the framework outlines what else is involved in critical thinking.

Step 3 relates to using moral imagination to make sure all moral and ethical issues have been taken into account. Moral imagination is required to see things from management's point of view *and* from the investor's point of view. Moral imagination is also required to understand what might motivate a fraudster in particular circumstances. Moral imagination is critical for assessing the intentions and capabilities of management in carrying out its plans. Step 3 is, thus, also a way of reminding the auditor to consider *all* the reasons—those supporting a particular conclusion as well as those that do not.

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Steps 4 and 5 in the framework reflect the role of logic, or the need for justification in critical thinking. Applying logic essentially means identifying reasons supporting a claim or conclusion. There must be a link between reasons and a conclusion, and on an audit engagement, we want that link to be strong. A second condition, that of truth or substantial truth of the reasons, should be met before we can say that an audit conclusion is justified by the reasons given. If both these conditions are satisfied, then we can say that our conclusion is justified by the reasons. The term "sound reasoning," the essence of being objective on an issue, can be used when our conclusions are justified this way. Thus, for example, CAS 200. A6-A7 requires the auditor to identify the broad principles and concepts serving as a basis for applying accounting policies to meet the general reporting objectives of a framework, such as Canadian GAAP. These broad principles and concepts are the basis for sound reasoning regarding fairness of presentation in particular circumstances.

If sound reasoning is sufficiently documented, then it also provides evidence on how objective and competent the auditor is on a particular engagement. This is why the Canadian Public Accountability Board (CPAB), the regulators, and the courts like to look at audit documentation and why the documentation standards of audit work are important.

Critical thinking involves questioning the application of a standard, the concepts and principles underlying it, and the consistency of standards to one another. Questioning of standards may go back to questions about the goals of financial reporting, as is becoming evident with the CAS's new classification of financial reporting frameworks as general purpose versus special purpose, and fairness of presentation versus compliance objectives.

Whereas logic is concerned with the link between reasons and conclusion, the truthfulness of reasons is determined by the source of the reasons. Sources of reasons include accounting and auditing theory and their underlying concepts, assumptions, and principles. These concepts, along with the words used to state them, affect the persuasiveness of your reasons as an auditor. A critical thinker uses language to clarify, not cloud or bias, the reasoning. For example, an auditor uses the words "present fairly" to persuade the user of the acceptability of the audited financial statements. But these words should have some meaning if they are to go beyond just sounding nice. CAS 200.13 now explicitly distinguishes between "compliance" and "fair presentation" financial reporting frameworks and we will get into these distinctions later in the text. For now, note from the *Continental Vending* case that had the auditor used better judgment, including more "common sense," rather than trying to "hide behind GAAP," he might not have been found guilty of committing fraud for issuing a report that he should have known would be misleading.

Professional judgment in auditing is essentially critical thinking on accounting issues and the evidence related to them. The critical-thinking framework can be used for deciding when an audit conclusion is sufficiently justified. When this reasoning is documented in an audit, there is no basis for questioning the sufficiency of audit documentation. The continuing problems found by the CPAB in auditor documentation suggest insufficient critical thinking in professional judgment on the part of practicing auditors. These CPAB findings are reviewed later in the advanced chapter on auditor responsibilities. For a more complete discussion of the critical-thinking framework, along with illustrations of its application, see Appendix 3A on Connect.

This brief review of the principles of ethics and critical thinking provides some background on the way people approach difficult decision problems. The greatest task is to take general ethical principles and apply them to a real decision. Applying them through codes of professional ethics is a challenge. In this book, we suggest that the minimal critical thinking issues auditors should consider are the following. It is important to supply good reasons for conclusions (claims). The most important reasons relate to ethical, accounting, and auditing principles underlying the professional standards. The reasons should be acceptable to third parties, especially capital providers. And the reasons should ultimately be based on materiality and the various risk concepts introduced in this book. At minimum, one dominant principle should be identified that drives the overall logic of the reasoning. See Appendix 3A on Connect for more details. Later chapters illustrate application of the critical-thinking framework on specific audit and accounting issues.

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The rest of this chapter is devoted to the more practical rules of professional ethics, related concepts and principles, and their application in relevant situations. However, these professional rules and principles rely on the various ethical theories discussed in this section, especially duty-based theories, for their justification.

REVIEW CHECKPOINTS

3-1 Why should auditors act as though there is always a potential conflict of interest between the auditor and the management of the enterprise under audit?

3-2 Can the auditor detect deception without being skeptical? Explain.

3-3 What is a professional accountant's role with regard to ethical decision problems?

3-4 When might the rule "Let conscience be your guide" not be a sufficient basis for your personal ethical decisions? for your professional ethical decisions?

3-5 Assume that you accept the following ethical rule: "Failure to tell the whole truth is wrong." In the illustrations about (a) your position as a bank director and (b) your knowledge of the cashier's forgeries, what would this rule require you to do? Why is an unalterable rule, such as this one, considered an element of duty-based ethical theory?

3-6 How do utilitarian ethics differ from duty-based ethics?

3-7 Why are simplified monastic theories of ethics not sufficient for professional decision making?

3-8 Why is critical thinking becoming more important in the CAS and International Financial Reporting Standards (IFRS) audit environment after 2011?

CODES OF PROFESSIONAL ETHICS

LO4 Analyze whether a PA's conduct conforms to principles underlying provincial rules of professional ethics.

All the Canadian PA bodies (CAs, CGAs, CMAs) and the International Federation of Accountants (IFAC) have their own rules of professional conduct for their members and students, either provincially or nationally. Generally, these rules are published as a part of a member's handbook identifying the various activities and regulations of the PA associations and include a section on professional conduct. Codes of conduct need to develop a balance between detailed rules and more general principles. They also need to be practical, and as a result, they tend to have similar frameworks, as indicated in the box below.

The codes of professional conduct are usually organized hierarchically, moving from general principles at the beginning, to rules, and then on to specific interpretations of the rules. The general principles are sometimes referred to as "ideal standards" and the more specific rules and related interpretations as "minimum standards."

IFAC FRAMEWORK FOR A CODE OF CONDUCT FOR PROFESSIONAL ACCOUNTANTS

- Objective: to serve the public interest (this cannot be accomplished by mere conformity to detailed rules—this dedication to serve is more like a state of mind). (CT: Goal)
- Principles necessary to attain objective: (CT: step 3)
  - Integrity
  - Objectivity
  - Professional competence and due care
  - Confidentiality
  - Professional behaviour
- Conformity is achieved by identifying, evaluating, and controlling threats to nonconformity to an acceptable level. (CT: step 4)
- Part B provides examples, but these are not exhaustive as this is impossible. Therefore, a principles approach should be followed (as indicated by the above principles). (CT: step 3)

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The various codes of professional conduct are meant to apply to all members, with exceptions for students and members not in public practice. Generally, codes for CAs and CMAs are the responsibility of provincial institutes or societies. CGAs have a national code set by CGA-Canada; however, provincial CGA associations may add modifications to this. Recently, the CA provincial institutes have substantially harmonized their codes so that the CA code can be viewed as more of a national one. The CASs do not refer to the IFAC's code of ethics. Instead, Canadian PAs use the code of the provincial accounting organization to which they belong.

An example of a code is the ICAO *Member's Handbook*, which identifies the various activities and regulations of the Ontario Institute, including a section on professional conduct which is divided into three parts: the Foreword, the Rules of Professional Conduct, and the Interpretation of the Rules. Many people consider the Foreword the most important part of the professional conduct regulations, because it contains principles that provide guidance in the absence of specific rules.[7] The Foreword is essential reading for CA members and students, as the handbook specifically advises that all the rules in it "are to be read in the light of the Foreword to the rules." In this sense, the Foreword is analogous to the conceptual framework of accounting; for example, section 1000 of the *CICA Handbook* and the rules themselves are like the Recommendations in the *CICA Handbook*.

The Foreword has clearly defined sections. The first section sets out the purpose of the rules, which is to guide the profession in serving the public. The second reviews the key characteristics that mark a profession and a professional, concluding that "chartered accountancy is a profession." The third section identifies the six "fundamental statements of accepted conduct" around which all the rules are centred. These six principles can be summarized as follows:

1. The member should act to maintain the profession's reputation.
2. The member should use due care and maintain his or her professional competence.
3. The member should maintain the appearance of independence as well as the fact of independence of his or her professional judgment.

4. The member should preserve client confidentiality.
5. The member should base his or her reputation on professional excellence—in particular, advertising should inform, not solicit.
6. The member should show professional courtesy to other members at all times.

These principles are ideals every professional aspires to. The rules themselves are more specific because they are intended as guides to action and enforceable. However, adherence to the rules represents only a minimum acceptable level of performance for CAs. On the other hand, because they are more detailed, the rules are more specific benchmarks that a member's performance can be measured against.

The Foreword singles out several principles requiring additional guidance: (a) sustaining professional competence (principle 2 above), (b) avoiding conflicts of interest in respect of a client's affairs (principle 3), and (c) practice development based on professional excellence rather than self-promotion (principle 5). It is evident from the space devoted to them that these particular principles require the most detailed guidance. However, as the Foreword makes clear, as ethical decision making becomes more complex yet indispensable for maintaining the public interest, the absence of specific rules makes the principles that much more important. As a result, some writers have concluded that the six principles should be given much more prominence and used more frequently.[8]

After the Foreword are the rules of conduct themselves. The ICAO Council also publishes "Council Interpretations" of these rules—detailed explanations to help members understand particular applications of them. Anyone departing from Council interpretations has the burden of justifying that departure in any disciplinary hearing.

7 K. Gunning, "Required reading," *CA Magazine,* November 1992, pp. 38–40.

8 K. Gunning, "Required Reading," *CA Magazine*, November 1992, pp. 38–40.

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The CMAs have a similar set of rules for each provincial society. For example, the *Society of Management Accountants of Ontario (SMAO) Handbook on Ethics* predominantly contains general principles of ethics; the more detailed rules and interpretations are covered in the remainder. Where CMAs have the right to perform assurance engagements, the rules require that they comply with local legislation.

The CGA's national code of conduct provides the basic framework for each of the provincial association rules. It consists of a preamble that explains why a code is necessary and who is affected; a statement of ethical principles; rules of conduct, with guidance concerning their application to certain specific situations; and a set of definitions of terms used throughout the code.

The IFAC includes a code of ethics for PAs as part of their standards as well. It avoids preparing detailed rules or interpretations as these will be influenced by national laws, culture, and the particular circumstances of the engagement. However, a detailed rule should not conflict with a basic principle, for if it did the system of ethical reasoning would be illogical. Instead, detailed rules should clarify the application of a principle yet be consistent with it. The principle has conceptual primacy over a detailed rule. This means that if a rule conflicts with a principle, the principle overrides the rule. This is referred to as principles-based reasoning. Principles-based reasoning has always been important in moral philosophy. Principles-based reasoning is also increasingly important in financial reporting and auditing, especially under the IFRS. It can also be referred to as "top down" reasoning if the reasoning is laid out in standard logical form, as explained in Appendix 3A (on Connect).

Part A of the IFAC code provides general concepts and a conceptual framework, and part B illustrates how the framework is applied by PAs in specific situations. IFAC feels that specific rules can be arbitrary and not represent the public interest in all cases, justifying a conceptual approach. The framework identifies threats against conformity to the general principles, evaluates their significance, and, if warranted, applies safeguards eliminating or reducing them to acceptable levels. This framework is summarized in the box below, and the principles are discussed in more detail in the rest of the chapter. Note that serving the public interest can be viewed as the most important principle, since the remaining principles and detailed rules are meant to support this objective. Thus, there can be a hierarchy of principles. As accounting and auditing further evolve you can expect more clarification of the principles. For example, should there be a priority or hierarchy of user needs that have to be met in serving the goal of meeting the public interest? If the professional standards do not specify such a priority, then the auditor must be making this decision on each engagement at least implicitly. This is one reason to practice critical thinking—it helps document the reasoning of your own thought process.

Elements of the critical-thinking (CT) framework of Exhibit 3–1 that closely correspond to this one are also indicated in the box to show the similarities between them. However, the CT framework is broader and allows extension to auditing and accounting issues. We illustrate the potential for such integration in subsequent chapters.

There is much similarity in the concepts of all professional codes. These are reviewed in the next section, along with the related rules.

Rules of Professional Conduct

The rules of professional conduct derive their authority from the bylaws of the various PA professional organizations (or those that strive to be recognized as such). Members of these groups (CAs, CGAs, CMAs) are responsible for compliance with the rules by all employees and partners associated with them. Further, members may not have other people to carry out prohibited acts on their behalf.

The various PA institutes and associations have detailed rules of conduct that have much in common, and we cannot list all of them, so those of the Institute of Chartered Accountants of Ontario (ICAO) are given in the following box and will serve as an illustration. (Full access to the ICAO handbook is at www.icao.on.ca/Membershandbook/1011page2635.pdf.) In terms of the critical-thinking framework, these rules can be viewed as important

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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF ONTARIO (ICAO) RULES OF PROFESSIONAL CONDUCT

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APPENDIX A

Former Rule of Professional Conduct 204 (Objectivity)

Source: The Institute of Chartered Accountants of Ontario "Rules of Professional Conduct." These materials are produced by permission of the Institute of Chartered Accountants of Ontario, and may not be further reproduced without the prior written permission of the Institute of Chartered Accountants of Ontario. These Rules are as of the date January 1, 2009, and are subject to revision and change at any time.

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IFAC CONCEPTUAL FRAMEWORK FOR RESOLVING A CONFLICT IN THE APPLICATION OF FUNDAMENTAL PRINCIPLES

- Step 1: Members should consider the following: (CT step 2)
  - Identify the relevant facts (CT steps 1, 3)
  - Identify ethical issues involved (CT step 3)
  - Identify fundamental principles related to the matters in question (CT steps 2, 3)
  - Identify established internal procedure. (CT step 3)
  - Identify alternative courses of action (CT steps 2, 3)
- Step 2: Identify appropriate course of action consistent with fundamental principles. (CT steps 4, 5)
- Step 3: If conflict cannot be resolved consistent with fundamental principles, then the auditor should refuse to be associated with the conflict whenever possible. (CT step 5)

reasons for taking (or not taking) a particular action. Specifically, the rules follow the logic of Kantian imperatives or duties, although there is also an element of utilitarianism, as is indicated in the discussion following the box.

The box above summarizes IFAC's conflict resolution process. The rest of this chapter discusses ethical and critical thinking principles, and their related rules, in more detail. However, you should refer to the appropriate CAs, CGAs, or CMAs members' handbooks for more extensive guidance on rules related to these professional groups.

Serving the Public Interest

The single most important principle for accountants is to serve the public interest; they can only do so if the profession maintains a good reputation. This is a way of characterizing expectations of the auditor's social role. The auditor cannot be said to meet the public interest unless the auditor fulfills the social role expected. "The phrase 'at all times' is significant because the public will view any serious transgression of a professional accountant, including those outside business or professional activity, as a black mark against the profession as a whole. Consequently, if a professional accountant is convicted of a minimal offense or fraud, his or her certification is usually revoked."[9] The remaining principles all serve to support this first one. In this sense, this principle has primacy over the others as discussed earlier.

Serving the public interest primarily means to competently fulfill the role expected by the public. This is succinctly captured in Rule 205, which prohibits the PA from being associated with false or misleading information. Note that violation of this rule is illustrated in the Continental Vending case. As stated in the auditor's report, the role of the auditor is to express an opinion based on the audit of the financial statements prepared by management. In fulfilling this responsibility, the auditor reduces the risk of the financial statements being false or misleading to an appropriately low level. Terms such as *present fairly*, *in all material respects*, *audit risk*, *materiality*, and *risk of material misstatements* used throughout the text capture this concept.

If the audit fails to detect a material misstatement, then the audit fails. This can have serious consequences for the accounting firm. The rapid demise of Arthur Andersen as a result of the failure of their Enron audit illustrates this. The profession is now particularly sensitized to the importance of not being associated with misleading information. And Rule 205 now probably represents the most important rule, particularly in light of responsibilities placed on auditors by SOX and the CPAB, as discussed in Chapter 2.

In a financial statement audit, Rule 205 relates to the auditor not being associated with misleading financial information. This rule clarifies what it means to serve the public interest as an auditor. The responsibility to the public is paramount. This primary

9 L. J. Brooks, *Professional Ethics for Accountants* (Minneapolis/St. Paul: West Publishing, 1995), p. 120.

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responsibility is different for auditors than for other professions, such as law or medicine, in which the primary responsibility is to the client or patient. The auditor's responsibility is so important to third parties that it overrides his or her obligations to companies or clients. This creates a unique moral situation in which the auditor is theoretically not working for the person or company that pays him or her. This uniqueness is captured by the independence rule, discussed in the next section, which exists primarily to convince the third parties in three-party accountability that the auditor's primary objective is to meet their financial reporting needs. This is the key responsibility of the auditor's role, thereby serving the public interest and maintaining the reputation of the profession. The rule, therefore, reflects society's expectations of the role of the auditor. As you will see, many audit concepts and standards relate to effectively fulfilling the social role associated with Rule 205.

Integrity

Integrity is the duty to be honest and conscientious in performing professional services. Integrity relates to the basic character of the professional—a PA must be upright, not kept upright. Without integrity among its members, the profession cannot maintain its good reputation and serve the public interest.

INDEPENDENCE AND OBJECTIVITY

LO5 Explain the importance of an independence framework for auditors.

Rule 204.1 dealing with independence was introduced to you in Chapter 2. *Independence* and *objectivity* are closely related terms; in this case, *independence* is a way of achieving objectivity, and it is the term given to the objectivity required in the special case of assurance engagements. The term independence is also used in the *Canada Business Corporations Act,* in some provincial corporations acts, and in various professional rules of conduct. Canadian legislation requires that the auditor be "independent"—presumably, the fact of independence must be determined by the courts.

The *Canada Business Corporations Act,* section 161, defines independence as a key qualification of an auditor, as indicated in the following box.

CANADA BUSINESS CORPORATIONS ACT, SECTION 161

161. (1) Qualification of auditor. Subject to subsection (5), a person is disqualified from being an auditor of a corporation if he is not independent of the corporation, of any of its affiliates, or of the directors or officers of any such corporation or its affiliates.

(2) Independence. For the purpose of this section,

(a) independence is a question of fact; and

(b) a person is deemed not to be independent if he or his business partner

(I) is a business **partner**, a director, an officer or an employee of the corporation or any of its affiliates, or a business partner of any director, officer or employee of any such corporation or any of its affiliates;

(II) **beneficially** owns or controls, directly or indirectly, a material interest in the securities of the corporation or any of its affiliates; or

(III) has been a receiver-manager, liquidator, or trustee in bankruptcy of the corporation or any of its affiliates within two years of his proposed appointment as auditor of the corporation.

(3) Duty to resign. An auditor who becomes disqualified under this section shall, subject to subsection (5), resign forthwith after becoming aware of his disqualification.

Source: *Canadian Business Corporations Act*, section 161.1.

The term *independence* is internationally recognized. For example, the International Federation of Accountants' *Technical Standard on Ethics,* section 8, specifies that "professional accountants in public practice when undertaking a reporting assignment should be independent in fact and appearance." Similar wording regarding the need for independence is used in the SMAO's code of conduct.

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The CICA, the IFAC, and the CGA-Canada all have standard frameworks for independence based on the five following threats or risks to a PA's independence:

1. Self-review—providing assurance on his or her own work
2. Self-interest—for example, benefiting from a financial interest in a client
3. Advocacy—promoting a client's position or opinion
4. Familiarity—becoming too sympathetic to a client's interests
5. Intimidation—being deterred from acting objectively by actual or perceived threats from a client

Under all the independence standards, the PA must identify and evaluate the significance of any independence threat. If threats are other than clearly insignificant, the PA must apply safeguards to eliminate the threats or take action to reduce them to a level that would pose no real or perceived compromise. If no safeguards are adequate to preserve independence, the PA must eliminate the activity, interest, or relationship that is creating the threat, or refuse to perform or continue the particular engagement.[10]

We refer to the need to control independence threats as the independence principle. Principles like this one assist sound, structured ethical reasoning by auditors. Independence problems and other elements indicating lack of audit quality have been a continuing concern in CPAB's monitoring reports over the years.[11]

The Canadian legislation referred to previously requires independence for financial statement audit services. However, review services of unaudited financial statements, such as engagements to report on prospective financial statements (forecasts and projections) and expressing opinions on representations other than financial statements (e.g., reports on internal control), all require independence as well. The definition of public practice is significant here. A member is considered to be in the public practice of accounting if he or she (1) lets it be known publicly that he or she is a PA, and (2) offers the types of services rendered by other PAs. The latter part of the definition is very broad because PAs perform a wide range of accounting, audit, taxation, and consulting services.[12] This means that most PAs who seek clients from the general public are in the practice of public accounting. For example, the PAs who work for H&R Block, the tax preparation corporation, are in public practice if they let themselves be known as PAs. Non-PAs who perform these same services are, of course, not held to these standards, and this is partly why PAs have a different social status.

Since the purpose of independent financial auditing is to add credibility to financial statements, auditors must be impartial and unbiased with respect to both the client management and the client entity itself. Auditors must be independent in fact and also independent of outside decision makers who rely on their assurance services. Independence is, in fact, a mental condition and difficult to demonstrate by physical or visual means. Thus, some things that give the appearance of lacking independence may be prohibited in specific interpretations of the independence principle. Note how awareness of other perspectives is crucial in correctly assessing the various independence risks (step 1 of Exhibit 3–1).

The rest of the critical-thinking framework is also useful for deciding if the independence risks are appropriately low for a specific situation. For example, the IFAC's conceptual framework approach to ethics consists of compliance with its fundamental principles, identification of threats to achieving those principles, and safeguarding against these threats. The safeguards include training, professional standards, regulatory monitoring, and corporate governance. They are implemented using a process similar to that outlined in Exhibit 3–1. In brief, achieving the objective of independence is accomplished through understanding users' perspectives, taking actions that address the risk of threats against

10 As modified from "Proposed new independence standards for auditors," *CA Magazine,* October 2002, p. 51.

11 See http://www.cpab-ccrc.ca/EN/default.aspx for the CPAB reports.

12 The CICA's definition of public accountant in its *Terminology for Accountants,* 4th ed. (1992), is as follows: "1. The performance of services for clients, the purpose of which is to add credibility to financial information that may be relied upon by interested parties. 2. The performance of independent professional accounting and related services for clients. 3. Any service so defined by a particular statute or authority."

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their interests, and reducing those risks of threats to acceptable levels. Thus, critical thinking and the independence principle have a great deal of overlap, not surprising as independence risks are a significant category of risks at issue on engagements involving third-party reliance. Critical thinking provides a broad reasoning-process framework to help address such issues.

To further develop critical thinking on independence, the box below identifies the concepts of programming, investigative, and reporting independence that are useful in avoiding influences that might bias judgment.

THREE ASPECTS OF PRACTICAL INDEPENDENCE

Programming Independence

Auditors must remain free from interference by client managers who try to restrict, specify, or modify the procedures auditors want to perform, including any attempt to assign personnel or otherwise control the audit work. Occasionally, client managers try to limit the number of auditors permitted in a location.

Investigative Independence

Auditors must have free access to books, records, correspondence, and other evidence. They must have the cooperation of management without any attempt to interpret or screen evidence. Sometimes, client managers refuse auditors' requests for access to necessary information.

Reporting Independence

Auditors must not let any feelings of loyalty to the client or auditee interfere with their obligation to report fully and fairly. Neither should the client management be allowed to overrule auditors' judgments on the appropriate content of an audit report. Disciplinary actions have been taken against auditors who go to a client management conference with a preliminary estimate for a financial adjustment and emerge after agreeing with management to a smaller adjustment.

Analysis of Independence Rules

Generally, the rules of professional conduct and corporate acts legislation imply a fine distinction between independence, integrity, and objectivity. The spirit of the rules is that integrity and objectivity are required in connection with all professional services and, in addition, independence is required for assurance services. In this context, integrity and objectivity are the larger concepts, and independence is a special condition largely defined by the matters of appearance specified in the codes or their interpretations. Conflicts of interest, for example, as cited in ICAO Rule 204, refers to avoiding business interests in which the accountant's personal financial relationships or relationships with other clients might tempt him not to serve the best interests of a client or the public that uses the results of the engagement. Note, however, that the focus of independence rules in the above box is on meeting third-party user needs, and that independence is required in performing any kind of assurance service.

The issue of independence gained even more prominence on January 6, 2000, when the Securities and Exchange Commission (SEC) published a report citing thousands of violations by one of the Big Four firms of rules requiring PAs to remain independent from companies they audit. This occurred despite concerns about independence that led to the May 1997 creation of a new private-sector body, the Independence Standards Board. In 1999, the Board issued its first standard, requiring auditors to confirm their independence annually to audit committees. Other items on the Board's agenda included an official definition of independence as well as a conceptual framework for it. The Board was disbanded and replaced in 2002 by the Public Company Accounting Oversight Board (PCAOB) created under the Sorbanes-Oxley Act (SOX). Fully operational since 2003, the PCAOB has even more demanding objectives. It is clear that maintenance of independence is a continuing and growing concern within the profession.

Phrases such as "shall not knowingly misrepresent facts" and "[shall not] subordinate his or her judgment to others" emphasize conditions people ordinarily identify with the

REVIEW CHECKPOINTS

3-9 What are the three specific aspects of independence that an auditor should carefully guard in the course of a financial statement audit?

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concepts of integrity and objectivity. PAs who know about a client's lies on a tax return, false journal entries, material misrepresentations in financial statements, and the like, have violated both the spirit and the letter of the rules of conduct.

Professional Competence and Due Care

The professional competence and due care rules of the codes of conduct can be summarized as follows:

A. *Professional competence.* Undertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence.
B. *Due professional care.* Exercise due professional care in the performance of professional services.
C. *Planning and supervision.* Adequately plan and supervise the performance of professional services.
D. *Sufficient relevant data.* Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

Analysis of Competence and Due Care Rules

The professional competence and due care principles are a comprehensive statement of general standards that PAs are expected to observe in all areas of practice. These are the principles that enforce the various series of professional standards. For example, there is usually a specific rule relating to compliance with professional standards.

Compliance with Professional Standards

A member engaged in the practice of public accounting shall perform his professional services in accordance with generally accepted standards of practice of the profession (from Rule 206 of the ICAO).

Analysis of Compliance Rule

This rule may be viewed as an extension and refinement of the due care principle. It implies adherence to technical standards in all areas of professional service, including review and compilation (unaudited financial statements), consulting, tax, and other professional services. The practical effect of this rule is to make noncompliance with all technical standards subject to disciplinary proceedings. Thus, failure to follow auditing standards, accounting and review standards, as well as assurance, compilation, and professional conduct standards are violations of this rule.

There are many more detailed rules as you can see from the ICAO handbook's table of contents. More thorough overage of the rules and the profession's system of enforcement of them are covered as an advanced topic in Chapter 18. An important part of enforcement is covered in the second half of this chapter as legal liabilities that arise for failing to follow professional standards.

Summary of Professional Ethics Responsibilities

This overview of professional ethics began with considerations of moral philosophy and their relationship to provincial rules of professional conduct.

Professional ethics for PAs is not simply a matter covered by a few rules in a formal code of professional conduct. Concepts of proper professional conduct permeate all areas of practice. Ethics and its accompanying disciplinary potential are the foundation for fulfilling the auditor's social role.

Your knowledge of philosophical principles in ethics will help you make decisions about the provincial rules of professional conduct. This structured approach to thoughtful decisions is important not only when you are employed in public accounting but also when you work in government, industry, and education. The ethics rules may appear to be restrictive, but they are intended for the benefit of the public as well as for the discipline of PAs.

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PAs must be careful in all areas of practice. Regulators' views on ethics rules may differ in several aspects from the provincial institute views. As an accountant, you must not lose sight of the non-accountants' perspective. No matter how complex or technical a decision may be, a simplified view of it always tends to cut away the details of special technical issues to get directly to the heart of the matter. A sense of professionalism coupled with sensitivity to the impact of decisions on other people is invaluable in the practice of accounting and auditing. This is the key lesson from the Continental Vending case.

Finally, it should be noted that there is a strong link between codes of conduct and GAAS. In fact, codes of conduct can be viewed as a means of fulfilling auditor responsibilities for GAAS and assurance standards. For example, the first GAAS standard, which relates to the personal attributes of the auditor (see Chapter 2), closely corresponds to the ethical principles of integrity, objectivity, independence, professional competence, and due care. The dominance of ethical issues over accounting or auditing techniques is increasingly being recognized throughout the profession. Most audit failures appear to be attributable to poor professional judgment, at least in hindsight, that arise from improper consideration of conflicts of interest on various disclosure and measurement issues. Critical thinking can help address this problem, at least for the more contentious issues.

THE LEGAL ENVIRONMENT AND AUDITOR LEGAL RESPONSIBILITIES

LO6 Outline auditor legal responsibilities.

Legal liability is an important measure of the costs of failing to fulfill professional responsibilities to society. In order to get our bearings on how the law affects auditors, we begin with an overview of the legal system. Law is essentially a social system for resolving conflicts. Conflicts between individuals (and corporations) that are settled in court are part of what is called *private law* or *civil law*. Disputes between an individual and the state, as well as those between states or different levels of government, are settled in the part of the legal system called public law. Public law includes criminal law, administrative law, and constitutional law. All public law is codified by statute passed by some level of government.

Common law refers to the system of law based primarily on previous judicial decisions; unlike public law, its laws have not been codified in statutes via legislation (statutory law). It is a distinctive part of the Anglo-American system of private/civil law used in Canada, the United States, and most former colonies of the British Empire. There are several major categories of civil law: contracts (agreements or promises that create expectations for others), torts (civil wrongs, such as negligent actions which create obligations for the offending party), and property (rights over goods and land). Common law liabilities for auditors arise from the law of contracts or torts. Statutory law liabilities for auditors arise from administrative law related to economic regulation and from criminal charges.

Because common law has been the main source of auditor liability in the past, most of this section is devoted to introducing the main principles of legal liability under common law. After that, we review some key statutory law responsibilities arising from legislation.

Lawsuit Causes and Frequency

One study of law cases showed that accountants' and auditors' legal troubles arose from five major types of errors. In 129 cases, 334 errors were found, classified as follows: (a) 33% involved misinterpretation of accounting principles, (b) 15% involved misinterpretation of auditing standards, (c) 29% involved faulty implementation of auditing procedures, (d) 13% involved client fraud, and (e) 7% involved fraud by the auditor.[13] These data suggest that accountants and auditors are exposed to liability for failure to report known departures from accounting principles, failure to conduct audits properly, failure to detect management

13 K. St. Pierre and J. Anderson, "An analysis of audit failures based on documented legal cases," *Journal of Accounting, Auditing, and Finance,* Spring 1982, pp. 236–237.

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fraud, and actually being party to frauds. Threat of lawsuits has also affected how PAs conduct their work in consulting services and tax practice; about 60% of civil damage suits arise from tax practice disputes. However, lawsuits related to audits tend to be "high cost" resulting in much higher claims.[14]

All litigation is serious and results in expenses for defence, but not all cases result in payments for damage. In fact, about 40% of the lawsuits in the period 1960–85 were dismissed or settled with no payment by the accounting firm. Another 30% were settled by payment of approximately $1 million or less. This leaves about 30% of the cases where the auditors paid significant damage awards. The legal fees for a long-running case can also be huge. For some reason, in Canada such lawsuits can drag out over a long time. Imagine the costs an accounting firm incurs in defending itself from a single lawsuit for over 20 years. All these data relate exclusively to lawsuits over audit services.[15]

Audit Responsibilities

Many users of audit reports expect auditors to detect fraud, theft, and illegal acts, and to report them publicly. In the auditor's report, auditors take responsibility for detecting material misstatements in financial statements, whether due to fraud or unintentional misstatements. Fraud and misleading financial statements are large concerns of financial statement users. They are afraid of information risk due to intentional misstatements, and they want it reduced, even eliminated. Some of their expectations are very high, resulting in an expectation gap between the diligence users expect and the diligence auditors are able to accept.

The audit responsibility for detection of fraud in financial statements is a complex topic, as seen in Chapters 7 and 21 (available on Connect). Auditors take some responsibility but not as much as many users expect. For example, see CAS 240, 250. This disparity leads to lawsuits, even when auditors have performed well.

REVIEW CHECKPOINTS

3-10 What are class action lawsuits, and why should auditors be concerned about them?

3-11 What are some causes of auditors becoming defendants in lawsuits?

3-12 What proportion of lawsuits against accountants relate to tax practice?

The next parts of this chapter cover PAs' legal liabilities under common law and statutory law. The principle of *stare decisis,* or to stand by a previous decision, is important to common law. The practical problem in many cases, however, is whether the facts in a given case are similar enough to a precedent-setting one. Rarely are the facts exactly the same. Common law is "common knowledge," in the sense that judges tend to follow the collective wisdom of past cases. In contrast, statutory law is prohibitions enacted in statutes by a legislature—for example, the *Canada Business Corporations Act* and related provincial corporations acts. Most countries' laws arise from legislation (statutory law) rather than precedent (common law). Such legal systems are called Code-Law systems.

LIABILITY UNDER COMMON LAW

LO7 Outline the various types of common law liability for PAs, citing specific case precedents.

Legal liabilities of PAs arise from lawsuits brought on the basis of the law of contracts or as tort actions for negligence. Most lawsuits stem from a breach of contract claim that accounting or auditing services were not performed in the manner agreed.

14 S. Andersen and J. Wolfe, "A perspective on audit malpractice claims," *Journal of Accountancy,* September 2002, p. 59.

15 Z. Palmrose, "An analysis of auditor litigation and audit service quality," *Accounting Review,* January 1988, pp. 55–73.

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tort: legal action covering civil complaints other than breach of contract; normally initiated by users of financial statements

Tort refers to a private or civil wrong or injury (e.g., fraud, deceit, and injury), actions normally initiated by users of financial statements. The rule of the law of torts is to compensate victims for harm suffered from the activities of others. The problem for tort law is to identify the actions creating a right to compensation. The law takes into account the fault or blame of the defendant (breach of duty) and whether the defendant's conduct could be considered the cause of the harm (causation), both of which must be established in order for the defendant to be found liable for damages. However, the burden of proof for tort actions varies depending on social policy. For example, under "no fault" schemes, the burden of compensation is spread widely to all automobile owners.[16]

Suits for civil damages under common law usually result when someone suffers a financial loss after relying on financial statements later found to be materially misleading. In the popular press, such unfortunate events are called *audit failures*. While a business failure is a bankruptcy or other serious financial difficulty arising from many kinds of adverse economic events, an audit failure is based on an auditor's faulty performance, a failure to conduct an audit in accordance with GAAS so that misleading financial statements get published.

Characteristics of Common Law Actions

When an injured party considers herself damaged by a PA and brings a lawsuit, he or she generally asserts all possible causes of action, including breach of contract, tort, deceit, fraud, or whatever else may be relevant to the claim.

Burden of Proof on the Plaintiff

Actions brought under common law place most of the burdens of affirmative proof on the plaintiff, who must prove that

(1) he or she was damaged or suffered a loss,
(2) there was a beneficiary relationship with the defendant,
(3) the financial statements were materially misleading or that the accountant's advice was faulty,
(4) he or she relied on the statements or advice,
(5) they were the direct cause of the loss, and
(6) the accountant was negligent, grossly negligent, deceitful, or otherwise responsible for damages.

Clients may bring a lawsuit for breach of contract. The relationship of direct involvement between parties to a contract is also known as *privity*. When privity exists, a plaintiff usually need only show that the defendant accountant was negligent—showed lack of reasonable care in the performance of professional accounting tasks. If negligence is proved, the accountant may be liable, provided the client did not contribute to his own harm.

legal responsibilities: auditor responsibilities imposed by the legal system

Most auditor **legal responsibilities** arise from the law of negligence, the part of the common law known as the law of torts. Negligence is the failure to perform a duty with the requisite standard care (due care as it relates to one's public calling or profession). Under the common law of torts for negligence, all of the following four elements of negligence must be established by the plaintiff if he is to successfully sue the audit.

Four Elements of Negligence

1. There must be a legal duty of care to the plaintiff.
2. There must be a breach in that duty (e.g., failure to follow GAAS and/or GAAP).

16 J. E. Smyth, D. A. Soberman, and A. J. Easson, *The Law and Business Administration in Canada,* 7th ed. (Prentice Hall, 1995), pp. 76–79.

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3. There must be proof that damage resulted (otherwise the plaintiff is limited to the amount of audit fee).
4. There must be a reasonably proximate connection between the breach of duty and the resulting damage (e.g., losses must occur subsequent to firm's audit).

The auditor's defence is to demonstrate that at least one of the preceding elements is missing. The auditor may also argue that the plaintiff contributed to his own loss by, for example, not correcting accounting weaknesses in the reporting system. However, this defence applies only to parties having a contractual relationship with the auditor. Just to keep things straight, the auditor is the first party, the contractual client (who hires the auditor for the audit engagement and thus has privity of contract with the auditor) is the second party, and other audited financial statement users are third parties.

These three parties are the same as in three-party accountability discussed in Chapters 1 and 2. The only difference in legal three-party accountability is that the company is viewed as inseparable from management. In the situation of a corporation, the company itself is the legal entity, and the management is acting on behalf of the legal entity. This illustrates how fundamental the legal system is in establishing auditor responsibilities to society. You have seen in Chapter 2 how critical three-party accountability is to the assurance engagement concept. In Chapter 4, you will see that three-party accountability is an important aspect of the broadest set of public accounting standards, association rules.

First Element of Negligence: Privity of Contract

It is important to understand the four elements of negligence underlying auditor liability under common law. In your business law course, you should learn that a legal duty arises when there is a contractual agreement with the client. We refer to this as two-party accountability. Two-party accountability arises between two parties when one of the parties agrees to provide some good or service to the other, usually for some consideration. In legal terms, there is "privity of contract" between the two parties. A practitioner, when agreeing to perform tax or consulting work for another party, owes a duty of care in performing that work in a professional manner. A company that hires an auditor has a contract with that auditor to perform the audit appropriately. The auditor has a duty of care to that company under privity of contract. Under common law, the auditor has a potential liability for negligence as part of the contractual duty to perform the audit service with due care. A breach of that promise in the contractual relationship is a breach of contract by the auditor, and the client may then sue the auditor for damages.

Fiduciary Duty in Audit Engagements Related to this contractual duty is a fiduciary duty that applies to professionals or others having specialized expertise. When one party to the contract relies on the specialized expertise of the other, the party with the expertise has a special duty called *fiduciary duty*. For example, an auditor has a duty to tell the client about problems in the client's accounting system. Auditors have this fiduciary duty even when they perform an audit for free, such as for a charitable organization.

No Liability to Shareholders under Privity of Contract Under common law, auditors also have a duty to limited classes of third parties, such as investors. However, this duty is limited to "reasonably foreseeable" third parties, not all third parties, a limited class of third parties based on the precedent-setting Hedley Byrne principle. For example, if the auditor knows that the financial statements are being prepared primarily for a third party's specific purpose, such as a buyer wishing to purchase the client, then this is a known or reasonably foreseeable third party. An example of this situation is the ongoing litigation involving Castor Holdings that has lasted more than 20 years. There a Quebec judge recently decided that "the typical concerns surrounding indeterminate liability" to all possible third parties do not arise in the Castor case. The class of potential investors was identifiable to the auditors and, in fact, the auditor knew that the purpose of the audit was

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to meet the investor needs. As a result, the CICA is now recommending that auditors modify their audit engagement letters to specifically identify intended users.[17]

This legal duty arises from the three-party accountability concept and illustrates that the concept has legal, ethical, and regulatory dimensions in terms of defining who can be a PA, and a dimension that affects the objectives of audit and accounting standards. Thus, three-party accountability is a pervasive concept in audit practice!

Do reasonably foreseeable third parties include the shareholders of the client? The answer is no. The reason for this is, "the only purpose for which shareholders receive an auditor's report is to provide them with information in order to be able to oversee the management and affairs of the corporation—not for purposes of guiding their personal investment decisions. Therefore, no duty of care is owed to them in that regard."[18] Since, in the corporate form of organization, the corporation is treated as a separate legal entity from the shareholders, it is assumed to be able to act on shareholders behalf, including taking legal action on their behalf. This the flip side of the limited liability privilege to shareholders. The most the shareholders can lose is their investment in the company's shares.

The limitation of liability to certain classes of reasonably foreseeable third parties applies to "ordinary negligence" on the part of the auditor in carrying out the audit. Ordinary negligence for an audit is failure to use due care in applying professional standards. To avoid an ordinary negligence finding, "it will normally be sufficient that the defendant auditor has followed a well-recognized practice, even though some other procedure might arguably have been better. . . . But established standards should not be allowed to become a means for protecting members of a profession from liability: where there is other evidence that can be understood by an ordinary person, that evidence can be taken into account by a court even when it contradicts the testimony of experts. . . . In this approach, foresight includes an element of awareness of the seriousness of the harm that may flow from faulty professional advice."[19] This quote quite dramatically illustrates the important role of moral imagination and ethical thinking in avoiding legal liability. It also illustrates why accounting standards needed to be revised as a result of the Continental Vending case described earlier. This case illustrates deficiencies in both accounting and auditing standard setting. Perhaps standard setters should also be using more moral imagination in the setting of the standards?

Gross Negligence Ordinary negligence is distinguished from "gross negligence" in terms of perceived intentions. Ordinary negligence is unintentional error in applying professional standards, whereas gross negligence is intentional or the constructive equivalent of intentional error on the part of the auditor. In both cases, there is a violation of professional standards. In the case of ordinary negligence (inadvertent error), the auditor is liable to limited classes of reasonably foreseeable third parties (the Hedly Byrne principle). In the case of gross negligence or auditor fraud, however, the auditor–third-party liability is much broader.

Second Element of Negligence: The Meaning of Due Care

A key aspect to the second element of negligence is due care. Due professional care implies the careful application of all the standards of the profession (GAAS, GAAP) and observance of all the rules of professional conduct. The courts have interpreted due care to be reasonably prudent practice; therefore, neither the highest possible standards nor the minimum standards would be considered due care. This suggests that following the rules of professional conduct or the *CICA Handbook* may not always be sufficient, as these would be minimum standards. In fact, over the years, the courts have helped shape audit practice by their interpretation of due care. For example, the concept of testing (less than 100% examination of the accounts) was first accepted as reasonable by the precedent-setting decision in *London v. General Bank* (1895). This case was also the first to acknowledge that there is some limit on the auditor's responsibility for the detection of fraud and the duty to take increased care in the presence of suspicious circumstances. This case influenced the development of later professional announcements and hundreds of subsequent cases

17 E. Stock, "Auditors' exposure expanded to potential investors? Case comment on the Castor decision," *Checkmark* (ICAO) Summer 2011: 31–32.

18 Smyth et al., *Law and Business,* p. 82.

19 Ibid. p. 85–86.

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(e.g., *1136 Tenants* [1967]). The general legal standard is that an auditor is "a watchdog not a bloodhound" (in *Kingston Cotton Mill Company* [1896]), which means that it is reasonable for auditors to assume management's honesty as a working hypothesis as long as the auditor can provide documented reasons for this assumption (i.e., that there is no evidence from audit procedures that management is dishonest).

Nonetheless, auditors need to be alert to factors (evidence) that conflict with this hypothesis, in which case auditors must take additional precautions under the due care requirement, as discussed in Chapters 7 and in Chapter 20 (available on Connect). CAS 240 characterizes this approach as presuming the possibility of management's dishonesty, but that such presumption is refutable by the evidence. Of course, such evidence must be documented in the audit file.

The courts have also influenced auditing standards (and, therefore, influenced due care provisions) in the requirement that the auditor corroborate management assertions with his or her own evidence. The auditor cannot just rely on management's words; he or she must justify reliance through checking, testing, and other audit procedures. This practice, following from the third examination standard, has been shaped by decisions in many court cases, such as the precedent setting *Continental Vending* (1969) in the U.S. and *Toromont v. Thorne* (1975) in Canada.

Another example of court influence in determining what constitutes auditor due care is *McKesson Robbins* (1939) discussed in detail in Chapter 20 (available on Connect), which also ultimately influenced the creation of the *CICA Handbook*'s CAS 501 and similar sections in U.S. standards. In that case, the auditor failed to observe inventory or confirm receivables, and the courts thought that it was "unreasonable" for the auditors to not perform these procedures. From this, it is evident that the due care provision of negligence can significantly shape and probably will continue to influence the development of audit standards. One impact of the *Continental Vending* case rests on the courts' decision not to accept the auditor's defence that he followed GAAP (i.e., the auditor was able to establish that the footnote in the financial statement was in accordance with GAAP); instead, the courts expected the auditor to use some higher standard of fairness in deciding on proper disclosure. This has led to greater diligence on the part of standard setters designing disclosure standards for various types of information. In the meantime, it may help for auditors to take a more structured framework such as critical thinking with a moral imagination to deal with such situations.

A sense of the importance on this issue of fairness was introduced to Canadian courts via the *Kripps* case discussed in the following box.

ACCOUNTING PROFESSION HAS A DUTY TO SHAREHOLDERS

Before buying shares in a company, investors usually rely on an important safeguard—the auditor's opinion of its financial statements. And that opinion usually declares that the statements are both "presented fairly" and are "in accordance with generally accepted accounting principles (GAAP)." For decades, though, auditors have tried to duck legal liability to the investors they serve. Auditors appear to want what does not exist: authority without responsibility.

Two Canadian lawsuits promise to clarify the trust that investors can place in auditors. One case, *Stephen Kripps et al. v. Touche Ross* (now Deloitte & Touche) *et al.*, emerged from the B.C. Court of Appeal. In 1985, Kripps et al. relied on the audited financial statements of a mortgage company to buy $1.9 million of its debentures. The company went into receivership, and the investors lost $2.7 million including interest. The investors sued the auditor, lost in a lower court, and won at appeal.

A 2-to-1 appeal court majority ruled that "Touche had actual knowledge that a simple application of GAAP would . . . lead to financial statements that could not be said to have fairly represented the financial position of the company. Auditors cannot hide behind [the formula] 'according to GAAP,'" the court declared, "if the auditors know . . . that the financial statements are misleading." It ruled against Touche. The court's point is correct—GAAP is too loose a standard to be a sufficient safeguard by itself. That is why the financial statements must also be "presented fairly," to use the actual language of the auditor's opinion. Despite the ruling's validity, some accountants want the Canadian Institute of Chartered Accountants (CICA) to support an appeal by Touche to the Supreme Court.

Postscript: On November 6, 1997, the Supreme Court of Canada denied Deloitte & Touche's right to appeal the negligence ruling against it by the B.C. Court of Appeal. However, as discussed earlier, the Supreme Court made it much more difficult for investors to sue Canadian auditors under common law in its *Hercules* decision.

Source: "Accounting profession has a duty to shareholders," *The Financial Post,* May 20, 1997, p. 14. Material reprinted with the express permission of the National Post Company a Canwest partnership.

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Note that this judgment concerns the due care element. Under this judgment, the PA auditor cannot just mechanically apply *CICA Handbook* rules and expect to have done a good job as auditor. Critical thinking clearly should have come into play. Yet in another court case, Hercules Management Ltd. et al., the courts limit this liability to foreseeable third parties, excluding the current shareholders. To close this gap for investors, legislation has been passed to better protect investors in public companies. These are discussed this review of the four elements of negligence under common law.

The Third and Fourth Elements of Negligence

The two remaining elements of negligence have also proven to be material issues in various court cases. The third element is that some damage must occur to the third party—otherwise only the audit fee can be recovered. This was the situation in *Toromont v. Thorne*.

The last element of negligence requires that there be a causal link between the breach of duty and the resulting damage. Thus, for example, if losses occur before the time of the audit, or if it can be proven that the plaintiff did not rely on the audited information to any significant degree, the lawsuit will fail. Cases illustrating this and the other elements of negligence under common law are covered in the advanced topics of Chapter 19 (available on Connect).

STATUTORY LAW LIABILITY

In addition to liabilities imposed by common law, auditors need to be concerned with statutory law liability. Auditors should not grumble too loudly about this special burden because it is statutory law requirements that drive much of the demand for audit services in the first place! For example, companies beyond a certain size, incorporated under the Canada Business Corporations Act (CBCA) or provincial corporation acts, are required to hire an external auditor to audit the financial statements. This creates a guaranteed demand for audit services, which some have argued has made the profession less vigilant in maintaining the quality of audits in today's rapidly changing financial reporting environment (e.g., see Rosen, A. and M. Rosen. *Swindlers*. (Toronto, Ontario: Madison Press Books, 2010), p. 17.). The highlights of the CBCA are as follows:

1. The CBCA identifies conditions under which the auditor is not considered independent in section 161.
2. It identifies conditions of appointing and retiring the auditor in sections 162 and 163.
3. It identifies the auditor's rights and responsibilities in section 168:
   (*a*) to attend shareholder meetings,
   (*b*) to provide a written statement of reasons for a resignation, and
   (*c*) to make an audit examination unimpeded and gain access to data the auditor considers necessary.
4. The CBCA identifies the financial statements subject to audit, and specifies that the financial statements must be in conformity with the *CICA Handbook.*
5. Until 1994, the CBCA requirements for audited financial statements applied to all companies incorporated under the Act with revenues in excess of $10 million or assets greater than $5 million. Under amendments to the CBCA made in 1994, privately held companies are no longer required to have their financial statements audited or disclosed. The *Ontario Business Corporations Act* requires audits only for companies having $100 million of either assets or revenues; other provincial corporations acts vary in their reporting requirements.

Legislation, such as the CBCA, can also increase auditor legal liability beyond that under common law. The earliest statutory law that increased auditor liability arose from the passage of the SEC Acts in the United States in 1933 and 1934. Canadian auditors are

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exposed to this liability when they audit companies whose shares are listed on the U.S. stock exchanges (NASDAQ, NYSE, AMEX). The SEC was created in the 1930s to enforce these Acts and subsequent legislation such as SOX. The SEC has the power to prevent auditors from auditing SEC registrants, either temporarily or permanently. In addition, the SEC can decide what the GAAP are.

The ultimate authority on accounting issues in the United States is the SEC, whereas in Canada, via the *CICA Handbook,* the CBCA mandates that it is the CICA. This gives the *CICA Handbook* standards much higher legal status than comparable standards in the United States. But note that this result is due to statutory law, again illustrating how the legal system shapes the auditors role in society.

In 1995, the American accounting profession was successful in having the U.S. Congress pass (over President Clinton's veto) the *Private Securities Litigation Reform Act,* which changed auditor liability under SEC section 10b (discussed in Chapter 21 on Connect). There were three objectives to the Act. First, it was intended to "discourage abusive claims of investors' losses due to fraudulent misstatements or omissions by issuers of securities" (and professionals associated with the misstatements or omissions, such as auditors). Second, the Act provided more protection against securities fraud. Third, the Act increased the flow of forward-looking financial information. The Act met these objectives by imposing specific pleading requirements, reducing discovery's effectiveness in coercing settlements, mandating sanctions for frivolous claims, giving the plaintiff class far more control of class actions, providing for proportionate liability except in cases of known fraud, creating a safe harbour for forward-looking information, and codifying auditor's responsibilities to search for and disclose fraud.[20]

For the purposes of this chapter, the most important feature of the Act concerns the reform of "joint and several liability," which, under SEC law, now applies only to auditors who knowingly commit a violation of the security law. "A defendant (auditor) whose conduct is less culpable is liable only for a percentage of the total damages corresponding to the percentage of responsibility allocated to the defendant (auditor) by the jury. . . . Thus, for example, if a PA firm is found 10% responsible for an injury and insolvent corporate management is allocated 90%, the PA firm no longer will have to make up all of the management's share (as long as the PA firm did not engage in knowing fraud)."[21] This type of liability is referred to as **proportionate liability**.

proportionate liability: a legal liability regime where a party found to be partly liable is only responsible for paying a part of the damages in proportion to their share of the blame

The CBCA was amended in 2001 to change the liability associated with financial statement misrepresentations from one of joint and several liability to modified proportionate liability. Auditors in Canada are now liable under the CBCA to the extent of their degree of responsibility for the loss (proportionate liability). However, the proportionate liability is modified in that if other defendants in the lawsuit are unable to pay, the auditor is then liable for additional payments capped at 50% of his own original liability. Under some conditions, the courts can revert to the joint and several liability, in which case the auditor may be required to pay up to 100% of the damages.[22]

Another example of legislation that has had widespread impact on auditors is the *Sarbanes-Oxley Act* (SOX) discussed in Chapter 2. As noted there, SOX created the PCAOB, which is now responsible for creating and enforcing U.S. auditing standards for public companies.

The SEC Act of 1933 regulates disclosure of information in a new public offering of securities for SEC registrants. If there is false or misleading information in the registration statement, auditors (and others associated with this information, such as management) are liable for losses suffered by third parties. The plaintiff does not have to prove negligence or fraud, only that a loss was suffered through investing in the registered security and that there was a material misstatement or omission in the audited statements. Unlike under

20 A. R. Andrews and G. Simonette Jr., "Tort reform revolution," *Journal of Accountancy,* September 1996, p. 54.

21 Ibid., p. 50.

22 See M. Paskell-Mede, "Fair shares," *CA Magazine,* November 2001, pp. 31–32; G. McLennan, "Trust not," *CA Magazine,* June/July, 1993, pp. 40–43; and M. Paskell-Mede, "Adviser relationships," *CA Magazine,* May 1995, pp. 27–32.

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common law, the plaintiff need not prove that the auditor was negligent, the second item of the list given earlier. Instead, the burden is on the defendant auditor to prove that he or she was not negligent. In other words, there is a shifting of the burden of proof from the plaintiff to the defendant auditor.

This shifting of the burden is important, as the party having the burden must provide the evidence that their claim is true. To illustrate how crucial this is in the reasoning process, think of the expression that you have probably heard before, "innocent until proven guilty." In other words, you cannot be locked up by the police arbitrarily unless they have strong evidence against you. You do not have to prove your innocence in criminal law; instead you are presumed innocent unless the prosecutor has met its burden of proof in providing convincing evidence that you are guilty. All this is established within a court of law. So, you can see now that the SEC Act of 1933 imposes an extra burden on the auditor of proving non-negligence in a court of law. This is one good reason to have the audit well documented.

The SEC Act of 1934 relates to auditor liability for periodic filings: annual reports (form 10-K), quarterly reports (form 10-Q), and selected special events (form 8-K), such as a change in auditor. The liability can be imposed on any one who makes a false or misleading statement in the filings. In order to avoid liability, the burden of proof falls on the auditor to prove he or she had no knowledge of the material misstatement in the filing. This defence is available only to auditors who can demonstrate that they "acted in good faith," meaning that they are not judged to be "grossly negligent" in conducting the audit.

Canadian Securities Administrators (CSA): organization of Canadian provincial securities market administrators and regulators

Post-Enron provincial legislation in Canada under the leadership of the **Canadian Securities Administrators (CSA)** is influencing a whole new set of auditor liabilities. These are in response to decreased liabilities resulting from the *Hercules* case that did away with most third-party liability under common law discussed above and in Chapter 20 (available on Connect).

The *Hercules* case along with post-Enron developments prompted Ontario to pass its Bill 198 in December 2002. Bill 198 (now the *Ontario Securities Act* or OSA) is similar in scope to SEC laws already discussed. The CSA is promoting passage of similar legislation throughout all of Canada's provinces in an effort to demonstrate that Canadian regulators are as concerned in preserving the integrity of their capital markets as the SEC is in the United States.

This legislation creates a statutory law civil liability for PAs and others accused of misleading the public. It allows class action lawsuits against PAs, placing the burden of proof that a drop in the client's share price was not due to a financial statement misrepresentation (this is the "fraud on the market" presumption used by the SEC in the United States. "In short, this is a presumption that the capital markets operate efficiently, such that there are sufficient market participants who in fact do understand and rely on corporate disclosures to affect share price. As a result, although a particular individual may not have been aware of the offending representation, or may not have understood it, his or her share price can be said to have been in reliance on it, as the price at which he or she traded was affected by the misrepresentation." Under the OSA regime, the plaintiff investors can make the case that fraud on the market took place, but the burden is on the plaintiff investors to prove so. If the plaintiff investor meets this burden and a misrepresentation has been identified, it is up to the auditor to show that any losses suffered by investors were not due to the misrepresentation. However, the legislation puts caps on the PA's liability, and it uses the proportionate rule, rather than the joint and several liability rule. These limitations on liability, however, do not apply if the PA knowingly deceived the market.[23] Although the OSA was passed in December 2002, it was not proclaimed (put into force) until late 2004 and went into effect December 2005. The article below discusses the significance of this legislation.

23 25 G. McLennan, "Trust Not," *CA Magazine*, June/July, 1993, pp. 40–43.

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These legislative initiatives seem to be inspired by U.S. statutory law covered in this chapter. It should be noted that PAs in Canada already had similar liabilities for initial public offerings of securities. The newer legislation extended the liability to subsequent financial statements of companies already listed on the Toronto Stock Exchange (TSE), and such an extension exposes the Canadian PA to far more potential legal liability, especially to shareholders of clients who could not previously sue.

LAW TO MAKE IT EASIER FOR INVESTORS TO SUE

"MORE GROUNDS FOR SUITS"

So you lost money on a stock and want to sue the company for misleading statements.

What is already a common practice in the United States is coming to Canada. Canadian public companies are readying themselves for broad new legislation that will greatly increase investors' ability to file civil lawsuits against them.

The new civil liability legislation will come out by the end of the year and substantially widens the type of disclosure investors can use as a basis for litigation.

This means that false or misleading information in press releases and financial statements will soon be fair game. It can even extend to public oral statements, such as conference calls or speeches, made by authorized company representatives. Currently, investor lawsuits are limited to information in a prospectus.

This new addition to the *Ontario Securities Act* was actually introduced by the provincial government in late 2004. But the clock is now ticking for companies to get their disclosure models in order, since it comes into effect Dec. 31. . . .

"This may constitute the biggest change to Canadian securities law in the last 25 years," according to a report by law firm Borden Ladner Gervais LLP.

One of the most significant parts of the new law is how plaintiffs will no longer have to prove they relied on the misrepresentation when investing in a company. For example, under the current legislation, an investor would have to say "I bought this stock reliant on XX amount of earnings, and it turns out they were really XXX . . . I relied on this information and I can prove it," said Paul Findlay, a lawyer at Borden Ladner who co-wrote the report.

This was a significant stumbling block to class-action suits in Ontario, since they typically involve groups of shareholders and it was pretty much impossible to prove that each investor had looked at and relied on the information in question, he added.

With this impediment removed, there is little doubt there will be an increase in securities class-action lawsuits in the province. Plus, it could make it more attractive for shareholders to file suits against cross-listed Canadian companies here, Mr. Findlay said. In the past, these actions have often taken place in the United States, which already has some provisions for materially false and misleading information in continuous disclosure.

Source: Lori McLeod, "Law to make it easier for investors to sue: More grounds for suits," *The National Post,* Friday, November 15, 2005, p. FP12. Material reprinted with the express permission of the National Post Company, a Canwest partnership.

The auditors defence under OSA is to show that they acted with due professional care and they had no reasonable basis for believing the financial statements are false. To prove due diligence, auditors need to document their work in the audit file—a topic discussed in later chapters.

An additional feature of OSA that is relevant to auditors is the restriction of the amount of liability to the proportionate liability. This amount is also capped at the greater of $1 million or the amount of revenues earned from the client "during the 12 months preceding the misrepresentation."[24]

Auditor's Liability in Foreign Corrupt Practices

Numerous other laws affect accountants and business, but two of them deserve special mention. The *Foreign Corrupt Practices Act* of 1977 (FCPA) and the Racketeer Influenced and Corrupt Organization Act (RICO) in the United States have changed the landscape of much audit practice and have influenced the nature of lawsuits. There are two Canadian counterparts to these laws: the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* (PCMLTFA) and *Corruption of Foreign Officials Act*. These two laws are modelled after RICO and the FCPA, respectively.

A rising tide of public indignation and impatience with wrongdoing prompted enactment of the FCPA. This law—an amendment of the *Securities Exchange Act* of 1934—makes

24 Ibid, p. 35.

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it a criminal offence for American companies to bribe a foreign official, a foreign political party, or a candidate for foreign political office for the purpose of influencing decisions in favour of the business interests of the company. Companies may be fined up to $2 million; individuals may be fined up to $100,000 and imprisoned up to five years for violations. In 1997, Canada signed a convention with the Organization for Economic Cooperation and Development (OECD) to fight foreign corruption, and in 2001 Canada passed legislation similar to the FCPA.

The FCPA is a law directed at company managements. Independent auditors have no direct responsibility under the law. They may advise clients about faulty control systems, but they are under no express obligation to report on deficient systems. The law cast a spotlight on companies and their internal auditors. It had the effect of making internal audit departments more important and more professional. The internal auditors often got the assignment to see that their companies complied with the FCPA. Under SOX, this has become a more urgent task and this is one reason internal auditors have become more important after SOX.

Under anti-bribery legislation, auditors are responsible to detect foreign bribes insofar as they have a material effect on financial statements. Materiality here needs to consider not only the amount of the bribe but also any fines, jail terms for guilty executives, and related consequences for the reputation of the firm and business risk. The auditor is responsible for disclosing material contingencies, disclosing findings to management and the audit committee, and proper consultation with lawyers (the client's, the auditor's, or both).

The Proceeds of Crime (Money Laundering) and Terrorist Financing Act

The Canadian version of the two U.S. Acts is known as *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* (PCMLTFA). It met with controversy when it was first proposed as Bill C-22, as described in the box on the next page. It gives auditor responsibility in fraud and illegal act detection, as these are covered in Chapter 7. If client organizations do not comply with the legislation, they risk fines of up to $2 million and their management and employees can be imprisoned. Auditors should be aware of these risks, their reporting responsibilities to outside agencies, and the need to avoid being considered accomplices under the legislation. Bill C-22 had been influenced by RICO and similar legislation in the U.S. RICO is a general federal law, not administered by the SEC, and it has both civil and criminal features. Lawsuits are often characterized as "civil RICO" or "criminal RICO." The original intent of the law was to provide an avenue for criminal prosecution of organized crime activities. However, clever lawyers have found ways to apply it in other cases, including malpractice lawsuits against accountants.

The civil RICO provisions permit plaintiffs to allege (a) fraud in the sale of securities and (b) mail or wire (e.g., telephone) fraud related to audit or tax practice. But RICO provides a perverse twist; if the plaintiffs can prove a "pattern of racketeering activity," they can win triple damages, court costs, and legal fees reimbursement. These potential losses raise the risk of the lawsuit considerably.

You might think that accountants may not be in great danger of being found to have participated in a "pattern of racketeering activity." Think again! Such a "pattern" can be established if a defendant accountant has engaged, whether convicted or not, in two racketeering acts—fraud in the sales of securities, mail fraud, wire fraud—within the past 10 years. An accounting firm can meet this test by losing a malpractice lawsuit that involved clients' mailing misleading financial statements and using the telephone during the audit. Since all the major PA firms have lost malpractice lawsuits, they are exposed to civil RICO lawsuits. In fact, RICO has been included among the charges in numerous lawsuits against accountants, and one accounting firm lost such a lawsuit, resulting in a judgment of about $10 million.

RICO is hated and feared not only because of the monetary effect on a lawsuit; being characterized as "racketeers" is not good for a PAs business. When the RICO threat is included in a lawsuit, PAs are more eager to settle with the plaintiffs before trial, paying damages that might not be won in a courtroom.

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FEDERAL CRIME LEGISLATION PUTS ACCOUNTANTS AT RISK OF BEING PROSECUTED

Vancouver: Amendments to Canada's Criminal Code could jeopardize unwary financial professionals, legal experts warn.

Bill C-22, known informally as the "proceeds of crime" legislation, is so sweeping that unsuspecting accountants could be guilty of a criminal offence for simply giving advice, the lawyers say.

The proceeds of crime legislation, which is now contained in Part XII.2 of the Criminal Code, is based on American antiracketeering statutes and is designed to deprive criminals of their ill-gotten gains.

But, although the new law may seem well intentioned, Bill C-22 is so broadly worded that, if accountants know or even suspect that a client has illegal profits, they could be guilty of a crime if they act for that client.

The amendments contained in the Bill create two new offences—money laundering and possession of property derived through drug trafficking.

Money laundering is defined as dealing with any property with intent to conceal or convert it while knowing that it was derived as a result of a "designated drug offence" or an "enterprise crime."

The Criminal Code describes "designated drug offences" as virtually any drug infraction other than simple possession. "Enterprise crimes" are generally profit-motivated offences and include things such as bribery, fraud, gambling, and stock manipulation.

Under the criminal law doctrine of "wilful blindness," people are deemed to know they are dealing with the proceeds of crime if they are suspicious about the source of any property but choose to remain ignorant rather than make further inquiries.

The effect of the legislation is that accountants who accept any property, including fees, from a client, knowing or being wilfully blind to the fact the property was obtained illegally, could be charged with possession or laundering.

Problems could also arise if accountants become suspicious about a client's finances during an ongoing engagement. If they continue to act and their advice relates to property obtained through a crime, they could be committing an offence.

Accountants will be particularly vulnerable because they are often aware of the intimate details of a client's financial dealings.

Source: Brad Dusley, "Proposed federal crime legislation puts accountants at risk of being prosecuted," *The Bottom Line,* November 1990, p. 6. Reprinted with permission.

Other Issues

Fiduciary Duty of Accountants

Here, we discuss the fiduciary duty of accountants beyond when they act in the role of external auditors. According to an article by G. McLennan, a unique feature of Canadian common law that may precipitate a litigation crisis here is the expanding concept of accountants' fiduciary duty.[25] An accountant may be a fiduciary when he or she acts as a trustee, receiver, auditor, or simply an adviser to a vulnerable client. Simply assisting someone who is a fiduciary to another might make a PA liable, although this would only be the case where a PA knows the fiduciary relationship and knows it is being dishonestly breached.

Allegations of a breach of fiduciary duty have become increasingly common in lawsuits against accountants in Canada. If a court concludes that an accountant is a fiduciary, he or she may be held responsible for damages, even though (1) the PA's conduct did not cause the damage, (2) the plaintiff failed to take reasonable steps to mitigate those damages, or (3) the plaintiff was partially at fault or other third parties contributed to the damages suffered. Thus, a PA's common defences to a negligence action, such as contributory negligence, remoteness of damages, failure to mitigate, and no duty of care, do not apply to an action in breach of fiduciary duty.

Literally, fiduciary means "trust-like," but the term has been used in so many contexts in the courts that it is applied as if it related to, among other things, all breaches of duty by accountants. The closest thing to legal definition is that set forth in the Supreme Court of Canada decision concerning *LAC Minerals v. Corona Resources*. Here, the court stated there were three factors to consider when determining if a fiduciary duty exists:

1. The fiduciary has scope for the exercise of some discretion or power.
2. The fiduciary can unilaterally exercise that power or discretion so as to affect the beneficiary's legal or practical interests.
3. The beneficiary is peculiarly vulnerable to or at the mercy of the fiduciary, who is holding the discretion or power.

25 M. Paskell-Mede, "Adviser relationships," *CA Magazine*, May 1995, pp. 27–32.

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All three factors must exist to prove a fiduciary duty. An article by M. Paskell-Mede reviews several cases where such duty exists. Generally, when an accountant acts as a receiver/manager or trustee in insolvency situations, he or she owes a fiduciary duty to creditors of an insolvent corporation. If an accountant has an established relationship with one lender, it may be that it is a breach of fiduciary duty to also act as a trustee or receiver of the insolvent borrower. Accountants that act as financial advisers or tax advisers also have a fiduciary duty. Accountants that have successfully defended themselves in lawsuits involving breach of fiduciary duty have done so by showing that either factors 1 or 3 in the definition were not present.[26]

The lessons for auditors arising from their legal responsibilities can be summarized as follows in the box below.

LESSONS AUDITORS IGNORE AT THEIR OWN RISK

Litigation is an exacting and uncompromising teacher, but it provides auditors with some hard and useful lessons. The tuition is the high cost of malpractice insurance, legal fees, adverse court decisions, embarrassing publicity and stress.

- There is no substitute for knowledge of the client's business.
- There is no substitute for effective, ongoing, substantial supervision of the work of people assigned to the engagement.
- The partner-in-charge of the engagement must constantly emphasize the importance of integrity, objectivity, and professional skepticism in carrying out the audit.

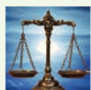
Source: W.D. Hall and A.J. Renner, "Lessons that auditors ignore at their own risk," *Journal of Accountancy,* July 1988, pp. 50–58.

Note: All material from the *Journal of Accountancy* appearing in this text is reprinted with permission from the American Institute of Certified Public Accountants, Inc. Opinions of the authors are their own and do not necessarily reflect policies of the AICPA.

26 M. Paskell-Mede, "Adviser Relationships," *CA Magazine,* May 1995, pp. 27–32.

APPLICATION CASE WITH ANALYSIS

Burden of Proof Concept in Law and Auditing



DISCUSSION CASE

In law, the "burden of proof" concept helps decide who wins at trial. The burden is normally on the plaintiff party. The reasoning in law is similar to that of critical thinking used in this book. In fact, legal reasoning has had a great impact on the argumentative aspects of critical thinking (step 4 in Exhibit 3–1). Under critical thinking, auditors have a burden of proof that must be satisfied on every audit engagement in order to be prepared to defend challenges to their decisions. This burden is reflected in auditing standards. What is the burden of proof on an audit engagement?

ANALYSIS

Auditors claim to provide high or reasonable evidential assurance on an audit engagement. In other words, they gather sufficient evidence so as to keep the risk of failing to detect material factual misstatements to an acceptable level.

The audit evidence responsibility—to be in conformity with audit evidence standards—is satisfied when evidence risk is acceptably low, and assurance (equals one minus evidence risk) is therefore acceptably high. This responsibility parallels burden of proof in civil law, which looks for "the balance of probabilities" or the "preponderance of evidence" acceptably high or reasonable. The meaning of these terms of civil law varies, depending on the context. For example, in commercial disputes, balance of probabilities means that if the evidence makes the plaintiff's position more likely to be true than the defendant's, then the plaintiff wins the case. On the other hand, the auditor's burden of proof is determined by the audit standards.

Civil burdens of proof are in sharp contrast to criminal law procedures, where the state must prove the guilt of the defendant "beyond a reasonable doubt" for a conviction. Applying both the concept of beyond a reasonable doubt and the courts' operating presumption that all are presumed innocent until proven guilty will result in an extremely remote chance of sending an innocent person to jail.

These distinctions can be important in defining auditor responsibility for detecting fraud, since fraud is a criminal act that falls under the criminal code. The O. J. Simpson

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trials can be used to illustrate the distinction. At his first trial in 1995, a criminal trial, Simpson was found not guilty of the charge of murdering his wife and her friend. That is, the jury was not convinced "beyond a reasonable doubt" that Simpson was guilty. The burden of proof was not met by the prosecution and the presumption of innocence was not overturned by the evidence presented at trial. But, at a civil trial in 1997, Simpson was found responsible for the wrongful deaths of both individuals and was required to pay a settlement of US$33.5 million. The facts and evidence were substantially the same, but the burden of proof is much lower for a plaintiff in a civil trial, so Simpson lost that case.

These cases have implications for auditors; even if they were able to meet the burden of proof of an audit engagement and provide high assurance that fraud took place, it does not mean the auditor can make an accusation of fraud. The fraud must be proved in criminal court. Moreover, auditors must be careful in the language they use to describe suspicions of fraud based on audit evidence. Auditors should always refer to the risks or evidence of fraud, not to proven fraud, lest they be sued for libel or slander. This is an important aspect of the context of audit engagements and the amount of responsibility auditors can take for detecting fraud. These responsibilities are discussed further in Chapter 7.

Burden of proof underlies the concept of audit assertions that will be introduced in Part II of this text. For these assertions, the auditor must obtain sufficient evidence on each audit that they are all reasonably true. Audit assurance is the same as "high" or "reasonable" assurance. Assurance relates to how sure the auditor is about the audit assertions. Thus, audit theory is closely tied to the burden of proof concept. However, not all possible assertions need to be given high assurance on an audit. The burden of proof for the auditor extends only to the assertions specified by GAAS. There are other assertions in financial reporting, such as the going-concern assumption and monetary-unit assumption of most reporting frameworks. The auditor is not required to prove these assumptions are true as assertions. Instead, the auditor assumes these assumptions are true unless there is evidence to the contrary during the engagement. If that is the case, then the auditor may need to take fairly drastic action, such as switching to another appropriate reporting framework. For example, if there is sufficient risk that the going-concern assumption is wrong, then the auditor may require that the client switch to a liquidation basis of accounting in order that the financial statements present fairly. This would be a fairly drastic and controversial action but, nevertheless, of increasing importance to auditors, as is reflected in continuing concerns about auditor failure to warn investors and the public about corporate failures and the need for government bailouts during the 2007–2009 financial crisis. The status of the going-concern assertion is discussed further in Chapter 19.

The monetary-unit assumption has not been questioned lately because of low inflation. However, when this assumption is violated by economic events, such as the high inflationary environment of the 1980s, then, again, auditors and accounting standards may require supplementary disclosures (i.e., using a different reporting framework), such as inflation-adjusted reporting as was common in the 1980s. These examples illustrate that the financial reporting environment is not static and can change rapidly. Users of financial statements expect auditors to be attuned to their needs and to take into account such environmental changes in selecting an acceptable reporting framework. The auditor obligations to (a) consider matching user needs with the financial reporting framework, in the particular circumstances; and (b) match the burden of proof with the relevant assertions, help explain why auditors need to be more critical thinkers if they are to maintain effectiveness in the 21st century.

Until Enron, the major source of liability for PAs was under common law, but Enron changed all that. The fatal damage to Arthur Andersen seems to have been caused by the SEC, which had charged the audit firm with securities fraud two years previously over its audit of Waste Management Company. It should be noted that SEC prosecutions are under statutory law. Arthur Andersen ultimately paid a $7 million fine in June 2001. This set the stage for the company's rapid loss of reputation when the Enron audit problems surfaced six months later. The company had already lost most of its big clients by the time of its conviction—which was overturned by the U.S. Supreme Court in 2005—and the accounting world was shocked and dazed by the speed of its disintegration.

Since Enron, the SEC appears to have become much more aggressive in imposing statutory legal liability. For example, on January 29, 2003, the SEC sued one of the Big Four firms for securities fraud, alleging that it let Xerox Corp. inflate pretax earnings by over $3 billion from 1997 to 2000. Xerox agreed to a record $10 million penalty to settle the SEC charges. By this point, Xerox had also dropped the PA firm as its auditor. After an investigation, this became SEC's first fraud case against a major accounting firm since Enron's collapse. The SEC alleged the following: "Instead of putting a stop to Xerox's fraudulent conduct, the PA firm defendants themselves engaged in fraud by falsely representing to the public that they had applied professional auditing standards to their review of Xerox's accounting." The PA firm vigorously and publicly defended its work, but the case illustrates that statutory law may become a bigger threat to the profession than common law liability, especially if reputational effects are taken into consideration.

It should be noted that under SEC law, securities fraud puts a greater burden of proof on the defendant PA, as outlined in this chapter, than is generally the case for fraud defendants, also discussed in this chapter. In addition, the SEC doctrine of "fraud on the market," which may be adopted by the OSC, increases PA liability to broader classes of potential plaintiffs.

In Ontario, Bill 198 was passed December 9, 2002, giving the Ontario Securities Commission potentially greater power in setting rules for appointing auditors than even SOX does. These events also suggest that statutory law

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liability may become a greater threat to the profession than common law liability.

However, there are few precedents to go by other than those already outlined. So, other than noting the potential changes in future liability in this introduction, this chapter focuses on the more traditional common law source of auditors' legal liability.

SUMMARY

- Litigation against accountants has greatly increased in Canada mirroring developments in the United States.
- Damage claims of hundreds of millions of dollars have been paid by PA firms and their insurers. Insurance is expensive and hard to obtain. The SEC has sued several of the largest accounting firms for securities fraud within the last decade. One of these firms, Arthur Andersen, paid fines of $7 million and later was convicted of "obstructing justice" and forced into bankruptcy. Accountants are not alone in this rash of litigation, which affects manufacturers, architects, doctors, and people in many other walks of life.
- The professional accounting organizations have joined with other interest groups pushing for "tort reform" of various types (e.g., limitation of damages, identification of liability) in an effort to stem the tide.
- Other effects of this climate take the form of changing the nature of organizations in which public accountants practice (such as to LLPs).
- Accountants' liability to clients and third parties under common law has expanded. Fifty years ago, a strict privity doctrine required other parties to be in a contract with and known to the accountant before they could sue for damages based on negligence. Of course, if an accountant was grossly negligent in such a way that his or her actions amounted to constructive fraud, liability exists as it would for anyone who committed a fraud.
- Over the years, the privity doctrine was modified in many jurisdictions, leading to liability for ordinary negligence to primary beneficiaries (known users) of the accountants' work product, and then to liability based on ordinary negligence to foreseen and foreseeable beneficiaries (users not so easily known).
- While the general movement has been to expand accountants' liability for ordinary negligence, some jurisdictions have held closer to the privity doctrine of the past. The treatment can vary from province to province.
- The last decade has brought increased risk of litigation arising from statutory law, especially in Ontario.
- There is increased liability and loss of reputation arising from laws against bribery, money laundering, and terrorist financing.
- The source of liability and burdens of proof are summarized in Exhibit 3–2 below.

EXHIBIT 3–2 Summary of Auditor Liabilities

SOURCE OF LAW	LIABILITY ARISING FROM	BURDEN OF PROOF
Common Law – Contractual Clients; Corporate Entity, not Shareholders	Breach of Contract Negligence Gross Negligence or Fraud	On Client On Client On Client
Common Law – Third Parties	Negligence Gross Negligence or Fraud	On Third Party non-shareholder On Third Parties including shareholders
Civil Liability Under Statutory Law (e.g. Ontario Securities Act)	Negligence Gross Negligence or Fraud Fraud on the Market	On Shareholder On Shareholder On Auditor in U.S., possible in Canada
Criminal Liability (i.e., auditor can be imprisoned)	Gross Negligence or Fraud	On Crown

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KEY TERMS

Canadian Securities Administrators (CSA)
consequentialism
critical thinking
critical-thinking framework
deontological (Kantian) ethics
ethical dilemma
imperatives
legal responsibilities
monistic theories
moral imagination
moral responsibilities
pluralistic theories
professional responsibilities (professional ethics)
professional skepticism
proportionate liability
tort
utilitarianism

EXERCISES AND PROBLEMS

EP 3-1 Independence, Integrity, and Objectivity Cases. LO3 Knowledge of the rules of conduct and related interpretations on independence, integrity, and objectivity will help you respond to the following cases.

Required:
For each case, state whether or not the action or situation shows violation of the rules of professional conduct, explain why, and cite the relevant rule or interpretation.

a. R. Stout, PA, performs the audit of the local symphony society. Because of her good work, she was elected an honorary member of the board of directors.

b. N. Wolfe, a retired partner of your PA firm, has just been appointed to the board of directors of Palmer Corporation, your firm's client. Wolfe is also an ex officio member of your firm's income tax advisory committee, which meets monthly to discuss income tax problems of the partnership's clients, some of which are competitors of Palmer Corporation. The partnership pays Wolfe $100 for each committee meeting attended and a monthly retirement benefit, fixed by a retirement plan policy, of $1000.

c. Archie Goodwin, PA, performs significant day-to-day bookkeeping services for Harper Corporation and supervises the work of the one part-time bookkeeper employed by Marvin Harper. This year, Marvin wants to engage PA Goodwin to perform an audit.

d. PA Fritz's wife owns 20% of the common shares of Botacel Company, which wants Fritz to perform the audit for the calendar year ended December 31, 20X4.

e. Fritz's wife gave her shares to their 10-year-old daughter on July 1, 20X4.

f. Fritz's daughter, acting through an appropriate custodian, sold the shares to her grandfather on August 1, 2007. His purchase, as an accommodation, took one-half of his retirement savings.

g. Fritz's father managed to sell the shares on August 15 to his brother, who lives in Brazil. The brother fled there 20 years ago and has not returned.

h. Clyde Brenner is a manager in the Regina office of a large national PA firm. His wife, Bonnie, is assistant controller in ATC Corporation, a client of the firm whose audit is performed by the New York office. Bonnie and Clyde live in Rhode Island and commute to their respective workplaces.

i. Clyde Brenner just received word that he has been admitted to the partnership.

j. The Rockhard Trust Company, a client of your firm, privately told your local managing partner that a block of funds would be set aside for home loans for qualified new employees. Rockhard's president is well aware that your firm experiences some difficulty hiring good people in the midsize but growing community and is willing to do what he can to help while mortgage money is so tight. Several new assistant accountants obtained home loans under this arrangement.

(AICPA adapted)

EP 3-2 Independence, Integrity, and Objectivity Cases. LO3 Knowledge of the rules of conduct, interpretations thereof, and related rulings on independence, integrity, and objectivity will help you respond to the following cases.

Required:
For each case, state whether or not the action or situation shows violation of the rules of professional conduct, explain why, and cite the relevant rule or interpretation.

a. Your client, Contrary Corporation, is very upset over the fact that your audit last year failed to detect an $800,000 inventory overstatement caused by employee theft and falsification of the records. The board discussed the matter and authorized its lawyers to explore the possibility of a lawsuit for damages.

b. Contrary Corporation filed a lawsuit alleging negligent audit work, seeking $1 million in damages.

c. In response to the lawsuit by Contrary, you decided to start litigation against certain officers of the company, alleging management fraud and deceit. You are asking for a damages judgment of $500,000.

d. The Allright Insurance company paid Contrary Corporation $700,000 under fidelity bonds covering the employees involved in the inventory theft. Both you and Contrary Corporation have dropped your lawsuits. However, under subrogation rights, Allright has sued your audit firm for damages on the grounds of negligent performance of the audit.

e. Colt & Associates, PAs, audit Gore Company. Ms. Colt and Bill Gore (president) found a limited real estate partnership deal that looked too good to pass up. Colt purchased limited partnership interests amounting to 23% of all such interests, and Gore personally purchased 31%. Unrelated investors held the remaining 46%. Colt and Gore congratulate themselves on the opportunity and agree to be passive investors with respect to the partnership.

f. A group of dissident shareholders filed a class-action lawsuit against both you and your client, Amalgamated Inc., for $30 million. They allege there was a conspiracy to present misleading financial statements in connection with a recent merger.

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g. PA Anderson, a partner in the firm of Anderson, Olds & Watershed (a professional accounting corporation), owns 25% of the common shares of Dove Corporation (not a client of AO&W). This year Dove purchased a 32% interest in Tale Company and is accounting for the investment using the equity method of accounting. The investment amounts to 11% of Dove's consolidated net assets. Tale Company has been an audit client of AO&W for 12 years.

h. Durkin & Panzer, PAs, regularly perform the audit of the North Country Bank, and the firm is preparing for the audit of the financial statements for the year ended December 31, 20X4.

i. Two directors of the North Country Bank became partners in D&P, PAs, on July 1, 20X4, resigning their directorship on that date. They will not participate in the audit.

j. During 20X4, the former controller of the North Country Bank, now a partner of D&P, was frequently called on for assistance regarding loan approvals and the bank's minimum chequing account policy. In addition, he conducted a computer feasibility study for North Country.

(AICPA adapted)

k. The Cather Corporation is indebted to a PA for unpaid fees and has offered to give the PA unsecured interest-bearing notes. Alternatively, Cather Corporation offered to give two shares of its common stock, after which 10,002 shares would be outstanding.

(AICPA adapted)

l. Johnny Keems is not yet a PA but is doing quite well in this first employment with a large PA firm. He has been on the job two years and has become a "heavy junior." If he passes the PA exam in September, he will be promoted to senior accountant. This month, during the audit of Row Lumber Company, Johnny told the controller about how he is remodelling an old house. The controller likes Johnny and has a load of needed materials delivered to the house, billing Johnny at a 70% discount—a savings over the normal cash discount of about $300. Johnny paid the bill and was happy to have the materials, which he otherwise would not have been able to afford on his meagre salary.

m. PA Lily Rowan inherited $1 million from her grandfather, $100,000 of which was the value of shares in the North Country Bank. Lily practises accounting in Hamilton, and several of her audit clients have loans from the bank.

n. Groaner Corporation is in financial difficulty. You are about to sign the report on the current audit when your firm's office manager informs you that the audit fee for last year has not yet been paid.

o. Your audit client, Glow Company, is opening a plant in a distant city. Glow's president asks that your firm's office in that city recruit and hire a new plant controller and a cost accountant.

EP 3-3 Rules of Professional Conduct LO2

Required:

For each of the following completely independent situations, describe the rules of professional conduct that are relevant. Have they been violated? Support your conclusion.

Situation A

Randi Woode, PA, was working on the year-end audit of her client, Pads N' Pens (PNP). PNP is an office stationery retailer with a July 31 year-end. She was having difficulty completing the audit because some accounting records for the months of April and May had been destroyed in a fire. She told the owner-manager of PNP, Joe Smith, that she might have to qualify her audit report because of her inability to substantiate some of the balances on the financial statements. Joe pointed out that he had been her client for eight years and that she knew him to be honest and trustworthy. He also said a qualified report would harm his negotiations with the bank for additional loans. After considering PNP's need for additional financing, as well as their long standing relationship, Randi agreed to issue an unqualified report.

Situation B

Lori Wilkes is an audit senior with a large PA firm in Toronto. She has learned that one of her largest clients, Superior Motors Ltd. (SML), is planning to acquire Steelco Inc. SML is Canada's largest automobile manufacturer, and Steelco is one of SML's biggest steel suppliers. Lori is confident that SML's acquisition of Steelco will reduce SML's costs dramatically, and that, as a result, SML's share price will rise. She has, therefore, encouraged her boyfriend, Tom, to buy some shares while being careful not to divulge the real reasons behind her recommendation.

Situation C

After obtaining his PA designation, Larry Wilde decided to set up his own public accounting practice. He reasoned that naming his practice "Quality Chartered Accountancy Services" would best attract new clients.

(ICAO adapted)

EP 3-4 Rules of Professional Conduct. LO2 In mid-May, Aileen Macdonald, PA, received a phone call from one of her largest clients, a manufacturer. The client wanted to know more details about the impact that the GST would have on his 20X4 operations and financial statements. When Aileen and the client had discussed the results of the 20X3 audit last February, part of their conversation had dealt with the tax. Aileen had indicated that she would be sending a newsletter about the tax by July 1.

Since February there had been more changes to the legislation, which Aileen and her partners had not had time to absorb. However, Aileen had registered for the annual June provincial conference, where she would attend the four technical sessions on the GST. She planned to ask questions about her client's situation during the question-and-answer periods that followed each session.

Aileen explained to the client that she would have more information within a month and would contact him then. At that time, she will ask the client for names of firms that might be interested in receiving her newsletter.

Required:

Which rules of professional conduct are relevant in the above situation? Discuss the rules with which Aileen Macdonald is in compliance as well as those she may have violated.

(ICAO adapted)

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EP 3-5 Common Law Liability Exposure. Smith, PA, is the auditor for Juniper Manufacturing Corporation, a privately owned company that has a June 30 fiscal year. Juniper arranged for a substantial bank loan, which was dependent on the bank's receiving, by September 30, audited financial statements showing a current ratio of at least 2 to 1. On September 25, just before the audit report was to be issued, Smith received an anonymous letter on Juniper's stationery indicating that a five-year lease by Juniper, as lessee, of a factory building that was accounted for in the financial statements as an-operating lease was in fact a capital lease. The letter stated that there was a secret written agreement with the lessor modifying the lease and creating a capital lease.

Smith confronted the president of Juniper, who admitted that a secret agreement existed but said it was necessary to treat the lease as an operating lease to meet the current ratio requirement of the pending loan and that nobody would ever discover the secret agreement with the lessor. The president said that, if Smith did not issue his report by September 30, Juniper would sue Smith for substantial damages that would result from not getting the loan. Under this pressure and because the working papers contained a copy of the five-year lease agreement supporting the operating lease treatment, Smith issued his report with an unqualified opinion on September 29. In spite of the fact that the loan was received, Juniper went bankrupt. The bank is suing Smith to recover its losses on the loan and the lessor is suing Smith to recover uncollected rents.

Required:

Answer the following, setting forth reasons for any conclusions stated:

a. Is Smith liable to the bank?

b. Is Smith liable to the lessor?

c. Was Smith independent?

(AICPA adapted)

EP 3-6 Litigation Resulting from Bankruptcy of Client. A bank that lent considerable funds to a "high-flying" and, until its recent bankruptcy, highly successful real estate development company has hired your firm to investigate the company's long-time auditors, a-medium-sized PA firm. The bank has claimed that the financial statements did not fairly represent the company's financial position. The senior partner in your firm in charge of the investigation has been provided with full access to the complete working papers of the initial auditor in order to complete the investigation. If the matter ultimately goes to court, the case will likely be very high in profile and will likely receive significant media coverage.

The senior partner in your firm has assigned you, a manager with considerable auditing experience, to assist him in evaluating the auditors' quality of work and actions.

Required:

a. Outline what you would do to help your senior partner prepare for the investigation. You should give details of those items he should consider in his preparation as well as the guidelines that would be used to develop an opinion as to the appropriateness of the auditors' actions.

b. On what basis (bases) will the court decide the auditors' liability in this situation?

(ICAO adapted)

DISCUSSION CASES

DC 3-1 General Ethics. LO1 Is there any moral difference between a disapproved action in which you are caught and the same action that never becomes known to anyone else? Do many persons in business and professional society make a distinction between these two circumstances? If you respond that you do (or do not) perceive a difference while persons in business and professional society do not (or do), then how do you explain the differences in attitudes?

DC 3-2 Ethics Decision Problem. LO1 You are treasurer of a church. A member approaches you with the following proposition: "I will donate shares to the church on December 31, if, on January 1, you will sell them back to me. All you will need to do is convey the certificate with your signature to me in return for my cheque, which will be for the asking price of the shares quoted that day without reduction for commissions."

The member's objective, of course, is to obtain the income tax deduction as of December 31, but he wants to maintain his ownership interest. The policy of the church board is not to hold any shares but to sell shares within a reasonably short time.

Required:

a. Should the treasurer accommodate the member? Would you if you were treasurer?

b. Would your considerations and conclusions be any different if the church

1. was financially secure and the gift was small?
2. was financially secure and the gift was large?
3. would be in deficit position for the year were it not for the gift?

DC 3-3 Competition and Audit Proposals. LO2 Accounting firms are often asked to present "proposals" to companies' boards of directors. These proposals are comprehensive booklets, accompanied by oral presentations, telling about the firm's personnel, technology, special qualifications, and expertise in hope of convincing the board to award the work to the firm.

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Dena has a new job as staff assistant to Michael, chairman of the board of Granof Grain Company. The company has a policy of engaging new auditors every seven years. The board will hear oral proposals from 12 accounting firms. This is the second day of the three-day meeting. Dena's job is to help evaluate the proposals. Yesterday, the proposal by Anderson, Olds & Watershed was clearly the best.

Then Dena sees Michael's staff chief, a brash go-getter, slip a copy of the AOW written proposal into an envelope. He tells Dena to take it to a friend who works for Hunt and Hunt, a PA firm scheduled to make its presentation tomorrow. He says, "I told him we'd let him glance at the best proposal." Michael is absent from the meeting and will not return for two hours.

What should Dena do? What should PA Hunt do if he receives the AOW proposal, assuming he has time to modify the Hunt and Hunt proposal before tomorrow's presentation?

DC 3-4 Engagement Timekeeping Records. LO2 A time budget is always prepared for audit engagements. Numbers of hours are estimated for various segments of the work—for example, internal control evaluation, cash, inventory, report review, and the like. Audit supervisors expect the work segments to be completed within budget, and staff accountants' performance is evaluated in part on ability to perform audit work efficiently within budget.

Sarah is an audit manager who has worked hard to get promoted. She hopes to become a partner in two or three years. Finishing audits on time weighs heavily on her performance evaluation. She assigned the cash audit work to Craig, who has worked for the firm for 10 months. Craig hopes to get a promotion and salary raise this year. Twenty hours were budgeted for the cash work. Craig is efficient, but it took 30 hours to finish because the company had added seven new bank accounts. Craig was worried about his performance evaluation, so he recorded 20 hours for the cash work and put the other 10 hours under the internal control evaluation budget.

What do you think about Craig's resolution of his problem? Was his action a form of lying? What would you think of his action if the internal control evaluation work was presented "under budget" because it was not yet complete, and another assistant was assigned to finish that work segment later?

DC 3-5 Audit Overtime. LO2 All accountants' performance evaluations are based in part on their ability to do audit work efficiently and within the time budget planned for the engagement. New staff accountants, in particular, usually have some early difficulty learning speedy work habits, which demand that no time be wasted.

Elizabeth started work for Anderson, Olds & Watershed in September. After attending the staff training school, she was assigned to the Rising Sun Company audit. Her first work assignment was to complete the extensive recalculation of the inventory compilation, using the audit test counts and audited unit prices for several hundred inventory items. Her time budget for the work was six hours. She started at 4 p.m. and was not finished when everyone left the office at 6 p.m. Not wanting to stay downtown alone, she took all the necessary working papers home. She resumed work at 8 p.m. and finished at 3 a.m. The next day, she returned to the Rising Sun offices, put the completed working papers in the file, and recorded six hours in the time budget/actual schedule. Her supervisor was pleased, especially about her diligence in taking the work home.

What do you think about Elizabeth's diligence and her understatement of the time she took to finish the work? What if she had received help at home from her husband? What if she had been unable to finish and had left the work at home for her husband to finish while he took off a day from his job interviews?

DC 3-6 Form of Practice, Technical Standards, and Confidentiality. LO2 Knowledge of the rules of conduct and interpretations thereof will help you respond to this case problem.

Gilbert and Bradley formed a corporation called Financial Services Inc. Each took 50% of the authorized common shares. Gilbert is a PA and a member of the provincial institute. Bradley is a CPCU (Chartered Property Casualty Underwriter). The corporation performs auditing and tax services under Gilbert's direction and insurance services under Bradley's supervision. The opening of the corporation's office was announced in a full-page advertisement in the local newspaper.

One of the corporation's first audit clients was the Grandtime Company. Grandtime had total assets of $600,000 and total liabilities of $270,000. In the course of the audit, Gilbert found that Grandtime's building with a book value of $240,000 was pledged as a security for a 10-year term note in the amount of $200,000. The client's statement did not mention that the building was pledged as security for the 10-year term note. However, as the failure to disclose the lien did not affect either the value of the assets or the amount of the liabilities, and the audit was satisfactory in all other respects, Gilbert rendered an unqualified opinion on Grandtime's financial statements. About two months after the date of his opinion, Gilbert learned that an insurance company was planning to lend Grandtime $150,000 in the form of a first-mortgage note on the building. Realizing the insurance company was unaware of the existing lien on the building, Gilbert had Bradley notify the insurance company of the fact that Grandtime's building was pledged as security for the term note.

Shortly after the events described above, Gilbert was charged with several violations of professional ethics.

Required:

Identify and discuss the rules of professional conduct violated by Gilbert and the nature of the violations.

(AICPA adapted)

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DC 3-7 Another Milestone Lawsuit Against Auditors. LO3 **The Unexpected Failure of Lehman Brothers.** The failure of Lehman Brothers bank on September 15, 2008, created the largest bankruptcy in U.S. history and the global financial crisis that followed. There was no indication of going concern problems in Lehman's financial reporting before it filed for bankruptcy. To say that the markets were surprised by its bankruptcy would be an understatement. The state of New York is pursuing a lawsuit against the audit firm seeking to recover $150 million dollars in fees earned. Many investors are also suing the audit firm. The audit firm publicly claimed that the financial statements of Lehman were "in accordance with GAAP." The audit firm tried to get legal jurisdiction changed to U.S. federal court in hopes of a better outcome. On March 22, 2012, the case was moved from the federal court back to the New York state court because it was not within federal jurisdiction. This is not good news for the audit firm or the profession.

With some additional research, discuss the similarities of the Lehman Bros. case with that of Continental Vending, also discussed in this chapter.

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CHAPTER 4

Reports on Audited Financial Statements

This chapter covers the most frequent variations in audit reports. Management has primary responsibility for the fair presentation of financial statements in conformity with generally accepted accounting principles. Auditors have primary responsibility for their own audit reports of the financial statements. As a starting point, you must have knowledge of the standard unmodified opinion audit report. This chapter then discusses changes necessary to the standard language when auditors cannot give a "clean opinion."

EcoPak Inc.

A few years have passed, and EcoPak's biomass-based food packaging business is doing very well and looking to further expand. Kam and Mike are considering taking EcoPak public, and Nima suggests they start by finding an auditor, since they will need several years of audited financial statements for their initial public offering (IPO). Nima recommends an acquaintance, Ella Foure, an audit partner from the firm Pettit and Foure (P&F).

Ella meets with Kam and Mike. They are very impressed by her expertise. She is very knowledgeable about their products and industry, as she has been on the Environmental Stewardship Board and has other audit clients in startup biotechnology businesses. Kam is so impressed that he asks Ella if she could appear in one of EcoPak's promotional videos to endorse the profit potential of their new product line: "If you are our auditor and also promote our products, it will send a really powerful message to prospective customers and investors!" Ella explains that if she were to do that she could not also be their auditor as she is then associated with EcoPak and its information. Under the ethics rules, she should not "advocate" for audit clients because it would impair her independence. For example, if she makes a claim about a new product and that product turns out to be a failure, it would be hard for her to be unbiased about reporting that she was wrong.

Ella gets back to talking about an audit engagement by asking about the company's information systems. Mike tells Ella about some problems they experienced in the past year. Their inventory system became corrupted and records for three months of transactions were lost. But the inventory and profit numbers are up, so Mike does not think there is any need to investigate or try to recreate those records. Ella finds this troubling, since she does not know Mike well and it sounds like they might be

LEARNING OBJECTIVES

After completing this chapter, you will be able to do the following:

LO1 Describe the association framework.

LO2 Determine whether a public accountant (PA) is associated with financial statements.

LO3 Describe the three levels of assurance.

LO4 Compare and contrast the scope and opinion paragraphs in an independent auditor's report.

LO5 For a given set of accounting facts and audit circumstances, analyze qualified, adverse, and disclaimer audit reports.

LO6 Determine the effects of materiality and uncertainty on audit report choices.

CHAPTER APPENDICES

Appendix 4A: The PCAOB/AICPA Standard Unqualified Report

Appendix 4B: Reporting on the Application of Accounting Principles

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trying to manipulate the financial records. But she sets that suspicion aside until she gets more familiar with things.

If EcoPak's system problem was unintentional and she cannot find an alternative means of getting audit evidence, Ella explains to Kam and Mike that they probably will get a qualified audit opinion because this is a scope limitation. If there is some way she can find alternate evidence to support the year-end numbers, however, an unmodified audit opinion might be given. Now Mike is really starting to get confused: "What would be wrong with a 'qualified opinion'? Isn't that a good thing—what we would want from a licensed auditor like you?" Ella explains that the term qualified is used in a special way by auditors. To auditors, it means that the auditor's opinion on the reliability of the financial statements is restricted or limited in some way. In this case, it is restricted by an inability to find all the records that they may need to be reasonably sure a material misstatement is not present in the inventory account or transactions.

On further questioning, Ella realizes that EcoPak's systems are really inadequate for the volume of business, and that the company is probably not auditable at this time. She suggests that EcoPak consider bringing in some information technology (IT) consultants to set up appropriate business processes, a reliable information system, and internal controls. It may be feasible and beneficial to have P&F perform a different type of assurance engagement this year, such as a review engagement. A review type of engagement provides only moderate assurance, not high assurance like an audit, so it requires less evidence than an audit. The IT system deficiency may allow the negative assurance type of opinion provided by a review engagement, as long as EcoPak's year-end numbers make sense. That will also give Ella a good basis for starting the audit in the following year, since she will already have a good knowledge of EcoPak's business, and its systems and internal control will be more reliable. Kam and Mike think this is a good plan to help them continue to grow their business, and thank Ella for all her advice. They decide to go ahead with her suggestions.

THE ASSOCIATION FRAMEWORK

LO1 Describe the association framework.

The public accounting services covered in this chapter are part of the broadest concept of auditor involvement with a business enterprise's information—that of association. **Association** is a term used within the profession to indicate a public accountant's involvement with an enterprise or with information issued by that enterprise. General standards for association are covered in the *CICA Handbook*. At the time of writing, there were comparable international standards on association but they are not in the Canadian Auditing Standards (CASs).

association: a term used within the profession to indicate a public accountant's involvement with an enterprise or with information issued by that enterprise

Association can arise in three ways:

1. Through some action, the PA associates himself or herself with information issued by the enterprise.
2. Without the PA's knowledge or consent, the enterprise indicates that the PA was involved with information issued by them.
3. A third party assumes the PA is involved with information issued by an enterprise.

According to paragraph 5020.04, a public accountant associates himself or herself with information when they either perform services or consent to the use of their name in connection with that information. When associated with information, a PA's professional responsibilities include the following:

1. Applicable standards in the *CICA Handbook* must be met.
2. The PA complies with the appropriate rules of professional conduct.
3. There is appropriate communication of the extent of their involvement with the information.

The PA should ensure that the information they are associated with is accurate, accurately reproduced, and not misleading. If the client attempts to make inappropriate use of his name, the PA should amend the information or get legal advice.

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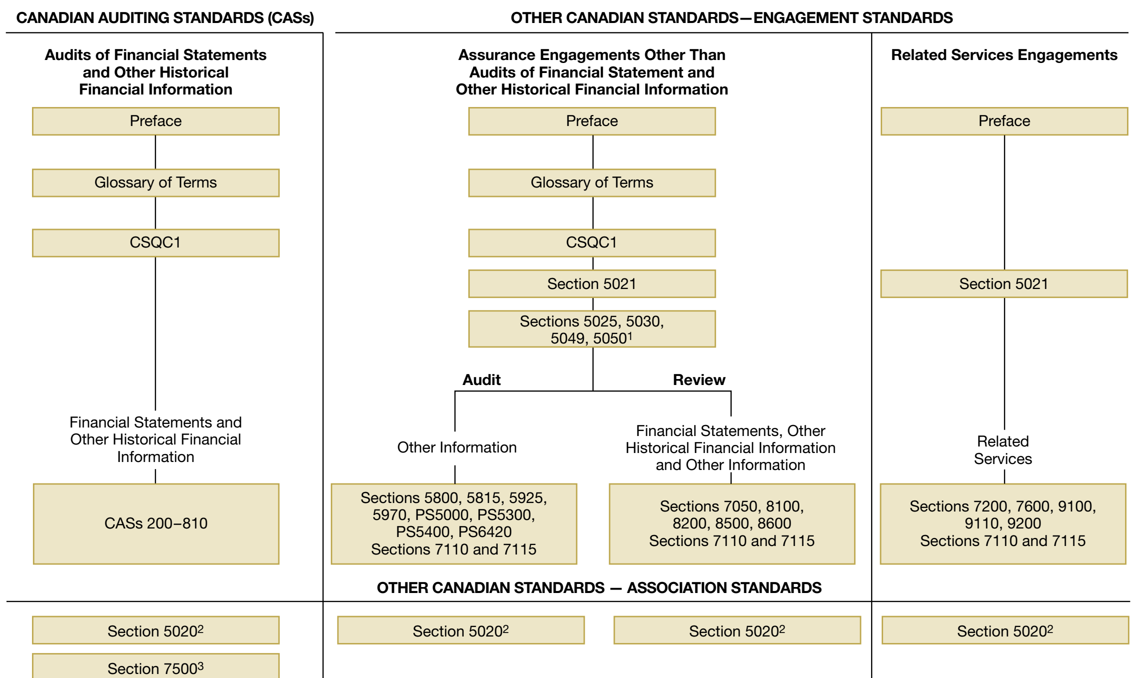
Exhibit 4–1 provides a framework illustrating the relationships between various types of engagements and *CICA Handbook* sections, including CASs. As a result of the changes to public accounting brought on by section 5025, the concept of association had to be revised to incorporate the assurance framework. Further revisions were required with adoption of CASs. CASs are for now viewed outside the association framework. The association responsibilities are illustrated in section 5020.A.

EXHIBIT 4–1 Overview of the *CICA Assurance Handbook*



[1] USING THE WORK OF INTERNAL AUDIT IN ASSURANCE ENGAGEMENTS OTHER THAN AUDITS OF FINANCIAL STATEMENTS AND OTHER HISTORICAL FINANCIAL INFORMATION. Section 5050, provides guidance on using the work of internal audit in carrying out an audit engagement other than an audit of financial statements and other historical financial information. The guidance may be useful for other types of engagements.

[2] ASSOCIATION, Section 5020, provides guidance on the public accountant's association with information, which may occur irrespective of the type of engagement.

[3] AUDITOR ASSOCIATION WITH ANNUAL REPORTS, INTERIM REPORTS, AND OTHER PUBLIC DOCUMENTS. Section 7500, provides guidance on the auditor's responsibilities, after the completion of the audit of the entity's financial statements, when the auditor agrees to consent to the use of the auditor's report in connection with a designated document.

Source: Preface to *CICA Handbook—Assurance,* Appendix 4.

Revising the concept of association meant that changes to PAs' responses to various client actions were also necessary. Their responsibilities concerning information or subject matters they are inappropriately associated with are summarized on the decision tree in the second box relating to section 5020.A.

Exhibit 4–1 provides a preliminary version of the evolving association framework for all assurance engagements. The CASs are also part of an assurance framework like that covered in section 5025. Many of the other types of engagements are covered in Chapter 21 (available on Connect). In the next section, we deal with determination and obligations of association.

LO2 Determine whether a PA is associated with financial statements.

associated with financial statements: any involvement of a public accountant with financial statements issued by a client

Association with Financial Statements

Auditing standards require a report in all cases where a PA's name is **associated with financial statements**. As a PA, you are associated with financial statements when (1) you

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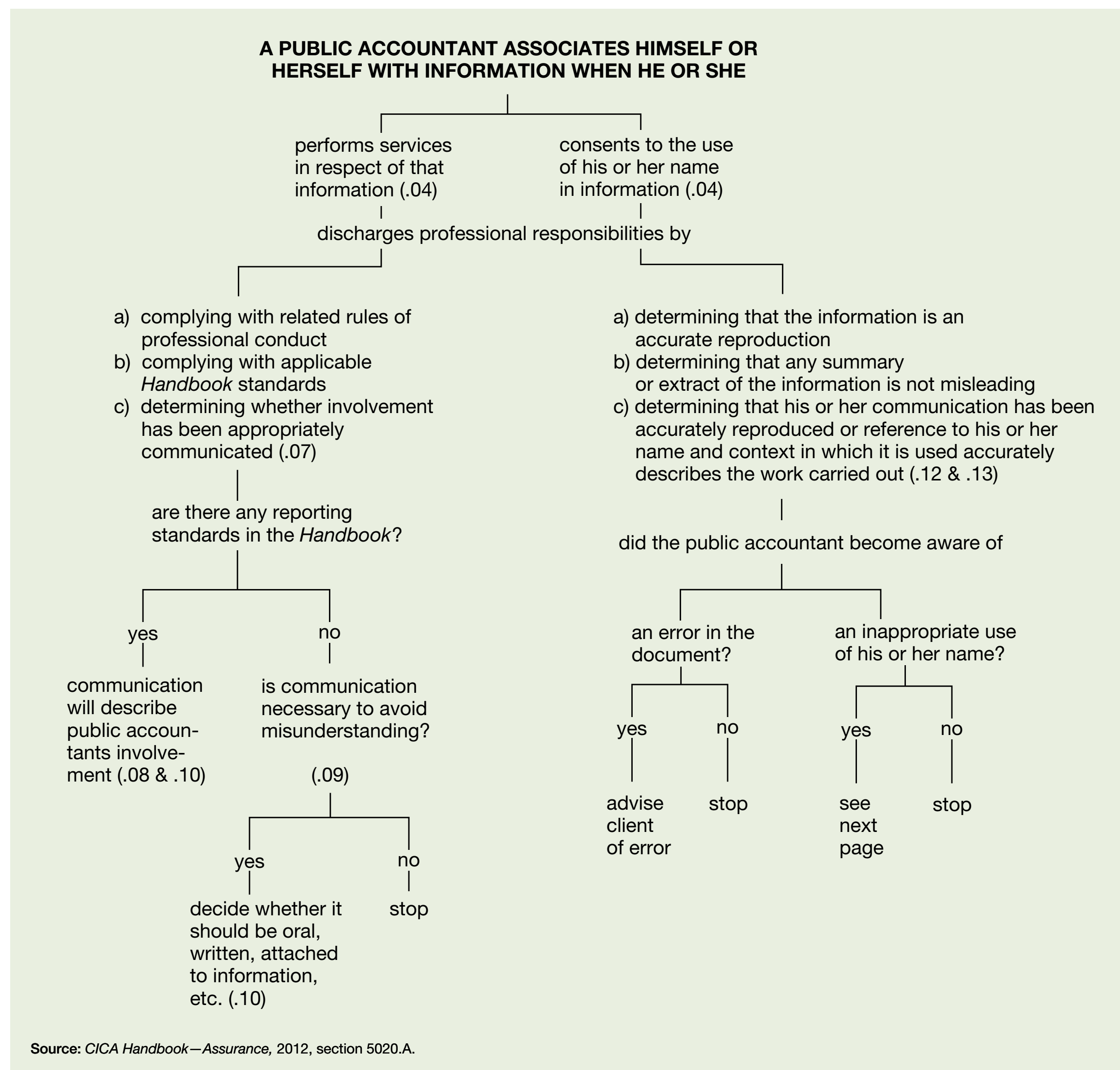
have consented to the use of your name in connection with them, or (2) you have prepared or performed some other services with respect to them, even if your name is not used in any written report. This is covered in the *CICA Handbook,* paragraph 5020.04.



Source: *CICA Handbook—Assurance,* 2012, section 5020.A.

The concept of association is far reaching with respect to financial statements. A PA is associated with them when (1) these are merely reproduced on their letterhead, (2) they are produced by their computer as part of a bookkeeping service, or (3) a document containing financial statements merely identifies them as the public accountant or auditor for the company. A report is required in these cases of association because most users of financial statements will assume that an audit has been conducted and that “everything is OK” on the basis of the involvement. Consequently, an obligation exists to inform the users about the nature of the work performed, if any, and the conclusions the PA has made about the financial statements. These responsibilities are summarized in the preceding and

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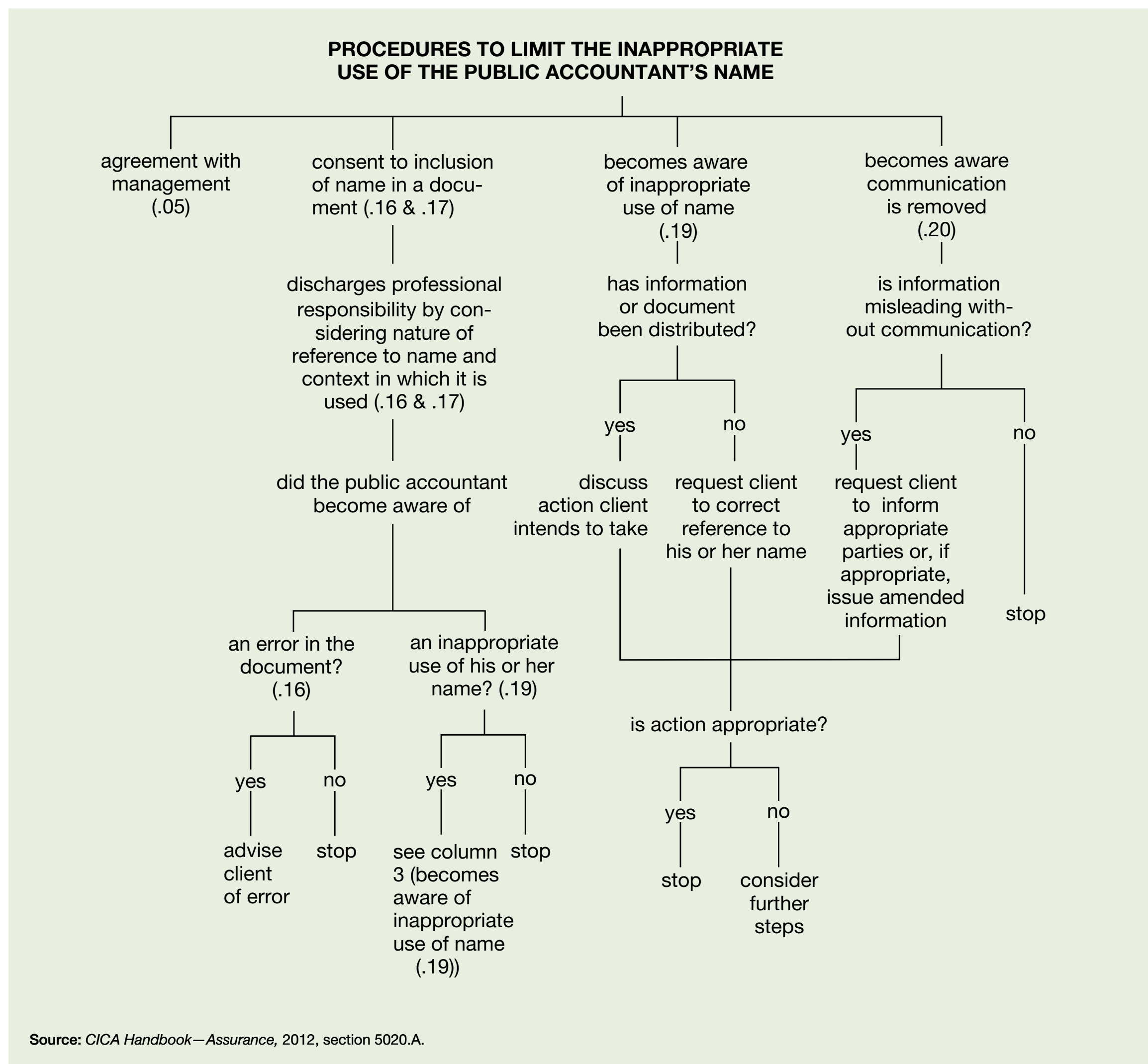
following boxes. Note that these responsibilities arise from potential legal liability due to misunderstandings of the nature of a PA's engagement. Many users, including the client, tend to assume that the PA involvement with financial information constitutes an audit. A good illustration is talk to your friends who have not taken an auditing course and ask them what they think "association" with a PA means. Association rules exist to clarify the role of a PA in an engagement, especially to third parties. Also, note that the focus of association rules is to reduce the risk that third parties will be misled by the nature of the PA's involvement. This reflects that unique obligation PAs have to third-party users of their work, discussed in Chapter 3. The existence of these rules indicates the overriding importance of PA responsibilities to third parties that dominates much of the reasoning of audit engagements.

The next section outlines the various levels of assurance that are possible in PA engagements. We then discuss the audit reports that result from an audit of financial statements—the main audit covered in this text.



Source: *CICA Handbook—Assurance,* 2012, section 5020.A.

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REVIEW CHECKPOINTS

4-1 Why should PAs issue a report whenever they are associated with financial statements?

Levels of Assurance

LO3 Describe the three levels of assurance.

In practice, accountants and auditors can render three types of conclusions, or **levels of assurance**, about financial statements. The highest level of assurance is the standard unmodified report, sometimes referred to as the **clean opinion**. Its opinion sentence reads, "In our opinion, the accompanying financial statements present fairly, in all material respects." This opinion sentence is sometimes called **positive assurance** because it is a forthright and factual statement of the PA's opinion based on an audit. Positive assurance is also frequently referred to as *reasonable* or *high assurance* in the *CICA Handbook*. The IFAC International Framework for Assurance Engagements refers to reasonable assurance also, noting that it is higher than moderate assurance.

levels of assurance: the amount of credibility provided by accountants and auditors

clean opinion: the highest level of assurance with an opinion sentence that reads, "In our opinion, the accompanying financial statements present fairly, in all material respects"

Current CASs cover only high assurance engagements; hence the old *CICA Handbook* sections still apply for the other engagement conclusions. The middle level, known as **negative assurance (moderate assurance)**, is typical in the review report of unaudited financial statements. Its opinion would read, "Based on my review, nothing has come to my attention that causes me to believe that these financial statements are not, in all material respects, in accordance with Canadian generally accepted accounting principles," as per paragraph 8200.42 of the *CICA Handbook*. This conclusion is called *negative* because it uses the backdoor phrase "nothing has come to my attention" to give assurance about conformity with generally accepted accounting principles (GAAP). Auditing standards prohibit the use of negative assurance in reports on audited financial statements because it is considered too weak a conclusion for the audit effort involved (CAS 700, paragraph 11). However, it is permitted in reviews of unaudited financial statements, in letters to underwriters, and in reviews of interim financial information. (More details about review reports on unaudited financial statements are found in Chapter 17.)

positive assurance: a high, but not absolute, level of assurance; also referred to as reasonable assurance in the context of audit reporting

STANDARDS CHECK

CAS 700

35. When expressing an unmodified opinion on financial statements prepared in accordance with a fair presentation framework, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following phrases, which are regarded as being equivalent:

(a) The financial statements present fairly, in all material respects, . . . in accordance with [the applicable financial reporting framework]; or

(b) The financial statements give a true and fair view of . . . in accordance with [the applicable financial reporting framework]. (Ref: Para. A27–A33)

Source: *CICA Handbook—Assurance*, 2012.

The lowest level of assurance is a **no assurance** engagement. Engagements in which no assurance is provided are not assurance engagements. The most common examples of non-assurance engagements involving financial statement information are compilation engagements and specified procedures engagements. The practitioner is, therefore, not expressing a conclusion on the reliability of the statements. Their involvement presumably adds accounting credibility to the financial statements even though there is no supporting evidence or audit assurance provided. For example, accounting credibility includes the use of correct account titles and format in the financial statements, but there is no verification of the accuracy of the underlying accounting records. (More details about compilation reports on unaudited financial statements are provided in Chapter 17.)

negative assurance (moderate assurance): statement that, having carried out a professional engagement, nothing has come to the public accountant's attention that would give reason to believe that matters under consideration do not meet specified suitable criteria

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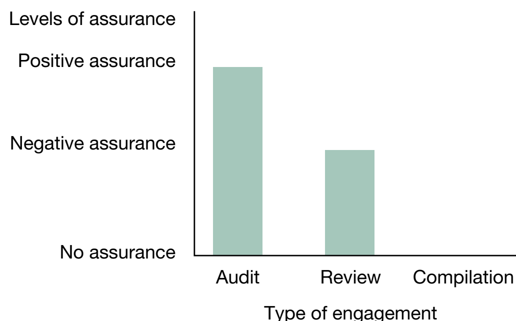
no assurance: the PA provides zero assurance credibility because there is no independent verification of the data provided by the client; for example, compilation engagement

The professional credibility in accounting and tax services provided by PAs is the main reason for the rules of association. These rules provide guidance on avoiding association with misleading information and, thereby, assist in maintaining the reputation of the public accounting profession. The levels of assurance are shown in Exhibit 4–2. It should be noted that audit, review, and compilation engagements are intended to provide the specified assurance levels given in Exhibit 4–2. As we will see when discussing the disclaimer of opinion, under some conditions not even an audit engagement can provide much assurance.

The most important aspect of the concept of assurance levels is that it reflects the separate levels of evidence which the PA has gathered to support the conclusions in the various types of assurance engagements. Compilation engagements provide no assurance because the PA is required to gather less evidence. The reason compilations are considered a no assurance engagement is because PAs are not required to gather any evidence on the financial information. In any of these engagements, however, a PA's responsibility is to not be associated if they become aware that there is a reporting deficiency associated with the financial information. We cover PA responsibilities for review and compilations in more detail in Chapter 17.

EXHIBIT 4–2 Levels of Assurance



REVIEW CHECKPOINTS

4-2 What is the most important distinction between an auditor's opinion on financial statements and other PA communications?

4-3 What is negative assurance? When is negative assurance permitted?

4-4 What is the difference between assurance and accounting credibility?

AUDITOR'S REPORTS AND VARIATIONS

LO4 Compare and contrast the scope and opinion paragraphs in an independent auditor's report.

In this section, we cover the various audit reports on management's financial statements. There are two broad categories: the standard unmodified report covered in CAS 700 and report reservations.

The standard unmodified report contains four basic segments: (1) introductory paragraph, (2) management (or other preparer) responsibility paragraph, (3) auditor responsibility paragraphs, and (4) opinion paragraph. An example is given in Exhibit 4–3. The technical details of this report were introduced in Chapter 2. The equivalent report used in the United States is given in Appendix 4A and is quite similar to the report used in Canada for audits before December 14, 2010.

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EXHIBIT 4–3 Independent Auditor's Report

To the Shareholders of ....

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity, and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements present fairly, in all material respects (or "give a true and fair view of,") the financial position of ABC Company as of December 31, 20X1, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

City (signed)........................

Date PUBLIC ACCOUNTANT

Source: *CICA Handbook—Assurance,* 2012, CAS 700 (adapted from Appendix, Illustration 1).

Meaning of the Introductory, Scope, and Opinion Paragraphs

Many users understand the audit report by counting the paragraphs! Crude as this may seem, it makes some sense because each of the six standard paragraphs is supposed to convey the same message on all audits. The first place most analysts look in the client's annual report is the audit report, as any major problems in using the financial statements should be identified there.

Introductory Paragraph

The introductory paragraph declares that an audit has been conducted and identifies the financial statements. These identifications are important, because if a financial statement is not identified in this introductory paragraph, the opinion paragraph at the end likewise does not offer any opinion on it.

Management's Responsibility Paragraph

The second paragraph gives notice of management's (or other preparer's) responsibility to prepare the financial statements in conformity with a fair presentation reporting framework. This includes designing, implementing, and maintaining internal control; selecting and applying appropriate accounting policies; making accounting estimates that are reasonable in the circumstances; and primary responsibility for avoiding fraudulent financial reporting.

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STANDARDS CHECK

CAS 210

CA8a. In Canada, incorporating or other governing legislation often specifies that generally accepted accounting principles be used when preparing general purpose financial statements. Such legislation usually indicates that generally accepted accounting principles means "the standards set out in the Handbook of The Canadian Institute of Chartered Accountants." The Handbook contains the accounting standards promulgated by the Accounting Standards Board and the Public Sector Accounting Standards Board. In Canada, these standards are generally accepted and are relevant in determining the acceptability of the applicable financial reporting framework even when incorporating or other governing legislation does not specify that generally accepted accounting principles be used when preparing general purpose financial statements. [This is a Canadian-only paragraph. There is no equivalent paragraph in corresponding ISA 210.]

CA8b. Some legislation and regulation also permits certain reporting issuers to use International Financial Reporting Standards, promulgated by the International Accounting Standards Board, or United States generally accepted accounting principles, promulgated by the US Financial Accounting Standards Board.

Note: This is a Canadian-only paragraph. There is no equivalent paragraph in corresponding ISA 210.

Source: *CICA Handbook—Assurance*, 2012.

Auditor's Responsibility Paragraphs

Auditors must render a fair presentation of their own work, as well as an opinion on the financial statements. These paragraphs, also referred to as the scope paragraphs, are the auditor's report of the character of the work in the audit. This portion of the report is vitally important for disclosure of the quality and extent of the audit itself. Note that it makes explicit the auditor's responsibility to detect fraudulent reporting, abide by ethical standards, and appropriately support the opinion with audit evidence.

The sentence "We conducted our audit in accordance with Canadian generally accepted auditing standards" refers primarily to the general and the examination standards. Its message is that (1) the auditors were trained and proficient, (2) the auditors were independent, (3) due professional care was exercised, (4) the work was planned and supervised, (5) a sufficient understanding of the internal control structure was obtained, and (6) sufficient appropriate evidential matter was obtained. To the extent that one or more of these standards is not actually satisfied during an audit, the scope paragraphs must be qualified. A qualification means that an explanation of exactly which standard was not satisfied is added. In practice, auditors always change the standard opinion paragraph language when the scope paragraph is qualified.

The scope paragraphs contain general descriptions of the audit work in addition to the reference to Canadian auditing standards. They make special mention of the auditors' assessment of the choice of accounting principles and the evaluation of the overall financial statement presentation. It also lists any conditions that prevented the auditor from getting sufficient appropriate evidence, things that might also be areas for improvement in the client's system of recordkeeping.

Opinion Paragraph

Users of audited financial statements are generally most interested in the opinion paragraph, which is actually one long sentence. This sentence contains the auditors' conclusions about the financial statements. It is the public manifestation of the private audit decision process.

The following reporting standards are incorporated in the opinion sentence:

1. The standard report states that the financial statements are presented fairly in all material respects in accordance with generally accepted accounting principles, such as IFRS or Canadian Accounting Standards for Private Enterprises (ASPE). Under CAS 700, general purpose financial statements using such GAAP are deemed capable of achieving fairness of presentation under certain conditions. General purpose financial reporting implies broad principles that are a basis for developing and applying policies

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consistent with the concepts underlying the requirements of the framework. Such a framework is also referred to as an "acceptable financial reporting framework," and it provides a proper context for evaluating fairness of presentation (CAS 210). Note that in the Exhibit 4–3 version of the report, the opinion paragraph has two options regarding fairness of presentation—the traditional one (present fairly) and the "true and fair" wording common in Europe.

2. The standard report, by its silence, regards the financial statement disclosures as reasonably adequate. This is part of the fairness criteria noted in item 1.
3. The standard report contains an expression of opinion regarding the financial statements.
4. An overall opinion is expressed in the standard report, so reasons for not doing so need not be stated.

STANDARDS CHECK

CAS 210

6. In order to establish whether the preconditions for an audit are present, the auditor shall:
   (a) Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable; and (Ref: Para. A2–A10)

A2. For purposes of the CASs, the applicable financial reporting framework provides the criteria the auditor uses to audit the financial statements, including where relevant, their fair presentation.

A3. Without an acceptable financial reporting framework, management does not have an appropriate basis for the preparation of the financial statements and the auditor does not have suitable criteria for auditing the financial statements.

CAS 210

A4. Factors that are relevant to the auditor's determination of the acceptability of the financial reporting framework to be applied in the preparation of the financial statements include:
- The nature of the entity (for example, whether it is a business enterprise, a public sector entity or a not-for-profit organization);
- The purpose of the financial statements, (for example, whether they are prepared to meet the common financial information needs of a wide range of users or the financial information needs of specific users) [*Note: These are called "general purpose frameworks" and "special purpose frameworks," respectively.*];
- The nature of the financial statements (for example, whether the financial statements are a complete set of financial statements or a single financial statement); and For example, whether the financial statements are a complete set of financial statements or a single financial statement); and
- Whether law or regulation prescribes the applicable financial reporting framework.

CAS 210

A8. At present, there is no objective and authoritative basis that has been generally recognized globally for judging the acceptability of general purpose frameworks. In the absence of such a basis, financial reporting standards established by organizations that are authorized or recognized to promulgate standards to be used by certain types of entities are presumed to be acceptable for general purpose financial statements prepared by such entities . . . Examples of such financial reporting standards include:
- International Financial Reporting Standards, and
- Accounting principles promulgated by an authorized or recognized standards setting organization in a particular jurisdiction, provided the organization follows an established and transparent process involving deliberation and consideration of the views of a wide range of stakeholders. [*Note: CICA's ASPE is one of these acceptable frameworks.*]

Source: *CICA Handbook—Assurance*, 2012.

The above points illustrate the importance of critical thinking and professional judgment in determining the acceptability of a financial reporting framework. Essentially, auditors are expected to be familiar with both the detailed accounting rules and the basic principles and concepts underlying them. These allow the auditor to determine if the rules are applicable in a specific auditee context. In particular, auditors must be sure that the particular rule applied is appropriate and not misleading in the context. This is the essence of the fairness of presentation framework of CAS 700.

With regard to the opinion reservations of CAS 705, other examples later in this chapter will show how auditors assert that an opinion cannot be expressed (disclaimer of opinion) or how audit responsibility can be limited (qualified opinion).

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STANDARDS CHECK

CAS 210

3. Acceptable financial reporting frameworks normally exhibit the following attributes that result in information provided in financial statements that is useful to the intended users:
   (a) **Relevance**, in that the information provided in the financial statements is relevant to the nature of the entity and the purpose of the financial statements. For example, in the case of a business enterprise that prepares general purpose financial statements, relevance is assessed in terms of the information necessary to meet the common financial information needs of a wide range of users in making economic decisions. These needs are ordinarily met by presenting the financial position, financial performance and cash flows of the business enterprise.
   (b) **Completeness**, in that transactions and events, account balances and disclosures that could affect conclusions based on the financial statements are not omitted.
   (c) **Reliability**, in that the information provided in the financial statements:
      (i) Where applicable, reflects the economic substance of events and transactions and not merely their legal form; and
      (ii) Results in reasonably consistent evaluation, measurement, presentation and disclosure, when used in similar circumstances.
   (d) **Neutrality**, in that it contributes to information in the financial statements that is free from bias.
   (e) **Understandability**, in that the information in the financial statements is clear and comprehensive and not subject to significantly different interpretation.

Source: *CICA Handbook—Assurance*, 2012.

When reading the reporting standards, the term financial statements includes not only the traditional balance sheet, income statement, and cash flows statement but also all the footnote disclosures and additional information (e.g., earnings per share calculations) that are integral to the basic financial presentation required by GAAP. The report comments on consistency only when accounting principles have been changed and disclosures are considered inadequate. The adequacy of disclosures may be judged by GAAP requirements, but auditors also must be sensitive to the information needs of investors, creditors, and other users when considering information that is not explicitly required by GAAP. Disgruntled investors often use the "lack of informative disclosure" criterion as a basis for lawsuits. Users feel they have been misled in that case, and auditors need to be sensitized to these expectations. This is part of the context of financial reporting in a particular engagement discussed in CAS 700. Critical thinking can aid in this understanding of the unique features of specific engagements, and moral imagination is an example of anticipating user needs for the engagement.

STANDARDS CHECK

CAS 700

13. In particular, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework:
   (a) The financial statements adequately disclose the significant accounting policies selected and applied;
   (b) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
   (c) The accounting estimates made by management are reasonable;
   (d) The information presented in the financial statements is relevant, reliable, comparable and understandable;
   (e) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and (Ref: Para. A4)
   (f) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

Source: *CICA Handbook—Assurance*, 2012.

The context of financial reporting usually impacts the audit report decision in two ways. First, additional disclosures beyond those required by specific accounting rules may be needed in order for the financial reporting not to be misleading. Second, mechanical

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application of a specific accounting rule may give misleading results in some circumstances, causing the auditor to insist on deviating from that rule in order to get a presentation that is not misleading. In both cases, the aim is to be consistent with the fairness of presentation framework.

STANDARDS CHECK

CAS 700

Definitions

7. For purposes of the CASs, the following terms have the meanings attributed below:
   (a) General purpose financial statements—Financial statements prepared in accordance with a general purpose framework. *[Note: CAS 800 deals with audit reports for 'special purpose' frameworks]*.
   (b) General purpose framework—A financial reporting framework designed to meet the common financial information needs of a wide range of users. The financial reporting framework may be a fair presentation framework or a compliance framework.

   The term "fair presentation framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

   (i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or
   (ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

   The term "compliance framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above.

Source: *CICA Handbook—Assurance*, 2012.

Reservation in the Audit Report

The following sections of this chapter explain major variations on the standard report, often referred to as **reservations**. There are two basic reasons for giving a report that contains other than the standard, unmodified audit opinion.

reservations: major variations on the standard audit report

When the financial statements contain a departure from GAAP, including inadequate disclosure, the auditors must choose between a qualified opinion and an adverse opinion. The choice depends on the materiality (significance) and pervasiveness of the effect of the GAAP departure. This is frequently referred to as an **accounting deficiency reservation**. When there is a scope limitation (extent of audit work has been limited), and the auditors have not been able to obtain sufficient appropriate evidence on a particular account balance or disclosure, the auditors must choose between a qualified opinion and a disclaimer of opinion. The choice depends on the materiality of the matter for which evidence is not sufficient. A scope limitation reservation is also frequently referred to as an **audit deficiency reservation**.

accounting deficiency reservation: reservation based on a known GAAP departure

audit deficiency reservation: reservation based on insufficient audit evidence (scope restriction)

The chart below summarizes the types of audit opinions introduced in this chapter: the unmodified, or "clean" audit report under CAS 700, and three main types of modified reports under CAS 705.

TYPES OF AUDIT OPINIONS IN CAS 700, 705			
	SEVERITY OF PROBLEM		
	NOT MATERIAL	MATERIAL BUT NOT PERVASIVE	MATERIAL AND PERVASIVE
Nature of Audit Problem			
GAAP Departure	Unmodified	Qualified for GAAP	Adverse opinion
Scope Limitation	Unmodified	Qualified for scope	Disclaimer of opinion

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STANDARDS CHECK

CAS 700

Definitions

7. (c) Unmodified opinion—The opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

CAS/ISA 705

Definitions

5. (b) Modified opinion—A qualified opinion, an adverse opinion or a disclaimer of opinion.

Source: *CICA Handbook—Assurance*, 2012.

Effects of Lack of Independence

Independence is the foundation of the audit function. When independence is lacking, an audit in accordance with generally accepted auditing standards is impossible, and the auditors should resign or not accept an audit engagement. An audit does not simply require the application of the tools, techniques, and procedures of auditing, it also requires independence in mental attitude of the auditors. This idea is reflected in the general standard and codes of professional ethics, an example of which is Rule 204, entitled "Independence."

204.1 (INDEPENDENCE IN) ASSURANCE AND SPECIFIED AUDITING PROCEDURES ENGAGEMENTS

A member or firm who engages or participates in an engagement (a) to issue a written communication under the terms of an assurance engagement, or (b) to issue a report on the results of applying specified auditing procedures shall be and remain independent such that the member, firm and members of the firm shall be and remain free of any influence, interest or relationship which, in respect of the engagement, impairs the professional judgment or objectivity of the member, firm or a member of the firm or which, in the view of a reasonable observer, would impair the professional judgment or objectivity of the member, firm or a member of the firm.

This rule applies to the auditors of financial statements. The criteria for determining independence are discussed in Chapter 4.

Source: Institute of Chartered Accountants of Ontario (ICAO).

REVIEW CHECKPOINTS

4-5 Think about the standard unmodified introductory and scope paragraphs. What do they identify as the objects of the audit? What is meant by this sentence, "We conducted our audit in accordance with Canadian generally accepted auditing standards"?

4-6 What are the major reasons for departures from the unmodified audit opinion?

4-7 If an auditor is not independent with respect to an auditee company, what should he or she do?

4-8 Why is independence important for auditors?

LO5 For a given set of accounting facts and audit circumstances, analyze qualified, adverse, and disclaimer audit reports.

LO6 Determine the effects of materiality and uncertainty on audit report choices.

AUDIT REPORT RESERVATIONS

Audit reports containing other than the standard unmodified audit opinion are called audit report reservations. The most common report reservations are called **qualified reports** because they contain an opinion paragraph that does not give the positive assurance that everything in the financial statements is in conformity with GAAP. There are two basic types of qualified reports: GAAP departure reports and scope limitation reports.

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GAAP Departure Reports

qualified reports: audit reports that contain an opinion paragraph which does not give the positive assurance that everything in the financial statements is in conformity with GAAP

For various reasons, a company's management can decide to present financial statements containing an accounting treatment or disclosure that is not in conformity with GAAP. They may not wish to capitalize leases and show the related debt, may calculate earnings per share incorrectly, may not accrue unbilled revenue at the end of a period, may make unreasonable accounting estimates, or may be reluctant to disclose all the known details of a contingency. Whatever the reason for the departure from GAAP, the auditor must decide on the type of opinion to render.

If the departure is immaterial or insignificant, it can be treated as if it did not exist and the audit opinion can be unmodified. What is considered immaterial under the circumstances is a matter of the auditor's professional judgment. Critical thinking can help structure this decision.

If, in the auditor's judgment, the departure is material enough to potentially affect users' decisions based on the financial statements, the opinion must be qualified. In this case, the qualification takes the "except for" language form. The opinion sentence begins, "In my opinion, except for the [nature of the GAAP departure], the financial statements present fairly, in all material respects . . . in accordance with Canadian generally accepted accounting principles." This style of qualification identifies the particular departure but says that the financial statements are otherwise in conformity with GAAP. The nature of the GAAP departure must be explained in a separate paragraph (called the *basis of modification paragraph*) placed immediately before the opinion paragraph, as covered by CAS 705, paragraph 16. The introductory and scope paragraphs are the same as in the standard unmodified report. After all, the audit was performed without limitation, and the auditors have sufficient appropriate evidence about the financial statements, including the GAAP departure.

GAAP departure report examples are hard to find in published financial statements. Most published statements come under the jurisdiction of the provincial securities commissions, which require public companies to file financial statements without any departures from GAAP. Exhibit 4–4 shows a GAAP departure due to a failure to record depreciation.

If the GAAP departures are either (1) much more material, or "so significant that they overshadow the financial statements," or (2) pervasive, affecting numerous accounts and financial statement relationships, there is a condition of **pervasive materiality** and an adverse opinion should be given. An adverse opinion is exactly the opposite of the unmodified opinion. In this type of opinion, auditors say the financial statements do not present the financial position, results of operations, and changes in financial position in conformity with GAAP. When this opinion is given, all the substantive reasons for it must be disclosed in the basis of modification paragraph(s), as covered by the *CICA Handbook* CAS 705. The introductory and scope paragraphs should not be modified because, in order to decide to use the adverse opinion, the audit team must possess all evidence necessary to reach the decision. Pervasive materiality is closely related to overall materiality of CAS 320. Specifically, pervasive materiality can greatly exceed overall materiality and may affect many line items in the financial statements. Pervasive materiality of misstatement in the financial statements results in a virtually guaranteed adverse opinion. For many auditors, misstatements in excess of overall materiality warrant an adverse opinion. This is another area of professional judgment. At the end of the chapter we summarize the effects of materiality concepts on the audit report.

pervasive materiality: GAAP departures so significant that they overshadow the financial statements or affect numerous accounts and financial statement relationships

Because of the securities commission requirements, adverse opinions are hard to find. The example in Exhibit 4–5 is due to a disagreement between the auditor and management on the carrying value of a long-term investment. That departure from GAAP is considered to be highly or pervasively material, or well in excess of what would be considered material for an "except for" qualification.

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EXHIBIT 4–4

Departure from generally accepted accounting principles—no depreciation recorded. When the auditor has determined that a qualification is the type of reservation required, the following wording may be appropriate.

AUDITOR'S REPORT

To the Shareholders of ....

(The introductory, management responsibility, and auditor responsibility paragraphs are the same as in the unmodified report [see Exhibit 4–3]. A basis of modification paragraph is added to provide more details immediately preceding the opinion paragraph as follows.)

Basis for Qualified Opinion

Note .... describes the depreciation policy with respect to the company's manufacturing plants and equipment. The note also indicates that the company is not depreciating its head office building, which it acquired 5 years ago, on the grounds that it is not a producing asset and is maintaining its value as a potential rental or resale property. In this respect the financial statements are not in accordance with generally accepted accounting principles. The estimated useful life of similar buildings is usually considered to be between 30 and 40 years. If depreciation had been provided on the basis of an estimated useful life of, say, 35 years, depreciation for the current year would have been increased by $.......... (20....$..........), net income after taxes would have been decreased by $..........(20....$..........), accumulated depreciation would have been increased by $..........(20....$..........) and the balance of deferred income taxes and the closing balance of retained earnings would have been reduced by $..........(20....$..........) and $..........(20....$..........) respectively.

Qualified Opinion

In my opinion, except for the effects of the failure to record depreciation as described in the Basis for Qualified Opinion paragraph, these financial statements present fairly, in all material respects, the financial position of the company as at ...., 20...., and the results of its operations and the cash flows for the year then ended in accordance with International Financial Reporting Standards..

(signed)....................

PUBLIC ACCOUNTANT

Source: *CICA Handbook—Assurance,* 2012, CAS 705 (adapted from Appendix Illustration 1).

EXHIBIT 4–5 Adverse Report

Departure from generally accepted accounting principles—disagreement on carrying value of a long-term investment. When the auditor has determined that an adverse opinion is the type of reservation required, the following wording may be appropriate. (For an adverse opinion, "present fairly" in the opinion paragraph need not be modified with the phrase "in all material respects.")

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of...................

(The introductory, management responsibility, and auditor responsibility paragraphs are the same as in the unmodified report [see Exhibit 4–3]. A new basis of modification paragraph is added after the scope paragraphs to provide more details immediately preceding the opinion paragraph as follows.)

Basis for Adverse Opinion

The company's investment in X Company Ltd., its only asset, which is carried at a cost of $10,000,000, has declined in value to an amount of $5,850,000. The loss in the value of this investment, in my opinion, is other than a temporary decline and in such circumstances generally accepted accounting principles require that the investment be written down to recognize the loss. If this decline in value had been recognized, the investment, net income for the year, and retained earnings would have been reduced by $4,150,000.

Adverse Opinion

In my opinion, because the write-down has not been made for the significant decline in value of the investment described in the preceding paragraph, these financial statements do not present fairly the financial position of the company as at ...., 20...., and the results of its operations and the cash flows for the year then ended in accordance with International Financial Reporting Standards.

City (signed)....................

Date PUBLIC ACCOUNTANT

Source: *CICA Handbook—Assurance,* 2012, CAS 705 (adapted from Appendix Illustration 2).

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Practically speaking, auditors require more evidence to support an adverse opinion than to support an unmodified opinion. Perhaps this can be attributed to auditors' reluctance to be bearers of bad news. However, audit standards are quite clear that if an auditor has a basis for an adverse opinion, the uncomfortable position cannot be relieved by giving a disclaimer of opinion. GAAP departure reports cover those situations where the auditor knows the true state of affairs—there is or there is not an accounting deficiency. The next section will outline situations where the auditor does not know the true state of affairs. These are situations where there are limitations on the scope of the auditors' work.

REVIEW CHECKPOINTS

4-9 With reference to evidence, what extent of evidence is required as a basis for the unmodified opinion? for an adverse opinion? for an opinion qualified for GAAP departure?

4-10 What effect does the materiality of a GAAP departure have on the auditor's reporting decision?

Scope Limitation Reports

Auditors are in the most comfortable position when they have all the evidence needed to make a report decision—whether the opinion is to be unmodified, adverse, or qualified. There are two kinds of situations, however, that can result in a **scope limitation**—condition where the auditors are unable to obtain sufficient appropriate evidence: (1) Management deliberately refuses to let auditors perform some procedures; or (2) circumstances, such as late appointment of auditor, make it impossible for some procedures to be performed.

scope limitation: condition where auditors are unable to obtain sufficient appropriate evidence

If management's refusal or the circumstances affect the audit in a minor, immaterial way, or if sufficient appropriate evidence can be obtained by other means, the audit can be considered to be unaffected, and the opinion can be unmodified as if the limitation had never occurred. Management's deliberate refusal to give access to documents or to otherwise limit audit procedures is the most serious condition. It casts doubt on management's integrity. (Why is management refusing access or limiting the work?) In most such cases, the audit report is qualified or an opinion is disclaimed, depending upon the materiality of the financial items affected.

Exhibit 4–6 (A and B) shows two reports that illustrate the auditors' alternatives. The failure to take physical counts of inventory, as shown, might have been a deliberate management action, or it might have resulted from other circumstances, such as the company's not anticipating the need for an audit and appointing the auditor after the latest year-end.

In Panel A, the opinion is modified. Here, the lack of evidence is considered material, but not pervasively or highly material enough (i.e., exceeding overall materiality) to overwhelm the meaning of modified audit opinion and the usefulness of the remainder of the financial statements. The proper qualification meaning here is: "In our opinion, except for the effects of adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the inventories, the financial statements present fairly, in all material respects, . . . in conformity with generally accepted accounting principles." This report "carves out" the inventory from the audit reporting responsibility, thus taking no audit responsibility for this part of the financial statements.

Note that the first four paragraphs in Panel A are the same as for an unmodified report. However, the last auditor's responsibility paragraph is modified because the audit was not

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EXHIBIT 4–6A Scope Limitation Reports

PANEL A: QUALIFIED OPINION

Scope limitation—The auditor is appointed during the year and is unable to observe the inventory count at the beginning of the year. (It is assumed that the prior year's figures were unaudited and that the auditor was satisfied with respect to all other aspects of inventories and all other opening figures.) When the auditor has determined that a qualification is the type of reservation required, the following wording may be appropriate.

INDEPENDENT AUDITOR'S REPORT

(The introductory and management responsibility paragraphs, and the first two of the Auditor's Responsibility paragraphs are the same as in the unmodified report [see Exhibit 4–3 on page XX].)

Auditor's Responsibility

(first two paragraphs are unmodified)

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Basis for Qualified Opinion

Because we were appointed auditor of ABC Company during the current year, we were not able to observe the counting of physical inventories at the beginning of the year nor satisfy ourselves concerning those inventory quantities by alternative means. Since opening inventories enter into the determination of the results of operations and cash flows, we were unable to determine whether adjustments to cost of sales, income taxes, net income for the year, opening retained earnings, and cash provided from operations might be necessary.

Qualified Opinion

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements present fairly, in all material respects, the financial position of ABC Company as at December 31, 20X1, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards

City (signed)....................

Date PUBLIC ACCOUNTANT

Source: *CICA Handbook—Assurance,* 2012, CAS 705 (adapted from Appendix Illustration 3).

completed entirely in accordance with generally accepted auditing standards. Specifically, sufficient appropriate evidence about the inventories was not obtained. Whenever the scope has been affected by an important omission of audit work, the opinion paragraph should also be qualified.

The Panel B situation is considered fatal to the audit opinion. In this case, the inventories are too large and too important to say "except for adjustments, if any." The audit report then must be a disclaimer of opinion.

It is important to remember that scope limitation reservations arise only when it is not possible to obtain compensating assurance from alternative audit procedures. If, for example, in Panel A and Panel B the auditor had been able to satisfy himself through alternative procedures that the inventory was materially accurate, then an unmodified opinion could have been issued for both panels. Thus, scope limitation reports are issued only if, in the auditor's judgment, the alternative procedures do not compensate for the restriction.

To summarize, we can view audit reservations as arising from two types of circumstances: audit deficiencies, due to scope limitations, and accounting deficiencies resulting from a GAAP departure. Audit deficiencies can result in either a qualification or a disclaimer of opinion, depending on the significance of the scope limitation. In an audit deficiency reservation, both the scope and opinion paragraphs are affected. When there is an audit deficiency, the auditor does not have enough evidence or does not know the true state of affairs. An accounting deficiency, on the other hand, can result in either a

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EXHIBIT 4–6B Scope Limitation Reports

PANEL B: DISCLAIMER OF OPINION

Scope limitation—the physical inventory count was not observed by the auditor and there are serious deficiencies in the accounting records and in the system of internal control over inventory. When the auditor has determined that a denial of opinion is the type of reservation required, the following wording may be appropriate. (For a disclaimer of opinion, "presented fairly" in the opinion paragraph need not be modified with the phrase "in all material respects.")

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of...................

(The introductory and management responsibility paragraphs are the same as in the unmodified report [see Exhibit 4–3]. The Auditor Responsibility paragraphs are modified, and a Basis of Disclaimer of Opinion paragraph is added before providing the disclaimer of opinion.)

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on conducting the audit in accordance with Canadian generally accepted auditing standards. Because of the matter described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for Disclaimer of Opinion

The company's investment in inventory is carried at xxx on the company's statement of financial position, which represents over 90% of the company's net assets as at December 31, 20X1. We were not able to observe all physical inventories due to limitations placed on the scope of our work by the company's management. As a result, we were unable to determine whether any adjustments were necessary in respect of the company's assets at year end, expenses and net income for the year, and retained earnings at year-end.

Disclaimer of Opinion

Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.

City (signed).....................

Date PUBLIC ACCOUNTANT

Source: *CICA Handbook—Assurance,* 2012, CAS 705. (adapted from Appendix Illustration 4).

qualification or adverse opinion, depending on the significance of the GAAP departure. In an accounting deficiency reservation, only the opinion paragraph is affected. To reach a conclusion about an accounting deficiency, the auditor must have sufficient appropriate evidence to support the conclusion. The auditor is in a position to know the true state of affairs.

It should be stressed that both auditor and client work to avoid a report reservation. It may take much discussion and negotiation between the auditor and client management to do this. This negotiation is discussed in more detail in Chapter 16, after we have considered the topic of available evidence at the end of the engagement.

OTHER RESPONSIBILITIES WITH A DISCLAIMER

A disclaimer of opinion because of severe scope limitation or because of association with unaudited financial statements carries some additional reporting responsibilities. In addition to the disclaimer, these rules should be followed:

- If the PA should learn that the statements are not in conformity with generally accepted accounting principles (including adequate disclosures), the departures should be explained in the disclaimer.
- If prior years' unaudited statements are presented, the disclaimer should cover them as well as the current-year statement.

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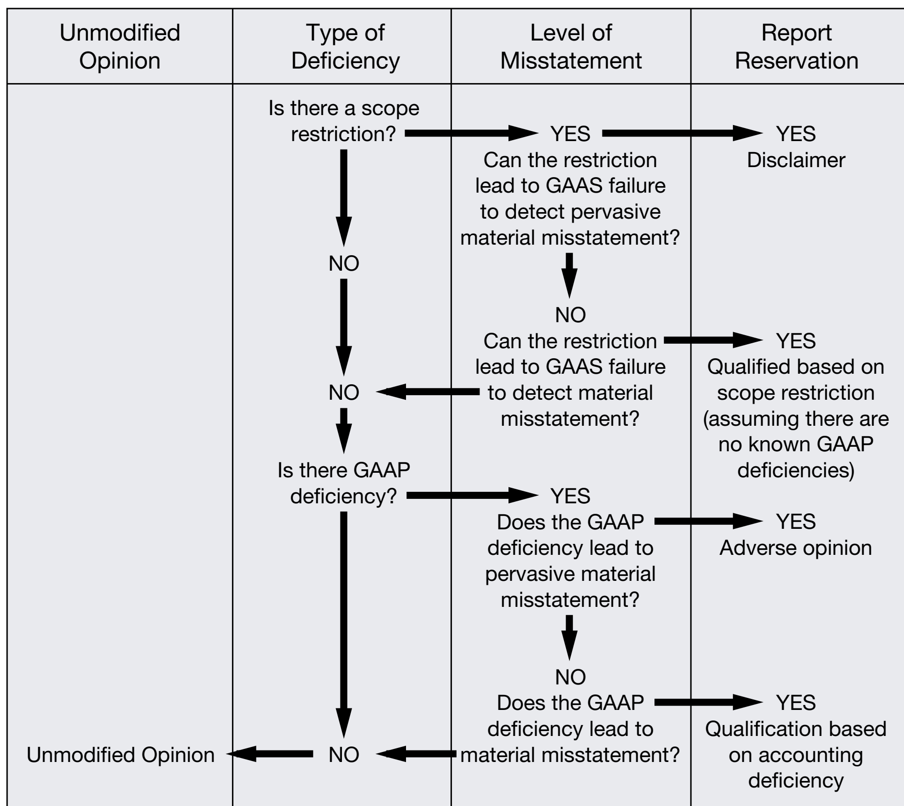
Exhibit 4–7 summarizes the audit decision process in arriving at either some type of reservation (far right column) or an unqualified opinion (far left column). Make sure you understand the reasoning behind the paths shown in this exhibit.

EXHIBIT 4–7 Audit Report Decision Process



REVIEW CHECKPOINTS

4-11 What are the differences between a report qualified for a scope limitation and a standard unmodified report?

4-12 What are the differences between a report in which the opinion is disclaimed because of scope limitation and a standard unmodified report?

4-13 The auditor knows about the client's situation for which opinions? Explain.

4-14 Explain the effect of materiality or pervasive materiality on an auditor report when the client uses an accounting method that departs from GAAP.

4-15 Explain the effect of pervasive materiality on an auditor report when there is a scope limitation.

4-16 Explain the effect of pervasive materiality on an auditor report when there is a material uncertainty associated with the financial statements.

4-17 Identify the levels of assurance associated with auditor reports.

4-18 Under what conditions would an auditor use an emphasis of a matter paragraph?

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APPLICATION CASE WITH ANALYSIS

Meaning of the Words "Present Fairly" in the Auditor's Report

DISCUSSION CASE

Your client, Margo N., has prepared financial statements that she feels are in conformity with Canadian GAAP, but she notes that in your report you use the words "present fairly, in all material respects . . . in accordance with Canadian GAAP." She asks you to explain what these words mean so that she can fulfill her responsibilities to prepare the financial statements appropriately.

ANALYSIS

"Present fairly" is one of those widely used accounting terms that is never defined in any standard. As auditor, you must provide an intuitive, reasonable, if not authoritative, explanation of its meaning. A good starting point is telling Margo that the statements must not mislead users. They must tell the truth about economic reality, including appropriate disclosures of business risks, using an acceptable reporting framework. Failure to appropriately disclose business risks and economic reality leads to information risk in financial reporting. Defining fairness of presentation in financial reporting so that it includes a risk orientation will lead to acceptable levels of information risk.

But what is "economic reality" then? Obviously, there should be no deliberate errors concerning the economic facts of Margo's reporting entity. This is implicit in both GAAP and your studies of financial accounting, and it is worth remembering as an auditor. By verifying those facts, as an auditor, you will determine which ones are correct and which are misleading. Hence, fair presentation includes an understanding that an auditor will be able to verify the facts through records kept by Margo's accounting system. The system should allow the auditor to gather independent corroborating evidence of the information. This way, the risk of errors in that information will be reduced to a level that you as auditor find acceptable for financial reporting. This is the low audit risk component of information risk that auditors aim to achieve. However, auditors also need to keep track of the accounting risks associated with forecasting in GAAP estimates. Forecasts are based on assumptions, and if those assumptions are unrealistic or unreasonable, the accounting risks associated with the accounting estimates increase. And increased accounting risks, in turn, lead to increased information risks in financial reporting. Thus, fairness of presentation also includes appropriately disclosing business risks through accounting entries and perhaps through appropriate note disclosures as well.

A specific example of this could be the proper accounting for accounts receivable that you studied in your financial accounting course. To determine the appropriateness of the presentation of accounts receivable in the balance sheet, it must be verified that the receivables exist, that they are owed to Margo's company, and that they have been properly recorded and classified, per GAAP, as of the balance sheet date. All of this is factual information based on past events that can be verified by various audit procedures that you will be studying in this book. Verification is, therefore, the process of assuring yourself and others that these facts are accurately recorded. As an auditor, you will gather evidence from Margo's accounting system that the facts regarding receivables are accurate.

However, auditors, in fact, rarely find it an economical use of their time to exhaustively gather evidence on accounts receivable. So, they do less than that and, instead, accept that the less-than-perfect evidence creates a risk of undetected material factual errors regarding receivables. It is important to remember that audit risk for receivables is the risk of failing to detect material factual errors in the records for receivables. Audit risk is, therefore, an evidence gathering risk.

The other component of information risk is accounting risk. This risk considers the question of whether all the receivables will be collected at their face amounts, regardless of how accurately the amounts were recorded. This uncertainty is unavoidable because it relates to the future and there is little that is certain about the future. Neither you the auditor nor Margo can predict with certainty, as of the balance sheet date, which receivables will be collected at face value. You might recall from your accounting course that there are techniques for calculating bad debt expense that do not seem to involve forecasting. However, such techniques are based on assumptions from past experience. If these assumptions are wrong, the resulting estimate will be wrong as well. Some common assumptions are that percentage collection experienced in the past will continue to apply, that interest rates won't change, or that other economic factors will remain the same. Only the passage of time and actual collection of payments on the receivables can eliminate the uncertainty around these things. But, in the meantime, under the periodic reporting system of GAAP accounting you do not have the luxury of waiting for these future events to take place; you need an estimate of these future events now! An estimate of amounts to be realized as future cash flows is made by estimating the amount that will be uncollectible. The forecast of uncollectible amounts is the basis for adjustments to the allowance for doubtful accounts that will help you estimate the realizable value of receivables. This is necessary for proper valuation of receivables and also for proper matching.

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Because there is no guarantee that the estimates will be accurate, it is likely that there will be a deviation between the estimate for bad debt expense and what will actually be realized as uncollectible. We call this the forecast error. A forecast error has the same impact on financial reporting as a recorded factual error—it is the difference between what is recorded and what is ultimately realized. Thus, material forecast errors have the same impact as material factual errors in financial reporting. This means that accounting risk is just as important as audit risk to users of financial statements. The problem, as we will see later, is that GAAP is largely silent on the acceptability of accounting risks for various accounts. GAAP does not normally consider the reasonableness of specific assumptions in making some forecasts. This forecast evaluation task is left to the professional judgment of the auditor. We introduce subjective concepts, such as accounting risk, to facilitate the decision making that goes into them. Thus, a logical aspect of fairness of presentation within GAAP is that accounting risk is kept to some "acceptable" level—at least as it concerns the amounts recorded as line items in the financial statements. This helps determine which assumptions to treat as reasonable. By keeping accounting risks appropriately low, we help keep information risk low and thereby make operational the concept of fairness of presentation.

Unless otherwise indicated, in this textbook we use the term "GAAP" to mean "presented fairly within Canadian GAAP." In the auditor's report, this wording can be viewed as a reminder to auditors that in applying GAAP they need to consider the reasonableness of assumptions for making accounting estimates (leading to acceptable accounting risk), as well as the importance of an acceptably low level of risk of factual errors in financial statements. (If we assume that auditors demand that management corrects all material factual errors upon detection, then the latter risk corresponds to audit risk.) With both conditions satisfied, a more comprehensive risk-oriented approach to achieving "fairness of presentation in conformity with GAAP" is possible. This is the approach we follow throughout this text.

SUMMARY

- This chapter began with setting forth the requirement that auditors must report whenever they are associated with financial statements. This report can take different forms in different circumstances—audit assurance, negative assurance, and no assurance. These levels of assurance are further explained in terms of (1) reports qualified for scope limitations and departures from GAAP, (2) adverse reports resulting from GAAP departures, and (3) disclaimers of opinion resulting from lack of independence and lack of sufficient appropriate evidence.
- Throughout this chapter's explanation of the auditors' choices of reports, the materiality dimension played an important role. When an auditor makes decisions about the audit report, immaterial or unimportant information can be ignored and treated as if it does not exist. However, when inaccuracies, departures from GAAP, accounting changes, and uncertainties have a large enough financial impact, the standard audit report must be changed. In practice, when an auditor decides a matter is material enough to make a difference, a further distinction must be made between misstatements of "specific materiality" and those of "overall materiality" of CAS 320. Overall materiality is for financial statements as a whole. Specific materiality is smaller than overall materiality and relates to specific user needs for specific classes of transactions, account balances, or disclosures. These are further discussed in Chapter 5, but the main point about specific and overall materialities is that they relate directly to user needs. This is what affects the audit report when the auditee refuses to adjust for their material misstatement.

  You might wonder why an auditee would **not** correct material misstatements. Well they may have their own reasons, and so critical thinking may be needed to decide if those reasons are good enough! This is also part of the report decision.
- Materiality means that the item in question is important and needs to be disclosed or that the opinion for it needs to be qualified—the information cannot simply be ignored. Overall materiality means that the item is important and has a significant impact on the reporting decision. The biggest distinction between the two materialities is the number of users affected by the potential misstatements: overall materiality affects many more users than does specific materiality. In the current environment, the amount of misstatement that is considered acceptable has been reduced in many audits so that both materialities have also been reduced. As you will see in later chapters, this effectively increases the amount of audit work in the engagement.

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- Auditing standards refer to several basic circumstances that cause departures from the standard unqualified audit report. These circumstances are shown in Exhibit 4–8 in relation to the influence of materiality. You can see that each report is qualified when the situation involves materiality, but becomes a disclaimer or an adverse report when the situation involves misstatements much greater than overall materiality. The exception is the lack of independence issue, where materiality does not make a difference.

EXHIBIT 4–8 Influence of Materiality on Audit Reports

CIRCUMSTANCES FOR DEPARTURE FROM STANDARD REPORT	*USUAL TYPE OF REPORT IF MISSTATEMENTS EXCEED THE GIVEN MATERIALITY*	
	SPECIFIC MATERIALITY	OVERALL MATERIALITY
Departure from GAAP	Qualified Opinion “except for”: separate paragraph discloses reasons and effects*	Adverse Opinion: separate paragraph discloses reasons and effects
Limitation on Scope (lack of evidence)	Qualified Opinion: refers to possible effects on financials	Disclaimer of Opinion: separate paragraph explains limitations
Uncertainty	Unmodified Opinion**	Unmodified Opinion**

*Where the departure is necessary to make the financials not misleading, an unqualified opinion is issued with an explanation of the circumstances.
**Unless there is a failure to properly disclose an uncertainty, such as an accounting contingency or going concern problem.

- Audit reports can also be modified and expanded with additional paragraphs. Such additions to the audit report arise from the need for emphasis of matter (EOM) and other matter (OM) paragraphs in certain situations. These are explained in Chapter 16. Appendix 4B of this chapter covers “shopping” for accounting principles and auditors. Standards exist to raise the public perception that auditors are careful about competing with each other on the basis of professional opinions.

KEY TERMS

accounting deficiency reservation
associated with financial statements
association
audit deficiency reservation
clean opinion
levels of assurance
negative assurance (moderate assurance)
no assurance
pervasive materiality
positive assurance
qualified reports
reservations
scope limitation

EXERCISES AND PROBLEMS

EP 4-1 Association with Financial Statements. LO1

Required:
For each of the situations described below, state whether the PA is or is not associated with the financial statements. What is the consequence of being associated with financial statements?

a. PA audits financial statements and his or her name is in the corporate annual report containing them.
b. PA prepares the financial statements in the partnership tax return.
c. PA uses the computer to process client-submitted data and delivers financial statement output.
d. PA uses the computer to process client-submitted data and delivers a general ledger printout.
e. PA lets client copy client-prepared financial statements on the PA’s letterhead.

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f. Client issues quarterly financial statements and mentions PA's review procedures but does not list PA's name in the document.

g. PA renders consulting advice about the system to prepare interim financial statements but does not review the statements prior to their release.

EP 4-2 Reports and the Effect of Materiality. LO6 The concept of materiality is important to PAs in audits of financial statements and expressions of opinion on these statements.

Required:

How will materiality influence an auditor's reporting decision in the following circumstances?

a. The client prohibits confirmation of accounts receivable, and sufficient appropriate evidence cannot be obtained using alternative procedures.

b. The client is a gas and electric utility company that follows the practice of recognizing revenue when it is billed to customers. At the end of the year, amounts earned but not yet billed are not recorded in the accounts or reported in the financial statements.

c. The client leases buildings for its chain of transmission repair shops under terms that qualify as capital leases. These leases are not capitalized as leased property assets and lease obligations.

d. The client company has lost a lawsuit. The case is on appeal in an attempt to reduce the amount of damages awarded to the plaintiffs.

EP 4-3 Scope Limitation, Auditor Independence. LO4 Crow Corporation, a public company, has set up a number of limited partnerships to pursue some risky development projects. The limited partnerships borrow money from various financial institutions to support the development projects, and Crow guarantees these loans. Crow's interest in each limited partnership is set at a level just below the percentage that would require the partnerships, and their debts, to be included in Crow's consolidated financial statements. These percentages are set out specifically in the professional accounting recommendations that form the basis of GAAP for the purpose of Crow's financial reporting.

Zilch Zulch, LLP (ZZ) has been the auditor of Crow since its incorporation thirty years ago. The current CFO of Crow was formerly an audit partner in ZZ and was in charge of the Crow audit for five years before Crow hired her as its CFO. Because of her familiarity with ZZ's approach to setting materiality for its audits, the CFO was able to suggest the amount of a loan that could be guaranteed in each limited partnership without being material. If an individual loan was material, it would need to be disclosed as a contingency in Crow's consolidated financial statements even if the partnership was not required to be consolidated. Approximately 1000 limited partnerships were set up, since a large sum of money was required to fund Crow's development activities. Because of the way the limited partnerships were structured, none of them was consolidated and no disclosure of Crow's loan guarantees to the partnerships was made in Crow's 2000 financial statements, despite the fact that in total they exceeded the reported long-term debt and shareholders' equity of Crow.

Zero Mustbe, the audit partner in charge of the audit of Crow's 2000 consolidated financial statements, was somewhat puzzled as to why there were so many limited partnerships, since only one development project was being undertaken. However, he was assured by Crow's CFO that the structure was appropriate and in accordance with GAAP because, in her words, "It was all set up by financial engineers with Ph.D.s in ZZ's consulting group. These people know all about GAAP and are much smarter that you are, Zero, so there is nothing to be concerned about."

As a result of his audit work, Zero provided a clean audit opinion on Crow's 20X0 consolidated financial statements. During 20X1, adverse events resulted in Crow's being unable to meet its obligations under the loan guarantees and it went bankrupt.

Required:

Comment on the adequacy of Zero's audit, the independence and scope issues raised, and the appropriateness of issuing a clean audit report in this scenario.

EP 4-4 Negative and Positive Assurance and Users' Needs. LO3 Ellen Eagle is a banker in a small town. Her customers, Dave and Dot Dauber, are the owners of a franchised candy store in town. They have an opportunity to buy a second franchised store in a nearby town, and are requesting that Ellen increase their bank loan from $300,000 to $2,000,000 to finance this acquisition. The Daubers are two of Ellen's best customers and have always made their loan payments on time during the 10 years they have been customers of her bank. Currently, Ellen is requiring the Daubers to provide annual financial statements with a review report of a PA. To approve the requested loan increase, the bank's head office will require them to provide audited annual financial statements.

Required:

Distinguish between a review report and an audit report. Why would the bank require an audit instead of a review in this case? Do you think the bank's policy is reasonable?

EP 4-5 Arguments with Auditors. LO5 Officers of the Kingston Company do not want to disclose information about the product liability lawsuit filed by a customer asking $500,000 in damages. They believe the suit is frivolous and without merit. Outside counsel is more cautious. The auditors insist upon disclosure. Angered, the Kingston Company chairman of the board threatens to sue the auditors if a standard unmodified report is not issued within three days.

Required:

Explain the issues raised in the preceding situation. What actions do you recommend to the company's auditor?

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EP 4-6 Errors in a Comparative Report with Change from Prior Year. LO5 (Appendix 4A). The following audit report was drafted by an assistant at the completion of the audit of Cramdon Inc., on March 1, 20X5. The partner in charge of the engagement has decided the opinion on the 20X4 financial statements should be modified only with reference to the change in the method of computing sales. Also, because of a litigation uncertainty, an uncertainty paragraph was included in the audit report on the 20X3 financial statements, which are included for comparative purposes. The 20X3 audit report (same audit firm) was dated March 5, 20X4, and on October 15, 20X4, the litigation was resolved in favour of Cramdon Inc.

Auditor's Report
To the Board of Directors of Cramdon Inc.:
We have audited the accompanying financial statements of Cramdon Inc., as of December 31, 20X4 and 20X3. These financial statements are the responsibility of the Company's Management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 7 to the financial statements, our previous report on the 20X3 financial statements contained an explanatory paragraph regarding a particular litigation uncertainty. Because of our lawyer's meritorious defence in this litigation, our current report on these financial statements does not include such an explanatory paragraph.

In our opinion, based on the preceding, the financial statements referred to above present fairly, in all material respects, the financial position of Cramdon Inc., as of December 31, 20X4, and the results of its operations and its cash flows for the period then ended in conformity with generally accepted accounting principles consistently applied, except for the changes in the method of computing sales as described in Note 14 to the financial statements.

/s/ PA Firm
March 5, 20X5

Required:
Identify the deficiencies and errors in the draft report and write an explanation of the reasons they are errors and deficiencies. Do not rewrite the report.

EP 4-7 Negative and Positive Assurance and Users' Needs. LO3 One of your neighbours, Hans House, is a minority shareholder of Grackle Corporation, a private company. Grackle is also the company that employs Hans. Recently Hans and the other Grackle Corporation shareholders were asked to approve a resolution that would waive the requirement for the company to have its financial statements audited. The company has been audited in past years but would have a review instead of an audit if the resolution is passed unanimously by the shareholders. Hans knows that you are an advanced accounting student and has asked for your advice on whether he should vote for or against the audit waiver.

Required:
List the factors that Hans should consider in making this decision. What fact situations would support voting for the audit waiver, and what fact situations would indicate he should vote against the waiver?

EP 4-8 Distinguishing Forms of Assurance. LO3

Required:
Explain the difference between "negative assurance" and an "adverse opinion."

EP 4-9 GAAS General Standard, Audit Scope. LO4

Required:
Give three examples of fact situations in which the General Standards of GAAS are not met. For each example, explain the impact of the violation on the scope of the audit and the audit report.

EP 4-10 GAAS Examination Standard, Audit Scope. LO5

Required:
Give one example of a fact situation in which each of the three Examination Standards of GAAS are not met. For each example explain the impact of the violation on the scope of the audit and the audit report.

EP 4-11 Audit Opinion on Financial Statements. LO5 The unmodified audit opinion states that the financial statements ". . . present fairly . . . in accordance with Canadian generally accepted accounting principles."

Required:
a. Explain, from the perspective of the auditing profession, reasons why the auditor's opinion on fair presentation of financial statements is given in reference to Canadian generally accepted accounting principles.
b. Explain, from the perspective of financial statement users, the contrasting view that the auditor's responsibility to assess the fair presentation goes beyond a literal interpretation of whether the statements meet the requirements of Canadian GAAP.
c. Which position, part (a) or part (b), do you agree with? Why?

EP 4-12 Audit Scope Limitations—Auditor Appointed Late. LO4

Required:
a. What alternative procedures can an auditor perform to determine whether the inventory balance is not materially

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misstated when he or she is appointed in the middle of the year and did not observe the inventory count at the end of the prior year?

b. What alternative procedures can an auditor perform to determine whether the inventory balance is not materially misstated when he or she was appointed after the year end under audit and was not able to observe the count of either the opening or the ending inventory.

c. What are the reporting implications if alternative procedures can be performed and provide sufficient audit evidence in situations (a) and (b) above?

d. What are the reporting implications if alternative procedures cannot be used to satisfy audit evidence requirements in situations (a) and (b) above?

EP 4-13 Audit Scope Limitations—Client Imposed. LO4

Required:

a. What alternative procedures can an auditor perform to determine whether the accounts receivable balance is not materially misstated when client management will not permit audit confirmations to be used?

b. What are the reporting implications if alternative procedures can be performed and provide sufficient audit evidence in situation (a)?

c. What are the reporting implications if alternative procedures cannot be used to satisfy audit evidence requirements in situation (a)?

EP 4-14 Reporting on Contingencies. LO6

Required:

Describe the pre-2011 requirements of Canadian GAAS for reporting for contingencies and uncertainties. Identify the pros and cons of the current approach, contrasting these with the pros and cons of the "subject to" opinions that were used in Canada prior to 1980.

EP 4-15 Reporting Going-Concern Uncertainties. LO6 Current Canadian GAAS through 2010 did not permit the auditor to refer to a going-concern uncertainty in the audit report when the uncertainty was properly disclosed in the financial statement notes.

Required:

a. Describe the strengths and weaknesses of this approach, taking into consideration the perspectives of the company, its financial statement users, and its auditor.

b. Identify one or more alternative reporting methods that may be more beneficial to financial statement users.

c. You have been invited to comment to the Canadian assurance standards-setting board on its current audit reporting standards. What comment would you make to the standard setters on the issue of audit reporting when there is substantial doubt about a company's ability to continue as a going concern?

EP 4-16 Going-Concern Assumption—One Year Limitation. LO6 For the purpose of assessing the going-concern assumption, it is presumed that the auditor will consider whether the company will continue in existence for a "reasonable time" that does not exceed one year beyond the date of the financial statements.

Required:

Give reasons that auditors are not required to consider the entity's ability to continue as a going concern for a period longer than one year. In your opinion, is this one-year limitation reasonable? Explain and evaluate possible alternative approaches to support your opinion.

EP 4-17 Standard-Setting Research. LO6

Required:

Investigate the history and current status of the CICA Exposure Draft on the going-concern assumption that was originally issued in 1996. Use the CICA website, *CA Magazine,* and other professional publications to conduct this research. Explain how the due process involved in setting Canadian auditing standards is illustrated by the history of this Exposure Draft.

EP 4-18 Going-Concern Issue. LO6 PA is the auditor of Jayhawk Inc. Jayhawk's revenues and profitability have decreased in each of the past three years and, as of this year end, 20X3, its retained earnings will fall into a deficit balance. Jayhawk's long-term debt comes due in 20X4, and its management is currently renegotiating the repayment date and terms with its bondholders. According to PA's discussions with management, the renegotiation is not going well and there is a significant risk that the bondholders will put Jayhawk into receivership and liquidate its assets. Jawhawk's CFO has provided draft 20X3 financial statements to PA that are prepared in accordance with GAAP.

Required:

a. Discuss the audit reporting implications of the preceding situation.

b. Assume the long-term debt repayment date was not until 20X5. Would your response differ?

EP 4-19 Going-Concern Audit Reporting. LO6 Before 2011, *CICA Handbook,* paragraph 5510.53, provided guidance for audit reporting when there is a going-concern problem.

Required:

a. Critique the audit reporting required by paragraph 5510.53 from the perspective of a financial statement user who owns shares of the auditee company.

b. Assume the role of the company's auditor. How would you respond to the criticisms raised in (a)?

EP 4-20 Report on the Application of Accounting Principles. LO5 *CICA Handbook* section 7600 sets out procedures relating to requests for advice from a PA from parties other than the PA's audit clients.

Required:

a. What are the purposes of section 7600?

b. Describe the requirements of section 7600 and explain how effective they are in achieving the purposes described in part (a).

EP 4-21 Report on the Application of Accounting Principles. LO5 Kite Corporation's auditor, PA1, formed the opinion that Kite should accrue for estimated future costs to clean up an environmental problem on one of Kite's

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properties in its 20X3 financial statements. Kite requested a second opinion from PA2 on this issue. PA2 gave an opinion that the estimated liability amount is contingent on various future events that are highly uncertain, such as changes in environmental regulations and environmental cleanup technologies. Thus it is a contingency that is too uncertain to accrue and, in accordance with GAAP, it should only be disclosed. Kite's management sides with the opinion of PA2 because it prevents the company from reporting a loss, allows Kite's management to receive bonuses for 20X3, and, in their view, it is a more appropriate application of GAAP.

Required:

a. Assume that Kite is a public company and PA1 and PA2 are Big Four audit firms. What public perception of auditors may arise if disputes on the application of GAAP can be resolved by the public company's obtaining an opinion from another auditor?

b. Take the role of PA1. What issues arise by Kite's taking this action in your dispute over the accrual of the contingent liability?

c. Take the role of PA2. What considerations should you make before issuing your opinion?

d. Take the role of one of Kite's Directors. What issues arise by Kite's management's taking this action in resolving its dispute with PA1 over the accrual of the contingent liability?

EP 4-22 Audit Evidence from Specialists. LO5 Lark Limited reports a material balance of deferred development costs in its current financial statements. The cost relates to the development of a mobile robot that can be used to monitor temperature, humidity, and security in large warehouses. Lark's auditor obtained an engineers' report to support the technological feasibility of the robotics project and a market research consultant's report to determine the selling prices and volumes likely to be achieved over the first ten years that the product is marketed.

Required:

Explain the nature of audit evidence obtained in this case. How would this audit evidence affect the auditor's report? Compare the use of these specialists' reports in the audit with using the reports of other auditors.

EP 4-23 LO6

Required:

Find Nortel's 2004 annual report on its website or SEC filings, and review the audit reports for 2001–2004. In light of Nortel's history (as indicated in Chapter 1), do you think these reports are appropriate? Discuss.

EP 4-24 LO6

Required:

Explain auditor responsibilities regarding going-concern disclosures under GAAS. Contrast these with GAAP requirements and discuss ways of reconciling the two.

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APPENDIX 4A

The PCAOB/AICPA Standard Unmodified Report

AU Section 508 (paragraph .08) Reports on Audited Financial Statements

Independent Auditor's Report

We have audited the accompanying balance sheet of X Company as of December 31, 20X1, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X1, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Signed,

Date,

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APPENDIX 4B

Reporting on the Application of Accounting Principles

The subject of reporting on the application of accounting principles touches a sensitive nerve in the public accounting profession. It arose from clients' "shopping" for an auditor who would agree to give an unmodified audit report on a questionable accounting treatment. Shopping often involved auditor–client disagreements, after which the client said, "If you won't agree with my accounting treatment, then I'll find an auditor who will." These disagreements often involved early revenue recognition and unwarranted expense or loss deferral. A few cases of misleading financial statements occurred after the shopping resulted in clients' switching to more agreeable auditors. However, the practice is not entirely undesirable, because complex accounting matters often benefit from consultation with other PAs. Note that these situations illustrate the importance of a variety of perspectives on a financial reporting issue—a key aspect of critical thinking in professional judgment. It is clear from such situations that the application of accounting standards in specific circumstances is not always straightforward. Critical thinking helps to deal with such situations in a systematic, more defensible way.

The *CICA Handbook* section 7600 established procedures for dealing with requests for consultation from parties other than an auditor's own clients. These parties can include other companies (nonclients who are shopping), lawyers, investment bankers, and perhaps other people. Section 7600 is applicable in these situations:

- When preparing a written report or giving oral advice on specific transactions, either completed or proposed
- When preparing a written report or giving oral advice on the type of audit opinion that might be rendered on specific financial statements
- When preparing a written report on hypothetical transactions

The standard does not apply to conclusions about accounting principles offered in connection with litigation support engagements or expert witness work, nor does it apply to advice given to another PA in public practice. It also does not apply to an accounting firm's expressions of positions in newsletters, articles, speeches, lectures, and the like, provided that the positions do not give advice on a specific transaction or apply to a specific company.

The basic requirements are to consider the circumstances of the request for advice, its purpose, and the intended use of the report of the advice; to obtain an understanding of the form and substance of the transaction in question; to review applicable GAAP; to consult with other professionals, if necessary; and to perform research to determine the existence of creditable analogies and precedents (e.g., find the authoritative support). When the request for advice comes from a business that already has another auditor, the consulting PA should consult with the other auditor to learn all the facts and circumstances.

Written reports are required and should include these elements:

- Description of the nature of the engagement and a statement that it was performed in accordance with standards for such engagements
- Statement of relevant facts and assumptions, and the sources of information
- Statement of the advice—the conclusion about appropriate accounting principles or the type of audit report, including reasons for the conclusions, if appropriate

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- Statement that a company's management is responsible for proper accounting treatments, in consultation with its own auditors
- Statement that any differences in facts, circumstances, or assumptions might change the conclusions

The purpose of the section 7600 standards is to impose some discipline on the process of shopping/consultation and to make it more difficult for companies to seek out a "willing" auditor.

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Basic Auditing Concepts and Techniques

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CHAPTER 5

Preliminary Audit Planning: Understanding the Auditee's Business

Chapter 5 will take you through the start-up activities of the audit of an organization's general purpose financial statements. You will study the activities, concepts, and tools seen in a typical audit engagement.

EcoPak Inc.

Following Ella's advice, Kam and Mike hire a highly regarded information technology firm called Enterprise Integration Solutions to provide the latest in manufacturing hardware and software. The information technology (IT) firm also designs and implements business processes to look after all the main aspects of EcoPak's information processing, customer revenues, supplier purchasing, process inventory costing, warehousing and shipping, and general ledger accounting and reporting to comply with the International Financial Reporting Standards (IFRS) financial reporting framework. While this work is underway, Nima has decided to leave her public accounting job and join EcoPak as its full-time chief financial officer (CFO) so she can oversee the establishment of strong controls and corporate governance structure within EcoPak. Kam and Mike are thrilled to have Nima as part of the management team of their growing company. To establish a corporate governance structure for EcoPak, Aunt Zhang has been appointed as chair of EcoPak's board of directors, Kam as chief executive officer (CEO), and Mike as chief operating officer (COO).

Over the past few years, Ella's firm Pettit and Foure (P&F) has audited EcoPak's annual financial statements. All the board members really appreciate Ella's attendance at board meetings and her clear explanations of the key audit planning decisions she and her staff made prior to the audit, their work plan for their fieldwork visits to EcoPak's facilities, and her key findings after the audit. In addition to

LEARNING OBJECTIVES

After completing this chapter, you will be able to do the following:

LO1 Summarize the financial statement audit process.

LO2 Explain the main characteristics of an independent audit engagement.

LO3 Describe the activities auditors undertake to decide whether to accept a financial statement audit engagement.

LO4 Explain why auditors need to understand the auditee organization's business and environment and its risks and controls at the start of a financial statement audit.

LO5 Use preliminary analytical procedures on management's draft financial statements to identify areas where misstatements are most likely.

LO6 Explain the materiality levels used for planning the audit and how these amounts are determined.

LO7 Identify the principal assertions in management's financial statements and the related risks of material misstatement.

LO8 List the preliminary planning decisions set out in the overall audit strategy.

CHAPTER APPENDIX

Appendix 5A: Selected Financial Ratios

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her standard report, she always included a few valuable tips on how to improve EcoPak's controls and efficiency.

During their first audit, Kam and Mike were a bit puzzled by all the questions the audit staff asked them about the business and about why the audit manager needed to see the draft financial statements before they even started their audit on site, but when Nima explained how it was all part of following the standards it started to make more sense. "I think I get it," Kam said. "The audit team needs to really understand how our business works to get an idea about what our financial reports should be saying. That is the only way they could ever have a clue about what might have gone wrong in our numbers. And then they need to check things out on their own, to be reasonably sure in their own minds that those things haven't actually gone wrong. I see they have to do all that before they can sign off on that report they give us that says everything is 'fair and square.'" "You've got the picture, Kam," replied Nima. "But they actually say that all our financial statements 'present fairly' and 'in accordance with GAAP'—and that sends an important message to any outsiders that our financial statements are reliable for their purposes."

Kam, Mike, and Nima have all settled down now, with houses, mortgages, and growing families, so things have gone well. Based on the continuing success of EcoPak and its growth prospects, the next big hurdle will be to take the company public. This will allow the current shareholders to realize some return on the value of their investments in EcoPak. When EcoPak's board tells Ella of their plan, she informs them that, with regret, her firm will not be able to continue as EcoPak's auditor if it becomes a public company: "My partner and I have made a strategic decision to focus our practice on small to medium-sized private enterprises and not-for-profit organizations. We decided to leave the high-risk public company audits to larger firms that do lots of public company audits and are registered with the Canadian Public Accountability Board (CPAB). A larger audit firm also will have the capacity to stay with EcoPak as it grows and succeeds, because EcoPak will soon be too big for my firm to handle anyway. I can refer you to some great audit partners, and I will be happy to provide the successor audit firm with all the information they will need to decide to take the audit and get going on it efficiently."

After some enquiries, EcoPak's board approaches Tariq Khan, a partner at a large auditing firm Meyer & Gustav (M&G), and starts the ball rolling to engage that firm as its new independent auditor. After completing the pre-engagement analysis process required by its quality control system, M&G is able to accept the EcoPak audit engagement for its upcoming fiscal year. Tariq will be assigned as the partner in charge of the EcoPak audit engagement.

PRELUDE TO PARTS 2 AND 3 OF THE TEXT: PLANNING AND PERFORMING THE AUDIT

Now that we have examined the professional responsibilities of public accountants in Part 1, in Part 2 we look at how the public accountant takes on the role of independent auditor and assesses risks to plan the audit engagement. This involves integrating a strong business understanding with the key auditing concepts to assess risks of misstatements in the financial statements and to create an overall audit strategy for obtaining evidence supporting the audit opinion.

Chapter 5 starts with an overview of the whole process required perform an audit that will meet the requirements of GAAS[1] to provide a roadmap to the key topics to be covered through Parts 2 and 3 of the text. It then explains what an independent audit is, how an auditor decides whether to accept an audit engagement, and the first things he or she needs to do to get it started. These preliminary activities include analysis and enquiries of management that help the auditor assess the various risks in the engagement and the financial statements so an effective audit can be planned.

Looking ahead, the remaining chapters in Part 2 take you through the audit planning process and then apply your knowledge and understanding in creating a preliminary audit plan. Chapter 6 (Assessing Risks and Internal Control) expands on the knowledge needed to plan the audit by describing the relation between the business strategy and its risks, the

1 In this text, when we use the term 'GAAS' it refers to the standards set out in the CICA Assurance Handbook as CAS, CSQC, and Other Canadian Standards (OCS).

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role of management's business processes in reducing these risks, and the related information systems and control activities used to capture, summarize, and present reliable financial information. Understanding the systems and controls helps auditors to decide on key areas to audit. Chapter 7 (Assessing Fraud Risk) focuses on fraud risk, and the auditor's procedures related to identifying the risks of material misstatement due to fraud or non-compliance with laws. Chapter 8 (Audit Evidence and Assurance) explains how risk assessment helps the auditor identify audit evidence relevant to the assertions, and explains the fundamental concepts and tools used to develop the audit plan and specific audit programs of auditing procedures. An audit program identifies the procedures needed to provide the evidence supporting the audit opinion. Chapter 9 (Control Assessment and Testing) expands on the understanding required to evaluate and test controls, and the important role this evaluation plays in developing the detailed audit plan and programs. Finally, Chapter 10 (Audit Sampling) explains the sampling concepts that underlie the decisions that go into designing audit tests to collect evidence. Throughout Part 2, the ongoing and iterative nature of the audit planning process is illustrated.

Part 3 moves on to explain the actual audit work done in response to the assessed risks, and how to apply the concepts and tools in specific accounting processes in the auditee's business, as well as techniques for auditing the estimates included in the financial statements. You will learn how auditors gather evidence from different components of the auditee's systems and processes by testing controls and balances, and by performing analytical procedures. These audit procedures generate knowledge used to meet the planned audit objectives, as well as to refine the preliminary plan if needed. Part 3 will also explain how auditors synthesize their knowledge and evidence to decide whether the financial statements are fairly presented in accordance with the appropriate financial reporting framework, such as generally accepted accounting principles (GAAP). The critical activities of documenting the audit planning, the evidence gathered, and the basis of the opinion at the conclusion of the work will also be discussed throughout.

To keep things simple, Parts 2 and 3 of this text will focus mainly on the audits of the general purpose financial statements of typical profit-oriented business entities that are prepared in accordance with GAAP, such as IFRS or Accounting Standards for Private Enterprise(s) as set out in the *CICA Handbook,* or the U.S. GAAP. As noted in Chapter 4, an entity's management can use choose from different acceptable frameworks to present its financial statements, but in this text we will just focus on a framework that provides fair presentation in accordance with GAAP. We will use the term GAAP generally to refer to the applicable fair presentation framework. While the text focuses mainly on audits of profit-oriented business entities, the concepts, tools, and procedures covered also apply to audits of other types of entities, such as governments, schools, hospitals, and charities.

After working through Parts 2 and 3, you should be ready to join an audit team out in the field and fully appreciate the tasks you will be trained to do under the supervision of more experienced auditors. Experience shows that most of the actual learning about how to audit happens on the job.

THE INDEPENDENT FINANCIAL STATEMENT AUDIT

Preliminary Risk Assessment, Engagement Acceptance, and Planning

Chapter 5 introduces the preliminary risk assessment work required in an independent financial statement audit. The chapter starts off with an overview of the audit process required to comply with GAAS, giving a roadmap to the key topics to be covered in subsequent chapters. An explanation of the main characteristics of an independent audit engagement is provided next. This is followed by a description of the pre-engagement arrangements made as the public accountant decides whether to take on the role of independent auditor. Before the audit can even be accepted, the auditor must gain familiarity

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with the entity and terms of the audit, and consider the risks the auditor will be taking on if the engagement were accepted. This chapter then outlines the preliminary analytical procedures involved in developing an understanding of the organization's business and environment, and the form and content of management's financial statements which are the subject matter of the audit. These procedures help the auditor both to understand the business performance being communicated by management to stakeholders in its financial statements and to assess the risk of material misstatements. The fundamental concept of materiality is then explained, along with the methods auditors use to determine appropriate materiality levels for audit planning. The chapter next introduces the challenging concept of management assertions, an important tool used by auditors to assess the risk of material misstatements and to establish assertion-based audit objectives.

Finally, the chapter describes how all these activities are integrated into the overall audit strategy, a document that gives the audit team their marching orders in terms of the scope of the audit, who will work on it and when, and what are the significant risks the auditors need to come to grips with. The overall audit strategy guides the development of the audit plan, which contains more specific procedures for assessing risk of material misstatements and detailed audit programs listing procedures for providing evidence to support the auditor's conclusion. The audit plan includes the audit team's decision on whether to use a "substantive approach" or a "combined approach" to the audit. A substantive audit approach focuses on gathering evidence directly substantiating the monetary balances and transactions in the financial statements. In a combined approach, some of the required assurance is obtained indirectly through evidence that controls are likely to have prevented or corrected any material misstatements. A combined approach will include testing the controls in the auditee's information systems in addition to substantive evidence gathering.

OVERVIEW OF THE FINANCIAL STATEMENT AUDIT PROCESS

LO1 Summarize the financial statement audit process.

As outlined in Part 1, the CAS provide the overall objectives of a financial statement auditor and set out the requirements that must be met to meet these objectives.

STANDARDS CHECK

CAS 200

11. In conducting an audit of financial statements, the overall objectives of the auditor are:
    (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
    (b) To report on the financial statements, and communicate as required by the CAS/ISAs, in accordance with the auditor's findings.

Source: *CICA Handbook—Assurance*, 2012.

Based on these requirements, Exhibit 5–1 provides an overview of the audit process used in practice. This overview serves as a roadmap for the material covered in Parts 2 and 3 of the text. Note that the CAS set out several additional dimensions that are required to complete a financial statement audit that complies with GAAS as follows:

- Communications among audit team members throughout the process
- Documentation of the audit decisions and findings
- Revisions to risk assessments and planned responses if appropriate due to knowledge obtained during audit process
- Communications with those charged with the auditee's governance and its management

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EXHIBIT 5–1 The Audit Process: An Overview of an Independent Audit of Financial Statements

STEPS	ELEMENTS	AUDITOR ACTIVITIES, PROCEDURES & DECISIONS	CH
Risk Assessment	Pre-engagement activities	Obtain understanding of entity and engagement	5
		Determine if pre-conditions for audit are present, including management integrity and responsibility	
		Assess auditor's independence from auditee	
		Identify auditor's risks arising from engagement	
		Engagement acceptance or continuance decision	
	Preliminary Audit Planning: Risk Identification	Understand auditee's business, environment, risks, and management control	
		Analyze management's draft financial statements	
		Determine materiality levels	
		Identify key financial statement assertions and related risks of material misstatement	
		Identify significant risks in the auditee, including governance, fraud, going concern, related parties, controls over financial reporting	
		Assess risks of material misstatement at overall financial statement level	
		Develop the overall audit strategy	
	Risk Assessment Procedures to Plan Audit	Determine audit risk level to be accepted	6
		Understand the accounting information system and financial reporting process	
		Assess inherent and control risks, combined as risk of material misstatement, at the assertion level for account balances, transaction classes and disclosures	
		Determine whether control reliance is appropriate for specific assertions	
		Assess fraud risk and risk of non-compliance with laws	7
		Identify evidence procedures available to meet audit objectives	8
		Determine nature and timing of control tests and substantive procedures required to respond to assessed risks at the assertion level	
		Develop audit plan and detailed programs	
		Document the planning by creating working paper files	
Response to Assessed Risks	Internal control documentation and testing	Identify key controls for reliance and any significant control deficiencies	9
		Evaluate key control effectiveness by control testing	
		Apply control evaluation to planning further substantive procedures	
	Sampling decisions	Apply sampling concepts to determine extent of control tests and substantive test procedures	10
	Substantive procedures	Perform planned substantive procedures for account balances and transactions in all significant accounting processes	11–14
		Perform audit of estimates	19
		Perform audit of revenues and expenses	15
		Perform audit completion procedures, review subsequent procedures, contingencies, assess going concern, etc.	
Concluding and Reporting	Review audit findings	Review documentation to assess sufficiency and appropriateness of audit evidence obtained	16
		Review accumulated known and likely misstatements to assess financial reporting risks, adequacy of disclosures	
	Form opinion and issue report	Form conclusion on fair presentation and issue appropriate audit opinion and report	17

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A more detailed picture of the independent audit process is presented on the inside front cover of the text, which also shows these additional key ongoing activities that auditors are required to perform throughout the engagement. Ongoing communication, reconsideration of planned audit work based on the knowledge gained as the audit proceeds, and documenting the work into a working paper file that provides an accurate record of the results of the audit work as support for the auditors' opinion, are critical activities throughout the engagement.

REVIEW CHECKPOINTS

5-1 What are the three main steps in the financial statements audit process?

5-2 What other ongoing activities do auditors need to perform to complete an audit in accordance with generally accepted auditing standards as set out in the CAS?

INDEPENDENT AUDIT ENGAGEMENT CHARACTERISTICS

LO2 Explain the main characteristics of an independent audit engagement.

A wide variety of organizations, or "entities," are required to produce financial statements to meet their external stakeholders' information needs, and to have them independently audited. The best-known examples of entities are corporations with publicly traded shares or bonds (e.g., Research In Motion, Bank of Montreal, Microsoft) that require audited financial statements due to securities laws. You have probably already looked at audited financial statements for these types of entities in your accounting and finance courses. Private corporations with significant non-management shareholders or creditors may also often need audits due to demands of these stakeholders. In some jurisdictions, however, the audit requirement for a private company can be waived if all the shareholders agree. As a result, private corporations with few external stakeholders often do not need audited financial statements. Governments, public sector corporations (e.g., Export Development Corporation), not-for-profit organizations (charities, hospitals, universities), large partnerships (e.g., law or accounting firms) will also often require audits, due either to law or demands of stakeholders.

Every entity will have one or more people who are responsible for the operations of the entity and thus are accountable to its stakeholders. These people are referred to in the CAS as **those charged with governance**. Depending on the type of entity, these people might be the board of directors, the executive management team, the president, or the sole shareholder.

those charged with governance: person(s) or organization(s) (may include management) with responsibility for overseeing the strategic directions of the entity and obligations related to the accountability of the entity; includes overseeing the financial reporting process

The text mainly uses the terms "auditee" or "organization" or "entity" to refer to the entity whose financial statements are being audited. In practice, auditors commonly refer to these as "audit clients" because most of the time the auditor is engaged by the people charged with governance within the auditee entity. Recalling the three-party accountability model, you can see three parties among the entities and people described above. You can also see the importance of the auditor maintaining professional independence when the accountable party is, at the same time, the auditee, entity, and client who has engaged the auditor and pays the fee. This is why, at the outset of an audit engagement, it is so important for the auditors to understand what kind of entity is being audited, who the people are who are charged with governance of the entity, the stakeholders to whom they are accountable, and the client's reasons for wanting an audit. These are key starting points for the auditor in really understanding the auditee's business, the risks of the financial statements being misstated, and the risks involved in taking on the audit engagement for the auditor personally and for the audit firm's own business.

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STANDARDS CHECK

CAS 200

4. The financial statements subject to audit are those of the entity, prepared by management of the entity with oversight from those charged with governance. ISAs do not impose responsibilities on management or those charged with governance and do not override laws and regulations that govern their responsibilities. However, an audit in accordance with ISAs is conducted on the premise that management and, where appropriate, those charged with governance have acknowledged certain responsibilities that are fundamental to the conduct of the audit. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities. (Ref: Para. A2–A11)

Source: *CICA Handbook—Assurance*, 2012.

REVIEW CHECKPOINTS

5-3 What types of company's need audited financial statements? What types of companies often do not need to be audited?

5-4 What is an "audit client"? How does it differ from an "auditee"?

5-5 Who are "those charged with governance", and what are their responsibilities?

AUDIT ENGAGEMENT ACCEPTANCE DECISION

LO3 Describe the activities auditors undertake to decide whether to accept a financial statement audit engagement.

Pre-engagement Activities

The first thing the auditor has to decide is whether to undertake the audit engagement at all. Not every organization is desirable as an auditee! Auditors undertake several activities, called the **pre-audit risk management activities**, before beginning any audit work on an organization's financial statements. This is our first introduction to the risk management activities auditors use in practice. The term **auditor's risk from taking the engagement** is used to refer to the possibility that negative consequences will arise for the auditor as a result of taking on a particular audit engagement. Such negative consequences could include damage to professional reputation, getting sued for being associated with misleading financial information, or suffering financial loss due to not recovering the cost of doing the audit. This auditor's engagement risk is carefully managed initially by exercising great care in deciding whether to acceptance the engagement in the first place. Once an engagement is accepted, auditors try to reduce risk by carefully conducting the audit to reduce the probability that something will go wrong that might lead to misstated financial statements being released to users. The flip side of risk management is quality management. Professional standards include requirements for firms to have a good risk management system and policies in place (CSCQ-1), and for quality to be monitored on individual engagements(CAS 220). The topics covered next are understood in the context of risk management and quality management.

pre-audit risk management activities: procedures auditors perform before accepting an audit engagement to ensure the client and the engagement do not pose an unacceptably high risk of audit failure

auditor's risk from taking the engagement: possibility that negative consequences will arise for an auditor's professional practice as a result of taking on a particular audit engagement, such as damage to reputation, litigation, or financial loss

STANDARDS CHECK

CSQC 1

11. The objective of the firm is to establish and maintain a system of quality control to provide it with reasonable assurance that:
    (a) The firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and
    (b) Reports issued by the firm or engagement partners are appropriate in the circumstances.

CAS 220

6. The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:
    (a) The audit complies with professional standards and applicable legal and regulatory requirements; and
    (b) The auditor's report issued is appropriate in the circumstances.

Source: *CICA Handbook—Assurance*, 2012.

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Audit Engagement Acceptance and Continuance

An important element of a public accounting firm's quality control policies and procedures is a system for deciding to accept a new audit engagement or to continue with current engagements. Public accounting firms are not obligated to accept undesirable audit clients or to continue when relationships deteriorate or the auditee's management comes under a cloud of suspicion. For example, an auditor may think twice about accepting an engagement with management that has a poor business reputation or questionable integrity.

Acceptance and continuance decisions involve the following policies and procedures:

1. Obtain and review financial information about the prospective auditee organization (e.g., annual reports, interim financial statements, registration statements, annual information forms, and reports to regulatory agencies) to determine the purpose and main users of the financial statements and the basis of accounting being used.
2. Evaluate the public accounting firm and individual auditor's independence and ability to comply with other relevant ethical requirements with regard to the prospective auditee.
3. Consider whether the public accounting firm has the competence and resources to perform the audit, including any need for special skills (e.g., information systems auditing or specialized industry knowledge).
4. Obtain information from the prospective auditee's management in order to understand the business and its risks, and to assess whether the organization's managers and those charged with its governance are willing and able to accept responsibility for preparing financial statements in accordance with an acceptable financial reporting framework and for implementing adequate controls to reduce risk of error and fraud.
5. Consider whether the engagement requires special attention or involves unusual risks (e.g., financial statement users rely heavily on the general purpose financial statements for important financial decisions and/or have no access to other information about the company's financial condition and performance; there is high media interest in the organization; management competence or integrity is questionable; etc.).
6. Search for information about the organization by looking for news reports, and, when possible, asking the prospective auditee's banker, legal counsel, underwriter, or other business associates about the organization, giving particular attention to any indicators relating to the integrity of principal owners, managers, or those charged with its governance.
7. For new audits, communicate with the previous auditor, if possible, for information on the integrity of management, on disagreements with management about accounting principles and procedures or similar matters, and on the reasons for a change of auditors.

Further details and guidance on the matters to consider prior to accepting the audit are provided in CSQC-1 and CAS 210.

STANDARDS CHECK

CSQC 1

Acceptance and Continuance of Client Relationships and Specific Engagements

26. The firm shall establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide the firm with reasonable assurance that it will only undertake or continue relationships and engagements where the firm:
    (a) Is competent to perform the engagement and has the capabilities, including time and resources, to do so; (Ref: Para. A18, A23)
    (b) Can comply with relevant ethical requirements; and
    (c) Has considered the integrity of the client, and does not have information that would lead it to conclude that the client lacks integrity. (Ref: Para. A19–A20, A23)

Source: *CICA Handbook—Assurance*, 2012.

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STANDARDS CHECK

CAS 300

6. The auditor shall undertake the following activities at the beginning of the current audit engagement:
   (a) Performing procedures required by CAS 220 regarding the continuance of the client relationship and the specific audit engagement;
   (b) Evaluating compliance with relevant ethical requirements, including independence, in accordance with CAS 220, and
   (c) Establishing an understanding of the terms of the engagement, as required by CAS 210. (Ref: Para. A5–A7)

Source: *CICA Handbook—Assurance*, 2012.

STANDARDS CHECK

CAS 210

3. The objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through:
   (a) Establishing whether the preconditions for an audit are present; and
   (b) Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.
4. For purposes of the CASs, the following term has the meaning attributed below:
   Preconditions for an audit: The use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted.
5. For the purposes of this ISA, references to "management" should be read hereafter as "management and, where appropriate, those charged with governance."

Source: *CICA Handbook—Assurance*, 2012.

Determining Auditability

Through discussions with the prospective auditee's management personnel (as well as those charged with governance; e.g., the board of directors), the auditor must determine whether the organization is "auditable." This involves determining whether the financial statements will be presented in accordance with GAAP or another acceptable reporting framework. Without an acceptable framework, the auditor lacks suitable criteria for evaluating whether the statements are properly presented, and the audit engagement must be declined.

The auditor must be satisfied that the prospective auditee's management understands their responsibilities for preparing financial statements in accordance with the acceptable financial reporting framework and for implementing and maintaining internal control adequate to ensuring financial statements are free of misstatements due to either error or fraud; otherwise, the risk of misstatements may be too high. Management also must be willing to provide all required information and to grant the auditor unrestricted access to records, documentation, and any other needed sources. The auditor will also want management's commitment to providing written representations at the end of the audit that they have given this information. If management will not do these things, or if it imposes some limitation on the scope of the auditor's work that could lead to a disclaimer of audit opinion, it is usually not appropriate to accept that engagement.

Decisions to continue auditing an organization are similar to acceptance decisions, except that the public accounting firm will have more first-hand experience with the auditee. *Retention reviews,* done annually, take many possible changes into account: management, directors, ownership, legal counsel, financial condition, litigation status, nature of the auditee's business, scope of the audit engagement, uses of the financial statements, and auditor's independence issues. Conditions causing an audit firm to reject a prospective auditee may develop at any time. For example, an auditee may expand and diversify on an international scale so that a small auditing firm does not have the competence to continue. It is not unusual to see newspaper stories, such as the ones summarized in the box on the next page about auditors dropping auditees.

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REASONS WHY AN AUDITOR QUITS

These news stories relate situations in which auditors needed to reconsider whether to continue engagements.

Questionable Management Integrity

Ernst & Young resigned early in 2001 as auditors of Cinar Corp. after Cinar management refused to assist in determining whether the company's books contain evidence of fraud, illegal acts, or related-party transactions, Cinar said. Cinar said it plans to issue unaudited financial statements for 1999 and the first six months of 2000. It would normally have had these financial statements audited. However, when Cinar informed its independent auditors Ernst & Young LLP that its management would not be able, until at least the completion of fiscal 2001, to make the necessary representations regarding the accuracy of the company's financial statements, Ernst & Young then resigned. In March 2000, Cinar fired founders and co-chief executives Micheline Charest and Ron Weinberg after auditors discovered $20 million in company funds had been invested in off-shore accounts without the knowledge of the board of directors.

Auditor Firm's Independence May Be Impaired

In July 2003, PricewaterhouseCoopers LLP resigned as one of two auditors for Royal Bank of Canada (RBC). PwC had provided non-audit services to one of the bank's subsidiaries in July and August of 2003, RBC said. Though providing such services did not violate any Canadian requirements, a review of the matter by RBC and PwC concluded such services may have impaired PwC's independence under the much more rigid U.S. rules of auditor independence. These toughened rules resulted in May 2003 when the U.S. Securities and Exchange Commission (SEC) adopted revised independence standards brought forward by the *Sarbanes-Oxley Act* (SOX). RBC said it must comply with U.S. rules because its shares are listed on the New York Stock Exchange and it files reports with the SEC. Although the fees for the nonaudit work by PwC came to less than $200,000, the amount is irrelevant under the SEC rules, RBC said. A financial analyst praised RBC for its handling of the issue. "While everyone is concerned when auditors resign," the analyst said in a research note, "this is an occasion when a company is showing its highly professional attitude toward corporate governance."

Management Fraud

In February 2007, the Institute of Chartered Accountants of Ontario (ICAO) found three Deloitte & Touche LLP accountants guilty of professional misconduct in connection with the disastrous audit of Livent's books in 1998. The auditors failed to uncover the alleged fraud in the financial statements of Livent Inc. and must each pay $100,000 in fines and $417,000 in costs following the longest disciplinary hearing on record for the ICAO. "The auditors knew this was a high-risk audit yet they failed to exercise the required degree of professional skepticism," the ICAO disciplinary panel wrote in its decision. Livent, the theatre company that produced shows such as *Phantom of the Opera* and *Ragtime*, collapsed amid allegations of widespread accounting fraud. Criminal charges have been laid against former members of Livent's management. A fourth Deloitte accountant who was originally included in the complaint disagreed with the accounting treatment of key elements of the audit and argued that Deloitte should resign after Livent managers allegedly lied to the auditors. His warnings were ignored, with devastating results for the other three auditors who were handed down the largest fines the ICAO has ever charged.

Sources: Adapted from "Ernst & Young resign as auditors of Montreal-based Cinar, management says," *Canadian Press NewsWire*, January 26, 2001; Keith Kalawsky, "PricewaterhouseCoopers resigns as RBC auditor," *CanWest News*, September 23, 2003, p. 1; John Gray, "Accountants get the hook," *Canadian Business*, 80 (21), October 22, 2007, p. 19.

Communication between Predecessor and Successor Auditors

predecessor: the auditor that held the engagement previously, before a new successor auditor took on the engagement

successor: a new auditor who takes over the engagement from the predecessor

When organizations change auditors, the former auditor is called the **predecessor**, and the new auditor the **successor**. Experience has shown that auditors are fired because of arguments about the scope of the audit or the acceptability of accounting principles. Sometimes, these arguments involve auditors' access to necessary evidence, questions of early revenue recognition, or disputes over deferral of expenses and losses. Often, however, a change in business ownership or a concern over fees is the reason.

As discussed in Part 1 of the text, ethics codes for professional accountants require a successor auditor to initiate contact and attempt to obtain basic information directly from the predecessor. The former auditor knows a great deal about the auditee and can give information that will be useful in (1) deciding whether to accept the new auditee and (2) planning the audit. The rules of conduct require the predecessor to respond promptly to communications from the successor.

It is common practice for the successor to explain the situation and the rules to the auditee's management, asking them to give the predecessor consent to speak to the successor and allow the successor to review the prior year's audit files. This consent will determine the amount of auditee information conveyed to the successor. Note that the audit files belong to the auditor, not the auditee, but confidentiality must be respected, even after

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the auditor–auditee relationship ends. The prospective auditee management's refusal to consent would raise serious concerns about their integrity, and the successor may decide it is too risky to accept this engagement.

With consent, the predecessor can speak freely. It is not unusual to have a cordial changeover, with the successor interviewing the predecessor's staff and obtaining copies of the predecessor's working papers, thus greatly facilitating the successor's first-time audit.[2]

Auditor's Risk from Accepting an Audit Engagement

There will always be some risk in taking on an audit, but, ultimately, the auditor must decide whether the risk is manageable prior to accepting a particular engagement. Some of the key factors that go into this decision are presented in the box below.

FACTORS AFFECTING THE AUDITOR'S RISK FROM ACCEPTING ENGAGEMENT	IMPLICATIONS FOR THE AUDITOR'S ASSESSMENT
How widely distributed are the audited financial statements?	If widely distributed to the public, such as for a publicly listed company, risk from accepting engagement is higher (reputation risk). If limited distribution, it is lower.
How strong is the financial condition of the auditee?	If financial condition is poor, risk from accepting engagement is higher because financial failure can lead to investor losses and lawsuits against the auditor to recover them (legal liability risk). Another concern could be that the audit fees cannot be collected to cover the costs of doing the audit. If financial condition is strong, risk is lower.
How trustworthy is auditee management?	If the auditor has reason to doubt management's integrity, the risk from accepting engagement is higher (misstated financial reporting risk). If the auditor has reasons to believe management is trustworthy, it is lower.
How complex is the financial reporting required?	If the auditee has complicated or unusual accounting requirements, such as derivatives use or foreign operations, and/or engages in unusual transactions, such as related party or inter-corporate investments, the accounting will be very challenging and the risk from accepting engagement will be higher (misstated financial reporting risk). If the auditee has relatively straightforward activities and transactions, it will be lower.
How knowledgeable are the people likely to be using the financial statements?	If the users are relatively naïve, and/or completely reliant on the audited financial statements for their decision needs, the risk from accepting engagement will be higher (legal liability risk). If the users are relatively sophisticated and/or have direct access to relevant information other than the audited financial statements for their decisions, it will be lower.

We can envision the auditor's assessment of his or her risk from an audit engagement along a continuum, an auditor may decide to take on low-, moderate-, or even a high-risk engagement, as long as the auditor is confident that the risk can be managed down to an acceptable level through careful performance of the audit work. But at very high levels, just like the "revs" of a car engine, at some point the risk crosses the "red line" and the auditor will have to decline the engagement. Where is the red line reached? It depends on the judgment of each auditor, which is based on their capacity to manage the risks and their personal tolerance for risk.

2 A change of auditors might cause the successor's report to be modified from the standard form. The predecessor/successor situation involves the successor reporting on the current year, but the prior-year comparative financial statements were audited by the predecessor. The successor's report should disclose this fact in a separate paragraph following the opinion paragraph, as required in CAS 710.

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REVIEW CHECKPOINTS

5-6 What sources of information can an auditor use in deciding whether to accept a new audit engagement?

5-7 Why does the successor auditor need to obtain the auditee's consent in order for the predecessor auditor to provide the successor with information about the auditee?

5-8 High Roller Inc. needs an audit and has asked two different audit firms to bid on the engagement. Both auditors assess the engagement risk to be high. Auditor A declines the engagement, but Auditor B agrees to accept it. Why could the two auditors reach different conclusions in this situation?

Engagement Letters

engagement letter: sets forth terms of engagement, including an agreement about the fee, when a new audit client is accepted

When a new audit is accepted, the auditor must obtain an **engagement letter** (Exhibit 5–2). Auditing standards require that the auditor and auditee management establish a mutual understanding of, and agreement on, the terms of the engagement.[3] The agreement is documented to reduce the risk that either the auditor or the auditee misinterprets the needs or expectations of the other party. For continuing auditees, the auditor confirms the terms of the engagement annually, in writing. Every year, the auditor must take into account whether there are any new circumstances that would require the terms to be revised, such as a significant change in the nature or size of the entity's business.

The engagement letter is, in effect, the contract. The letter should cover the objective, scope, and limitations of the audit as well as respective responsibilities of both parties. It should specify the applicable financial reporting framework to be used, explain the form of audit report expected to be given, and indicate that the form of report may change if circumstances require that. The letter may list special requests and assignments the auditors will undertake, or it may be a standard letter stating that an audit of financial statements will be performed in accordance with generally accepted auditing standards (GAAS). An engagement letter can head off claims that the auditors did not perform the work promised; for example, agreeing on a completion date can reduce disappointments later on.

The engagement letter also may set forth the auditor's fee, which normally is based on the time required to perform the services. Such time estimates require some familiarity with the accounting system. Also, changes in fees and services from the previous year would be communicated.

STANDARDS CHECK

CAS 210 (PARTIAL)

10. . . . the agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include: (Ref: Para. A22–A25)
    (a) The objective and scope of the audit of the financial statements,
    (b) The responsibilities of the auditor;
    (c) The responsibilities of management;
    (d) Identification of the applicable financial reporting framework for the preparation of the financial statements; and
    (e) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

Source: *CICA Handbook—Assurance*, 2012.

Auditing standards provide a template for an engagement letter. Every letter needs to be adapted to the circumstances of the auditee organization and the audit. Exhibit 5–2 shows an engagement letter for the audit of a privately held real estate development company.

3 CAS 210, paragraphs 3, 6, and 10.

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EXHIBIT 5–2 Example of an Engagement Letter

November 6, 20X4
Ms. Harriet Liu, President
Real Estate Development Limited
600 Paree Street
Richmond, BC

Dear Ms. Liu:

You have requested that we audit the financial statements of Real Estate Development Limited ("the company"), which comprise the balance sheet as at December 31, 20X4, and the income statement, statement of changes in equity, and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes. Our audit will be conducted with the objective of expressing an opinion on the financial statements. Our understanding is that the intended purposes of the financial statements are to report to the Real Estate Development Limited shareholders and to satisfy the requirements of Real Estate Development Limited's credit agreement with the Regal Bank of British Columbia. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter.

Our Responsibilities

As auditors, our responsibility is to conduct the audit in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

Because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements may remain undiscovered.

In making our risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing a separate opinion on the effectiveness of the entity's internal control. However, if we identify any of the following matters, they will be communicated to you.

(a) Misstatements, resulting from error, other than trivial errors
(b) Fraud or any information obtained that indicates that a fraud may exist
(c) Evidence obtained that indicates that an illegal or possibly illegal act, other than one considered inconsequential, has occurred
(d) Significant weaknesses in the design or implementation of internal control to prevent and detect fraud or error
(e) Related party transactions identified by our audit team that are not in the normal course of operations and that involve significant judgments made by management concerning measurement or disclosure

The matters communicated will be those that we identify during the course of our audit. Audits do not usually identify all matters that may be of interest to management in discharging its responsibilities. The type and significance of the matter to be communicated will determine the level of management to which the communication is directed.

One of the underlying principles of the profession is a duty of confidentiality with respect to client affairs. Accordingly, except for information that is in or enters the public domain, we will not provide any third party with confidential information concerning the company's affairs without the company's prior consent, unless required to do so by legal authority, or the rules of professional conduct/code of ethics of the provincial public accountancy council.

Company responsibilities

Our audit will be conducted on the basis that you, your management team, and the company's Board of Directors who are charged with governance acknowledge and understand that you are responsible for:

(a) Preparation and fair presentation of the financial statements in accordance with Canadian generally accepted accounting principles. This includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.
(b) Providing us with all information, such as records, documentation and related data, copies of all minutes of meetings of shareholders, directors, and committees of directors, and other matters that are relevant to the preparation and fair presentation of the financial statements.
(c) Providing us with any additional information we may request from the company, such as
   - Information relating to any known or probable instances of non-compliance with legislative or regulatory requirements, including financial reporting requirements;
   - Information relating to any illegal or possibly illegal acts, and all facts related thereto;
   - Information regarding all related parties and related party transactions;
   - An assessment of the risk that the financial statements may be materially misstated as a result of fraud;
   - Information relating to fraud or suspected fraud affecting the entity involving management, employees who have significant roles in internal control, or others, where the fraud could have a non-trivial effect on the financial statements;
   - Information relating to any allegations of fraud or suspected fraud affecting the entity's financial statements communicated by employees, former employees, regulators, or others;
   - Significant assumptions underlying fair-value measurements and disclosures in the financial statements, and management's assessment of their reasonableness;
   - Any plans or intentions that may affect the carrying value or classification of assets or liabilities;

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EXHIBIT 5–2 Continued

- Information relating to the measurement and disclosure of transactions with related parties;
- An assessment of all areas of measurement uncertainty known to management that are required to be disclosed in accordance with Canadian generally accepted accounting principles;
- Information relating to claims and possible claims, whether or not they have been discussed with Real Estate Development Limited's legal counsel; other liabilities and contingent gains or losses, including those associated with guarantees, whether written or oral, under which Real Estate Development Limited is contingently liable;
- Information on whether Real Estate Development Limited has satisfactory title to assets, whether any liens or encumbrances on assets exist, and whether any assets are pledged as collateral;
- Information relating to compliance with aspects of contractual agreements that may affect the financial statements; and
- Information concerning subsequent events.

(d) Providing us with unrestricted access to those within the company from whom we determine it is necessary to obtain audit evidence

As part of our audit process, we will request from management and, where appropriate, those charged with governance, written confirmation concerning representations provided to us during the audit on matters that are

- Directly related to items that are material, either individually or in the aggregate, to the financial statements;
- Not directly related to items that are material to the financial statements but are significant, either individually or in the aggregate, to the engagement; and
- Relevant to your judgments or estimates that are material, either individually or in the aggregate, to the financial statements.

Reporting

Unless unanticipated difficulties are encountered, at the conclusion of my audit we will submit to you a report containing our opinion on the financial statements. We expect to report as shown in the Appendix to this letter:

[Include Standard Audit Report as an Appendix.]

If during the course of my work it appears for any reason that we will not be in a position to render an unqualified opinion on the financial statements, we will discuss this with you.

Other Matters

We will ask that your personnel, to the extent possible, prepare various schedules and analyses, and make various invoices and other documents available to the audit team members. This assistance will facilitate our work and minimize your audit costs. We look forward to full cooperation from your staff during our audit.

We may also submit to you a memorandum containing our comments on the adequacy of existing systems of internal control, accounting policies and procedures, and other related matters which come to our attention during the course of the audit.

We ask that our firm name be used only with our consent, and that any information to which we have attached a communication be issued with that communication unless otherwise agreed to by our firm.

Our charges to the company for the audit services will be made at our regular rates plus out-of-pocket expenses. Bills will be rendered on a regular basis with payment to be made upon presentation.

The above terms of this engagement will be effective from year to year until amended or terminated in writing. If you have any questions about the contents of this letter, please raise them with Mo Kelley, the audit partner assigned to your audit. If the services outlined are in accordance with your requirements and if the above terms are acceptable to you, please sign the copy of this letter in the space provided and return it to us. We appreciate the opportunity to be of service to your company.

Yours very truly,

Kelley and Randu, LLP, PUBLIC ACCOUNTANTS

Acknowledged and agreed on behalf of Real Estate Development Limited by

Harriet Liu [date]

Source: Adapted from *CICA Handbook* (2006 ed.), section 5110, appendix, and CAS 210.

Staff Assignment and Time Budgets

The availability of staff with appropriate skills to conduct the audit is a key practical consideration in the engagement acceptance decision. If a new audit engagement is accepted, most public accounting firms will assign a full-service team to it. For audits of larger organizations, this team usually consists of the audit engagement partner (the person with final responsibility for the audit), the audit manager, one or more senior audit staff members, staff assistants or public accounting students, information systems or industry experts (if needed), a tax partner, and a second audit partner. For smaller auditees, the team may consist of only one or two people; for example, the partner and one staff assistant.

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Firm policy, particularly for public company audits, will require that a second audit partner review the work of the audit team to ensure firm quality standards are met. This partner is expected to have a detached professional point of view because he or she is not directly responsible for keeping friendly relations with the auditee's personnel. The partner and manager in charge of the audit prepare a time budget as a plan for the timing of the work and the number of hours each segment of the audit is expected to take. The budget is based on last year's performance for continuing auditees, taking into account any changes in the auditee's business. In a first-time audit, it may be based on a predecessor auditor's experience or on general experience with similar companies. A simple time budget is shown in Exhibit 5–3.

This particular budget is illustrative only and not complete. Real time budgets are much more detailed, but the exhibit shows a typical assignment of work to audit team members at different experience levels, such as partner, manager, senior auditor in charge of field work, intermediate and junior staff assistants. This table shows time at interim and at year-end.

Interim audit work covers procedures performed several weeks or months before the balance sheet date. The exact timing of the interim work depends on the circumstances, such as when enough transaction data will be available making it efficient for the auditor to start performing procedures; when auditee reconciliations or count procedures are available for audit purposes; when auditee staff has time to accommodate and assist the auditors; and other practical issues.

interim audit work: covers procedures performed several weeks or months before the balance sheet date

Year-end audit work refers to procedures performed at and shortly after the balance sheet date. As many auditees have year-ends on the same date (December 31 is common), audit firms typically ensure they will have time and people available by spreading the workload over the year. For many audit firms, the "busy season" runs from October through June of the following year. The interim work can consist of both internal control risk assessment and auditing balances as they exist at an early date, or examination of documents or electronic information only available for a certain period during the year.

year-end audit work: audit procedures performed at and shortly after the balance sheet date

The time taken to perform procedures for each segment of the audit work is recorded by budget category so that (1) there is a record for billing the auditee, (2) the efficiency of the audit team members can be evaluated, and (3) there is a record for planning the next audit. This may cause some staff members to feel pressured to "meet the budget." Beginning auditors, in particular, can get frustrated before they learn how to work efficiently. They

EXHIBIT 5–3 Illustration of a Simple Time Budget

		AUDIT TIME BUDGET (HOURS)	
	STAFF ASSIGNED	INTERIM	YEAR-END
Knowledge of the business	Whole team	15	
Assessment of risk of material misstatement	Partner, Manager, and Senior	10	
Control testing	Senior and Junior	30	10
Audit planning	Partner and Manager	25	
Related parties investigation	Manager	5	15
Auditor-auditee conferences	Whole team	10	18
Cash	Junior	10	15
Accounts receivable	Intermediate	15	5
Inventory	Senior	35	20
Accounts payable	Intermediate	5	35
Other accounts	Senior		10
Representation letters	Manager and Senior		10
Financial statement review	Partner and Manager		25
Report preparation	Partner		12
Total		160	175

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may be tempted to understate the actual time they spent, with the result that not enough time is budgeted for future audits. Firms can lessen the problem by building learning time for less-experienced staff into the budgets.

REVIEW CHECKPOINTS

5-9 What benefits are obtained by having an engagement letter?

5-10 What is the purpose of a time budget, and what information does it contain?

5-11 What is interim audit work? year-end audit work?

LO4 Explain why auditors need to understand the auditee organization's business and environment and its risks and controls at the start of a financial statement audit.

overall audit strategy: an audit planning document that sets the scope, timing and direction of the audit, and that guides the development of the audit plan, including the reporting objectives; the nature, timing, and extent of resources necessary to perform the engagement; and the nature of the communications required

audit plan: document containing all the detailed auditing programs with procedures to be performed in response to the assessed risk of material misstatement on an audit, guided by the decisions made in the overall audit strategy

UNDERSTANDING THE AUDITEE'S BUSINESS, ENVIRONMENT, AND RISKS

Understanding the Business and Its Environment and Risks

The objective of a financial statement audit is to render an opinion on whether the financial statements, taken as a whole, are fairly presented in accordance with generally accepted accounting standards. Understanding the auditee's business and its operating environment is very important in starting out the audit, as it helps to assess the risk that the auditee's financial statements might contain material misstatements and therefore not be fairly presented. The term "material" in the preceding sentence refers to the key accounting and auditing concept of materiality—a misstatement significant enough to affect an important decision someone might make on the basis of that information.

Early in the engagement, the auditor sets out to understand the auditee's business, its environment, and its internal controls, in order to identify and assess the risks of material misstatement in the financial statements. This understanding is the basis of establishing an **overall audit strategy** for the engagement and to guide the design of a detailed **audit plan** containing a set of audit programs that effectively address all the significant risks of financial statement misstatements. An **audit program** is a list of the procedures believed necessary to obtain sufficient appropriate evidence about significant components of the financial statements. This evidence is the basis on which the auditor obtains 'reasonable assurance' that the financial statements are fairly presented and supports the opinion stated in the auditor's report.

STANDARDS CHECK

CAS 320

2. Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:
   - Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
   - Judgments about materiality are made in light of surrounding circumstances and are affected by the size or nature of a misstatement or a combination of both; and
   - Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

Source: *CICA Handbook—Assurance*, 2012.

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Auditing standards require the auditor to document the overall strategy, audit plan, audit programs, and evidence that support the report.[4] A program "in my head" is not sufficient. Audit programs are explained more fully in the remaining chapters of Part 2 and detailed examples are provided in Part 3.

audit program: a list of the audit procedures auditors need to perform to produce sufficient, competent evidence as the basis for good audit decisions

STANDARDS CHECK

CAS 315

3. The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

5. The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. (Ref: Para. A1–A5)

Source: *CICA Handbook—Assurance*, 2012.

To ascertain the auditee's business risks, first the auditor investigates the management's understanding of its business risks, and then he or she independently assesses both the business risk and management's risk assessment process to determine how likely a material misstatement of the financial statements is. The auditing standards explain the risk assessment procedures for obtaining an understanding of the auditee as well as sources of information about the auditee entity and its environment, including its internal control.

STANDARDS CHECK

CAS 315

11. The auditor shall obtain an understanding of the following:
    (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. (Ref: Para. A17–A22)
    (b) The nature of the entity, including:
        (i) Its operations;
        (ii) Its ownership and governance structures;
        (iii) The types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
        (iv) The way that the entity is structured and how it is financed, to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements. (Ref: Para. A23–A27)
    (c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. (Ref: Para. A28)
    (d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. (Ref: Para. A29–A35)
    (e) The measurement and review of the entity's financial performance. (Ref: Para. A36–A41)

Source: *CICA Handbook—Assurance*, 2012.

The standards also require the audit team to discuss the susceptibility of the auditee's financial statements to material misstatement. Based on its shared understanding, the audit team can identify what can go wrong at the financial statement level.[5] Assessing the **risk of material misstatement** at the financial statement level requires the audit team to identify any factors that create significant business and fraud risks that could have a pervasive effect on many elements of the financial statements.

risk of material misstatement: assessed on the financial statements overall and based on pervasive factors such as fraud, going concern, or other significant business-level risks; the auditor's assessment of combined inherent and control risk

4 CAS 300, paragraphs 7–8.; CAS 230, paragraph 8.

5 CAS 315.

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STANDARDS CHECK

CAS 315

10. The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion. (Ref: Para. A14–A16)

Source: *CICA Handbook—Assurance*, 2012.

Later, the audit team will perform more detailed risk assessments of the individual elements of the financial statements: the classes of transactions, account balances, and disclosures. These financial statement elements are made up of specific "assertions" or fundamental claims by management. There are five principal assertions: the element exists, it is properly owned or owed by the entity, it is complete, its value is measured appropriately in accordance with the financial reporting framework, and it is presented appropriately in terms of classification, description, and disclosure. The auditor assesses risk in the financial statement elements assertion by assertion.[6]

STANDARDS CHECK

CAS 315

25. The auditor shall identify and assess the risks of material misstatement at:
    (a) The financial statement level; and (Ref: Para. A105–A108)
    (b) The assertion level for classes of transactions, account balances, and disclosures (Ref: Para. A109–A113), to provide a basis for designing and performing further audit procedures.
26. For this purpose, the auditor shall:
    (a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements; (Ref: Para. A114–A115)
    (b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
    (c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and (Ref: Para. A116–A118)
    (d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Source: *CICA Handbook—Assurance*, 2012.

We will begin with a discussion of the risk assessment at the financial statement level. The table below summarizes the auditor's considerations in this risk assessment process and the role these considerations contain in the thought process of assessing risk. The table then gives some specific examples of the kinds of risk factors the auditor will investigate to learn if risks exist and how significant they might be. To plan an effective audit, the auditor needs to assess the most significant ways that the financial statements might have become misstated. The audit needs to be performed with significant risks in mind to make sure the auditors look at the right things in enough depth when they do their audit work.

6 These more detailed risk assessment procedures are what the CAS refer to as the "assertion level" risk assessments. Stay tuned: The assertion concept will be explained later in this chapter, and these more detailed risk assessments at the assertion level will be discussed later in Chapter 6. These different concepts and perspectives illustrates the integrative thinking an audit team has to do to draw together considerations gathered by many different people from different sources and perspectives when they are assessing risks of material misstatement.

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As set out in the examples in the table below, some risks are inherent in the auditee's normal business operations. All businesses operate in a risky environment, and their managers need to have good strategies and processes to survive and succeed. Risks also arise from internal characteristics of the entity, such as the quality of its governance and management structure and the strength of its accounting systems and controls. **Significant risks** generally arise when the business risks are not adequately managed and controlled, or when the business's strategy involves taking on more risk that it can handle. Risks tend to become significant through business environment and operational risks in combination with entity risk factors.

significant risks: identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration

AUDITOR RISK ASSESSMENT WHAT NEEDS TO BE CONSIDERED?	IMPLICATIONS WHY IS THIS CONSIDERED?	EXAMPLES WHAT DO AUDITORS NEED TO LOOK FOR, AND DO?
• What is the entity's underlying economic reality?	This is what the financial statements should capture and communicate to users	Business environment risks due to: • Industry, regulatory, economy related and other external factors Business operational risks due to: • Strategy and related business processes, investments, financing, performance measures
• What could have gone wrong in preparing the financial statements?	This will lead to misstating the financial statements	Entity risks due to: • Corporate governance, management quality, related parties, internal control, accounting policies, information systems, etc.
• Is there any significant risk that any of these things have gone wrong?	This is the auditor's assessment of risk of material misstatement at the financial statement level	Significant risks due to: • Fraud, • Weak governance • Questionable management integrity and competence • Risky business strategy fits poorly with business's risks • Going-concern assumption is questionable • Weak internal controls • Management control overrides • Management bias in accounting policy choices and estimates • Manipulation of financial statements through inappropriate closing entries • Complex accounting principles and policies • Complex information systems and information technology • Unusual related party transactions • Etc.
• If there are one or more significant risks, what evidence can auditors obtain to confirm or dispel suspicions that the events occurred/exists?	This will guide the auditors overall audit strategy, and planned audit procedures . . .	**The whole audit process needs to be designed to address these risks!**

STANDARDS CHECK

CAS 315

28. In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:
    (a) Whether the risk is a risk of fraud;
    (b) Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention;
    (c) The complexity of transactions;
    (d) Whether the risk involves significant transactions with related parties;
    (e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
    (f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. (Ref: Para. A119–A123)

Source: *CICA Handbook—Assurance*, 2012.

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STANDARDS CHECK

CAS 330

Substantive Procedures Related to the Financial Statement Closing Process

20. The auditor's substantive procedures shall include the following audit procedures related to the financial statement closing process:

(a) Agreeing or reconciling the financial statements with the underlying accounting records; and

(b) Examining material journal entries and other adjustments made during the course of preparing the financial statements. (Ref: Para. A52)

Source: *CICA Handbook—Assurance*, 2012.

Special Note: Managing Risks in the Audit Profession and Practice, and in Audit Engagements

At this point in the discussion, you may be wondering, "Just how many kinds of risk do auditors have to deal with? There seem to be just too many to keep track of!" You are right—the risks that need to be managed in the auditor's role are varied and complex, and this certainly is a challenge in learning, and practising, auditing! This special note will try to organize and classify these risks to help understand why there are so many different types.

Earlier under LO3, we discussed the idea of the "auditor's risk from accepting the engagement" as a key element in the decision to even become an organization's auditor in the first place. You may have noted that this type of risk is from the auditor's own personal perspective, as a professional person running a public accounting "practice" as a business. While it may seem somewhat self-interested for auditors to care about these more personal risks, auditors need to do this to ensure they succeed personally and also to ensure the whole auditing profession stays viable and strong. Consider what could happen if lots of auditors try to do audits that are too risky; many of them would fail and the quality of financial statements would decline.

Now, under LO4, note that our perspective has shifted away from thinking about an auditor's personal perspective on his or her own risks; we are thinking about risks from the perspective of the auditor's professional role in performing their responsibility to reduce information risk for financial statement users. Once they accept the audit engagement and start to perform it, auditors have to start focus on risks in the auditee's business and how those risks might lead to material misstatement in the financial statements. These are the audit risks that need to be managed to provide an opinion on whether a set of financial statements is fairly presented to users. The remaining discussions on risk will be focused on this perspective of auditors meeting their professional duties through performing audits that reduce the risk of material misstatement to an acceptable low level. But it may be helpful to keep in mind this 180-degree swing in our perspective on risk as we proceed to look at how auditors assess and respond to risk of material misstatement in the auditee's financial statements.

One additional perspective on risk should also be noted. All businesses face risks in their operating environment. How big these business risks are, and how good the managers are at keeping things under control are the underlying factors that may, or may not, lead to the material misstatements an auditor is concerned about. So, it is also important to keep in mind these two aspects of risk that are contained within the auditor's perspective on assessing the risk of material misstatement.

Business Environment Risks

In order to design the audit, auditors must understand the broad economic environment the auditee operates in, including such things as the effects of national economic policies (e.g., price regulations and import/export restrictions), the geographic location and its economy (e.g., Alberta's resource-based economy, or Ontario's manufacturing-based economy), and developments in taxation and regulatory areas (e.g., deregulation in agriculture and telecommunications, approval processes in the drug and chemical industries). For example, an increase in the Canadian dollar relative to the U.S. dollar negatively affects Canadian firms that rely on exports to the United States because their products become

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more expensive and thus less competitive in the U.S. market. A rapid, unexpected increase in energy prices, as occurred during 2008, negatively impacts businesses, such as manufacturing through increased costs and retail or tourism by reducing disposable incomes of consumers. In response to climate change concerns, a global initiative to reduce carbon emissions by imposing carbon taxes or emissions caps creates uncertainty and risk affecting many business models, particularly those whose energy needs result in high levels of carbon emissions.

In 2008, a credit crisis in the global financial system resulted in a deep, worldwide economic recession affecting many sectors of the economy. Such economic events can require business managers to make drastic changes to operating plans in order to survive and succeed. Some businesses benefit from economic turmoil but many are not able to continue as going concerns. Clearly, auditors must have a strong grasp of the potential impact of economic events on a company's business in order to ensure its financial information fairly presents its underlying economic condition.

Industry characteristics also affect business risks. There are great differences in the production and marketing activities of banks, insurance companies, mutual funds, supermarkets, hotels, oil and gas, agriculture, manufacturing, and so forth. No auditors are experts in all these businesses. Audit firms typically have people who are expert in one or two industries and rely on them to manage audits in those industries. Indeed, some public accounting firms have a reputation for having many auditees in particular industries.

RISK IN THE FORESTRY INDUSTRY

During the 2000s, the Canadian forestry industry became subject to countervailing and anti-dumping duties of 27% on all lumber exported to the United States, its major buyer. In a poll of its members taken in June 2003, the Canadian Federation of Independent Businesses found that 70% of British Columbia's small forestry businesses reported being significantly or somewhat harmed by the lumber dispute. This is an example of a strategic risk faced by businesses in industries that depend on foreign sales where high, unexpected duties could put some companies into financial distress if profits fall. Auditors need to be aware of such risk to understand the business performance and how it affects the financial statements. Alternatively, financial statements indicating growth in profitability while heavy duties were being imposed go against expectations and need to be investigated carefully. It may suggest a misstatement.

While the duty crisis described above was resolved by an agreement between Canada and the United States in 2006, in late 2008 another risk for the forestry industry reared its head when AbitibiBowater Inc. decided to shut a money-losing newsprint mill in Newfoundland. The provincial government took action to expropriate the company's timber cutting rights. These rights had been granted in 1905 to a company that eventually became AbitibiBowater in exchange for creating jobs and making investments in Newfoundland. The government also took steps to expropriate the company's hydroelectricity rights, which are even more valuable. Taking the view that the company has reneged on its side of the agreement by throwing the newsprint workers out of their jobs, the government's position was that the deal was no longer valid. As AbitibiBowater was planning to sell these rights to try to turn its struggling business around, this extraordinary event could have a significant impact on results in its financial position and future prospects. The company's auditors need a good understanding of this situation involving the ownership of these rights to ensure the financial statements present it fairly to users. This type of risk can also arise in oil producing businesses operating in countries such as Venezuela, where the government has introduced laws to nationalize all oil properties regardless of ownership.

The latest development affecting the Canadian forestry industry is a dramatic global shift in demand from its traditional trading partner, the United States, to China's booming economy. In May 2011, BC's softwood lumber exports to China were 746,000 cubic metres, triple what they were a year earlier and surpassing the U.S. sales by $3 million. The shift is in part attributable to a significant slump in U.S. housing starts, but opening up to a huge new market gives Canadian producers a lot more leverage in negotiating duties with the United States, since there is less basis to accuse Canada of "dumping." And other Asian countries, such as Japan and India, also present enticing new markets. How predictable is this volume of sales, and at what prices, depends on many future factors such as growth in housing starts in Asia, types of wood demanded, competition from other global lumber producers like Europe—all factors an auditor will need to track to understand the business risks in any forestry company!

Source: Ministry of Forests and Range, Province of British Columbia website, www.for.gov.bc.ca/HET/Softwood/; "NL government to expropriate most AbitibiBowater assets," *Fort McMurray Today,* December 16, 2008, p. 2; "Premier Williams takes on pulp giant; but AbitibiBowater threatens legal action as Newfoundland seizes hydro and timber assets," *The Toronto Star,* December 17, 2008, p. B01; "AbibitiBowater calls expropriation 'hostile'," *Waterloo Region Record*, December 20, 2008, p. F3; CBC News, "B.C. lumber exports to China soar," Jul 17, 2011, http://www.cbc.ca/news/canada/british-columbia/story/2011/07/17/bc-china-lumber.html; http://www.woodmarkets.com/pressreleases.html; Frank Jack Daniel, "Venezuela to nationalize U.S. firm's oil rigs," Reuters US Edition, June 24, 2010, http://www.reuters.com/article/2010/06/24/us-venezuela-nationalizations-idUSTRE65N0UM20100624.

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These events illustrate why in-depth knowledge of business is required to plan an audit. Auditors are expected to use integrative reasoning to draw together many complex and rapidly changing factors in reaching their conclusions. Accounting is supposed to reflect the economic substance of an entity's transactions, events, and conditions. Auditing in this dynamic world requires asking management the right questions, which calls for strong understanding of the auditee's business, environment, and risks.

The following box illustrates the kinds of risks a high-technology business faces. Intellectual property rights and patents raise a possibility that certain liabilities might be understated in the financial statements. In this case, the company faced significant risks related to development and patenting of its technology and the existence of other, similar patents. Management needs a process for managing these risks, and auditors need to assess whether these risks and liabilities have been reported fully in the statements.

MICROSOFT LOSES PATENT BATTLE WITH CANADA'S i4i

A Win for Intellectual Property Rights, or "Patent Trolls"?

Microsoft has lost an appeal to the U.S. supreme court over a $290 million award made against it in a patent dispute with the Canadian company i4i, which claimed a version of Microsoft Word infringed a patented method for editing documents.

The case began in 2007 when i4i sued Microsoft for infringing a patent covering a technology that lets users manipulate the architecture and content of a document. It said that Microsoft infringed the patent by allowing Word users to create custom XML documents. In 2009, the U.S. District Court for the Eastern District of Texas ruled in i4i's favour and ordered Microsoft to stop selling Word products in the United States in their current form. Microsoft removed the feature in order to keep selling its software.

Microsoft then appealed to the Supreme Court, saying the trial court's requirements had put an "overly demanding" standard to its invalidity defence: requiring it to prove its defence by "clear and convincing" evidence, rather than the more relaxed "preponderance of evidence." The difference would be similar to a criminal versus civil standard of proof; between "beyond all reasonable doubt" and "balance of probability."

Currently, when a patent holder accuses someone of infringing a patent, the burden is on the infringer to prove with "clear and convincing evidence" that the patent is invalid, said Sarah Columbia, head of the intellectual-property litigation practice at McDermott Will & Emery LLP. The decision means companies challenging patents being used in court battles will have to provide convincing proof that a patent is invalid if they want to have it set aside. Microsoft had sought to weaken the level of proof needed.

Microsoft argued that when new evidence is presented that could invalidate a patent, the burden of proof should be lowered to a preponderance of the evidence, considered a less-strict burden than clear and convincing evidence. The Supreme Court, however, upheld the lower court decisions that the burden of proof should continue to be applied.

Microsoft and others in the technology sector are likely to be unhappy with the ruling. While such companies have plenty of their own patents, they are more likely to be the subject of lawsuits, often lodged by so-called patent trolls, than to be defending their own patents. Patent trolls are companies that buy patents with the primary goal of asserting them for financial gain.

i4i, set up in 1993 by Michel Vulpe, has provided systems for the U.S. Patent Office ("Ironic, in the circumstances" remarked Loudon Owen, chairman of i4i), U.S. Air Force and a number of pharmaceutical companies, including Novo Nordisk and Bayer. Basically, it takes huge amounts of unstructured data and puts XML wrappers around it, making it useful and usable. The company has repeatedly insisted that it is not a "patent troll" and that it creates real value through the application of its systems for clients.

Microsoft and i4i held discussions in 2000 and 2001 about XML and custom XML, but no business emerged. Microsoft subsequently began using structured XML in Word, infuriating i4i.

Mr. Owen said, "Microsoft tried to gut the value of patents by introducing a lower standard for invalidating patents. It is now 100% clear that you can only invalidate a patent based on 'clear and convincing' evidence." He called the ruling "one of the most significant business cases the court has decided in decades. Affirmation of the federal circuit on a ruling in favour of patent holders is virtually unprecedented. While this ruling maintains the prevailing standard, the innovation community must be ever-vigilant to defend its property rights."

The decision will have repercussions in cases where patents are the key element of the case—which will affect everyone from smartphone manufacturers to app developers.

Organizations including Apple, Google, EMC, Cisco Systems and the Electronic Frontier Foundation had all filed documents with the court in support of Microsoft's argument.

Doug Cawley of the law firm McKool Smith worked as lead trial counsel for i4i. He says today's ruling is an important victory for patent holders everywhere. "We are very pleased that the High Court agreed with our position that Congress intended a heightened standard of evidence to invalidate a patent," said Mr. Cawley. "Today's ruling, which enforces the Federal Circuit's historical reliance on 'clear and convincing evidence,' will have a sweeping impact on how patents are protected." Pharmaceutical companies, however, are likely to

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applaud the decision, Ackerman said. "They haven't seen these troll suits and they rely very heavily on patent protection to keep [generic brands] out," he said. "They invest lots of money and want their patents to be strong."

Sources: Nancy Gohring, "Supreme Court ruling seen as a win for patent trolls," IDG News, June 9, 2011 at http://www.pcworld.com/article/229968/supreme_court_ruling_seen_as_a_win_for_patent_trolls.html; "McKool Smith helps i4i win $290 million Supreme Court ruling," PR Newswire, June 9, 2011 at http://www.prnewswire.com/news-releases/mckool-smith-helps-i4i-win-290-million-supreme-court-ruling-123571679.html; Charles Arthur, "Microsoft loses patent battle with Canada's i4i: Supreme Court decision means firms will have to provide proof a patent is invalid," *The Guardian* (UK), June 10, 2011 at http://www.guardian.co.uk/technology/2011/jun/10/microsoft-canada-i4i-patent.

REVIEW CHECKPOINTS

5-12 Why does the auditor need a good understanding of the auditee's business and environment?

5-13 How do changes in the economic environment affect a business's risks?

5-14 How do changes in the industry environment affect a business's risks?

5-15 What specific risks exist in high-tech companies? in the forestry industry?

PRELIMINARY ANALYTICAL PROCEDURES FOR AUDIT PLANNING

Preliminary Analytical Procedures

LO5 Use preliminary analytical procedures on management's draft financial statements to identify areas where misstatements are most likely.

Auditors use the planning tools of business risk assessment, analytical procedures, materiality decisions, overall audit strategy, audit risk assessment, and audit plans to guide and direct their work. Based on the preliminary analysis and on understanding the auditee's financial reporting and its business risks, auditors establish the overall audit strategy for the engagement; set out the basic scope, nature, and timing of the work to be performed; and identify any key risk areas requiring special attention by the audit team.[7]

Even though auditing standards do not require particular analytical procedures, their application is required at two points in the audit. At the beginning of an audit, the planning stage risk assessment discussed in this chapter (CAS 315) is required, and at the end of an audit it is required that the partners in charge review the overall quality of the audit work and look for problems by analyzing the financial statements (CAS 520). Auditors may also decide to include analytical procedures as a way of providing substantive evidence about specific financial statement assertions (CAS 520 and 330).[8]

STANDARDS CHECK

CAS 315

6. The risk assessment procedures shall include the following:
   (a) Inquiries of management and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error. (Ref: Para. A6)
   (b) Analytical procedures. (Ref: Para. A7–A10)
   (c) Observation and inspection. (Ref: Para. A11)

CAS 520

6. The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity. (Ref: Para. A17–A19)

Source: *CICA Handbook—Assurance*, 2012.

7 CAS 300.

8 Stay tuned: Examples of this use are provided in Part 3.

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analytical procedures: specific methods and tests used to perform analysis on client account balances

Analytical procedures are powerful techniques for identifying unusual changes and relations in financial statement data. The purpose of doing analysis at the beginning of the engagement is "attention directing"—to alert the audit team to problems (errors, fraud) that may exist in the account balances, transactions, and disclosures and to guide the design of further audit work. The auditor's understanding of the business risks is important in identifying the changes and relations expected based on how the business performed during the audited period and what might indicate the financial information is misstated.

Five types of general analytical procedures that may be performed on financial statement data are listed below. The first three types involve comparisons with other relevant data and the last two involve studying relationships.

1. Compare current-year account balances with balances for one or more comparable periods.
2. Compare current-year account balances and financial relationships (e.g., ratios) with similar information for the industry the company operates in.
3. Compare the current-year account balances with the company's anticipated results as found in the budgets and forecasts.
4. Evaluate the relationships of current-year account balances to other current-year balances for conformity to predictable patterns based on the company's experience.
5. Study the relationships of current-year account balances to relevant nonfinancial information (e.g., physical production statistics).

horizontal analysis: comparison of changes of financial statement numbers and ratios across two or more years

vertical analysis: analytical procedure of comparing all financial statement items to a common base; for example, total assets or total sales

The two procedures most commonly used as a starting point are **horizontal analysis** (type 1), comparison of changes of financial statement amounts across two or more years, and **vertical analysis** (type 4), comparison of financial statement amounts expressed each year as proportions of a base (e.g., sales for the income statement accounts and total assets for the balance sheet accounts, or ratios such as debt-to-equity or working capital), are often used. In the sections that follow, these procedures are emphasized. In particular, type 1 is implemented by comparison of current-year account balances with balances for one or more comparable periods, and type 4 by analysis of the relationships of individual account balances with other current-year total balances as the base. A combination of both types, implemented by examining the trends in various ratios over time, is very effective as well.

Research finds that analytical procedures are most effective when integrated with other sources of information, especially when accompanied by a strong knowledge of the auditee's business. "Auditors must combine different types of knowledge (accounting, general business, industry, and auditee-specific) and issues (operating, financing, and investing) into a whole. This skill is needed whether analytical procedures are used for planning, substantive testing, or overall review purposes, but it appears to be most critical at overall review, where the auditor's goal is to examine the financial statements to determine whether they make sense taken as a whole."[9]

Analytical procedures can also take other forms, ranging from simple to complex. A wide range of early information-gathering activities can be defined as "analytical procedures," including the following:

- Review of accounting misstatements discovered in prior year audits and any adjustments proposed to management
- Conversations with auditee personnel regarding developments affecting the organization, such as changes in strategy, business processes, information technology, key management, ownership, industry conditions, economic conditions, legal environment, etc.
- Review of the corporate charter and bylaws or partnership agreement
- Review of contracts, agreements, and legal proceedings
- Reading and study of the **minutes** of meetings of the board of directors, the group charged with governance of the organization, as well as of any sub-committees of the board (e.g., executive committee, finance committee, compensation committee, audit committee)

minutes: notes taken to summarize key decisions made in a formal meeting, such as a corporate board meeting

9 E. Hirst, L. Koonce, and F. Philipps, "First, know the business," *CA Magazine*, August 1998, p. 41.

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The box below outlines some of the key knowledge that auditors obtain from reading minutes.

WHAT'S IN THE MINUTES OF MEETINGS?

Boards of directors are responsible for monitoring the auditee's business. The minutes of both their meetings and those of their committees (e.g., executive committee, finance committee, compensation committee, audit committee) contain information of vital interest to the independent auditors. Some examples are as follow:

- Declared amount of dividends
- Authorization of officers' salaries and bonuses
- Authorization of stock options and other "perq" compensation
- Acceptance of contracts, agreements, and lawsuit settlements
- Approval of major purchases of property, plant, and equipment and of investments
- Discussions of any acquisitions, mergers, and divestitures in progress
- Authorization of financing by share issues, long-term debt, and leases
- Approval to pledge assets as security for debts
- Discussion of negotiations on bank loans and payment waivers
- Approval of accounting policies and accounting for estimates and unusual transactions
- Authorizations for individuals to sign bank cheques

Auditors take notes on or make copies of important parts of the minutes and compare them with information in the accounting records, financial statements, and note disclosures (e.g., compare the amount of dividends declared with the amount paid and reported in the financial statements, etc.). Because the minutes are so important in determining what needs to be reported in order to obtain fair presentation, denying access to the board of directors meeting minutes constitutes a major scope restriction by an auditee. In such a case, because of the pervasive impact that boards of directors' decisions can have on financial statement measurements and disclosures, a disclaimer of audit opinion is likely. When the auditor expects to issue a disclaimer of opinion, the audit firm will usually resign from the audit engagement since the audit would add little value.

Other types of analytical procedures can be complex, including mathematical time series and regression calculations, comparisons of multi-year data, and trend and ratio analyses. Exhibit 5–4 on the next page illustrates an approach that combines analysis of relationships (financial ratios) and trends (current year versus prior year).

REVIEW CHECKPOINTS

5-16 What is the purpose of performing analytical procedures at the beginning of the audit engagement?

5-17 What is the role of the auditor's understanding of the business and its risks in performing analytical procedures?

5-18 What are five types of general analytical procedures?

5-19 What official documents and authorizations should an auditor read when performing preliminary analytical procedures?

5-20 What important information can be found in directors' minutes about officers' compensation, business operations, corporate finance, accounting policies, and control?

5-21 What is the role of business risk analysis in the audit planning process?

Applying Analytical Procedures to Management's Draft Financial Statements

One of the first things the auditor receives is management's draft financial statements. Depending on the organization, these financial statements may be virtually complete and final (e.g., in a large company with many professionally qualified accountants on staff) or

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preliminary statements that still require adjustments for items such as bonuses and income taxes (e.g., in a small company with few in-house accountants). Even when the audit begins with a set of draft statements still requiring final adjustments, the auditor must remember that all financial reporting decisions are management's responsibility. Particularly in smaller organizations, an auditor may identify appropriate adjustments or accounting entries, but, to maintain independence, the auditor must ensure that management approves and takes responsibility for all the accounting choices made.

Analysis Procedures for Attention Directing

representational faithfulness: when information presented in an entity's financial statements closely corresponds to the actual underlying transactions and events affecting it, conveying their economic substance rather than simply their legal form

Auditors perform analytical procedures on the draft statements looking for relationships that do not make sense, as these may indicate problem areas where the accounts do not faithfully represent the underlying economic substance. **Representational faithfulness** is a fundamental accounting concept relating to the claims, or assertions, that management makes in its financial statements. Analysis of the financial statements' assertions is very important in the business risk approach to auditing, as we will discuss in more depth later in this and later chapters. Here in the planning stage, analytical procedures are primarily attention directing; they do not provide direct evidence about the numbers in the financial statements, but their main purpose is to help the audit team plan effective audit programs, maximizing the probability of finding any material misstatements. They identify potential problem areas so that the subsequent work can be designed to reduce the risk of missing something important. The analysis application explained here illustrates this attention-directing aspect—the pointing out of accounts that may contain misstatements.

Use an Organized Approach

By following an organized approach—using a standard starting place—preliminary analytical procedures can provide considerable familiarity with the auditee's business. Many auditors start with comparative financial statements and calculate common-size statements (vertical analysis) and year-to-year change in balance sheet and income statement accounts (horizontal analysis). This is the start of describing the financial activities for the current year under audit.

Exhibit 5–4 contains financial balances for the prior year (consider them audited) and the current year (consider them draft numbers not yet audited). Common-size statements (vertical) are shown in parallel columns, and the dollar amount and percentage change (horizontal) are shown in the last two columns. These analytical procedures generate basic analytical data that are the starting point for the auditors' further evaluation and enquiry.

Describe the Financial Activities

After generating these basic financial data, the next step is to describe the financial changes and relationships visible in them. According to the draft financial statements in Exhibit 5–4, the company increased the net income through increasing sales by 10%, reducing cost of goods sold as a proportion of sales, and controlling other expenses. At least some of the sales growth appears to have been prompted by easier credit (larger accounts receivable) and more service (more equipment in use). The company also used much of its cash and borrowed to purchase the equipment, make its payment on the long-term debt, and pay dividends.

Ask Relevant Questions

The next step is to ask, "what could be wrong?" and "what errors, fraud, or legitimate explanations might account for these financial results?" For this explanation we will limit our attention to the accounts receivable and inventory, while other ratios can help support the analysis. Exhibit 5–5 contains several familiar ratios and Appendix 5A includes a list of commonly-used ratios with their formulas.

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EXHIBIT 5–4 Anycompany Inc.: Preliminary Analytical Procedures Data

	PRIOR YEAR		CURRENT YEAR		CHANGE	
	BALANCE	COMMON SIZE ANALYSIS	BALANCE	COMMON SIZE ANALYSIS	AMOUNT	PERCENT CHANGE ANALYSIS
Assets						
Cash	$ 600,000	14.78%	$ 200,000	4.12%	($ 400,000)	−66.67%
Accounts receivable	500,000	12.32	900,000	18.56	400,000	80.00
Allowance doubtful accounts	(40,000)	−0.99	(50,000)	−1.03	(10,000)	25.00
Inventory	1,500,000	36.95	1,600,000	32.99	100,000	6.67
Total current assets	2,560,000	63.05	2,650,000	54.63	90,000	3.52
Equipment	3,000,000	73.89	4,000,000	82.47	1,000,000	33.33
Accumulated amortization	(1,500,000)	−36.95	(1,800,000)	−37.11	(300,000)	20.00
Total assets	$4,060,000	100.00%	$4,850,000	100.00%	$ 790,000	19.46%
Liabilities and Equity						
Accounts payable	$ 500,000	12.32%	$ 400,000	8.25%	($ 100,000)	−20.00%
Bank loans, 11%	0	0.00	750,000	15.46	750,000	
Accrued interest	60,000	1.48	40,000	0.82	(20,000)	–33.33
Total current liabilities	560,000	13.79	1,190,000	24.53	630,000	112.50
Long-term debt, 10%	600,000	14.78	400,000	8.25	(200,000)	−33.33
Total liabilities	1,160,000	28.57	1,590,000	32.78	430,000	37.07
Share capital	2,000,000	49.26	2,000,000	41.24	0	0.00
Retained earnings	900,000	22.17	1,260,000	25.98	360,000	40.00
Total liabilities and equity	$4,060,000	100.00%	$4,850,000	100.00%	$ 790,000	19.46%
Income						
Sales (net)	$9,000,000	100.00%	$9,900,000	100.00%	$ 900,000	10.00%
Cost of goods sold	6,750,000	75.00	7,200,000	72.73	450,000	6.67
Gross margin	2,250,000	25.00	2,700,000	27.27	450,000	20.00
General expense	1,590,000	17.67	1,734,000	17.52	144,000	9.06
Amortization	300,000	3.33	300,000	3.03	0	0.00
Operating income	360,000	4.00	666,000	6.46	306,000	85.00
Interest expense	60,000	0.67	40,000	0.40	(20,000)	–33.33
Income taxes (40%)	120,000	1.33	256,000	2.59	136,000	113.33
Net income	$ 180,000	2.00%	$ 370,000	3.74%	$ 190,000	105.56%

EXHIBIT 5–5 AnyCompany Inc.: Selected Financial Ratios

	PRIOR YEAR	CURRENT YEAR	PERCENT CHANGE
Balance Sheet Ratios			
Current ratio	4.57	2.23	−51.29%
Days' sales in receivables	18.40	30.91	67.98
Doubtful accounts ratio	0.0800	0.0556	−30.56
Days' sales in inventory	80.00	80.00	0.00
Debt/equity ratio	0.40	0.49	21.93
Operations Ratios			
Receivables turnover	19.57	11.65	−40.47
Inventory turnover	4.50	4.50	0.00
Cost of goods sold/sales	75.00%	72.73%	−3.03
Gross margin percentage	25.00%	27.27%	9.09
Return on beginning equity	6.62%	12.76%	92.80
Financial Distress Ratios (Altman, 1968, Appendix 5A)			
Working capital/total assets	0.49	0.30	−38.89
Retained earnings/total assets	0.22	0.26	17.20
EBIT/total assets	0.09	0.14	54.87
Market value of equity/total debt	2.59	1.89	−27.04
Net sales/total assets	2.22	2.04	−7.92
Discriminant Z score	4.96	4.35	−12.32

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REVIEW CHECKPOINTS

5-22 What are management's draft financial statements?

5-23 What steps can auditors use to apply comparison and ratio analysis to management's financial statements?

5-24 What can the auditor learn from a vertical analysis?

5-25 What can the auditor learn from a horizontal analysis?

5-26 What are some of the ratios that can be used in preliminary analytical procedures?

Here are two examples of the kinds of questions auditors should ask about these financial statements.

- *Are the accounts receivable collectible?* (Or, is the allowance for doubtful accounts large enough?) Easier credit can lead to more bad debts. The company has a much larger amount of receivables (see Exhibit 5–4), days' sales in receivables has increased significantly (see Exhibit 5–5), receivables turnover has decreased (see Exhibit 5–5), and allowance for doubtful accounts is smaller in proportion to the receivables (see Exhibit 5–5). If the prior-year allowance for bad debts at 8% of receivables was appropriate, and conditions have not worsened, perhaps the allowance should be closer to $72,000 than to $50,000. The auditors should work carefully on the evidence related to accounts receivable valuation.
- *Could the inventory be overstated?* (Or, could the cost of the goods sold be understated?) Overstatement of the ending inventory would cause the cost of goods sold to be understated. The percentage of cost of goods sold to sales shows a decrease (see Exhibits 5–4 and 5–5). If the 75% of the prior year represents a more accurate cost of goods sold, the income before taxes may be overstated by $225,000 (75% of $9.9 million minus $7.2 million unaudited cost of goods sold). The days' sales in inventory and the inventory turnover remained the same (see Exhibit 5–5), but you might expect them to change in light of the larger volume of sales. Careful work on the physical count and valuation of inventory is needed.

Other questions can be asked and other relationships derived when industry statistics are available. Industry statistics from services such as Statistics Canada, FPinformart.ca, Dun & Bradstreet, Investext Plus, and Mergent Online typically include industry averages for important financial yardsticks, such as gross profit margin, return on sales, current ratio, and debt/net worth. A comparison with auditee data may reveal out-of-line statistics indicating company strength, a weak financial position, or possibly an error or misstatement in the statements. However, remember that averages may not be representative of a particular company.

Comparing reported financial results with internal budgets and forecasts also can be useful. If a budget or forecast represents management's estimate of probable future outcomes, items that fall short of or exceed the estimates become audit-relevant questions. If a company expected to sell 10,000 units of a product but sold only 5000, the auditors will plan a careful lower-of-cost-and-market study of the inventory of unsold units. If 15,000 were sold, they will plan a careful audit for sales validity. Comparisons can be tricky, however. Some companies use budgets and forecasts as goals rather than as expressions of probable outcomes. Also, the avoidance of shortfall or excess might be the result of managers manipulating the numbers to "meet the budget." Auditors must be careful to know something about a company's business conditions from sources other than the internal records when analyzing comparisons with budgets and forecasts.

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Look at the Cash Flows

The analysis of changes in cash flows from operating, investment, and financing activities is a very informative tool. A cash flow deficit from operations may signal financial difficulty. Companies fail when they run out of cash (no surprise) and are unable to pay their debts when they become due. In a small business audit, the auditee may not have prepared a cash flow statement. In that case, the auditors can use the comparative financial statements to prepare one, providing this important part of their preliminary analysis.

REVIEW CHECKPOINTS

5-27 How can computing the accounts receivable turnover ratio indicate potential misstatement in the accounts receivable balance?

5-28 How can computing the number of days of sales in inventory indicate potential misstatement in the inventory balance?

5-29 Is anything questionable about the relationship between retained earnings and income for the Anycompany data shown in Exhibit 5–4?

5-30 What is the operating cash flow for the current year for Anycompany shown in Exhibit 5–4?

5-31 Why don't preliminary analytical procedures provide direct evidence about financial statement misstatements? What then is their purpose in an audit?

MATERIALITY LEVELS FOR AUDIT PLANNING

Materiality Levels in Audit Planning

LO6 Explain the materiality levels used for planning the audit and how these amounts are determined.

Materiality is one of the first important judgments the auditor must make, since it affects every other planning, examination, and reporting decision. The materiality decision is an important application of professional judgment and is based on the auditor's knowledge about the organization's business risks, identification of the likely users and uses of its audited general purpose financial statements, preliminary analysis of its draft financial statements, and experience in prior audits.

STANDARDS CHECK

CAS 320

5. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report. (Ref: Para. A1)
6. In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:
   (a) Determining the nature, timing, and extent of risk assessment procedures;
   (b) Identifying and assessing the risks of material misstatement; and
   (c) Determining the nature, timing, and extent of further audit procedures.

Source: *CICA Handbook—Assurance*, 2012.

When planning a financial statement audit, auditors first decide on a level of **materiality for the financial statements as a whole (overall materiality)** which they consider as the largest amount of uncorrected dollar misstatement that might exist in published financial statements that still **fairly present** the company's financial position and results of

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operations in conformity with GAAP. The concept of fair presentation comes from the accounting standards and generally means that the financial statements do not contain misstatements or omissions significant enough to mislead users into making inappropriate economic decisions based on those financial statements.

STANDARDS CHECK

CAS 320

10. When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. *[Note: In this text we use the term `overall materiality' for this amount.]* . . .

Source: *CICA Handbook—Assurance*, 2012.

Financial Statement Materiality

materiality for the financial statements as a whole (overall materiality): largest amount of uncorrected dollar misstatement that might exist in financial statements that still fairly present the auditee's financial position and results of operations under an acceptable financial reporting framework

fairly present: in financial reporting, that management's financial statements achieve the properties of being a faithful representation of the economic realities they purport to portray, and of not being misleading to users

So, what is materiality, and how can you deal with it? In financial accounting and reporting, information is material and should be disclosed if it is likely to influence the economic decisions of financial statement users. Auditing standards provide guidance intended to help auditors with these judgments.[10] The emphasis is on the users' point of view, not that of accountants or managers. Thus, "material" means important or significant.

An analogy placing the materiality concept in a more everyday context may be helpful. Imagine you are planning to get your car repaired, and the mechanic tells you it will most likely cost $500, but the actual amount could be between $490 and $510. Would you decide to go ahead with the repairs, given the range in estimates? Most people probably would not let a $10 difference on $500 affect their decision; that is to say, $10 is not "material" to their decision. If the mechanic said the actual price could be between $100 and $900, most people would find that range too big to accept. The possible $400 variation (in either direction) from the likely cost of $500 is an amount that does affect the decision: it is highly material. If a mechanic said the repair would be $500 and it ended up being $900, most people would say that the $500 number was materially misstated! What if the mechanic gave a range of $450 to $550? Some people might be okay with this range, while others would find another mechanic who could give a more precise amount. This analogy illustrates how materiality is viewed as an amount that a typical user of the information finds significant to their decision making. It also illustrates how materiality is a judgment call because the exact amount cannot be specified and it can vary from user to user.

It is a challenge for an auditor to reach a judgment about what amount is material to users. To some extent, the auditor guesses what a typical financial statement user would consider significant to his or her decisions. It is even more challenging to apply materiality in performing the audit and evaluating the audit results. Financial statement measurements and information in disclosures are not perfectly accurate. However, do not conclude that financial reports are inherently imprecise and inaccurate. Some numbers will contain mistakes, and some are imprecise because they are based on estimates. Everyone knows that people make mistakes (e.g., billing a customer the wrong amount or using the wrong price to value inventory), and many financial measurements are based on estimates (e.g., the estimated depreciable lives of fixed assets or the estimated amount of uncollectible accounts receivable). However, this is not an excuse to be sloppy about clerical accuracy or negligent in accounting judgments. As an example of applying materiality to auditing accounting numbers that involve a high degree of management judgment, the box on the next page illustrates the auditor's approach for assessing management's estimates.

10 CAS 320, paragraphs 9-11.

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AUDIT CONSIDERATIONS FOR ACCOUNTING ESTIMATES

An accounting estimate is an approximation of a financial statement number, and estimates are often included in financial statements (see CAS 540). Examples include net realizable value of accounts receivable, fair values of assets and liabilities, amortization expense, lease capitalization criteria, percentage-of-completion contract revenues, pension expense, and warranty liabilities.

Management is responsible for making accounting estimates. Auditors are responsible for determining that all appropriate estimates have been made, that they are reasonable, and that they are presented and disclosed in conformity with GAAP.

As part of the audit process, the auditors produce their own estimate and compare it with management's. Often, a range for an amount is considered. For example, management may estimate an allowance for doubtful accounts at $50,000, and the auditors may estimate it at $40,000 to $55,000. In this case, management's estimate is within the auditor's range of reasonableness. However, the auditors should take note that the management estimate leans toward the conservative side (more than the auditors' $40,000 lower estimate, but not much less than the auditors' higher $55,000 estimate). If other estimates exhibit the same conservatism and the effect is material, the auditors will need to evaluate the overall reasonableness of the effect of all estimates taken together.

If the auditors develop an estimate that differs (e.g., a range of $55,000 to $70,000 for the allowance that management estimated at $50,000), the difference between management's estimate and the closest end of the auditors' range is considered a misstatement (in this case, misstatement = $5,000 = auditors' $55,000 minus management's $50,000). The remaining difference to the farthest end of the range ($15,000 = $70,000 − $55,000) is noted and reconsidered in combination with the findings on all management's estimates.

Some evidence of the reasonableness of estimates is the actual experience of the company with financial amounts estimated at an earlier date. Tracking the accuracy of management's earlier estimates can provide the auditor with information on the expected accuracy of future estimates.

Auditors are limited by the nature of accounting. Some amount of inaccuracy is unavoidable in financial statements for the following reasons:

1. Unimportant inaccuracies do not affect users' decisions and hence are not material.
2. The cost of finding and correcting small errors is too great.
3. The time taken to find them would delay issuance of financial statements.

Accounting numbers are never perfectly accurate, but public accountants and auditors want to ensure that financial reports do not contain material misstatements that could make them misleading.

REVIEW CHECKPOINTS

5-32 Why is the materiality decision one of the first decisions made in the audit?

5-33 What is material information in accounting and auditing?

5-34 What limitations of accounting affect auditors?

5-35 How is the materiality level applied in auditing an accounting estimate?

5-36 What do you think is the best objective evidence of the reasonableness of an accounting estimate? Use the allowance for doubtful accounts receivable as an example.

STANDARDS CHECK

CAS 320

4. The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:
   (a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
   (b) Understand that financial statements are prepared, presented, and audited to levels of materiality;
   (c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment, and the consideration of future events; and
   (d) Make reasonable economic decisions on the basis of the information in the financial statements.

Source: *CICA Handbook—Assurance*, 2012.

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When setting out the overall audit strategy, the auditor first determines a materiality level for the financial statements as a whole (this is the same as overall materiality of Chapter 4). However, just as accounting may have limitations, there are also limitations in performing an audit. Since every item cannot be tested and totally conclusive evidence is never available, auditors may misinterpret or overlook evidence that could reveal misstatements. To leave room for the possibility that their audit work might miss some errors in the financial statements, auditors may determine an amount referred to as **performance materiality** that is somewhat less than the materiality for the financial statements as a whole. By designing their audit work to search out this smaller amount of misstatement, they can reduce the risk that the total of uncorrected and undetected misstatements exceeds the materiality level for the financial statements as a whole. For example, imagine you are going on a four-day holiday that you expect will be sunny and warm. You have $600 to spend and know your hotel will be $100 per night. You could spend all your remaining $200 on meals and entertainment, but if you are cautious, you will keep some of it aside for unexpected events such as a lost camera or a medical emergency.

performance materiality: amount(s) set by the auditor at less than materiality for the financial statements as a whole, to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole; if applicable, also the amount(s) set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances, or disclosures

The difference between the whole materiality level and the performance materiality level can be seen as a cushion against misstatements, unknown to the auditor, that could make the financial statements materially misstated, just as holiday cash is kept aside for unexpected events. The smaller performance materiality is used for identifying and assessing risks, for determining audit procedures to be done in response to the assessed risks, and for evaluating the materiality of the total misstatements discovered during the audit. How much smaller should it be? Again, we see the need for auditors to use their judgment. Hints for making your decision can be found in the amount of misstatements found in previous audits, in the average in similar organizations if it is a new audit, or in practical application guidance rules of thumb.

STANDARDS CHECK

CAS 320

9. For purposes of the CASs, performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures. . . .

CAS 320

11. The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. (Ref: Para. A12)

Source: *CICA Handbook—Assurance*, 2012.

Since the materiality decisions are made early in the audit, auditors must reconsider their decisions whenever new information that might affect the materiality decision surfaces during the audit. If the auditor decides the materiality should be revised to a smaller amount, the auditor will probably have to extend any testing that was done based on the larger materiality level. Note an important relationship illustrated here: As the audit materiality level gets smaller, the auditor must do more work to find any material misstatements. As an analogy, imagine you drove your car to school one day, and parked in the school parking lot just as a snow storm was starting. When you go back outside after the class, everything is covered in a deep blanket of snow. Imagine that your car is “material”—you need to find it so you can drive home. You will probably have a bit of work to do to identify which bump in the snow has your car under it, maybe brushing off one or two others in the general area before you find the right one. But say you realize that you had dropped your car keys on the way into school, so now your tiny car keys are material to being able

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to drive home. How much more work will you need to do to find your keys under all that snow, compared with finding a big car? A lot more digging![11]

REVIEW CHECKPOINTS

5-37 How does overall materiality for the financial statements as a whole differ from overall performance materiality in the auditing standards?

5-38 What issues arise if an auditor realizes part way through the audit that a smaller materiality level is appropriate?

Materiality Judgment Criteria

Materiality is both a quantitative and a qualitative judgment, made in the context of the auditee's specific circumstances. The importance of the qualitative aspects of materiality is highlighted in the current environment because of a perception that the materiality concept had been "abused"—used as an excuse to do less audit work or not require correction of significant misstatement. For example, under SEC regulations, auditors are not allowed to rely exclusively on quantitative benchmarks. In particular, any quantitatively small misstatements resulting from intentional misstatement, intentional violation of the law, or intentional earnings manipulation must be considered material. Generally, a quantitatively immaterial misstatement is now considered material if it:

- masks a change in earnings or other trends,
- hides a failure to meet analysts' consensus expectations for the auditee,
- changes a loss into net income or vice versa,
- concerns a segment of the business that is considered significant,
- affects the auditee's compliance with regulatory requirements,
- involves concealment of an unlawful transaction or fraud, and
- has the effect of increasing management compensation—for example, satisfies requirements for the award of bonuses or other forms of incentive compensation.[12]

The next section covers some traditional quantitative materiality guidelines, and it also will show how even these considerations include qualitative aspects. Auditors consider these factors as well as professional judgment in determining materiality levels.

Materiality Judgment Criteria—Quantitative

Accountants might prefer that definitive, quantitative materiality guides could be issued, but understand the drawbacks of having guidelines that are too rigid. Appropriate materiality levels are based on auditor judgment on an audit-by-audit basis. The auditing standards offer some guidance on quantitative measures of materiality that might be appropriate when making a preliminary assessment of what is material to the financial statements.[13]

Some common rules of thumb are as follows:

- 5–10% of income from continuing operations
- 5–10% of net income before bonus (for an owner-managed enterprise with a tax-minimization objective where net income is consistently nominal)
- Industry-specific measures of materiality that have become generally accepted in practice may also be used; examples include:

  a. Not-for-profit entity, 0.5–2% of total expenses or total revenues
  b. Mutual fund industry, 0.5–1% of net asset value
  c. Real estate industry, when an entity owns income-producing properties, 1% of revenue

11 The authors are grateful to Professor Morley Lemon for inspiring this analogy, and for many other inspiring ways to think about auditing.

12 SEC Staff Accounting Bulletin (SAB) 99.

13 CAS 320, paragraphs A3–A5.

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The auditor must use professional judgment in selecting alternative financial statement items when making a quantitative determination of materiality. Depending on circumstances, other items used could include total revenues (for start-up companies), net assets, total assets, gross profit, and cash flows from operations. An averaging technique based on several items may be useful in some situations.

If income is used, it should be adjusted for abnormal or extraordinary items. If it is negative, close to zero, or fluctuates significantly from year to year, an average could be used. "Normalizing" income should be done with caution, and if it is difficult to justify normalized income, such as when income is negative or too small relative to other items, then it may be best to use a different basis altogether. Auditors cannot apply the rules of thumb mechanically and other factors, such as those discussed below, must be considered. Note the role of qualitative factors in these, even though the main issue is quantitative in nature.

STANDARDS CHECK

CAS 320

A3. Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
- The nature of the entity, where the entity is in its life cycle, and the industry and economic environment in which the entity operates;
- The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
- The relative volatility of the benchmark.

A4. Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, and total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.

A5. Circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that materiality for the financial statements as a whole is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results.

Source: *CICA Handbook—Assurance*, 2012.

Absolute Size A potential misstatement may be important because of its size, regardless of any other considerations. Not many auditors use absolute size alone as a criterion, because a given amount may be appropriate in one case but not in another. Yet some auditors have been known to say that $1 million (or some other large number) is material, no matter what. Even in a very large company, people may find it hard to believe that a large dollar amount of error could be missed first by management, and then by auditors!

Relative Size The relationship of potential misstatement to a relevant base number is often used. Potential misstatements in income statement accounts are usually related to net income before taxes. In balance sheet accounts, they may be related to a subtotal number, such as current assets or net working capital. A misstatement in segment information may be small in relation to the total business but important for analysis of the segment.

Particular Transactions, Balances, or Disclosures Requiring Lower Materiality Level In some audits, an auditor may decide that certain classes of transactions, account balances, or disclosures should be audited to a lower amount than the amount being used as the materiality level for the financial statements as a whole. The auditor might expect that users' decisions based on these items will be affected by a lesser amount of misstatement than the level for the financial statements as a whole. This could arise in the case of certain

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measures or disclosures required by law (for example, executive compensation and related party transactions), for disclosures that are key to a particular industry (such as research and development costs for a pharmaceutical company), or for disclosures that are given special attention by users (such as a newly acquired business). Using an amount lower than whole materiality for a certain account affects audit sampling decisions, as it can be the basis for setting a **specific materiality** for that account, and there might also be a **specific performance materiality** level based on it.[14] In this text we mainly focus on the overall materiality for the financial statements as a whole and, to a lesser extent, specific materialities. That is, we focus on materialities that reasonably can be expected to influence user decisions. Some discussion of the specific materialities is provided in understanding different types of audit report qualifications in Chapter 4.

specific materiality: materiality level(s) to be applied to those particular classes of transactions, account balances, or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements

STANDARDS CHECK

CAS 320

10. . . . If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures. *[Note: In this text we use the term 'specific materiality' for this amount.]*

Source: *CICA Handbook—Assurance*, 2012.

Materiality Judgment Criteria—Qualitative

The quantitative materiality guidelines are a good starting point for qualitative judgments, as they can be applied fairly objectively in every audit. Having the result of the mechanical quantitative calculation, the auditor then needs to stand back to take a broad perspective and consider other factors that may be informative about the consequences of the materiality level used. New information that causes revision to materiality during the audit is usually a qualitative consideration.

specific performance materiality: amount(s) set by the auditor at less than the specific materiality level(s) to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds specific materiality

User-related Factors Certain users may require more precise financial information. It might be the only information available for a new business or it might contain the profit information that shareholders' dividend income is based on. Some users might scrutinize financial reports to determine whether specific laws or practices, such as anti-competitive practices or environmental protection agreements, are being followed. For audits of public sector entities, the financial statements may be used to make non-economic decisions, for example whether policies have been complied with and operations have been effective in meeting policy objectives, so what is significant may go beyond just the financial information.

STANDARDS CHECK

CAS 320

Considerations Specific to Public Sector Entities

A2. In the case of a public sector entity, legislators and regulators are often the primary users of its financial statements. Furthermore, the financial statements may be used to make decisions other than economic decisions. The determination of materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances, or disclosures) in an audit of the financial statements of a public sector entity is therefore influenced by law, regulation, or other authority, and by the financial information needs of legislators and the public in relation to public sector programs. (Ref: Para. 10)

Source: *CICA Handbook—Assurance*, 2012.

14 CAS 320 (9-10, A10), CAS 530, and further discussion in Chapter 10.

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Nature of the Item or Issue Small items may be considered material because of what they suggest about management's character or how they interact with a specific user decision or evaluation. For example, an illegal payment is important because of what it is, not because of its absolute or relative amount. Other qualitative factors include whether a misstatement affects the trend of earnings, whether analysts' forecasts are met, and whether a loan covenant is violated. Generally, potential errors in the more liquid assets (cash, receivables, and inventory) are considered more important than potential errors in other accounts (such as fixed assets and prepaid expenses) because of their impact on liquidity ratios that are often included in debt covenants.

Circumstances Auditors generally use a smaller materiality level, and thus smaller permitted misstatement, for auditees whose financial statements will be widely used (publicly held companies) or used by important outsiders (bank loan officers) than they do for auditees whose financial statement users are closer to management and may have access to other sources of information. Auditors also tend to exercise more care and use a more stringent materiality criterion when management exercises discretion over an accounting treatment, and when important decisions will be based on the financial statement information. Troublesome events, such as the string of corporate and audit failures of the current environment, have also led auditors to lower materiality and audit measurement and disclosures with more precision. These matters relate as much to risks as they do to financial statement materiality, as the two concepts are closely related in planning the nature, timing, and extent of the auditor's work.

Summary of Materiality Levels in the Auditing Standards

To summarize the discussion so far, the table below summarizes the four main types of materiality levels set out the auditing standards and provides the terms we will use in the text. Although this is a complete listing of all the materiality concepts covered by audit standards and practice, they do not necessarily all need to be used on an audit. Specifically, one that is absolutely required on every audit engagement is the overall materiality. This is the one we focus on in the text. Performance materiality can be viewed as a function of how auditors frame an audit decision problem with the help of a sampling model. Some sampling models do not require the use of a different performance materiality to allow for potential undetected misstatements due to sampling risk. This is explained in Chapter 10. The specific materiality amounts are used only when auditors determine that, to meet specific user needs, there are particular classes of transactions, account balances or disclosures that need to be audited to a lower level than the overall materiality. Thus specific materiality would not be used in every audit.

MATERIALITY AMOUNTS SET OUT IN CAS 320 AND *TERMINOLOGY USED IN THIS TEXT*		
Two types:	**Overall materiality** User-needs–based amount(s)	**Performance Materiality** Lesser amount(s) allowing a margin for potential undetected misstatements due to sampling risk
Two levels at which materiality is determined:		
For the financial statements as a whole (Overall materiality is required to be determined on every audit)	*"Overall Materiality"*	*"Overall Performance Materiality"*
For a particular class of transactions, or account balance, or disclosure (Required only when auditor determines users have needs for certain financial statement elements to be more precise)	*"Specific Materiality"*	*"Specific Performance Materiality"* (Note: This is similar to "tolerable misstatement" as defined in CAS 530)

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STANDARDS CHECK

CAS 320

Performance Materiality (Ref: Para. 11)

A12. Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. Performance materiality (which, as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance, or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance, or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures, and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.

Source: *CICA Handbook—Assurance*, 2012.

While it may seem that the "performance" concept complicates things unnecessarily, you can think about the performance materialities as a means to an end. The performance materiality concept exists to aid auditors in meeting the ultimate objective of addressing user needs as reflected by overall and specific materialities. Performance materialities are used in statistical auditing to control some of the risks associated with auditing procedures. This application is further discussed in Chapter 10.

Exhibit 5–6 on the next page illustrates a materiality worksheet that could be used to summarize the quantitative and qualitative factors that go into an auditor's decision on both the materiality level for financial statements as a whole and the performance materiality.

The materiality judgment for the current-year financial information of Anycompany Inc. shown in Exhibit 5–4 involves focusing on the most important financial decisions made based on the financial statements. The centre of attention will be different for different audits. For example, the focus may be the current asset–liability position for a company in financial difficulty seeking to renew its bank loans. This company may be experiencing operating losses, and the balance sheet, rather than the income statement, will be the most important information. In other cases, such as when a company is growing and issuing shares to the public, decisions based on income performance are the focus, so the income statement and the net income number may be the most important.

At this point, it is useful to review the reason for determining materiality. First, materiality levels determined at the planning stage are used to decide how much work to do on each financial statement item. At the completion stage of the audit, auditors use them to evaluate the cumulative effects of known or potential misstatements. If the audit work discovered five different $15,000 mistakes that all increase net income, and the net income-based materiality limit is $50,000, it would not be appropriate to consider these as immaterial because in total they exceed materiality.

While misstatements may be discovered in auditing an income statement account, the misstatement's materiality must be considered in relation to one or more balance sheet accounts. This is because income misstatements in the double-entry bookkeeping system can leave a **dangling debit** or a dangling credit somewhere in the balance sheet accounts, and the audit challenge is to find it. (E.g., if fictitious credit sales were recorded, setting up fictitious accounts receivable will balance the accounts.) If there is no dangling debit or credit, the other side of the misstatement transaction has gone through the income statement, probably causing misstatement in two accounts (opposite directions), with no net effect on the net income bottom line. (In the previous example, if the fictitious accounts receivable were written off as bad-debt expense, both the revenue and expense would be overstated, but the income would not be misstated.) The articulation of the balance sheet and income statement shown here support setting materiality at the financial statement level, since then what is material in the balance sheet is also material in the income statement, and vice versa.

dangling debit: a false or erroneous debit balance that exists because one or more accounts are misstated

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REVIEW CHECKPOINTS

5-39 Why are qualitative criteria important in the auditor's materiality decision?

5-40 Do auditing standards require auditors to use a specific quantitative criterion to determine materiality?

5-41 How do fraud considerations relate to the auditor's materiality decision?

5-42 What are the advantages of using the same overall materiality level for planning the audit instead of assigning a part of the overall materiality to each account balance?

EXHIBIT 5–6 Materiality Assessment

Auditee: ______________________________ **Year end:** ____________

Materiality Assessment

1. Qualitative Factors

	Comments
a) Identify the specific users of the financial statements for this engagement.	
b) Identify what expectations the users may have for the financial statements for this engagement.	
c) Identify any possible situations or misstatements that would affect a user now or at some future point, regardless of the materiality level. (e.g., Consider environmental matters, policies, statutes, safety issues, etc.)	

2. Quantitative Factors

a) Planning data

	This Year Actual (adjusted)	This Year Anticipated	Last Year	2nd Preceding Year
Assets				
Liabilities				
Equity				
Sales/revenue				
Gross profit				
Expenses				
Income before tax				
Previous materiality				

b) Normalized pre-tax income

	This Year Actual (adjusted)	This Year Anticipated	Last Year	2nd Preceding Year
Estimated pre-tax income	$			
Adjustment for nonrecurring items or unadjusted errors brought forward				
____________________ ____________________				
Normalized pre-tax income	$			

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Date & initials			

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EXHIBIT 5–6 Continued

3. Materiality Considerations

a) Profit-oriented enterprises

Identify FInancial Statement Users	Measurement Base	Factor Applied*	Possible Materiality	Comments
	Normalized pre-tax income		$	
	Assets		$	
	Equity		$	
	Revenue		$	
	Gross profit		$	
	Other		$	

*Materiality guidelines

Normalized pre-tax income	5–10%
Assets	½–1%
Equity	½–5%
Revenue	½–1%
Gross profit	½–5%

These materiality factors are provided as guidelines only and should be used only as an aid in the development of your professional judgment. The materiality level should represent the largest amount of a misstatement or group of misstatements that would not, in your judgment, influence or change a decision based on the financial statements.

Often, normalized pre-tax income is used as an initial reference point for businesses although it may not be sufficient for businesses with little or no income. Weighted averages are also used at times. Revenue is often used for NPOs. See CAS 320, paragraphs A3–A9 for more guidance.

b) Not-for-profit enterprises

Identify Financial Statement Users	Measurement Base Revenue/Expenses	Factor Applied*	Possible Materiality	Comments
Governmental authorities				
Funding organizations				
Directors				
Other				

*Materiality factors
Total expenses or total revenues ½ to 2%

c) Other factors considered in determining overall materiality and performance materiality for this engagement

____

____

____

Overall Materiality Assessment for Financial Statements as a Whole

Based on the anticipated financial statement amounts and on the other factors described above, overall materiality for this engagement is as follows:
$__________________ Misstatements below this threshold, if not corrected, will be accumulated on the Possible Adjustments Sheet unless such misstatements are deemed trivial (below $ _____). Note: The auditor may designate an amount below which misstatements are deemed trivial and need not be accumulated because the auditor expects that the accumulation of such amounts clearly will not have a material effect on the financial statements. In so doing, the auditor considers the fact that the determination of materiality involves qualitative as well as quantitative considerations and that misstatements of a relatively small amount could nevertheless have a material effect on the financial statements. The summary of uncorrected misstatements included in or attached to the management representation letter need not include trivial misstatements.

Performance Materiality Assessment

Based on expected misstatements in current period financial statements of $______________, and on other factors noted above, performance materiality for planning the audit is as follows:
$__________________.

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FINANCIAL STATEMENT ASSERTIONS AND AUDIT OBJECTIVES

Assertions in Financial Statements

LO7 Identify the principal assertions in management's financial statements and the related risks of material misstatement.

assertions: claims that management makes on financial statements

This section explains the concept of the financial statement **assertions** that are the claims management makes. Keep the following things in mind as you study this:

- Management's accounting system produces a trial balance.
- Management arranges the trial balance in financial statements and thereby makes certain assertions about how the financial statements represent the underlying economic data in the accounting system.
- Auditors use these assertions as focal points assessing specific risks of material misstatements.
- Auditors use the risk assessments at the assertion level to set audit objectives and design specific evidence-gathering procedures in response to these assessed risks.
- The practical audit objectives are to obtain and evaluate evidence about whether or not the assertions made by management in financial statements hold true.

We will start with five principal assertions that, while broadly defined, are distinct and comprehensive conceptual descriptions of the claims in financial statement elements:

1. Existence (occurrence)
2. Completeness
3. Ownership (rights and obligations)
4. Valuation (measurement and allocation)
5. Presentation (classification and disclosure)

Exhibit 5–7 on the next page shows these assertions in relation to one of the main accounts in a typical balance sheet, inventory.

The five assertions will next be described in more detail in the context of audit objectives and procedures. For all assertions, the audit objective is to prove with evidence that the assertion holds true.

Existence (Occurrence)

Management's claim is that the reported financial statement amounts are genuine, not fictitious. For revenue and expense transactions, the existence assertion is also described as *occurrence,* as the auditor requires evidence that transactions are valid and actually occurred. An account balance overstatement, for example, is an existence error. In determining whether cash, inventory, receivables, and other assets actually exist, auditors will physically count cash and inventory, obtain written confirmation of receivables from the customers, and perform other validation procedures. Beginning students must be careful at this point, however, because finding evidence of existence alone generally proves little about the other four assertions.

Completeness

Management's claim is that all amounts that should be included in the financial statements have been included. A completeness error exists when a transaction total or account balance is understated. Thus, auditors gather evidence that, for example, inventory on hand is included, inventory consigned out is included, sales that occurred have been recorded, and so forth. Auditing this assertion means auditing what is not there, so it creates special difficulties for the auditor. Management's written representation that all transactions are included in the accounts is always obtained by the auditor, but this alone is not sufficient. Auditors also need to gather corroborating evidence, often from several sources.

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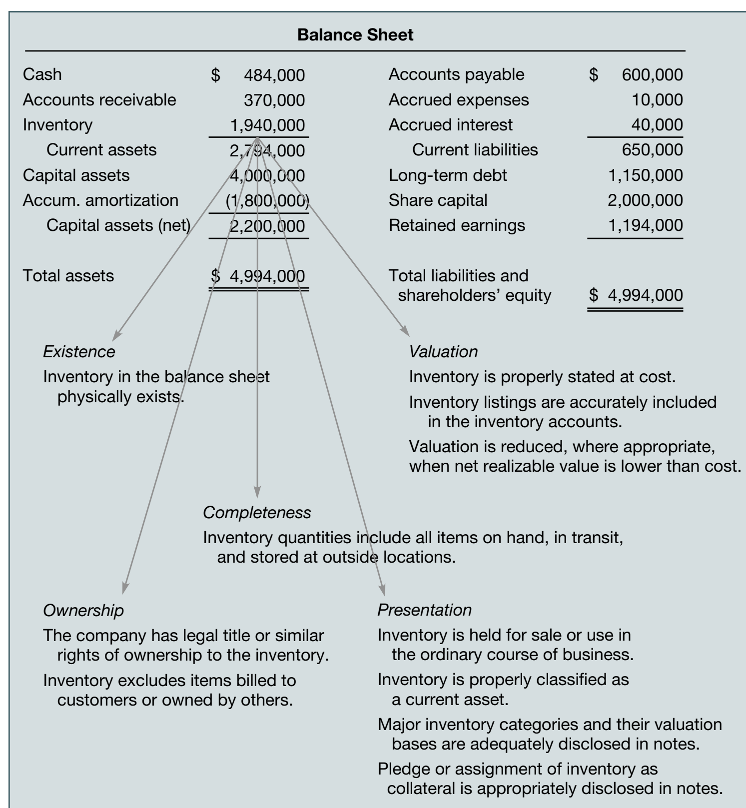
EXHIBIT 5–7 Management Assertions about Inventory



Cutoff

Proper *cutoff* means accounting for all transactions that occurred during a period without postponing some recordings to the next period or accelerating next-period transactions into the current-year accounts. Cutoff errors result in accounts being overstated or understated and, therefore, relate to either the existence or the completeness assertions. Audit procedures to verify that the cutoff transactions are correctly accounted for provide essential evidence related to the existence and completeness assertions, and some auditors consider cutoff as a separate assertion of its own due to its importance.

Simple cutoff errors occur in the revenue accounting process when late-December sales invoices are recorded for goods not actually shipped until January, or when cash receipts are recorded through the end of the week (e.g., Friday, January 4) and the last batch for the year should have been processed on December 31, thus overstating sales or cash receipts. They can occur in the purchases process when there is a failure to record accruals for expenses incurred but not yet paid, thus understating both expenses and liabilities. A failure to record materials purchased but not yet received, and therefore not included in the ending inventory, results in understating both inventory and accounts payable.

In a financial statement audit, the cutoff date usually refers to the auditee's year-end balance sheet date; however, it can be required at other times, for example when one accounting system is converted to a new system during the year.

Ownership (Rights and Obligations)

The ownership assertion is management's claim that the entity has proper rights to all the assets and revenues reported and proper obligations to pay out all the liabilities and expense.

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The auditor's objective related to *ownership* is establishing, with evidence, the ownership rights for assets, for liabilities (more like "ower"-ship when they are obligations), and the propriety of revenue and expense transactions. Ownership, however, can include assets (rights) for which the company does not actually hold title. For example, an auditor will specifically gather evidence about the amounts capitalized under finance leases. Likewise, ownership includes accounting liabilities that a company may not yet be legally obligated to pay. For example, an auditor would gather evidence about the obligations under a capitalized lease, estimated liability for product warranties, or estimated future environmental clean-up costs. This assertion links to the fundamental "entity" concept you are familiar with from the conceptual framework of financial accounting. The auditor's knowledge of the boundaries of the auditee entity are important in setting the scope of the audit and in assessing the appropriate application of accounting principles in the financial statements.

Valuation (Measurement and Allocation)

Management's claim is that the dollar amounts recorded in the financial statements are correctly calculated and allocated, and the measurement bases used are appropriate in accordance with GAAP. It can involve the measurement approach used (historic cost, fair value, present value) or the method of allocating joint costs. Auditors obtain evidence about specific dollar measurements by procedures, such as reconciling bank accounts, comparing vendors' invoices to inventory prices, obtaining lower-of-cost-and-market data, evaluating collectability of receivables, and so forth. Many valuation and allocation decisions involve determining the proper application of GAAP.

Presentation (Classification and Disclosure)

Management's claim is that the financial statements are presented fairly in accordance with GAAP. Auditors also must determine whether accounting principles are properly selected and applied, whether financial information is presented in accordance with the underlying economic reality, whether disclosures are adequate, and whether any GAAP that apply have been followed—all aspects of financial statement *presentation*. Specific objectives of presentation include proper balance sheet classification (e.g., current versus long-term), proper income statement classification (e.g., cost of sales components, discontinued operations items, interest expenses), and note disclosure of accounting policies and account details. The presentation assertion is the meeting place between accounting principles and audit reporting standards.

Further Considerations Regarding Assertions

Although it is not normally listed as a separate assertion, *compliance* with laws and regulations is very important for a business, and disclosure of known non-compliance is necessary for presentation of financial statements in conformity with GAAP. The **compliance assertion** increases in importance as new laws and regulations come into force to improve governance and accountability (in response to corporate scandals and higher expectations for corporate social responsibility). Auditors gather evidence related to laws and regulations that can have financial implications, such as provincial securities acts, tax withholding regulations, minimum wage laws, wage and price guidelines, credit allocation regulations, income tax laws, environmental regulations, and specialized industry regulations. Compliance with legal terms of the company's private contracts (e.g., merger agreements and bond indentures) is also important for financial statement presentation, as failures to comply may be a warning sign that the company is not a going concern, which requires financial statement disclosure and must be emphasized in the auditor's report. CAS 570, "Going Concern," has elevated the importance of this assertion and provides additional guidance on dealing with it in the audit of financial statements.

compliance assertion: management's claim that it has disclosed any non-compliance with laws or regulations that affect the entity and its business

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What is the "Assessed Risk of Material Misstatement at the Assertion Level"?

You can think of the assertions as the claims that management is making to outside users in relation to each amount and disclosure in the entity's general purpose financial statements. Remember that management is responsible for creating a set of financial statements that tell a true and complete story about the entity's performance and financial position to outside users. If, taken all together, the assertions are all valid then management's financial statements will likely be "fairly presented"; that is, they will exhibit the required qualities of relevance, completeness, reliability, neutrality, and understandability (CAS 210, Appendix 2), and contain all the disclosures necessary for a "fair presentation financial reporting framework" (CAS 700, paragraph 13), as discussed in Chapter 4.

In turn, an auditor's responsibility is to provide her independent opinion on whether management's financial statements are fairly presented. To achieve this objective, assertions are a very useful analytical tool that helps the auditor identify what types of evidence to get when performing her audit procedures. Assertions break down the claims that need to be proven into logical, focused pieces. This makes the job of planning audit procedures much more manageable because auditors can use the assertions to think specifically about "what could go wrong?" and "how likely is it that this could have happened?" In the CAS terminology, when auditors think about these questions they are "assessing the risks of material misstatement at the assertion level" (CAS 315). When auditors identify the evidence they need to get to determine whether the assertions hold water, and perform procedures to get that evidence, these are their "responses to the assessed risks" (CAS 330). So, you can see that assertions provide a key linkage throughout the audit process. It may be a bit challenging to understand them at first, but once you do it will give you a very strong basis for understanding the whole audit process!

STANDARDS CHECK

CAS 315

25. The auditor shall identify and assess the risks of material misstatement at:
    (a) The financial statement level; and (Ref: Para. A105–A108)
    (b) The assertion level for classes of transactions, account balances, and disclosures (Ref: Para. A109–A113), to provide a basis for designing and performing further audit procedures.
26. For this purpose, the auditor shall:
    (a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements; (Ref: Para. A114–A115)
    (b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
    (c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and (Ref: Para. A116–A118)
    (d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Source: *CICA Handbook—Assurance*, 2012.

Exhibit 5–7 indicates the specific assertions management is making for one major balance sheet account, inventory. Exhibit 5–8 expands on this, by giving a statement of each assertion for all the main financial statement amounts, plus one example of what could go wrong for each assertion. It is important to note that the exhibit gives just one example; there usually are other things that can go wrong, too. You might try to think of other things that could go wrong as a good exercise to test your understanding of assertions at the conceptual level. (*Hint:* Try to think about what each account represents in terms of the real economic information it is supposed to communicate about the entity, then think about what management's accounting system is supposed to capture to present that

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information, and what might have not worked properly to result in a misstatement in the amount in relation to a particular assertion.)

EXHIBIT 5–8 Assertions for Financial Statements Elements in Exhibit 5–7, Related Audit Objectives and Examples of Misstatements

Audit objectives: To prove with evidence whether each assertion holds for the information in management's financial statements:
Example of what could go wrong to cause a misstatement for each assertion

ACCOUNTS	AMOUNTS (in Canadian dollars)	EXISTENCE	COMPLETENESS	OWNERSHIP	VALUATION	PRESENTATION
Assets						
Cash	$ 484,000	There is real cash on hand and in bank accounts of this amount. *The company has failed to record outstanding cheques.*	All the cash that exists is included in the balance. *The company has failed to record outstanding deposits.*	The company has the right to use all this cash. *Use of some of the cash balance is restricted due to requirement of a bank loan.*	The cash value is calculated in Canadian dollars. *The cash is in U.S. dollars and has not been converted to Canadian dollars.*	The cash is appropriately presented as a current asset. *The net balance in the company's bank accounts is an overdraft (negative) and should be shown as a current liability.*
Accounts receivable	370,000	The amounts are actual debts owing to the company by its customers. *Amounts are still included that have already been paid by customers.*	All the invoices outstanding have been included. *Sales on account for the last day of the year were not recorded until the start of the following year (cutoff error).*	The company has the right to collect the cash for these amounts. *The company has already sold the receivables to a finance company for 75% of face value.*	The amount is the net realizable amount that is likely to be collected. *The company has not made any allowance for possible bad debts.*	The amounts are due to be collected in the current operating period. *Some amounts are not due for two years and should be included in long-term assets.*
Inventory	1,940,000	Inventory in the balance sheet physically exists. *Items of inventory that have already been sold and shipped to customers have not been removed from inventory records.*	Inventory quantities include all items on hand, in transit, and stored at outside locations. *Items of the company's inventory that are being stored offsite in a public warehouse have been omitted from the inventory records.*	The company has legal title or similar rights of ownership to the inventory. Inventory excludes items billed to customers or owned by others. *Items of inventory sold but not yet picked up by the customer have been included in the inventory balance.*	Inventory listings are accurately included in the inventory accounts. Inventory is properly valued at cost. Valuation is reduced where appropriate when net realizable value is lower than cost. *Selling prices for all items in inventory have dropped below cost but no write down has been recorded.*	Inventory is held for sale or use in the ordinary course of business, properly classified as a current asset, and major categories and their valuation bases are adequately disclosed in notes. Pledge or assignment of inventory as collateral is appropriately disclosed. *The basis of valuation for inventory is not disclosed in the accounting policy note.*
Capital Assets (PP&E and intangibles)	4,000,000	PP&E and intangibles included in the balance sheet physically or legally exist.	All PP&E and intangibles owned or under capitalized lease by the company are included in the account.	The company has legal title of ownership or similar ownership rights, or a capitalized lease for all recorded PP&E and intangibles.	PP&E and intangibles are properly valued at cost (or fair value) according to the company's accounting policy. A reasonable allowance for depreciation/ amortization is recorded.	PP&E and intangibles are held for use in the ordinary course of business, properly classified as long-term assets, and major categories and their valuation bases are adequately disclosed in notes.

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EXHIBIT 5–8 Continued

ACCOUNTS	AMOUNTS	EXISTENCE	COMPLETENESS	OWNERSHIP	VALUATION	PRESENTATION
Capital Assets (continued)		*An old truck has been scrapped but its cost has not been removed from the accounts.*	*A new truck was purchased but the accountant forgot to record it in the PP&E account.*	*The company entered a sale and lease back agreement during the year on a factory building that is still included in PP&E but the lease is an operating type.*	*The company did not record amortization on patents it owns that will expire in five years.*	Pledge or assignment of PP&E for collateral is appropriately disclosed. *The detailed breakdown of the PP&E and intangibles categories, cost and accumulated amortization, is not disclosed in the notes.*
Accumulated. amortization (AA)	(1,800,000)	AA included in the balance sheet relates to existing PP&E and intangibles. *An old truck has been scrapped but its AA has not been removed from the accounts.*	AA is recorded for all PP&E and intangibles owned or under capitalized lease. *A new truck was purchased in the year but the accountant failed to record amortization on it for the year.*	AA included in the balance sheet relates to PP&E and intangibles owned or properly capitalized by the company. *AA has been included that relates to a building now used under operating lease.*	AA has been correctly calculated and recorded in accordance with the company's accounting policies. *The company used the wrong declining balance percentage to calculate depreciation on its trucks.*	AA is properly classified as a contra-asset, allocation methods for each major PP&E and intangibles categories are adequately disclosed in notes. *The amortization method for intangible assets is not disclosed in the notes.*
Liabilities and Equity						
Accounts payable	$ 600,000	All accounts payable included in the balance are existing obligations of the company to its suppliers. *A supplier's invoice that was accrued has been paid, but the amount was debited to office supplies rather than accounts payable.*	No actual obligations to suppliers have been omitted from the balance. *Goods are in transit to the company at year end with FOB shipping point, but the supplier's invoice was not included in accounts payable.*	All obligations are actually owed by the company to its Suppliers. *A supplier invoice was received that was actually for a different company, but it has been recorded in the accounts payable balance.*	Accounts payable are shown at the correct amounts that will ultimately be paid. *The company's accounting policy is to recognize any early payment discounts available at the time the invoice is accrued, but the accountant has not made the proper adjustments at year end.*	The amounts are due to be paid in the current operating period. *Some amounts are not due for two years and should be included in long-term liabilities.*
Accrued expenses	10,000	All accrued expenses are existing non-trade related obligations of the company. *The company accrued its outstanding utility bill twice in error.*	No actual non-trade obligations have been omitted from the balance. *The company failed to accrue for outstanding employee wages.*	All obligations are actually owed by the company to outside parties. *The company accrued a property insurance premium that is actually owed by the company's president personally.*	All accrued expenses are shown at correct the amounts that will ultimately be paid. *The company miscalculated its accrual for outstanding vacation pay.*	The amounts are due to be paid in the current operating period. *Some amounts are not due for two years and should be included in long-term liabilities.*

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EXHIBIT 5–8 Continued

ACCOUNTS	AMOUNTS	EXISTENCE	COMPLETENESS	OWNERSHIP	VALUATION	PRESENTATION
Accrued interest	40,000	All accrued interest exists and related to real obligations of the company. *The company has accrued interest on a bank loan that was repaid early and not outstanding year-end.*	No actual unpaid interest obligations have been omitted from the balance. *The company failed to accrue for interest outstanding on a new mortgage loan.*	All interest obligations are actually owed by the company to outside parties *The company accrued mortgage interest that is actually owed by an employee.*	Accrued interest is correctly calculated. *The company miscalculated the number of days interest accrued prior to year-end and accrued an incorrect amount.*	The amounts are properly presented as interest accruals and details of interest terms are correctly disclosed. *The company failed to disclose the interest rates on its long-term liabilities.*
Long-term debt	40,000	All long-term debts are real obligations of the company. *The company has included a bank loan that was repaid early and no longer outstanding year-end.*	No outstanding long-term obligations have been omitted from the balance. *The company failed to record a capitalized lease obligation.*	All long-term obligations are actually owed by the company to outside parties. *The company accrued mortgage interest that is actually owed by an employee.*	Accrued interest is correctly calculated. *The company miscalculated the number of days interest accrued prior to year-end and accrued an incorrect amount.*	The amounts are properly presented as interest accruals and details of interest terms are correctly disclosed. *The company failed to disclose the interest rates on its long-term liabilities.*
Share capital	2,000,000	All share capital recorded was properly issued and outstanding at year-end. *The company included shares that were not issued till the following year.*	No outstanding paid up share capital has been omitted. *The company issued new shares and forgot to record them.`*	All shares issued properly represent legal ownership interests in the company. *The company repurchased and cancelled some shares but is still showing them as issued and outstanding.*	Shares are recorded at amounts received or other appropriate valuation basis. *The fair value of property received in exchange for shares was calculated incorrectly.*	All shares issued are properly classified as equity, and details of amounts and numbers of shares issued for all share classes are properly disclosed in notes. *The detailed breakdown of the PP&E and intangibles categories, cost, and accumulated amortization is not disclosed in the notes.*
Retained earnings	1,194,000	Retained earnings includes only the net earning retained in the company. *The company paid a dividend and recorded it as an expense rather than as a reduction of retained earnings.*	Retained earnings includes all the net earning retained in the company. *The company has forgotten to close its current net income into the retained earnings account.*	The company has the right to distribute the amount in its retained earnings account. *The company declared a dividend prior to year-end and did not record a dividend payable or reduce retained earnings.*	Retained earnings is correctly calculated. *A debit to retained earning that arose on repurchasing some shares at their fair value was incorrectly calculated.*	Retained earnings continuity is properly reported and all changes to retained earnings are adequately described. *The company recorded a large debit to retained earnings which is not described fully in the financial statement or explained in the notes.*

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EXHIBIT 5–8 Continued

ACCOUNTS	AMOUNTS	EXISTENCE	COMPLETENESS	OWNERSHIP	VALUATION	PRESENTATION
Revenues	1,000,000	All revenue recorded by the company actually occurred and is appropriate to recognize in the current year. *A sale completed just prior to year-end was not recorded until the following year.*	No revenues that should have been recognized in the year have been omitted. *A sale contract was recognized in the current year, but the criteria for revenue recognition were not met until the following year.*	The company has the right to receive benefits for all revenues recorded in the year. *The company sold consignment inventory on behalf of another company but recorded the entire sale amount instead of just the 5% commission it is entitled to.*	Revenues have been correctly calculated and allocated to the year in which they are earned. *Revenue recognition on a percentage-of-completion basis was calculated using the wrong percentage.*	Revenues are clearly presented in the financial statements, significant categories are shown separately, and revenue recognition accounting policies are adequately explained in the notes. *Revenue recognition policies are not disclosed in the notes.*
Cost of sales	650,000	All costs of sales recorded by the company are appropriate to recognize in the current year. *Cost of sales was overstated due to an understatement error in counting year-end inventory.*	No costs of sales that should have been recognized in the year have been omitted. *Cost of sales was understated due to an overstatement error in counting year-end inventory.*	All the costs of sales recorded in the year were related to generating the company's own sales revenues. *The company included an electricity bill of the next door factory in its own costs of sales in error.*	Costs of sales have been correctly calculated and allocated to the year in which the related revenues are recognized. *Allocation of fixed overheads to ending inventory was calculated incorrectly.*	Costs of sales are presented appropriately in the financial statements, and significant accounting policies used are adequately explained in the notes. *Accounting policies related to the reported costs of sales are not disclosed in the notes.*
Other expenses	200,000	All other expenses recorded by the company are appropriate to recognize in the current year. *Other expense was overstated due to an overaccrual of management bonuses that were not earned in the year.*	No other expenses that should have been recognized in the year have been omitted. *Other expense was understated due to failure to accrue management bonuses earned in the year.*	All the other expenses recorded in the year were related to the company's own operating, financing, or investing activities. *The company included air fares expenses for employee vacation travel that are not proper expenses of the company.*	Other expenses have all been correctly calculated and allocated to the year to which they relate. *Compensation expense for employee stock options granted in the year is not correctly calculated.*	Costs of revenues are presented appropriately in the financial statements, and significant accounting policies used are adequately explained in the notes. *Accounting policies related to the reported other expenses are not disclosed in the notes.*

Now that you have an understanding of the main concept of assertions as they relate to the criteria of fair presentation, our next step is to look at how assertions are further refined and focused in the CAS. For example, CAS 315, paragraph A111 defines the assertions in terms of the three main financial reporting categories: account balances, classes of transactions, and disclosures. These finer definitions make it easier for auditors to use the assertion concepts to consider potential misstatements in financial statement information and to design effective auditing procedures. The detailed assertions as set out in the CAS are shown in the following box, with cross-references to the five principal assertions.

Summary: Assertions and Planning the Audit

Financial statement assertions are the fundamental management claims to be audited and the focal points for all audit procedures. In an audit program, the evidence produced by each procedure relates to one or more specific objectives linked to specific assertions. If

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ASSERTIONS FOR CLASSES OF TRANSACTIONS, ACCOUNT BALANCES, AND PRESENTATION AND DISCLOSURE

Auditing standards require the auditor to assess risk of material misstatement assertion by assertion at the levels of transactions and events, account balances, and presentation/disclosure. In planning and performing the audit, an auditor may use the assertions as described in the standards, or he may express them differently as long as all aspects described in the standards above have been covered. Some auditors may prefer to combine assertions about transactions and events with those about account balances, or to cover proper cutoff of transactions and events under occurrence and completeness assertions rather than as a standalone assertion.

Assertion terms used at the transaction, account balance, and disclosure levels are shown with links to the five principal assertions.

DETAILED ASSERTIONS PER CAS 315	PRINCIPAL ASSERTION(S) LINKED TO DETAILED ASSERTION
1. Assertions about classes of transactions and events	
(i) Occurrence—transactions and events that have been recorded have occurred and pertain to the entity	Existence
(ii) Completeness—all transactions and events that should have been recorded have been recorded	Completeness
(iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately	Valuation
(iv) Cutoff—transactions and events have been recorded in the correct accounting period	Existence Completeness —depending on direction of testing
(v) Classification—transactions and events have been recorded in the proper accounts	Presentation
2. Assertions about balance sheet items	
(i) Existence—assets, liabilities, and equity interests exist	Existence
(ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity	Ownership
(iii) Completeness—all assets, liabilities, and equity interests that should have been recorded have been recorded	Completeness
(iv) Valuation and allocation—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts, and any resulting measurement or allocation adjustments are appropriately recorded	Valuation
3. Assertions about presentation and disclosure	
(i) Occurrence and rights and obligations—disclosed events, transactions, and other matters have occurred and pertain to the entity	Existence Ownership
(ii) Completeness—all disclosures that should have been included in the financial statements have been included	Completeness
(iii) Classification and understandability—financial information is appropriately presented and described, and disclosures are clearly expressed	Presentation
(iv) Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts	Valuation

Source: Adapted from CAS 315.

you have obtained a list of audit procedures (e.g., from last year's audit file), you can begin planning by asking the following questions:

- What are the assertions management is making by reporting this financial information?
- What are the risks of material misstatement in these assertions?

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- Which assertion(s) does this audit procedure produce evidence about?
- Does the list of procedures (the audit program) address the risk of material misstatement in all the assertions?

Qualitative factors, cost of the procedure, risk level associated with each assertion, and materiality determine the extent that a particular procedure is used.

You can simplify the five major assertions by thinking of them as existence, completeness, ownership, valuation, and presentation [E,C,O,V,P]. Each of them has additional aspects, depending on the financial items you are auditing and the audit evidence available. How procedures are linked to assertions is an important topic in understanding audit evidence and the assurance it provides, and is our starting point for developing the audit plan and detailed programs.

REVIEW CHECKPOINTS

5-43 Briefly explain the five principal assertions that can be made about assets and liabilities, and auditors' objectives related to each.

5-44 How do financial statement assertions relate to audit procedures?

5-45 Why is it particularly challenging to obtain audit evidence about the completeness assertion?

5-46 Why should auditors think about a compliance assertion that is not listed in the auditing standards about assertions?

5-47 How are assertions used in audit planning?

DOCUMENTING THE OVERALL AUDIT STRATEGY AND AUDIT PLAN

Overall Audit Strategy

LO8 List the preliminary planning decisions set out in the overall audit strategy.

As discussed throughout Part 2 of the text, audit planning is an ongoing, iterative process where information gained as the audit is performed may result in refinements to the plan. The preliminary planning activities are the basis for establishing the overall audit strategy, which sets the scope, timing and direction of the audit engagement, and guides the development of the detailed audit plan. In developing the overall audit strategy, CAS 300 requires the audit partner to consider the following:

- The characteristics of the entity and the engagement that define its scope
- What reporting is expected to result from the engagement that affects the timing of the audit work and the communications needed between team members and between the audit team and the auditee
- What key factors will be significant in planning and executing the audit work
- What resources the audit firm will need to perform the audit effectively

The overall audit strategy documents information about (1) investigation or review of the prospective or continuing engagement and client relationship, including relevant ethical and independence considerations; (2) staff, and special technical or industry expertise required; (3) preliminary materiality levels; (4) assessment of significant industry or company risks and related audit issues; (5) identification of unusual accounting principles; (6) use of substantive or combined audit approach; (7) nature and extent of resources required; (8) staff assignment and scheduling of team communications and field work; and (9) special considerations for initial or group audit engagements.

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STANDARDS CHECK

CAS 300

7. The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.
8. In establishing the overall audit strategy, the auditor shall:
   (a) Identify the characteristics of the engagement that define its scope;
   (b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
   (c) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;
   (d) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
   (e) Ascertain the nature, timing, and extent of resources necessary to perform the engagement. (Ref: Para. A8–A11)

Source: *CICA Handbook—Assurance*, 2012.

Exhibit 5–9 provides a checklist of considerations auditors include in developing the overall audit strategy for a typical continuing audit engagement. The checklist is a questionnaire form that could be used to document the planning, as required by the auditing standards. The first part lists considerations that are usually relevant in ongoing audits, and the following two parts relate to specific circumstances such as initial engagements or audits of consolidated financial statements. Many of these matters will influence the auditor's detailed audit plan, which the auditor will develop after fully assessed the auditee's business risks and related internal control. The examples cover a broad range of matters applicable to many engagements. While some of the matters referred to below may be required by other CASs, not all matters are relevant to every audit engagement, and the list is not necessarily complete.

EXHIBIT 5–9 Considerations in Establishing the Overall Audit Strategy

Matters relevant to planning financial statement audits	
Document the following information based on enquiries of appropriate auditee personnel:	**Response/File Documentation Reference**
Considerations applicable on most continuing audits of standalone financial statements	
Engagement Characteristics	
• Entity's reporting requirements and deadlines.	
• Financial reporting framework used in financial information to be audited a "GAAP" framework or otherwise acceptable per CAS 210?	
• Any requirement to reconcile to another financial reporting framework?	
• Any additional specific reporting requirements; e.g., industry, regulatory, legislated (e.g., in public sector) requirements?	
• Expected audit coverage, including the number, locations, and nature of business components.	
• Reporting currency to be used; need for currency translation in the financial information audited.	
• Existence of related parties and extent of any related party transactions and balances.	
• Impact of information technology on data available for audit procedures; potential to use computer-assisted audit techniques.	
• Organizational structure, key auditee personnel, information systems, and availability of data relevant to audit.	
• Need to use work of others for audit evidence, such as other auditors, experts with specialized knowledge, internal audit work, service organizations; audit reports on effective design or operation of controls performed by them?	
Audit Timing and Communications	
• Schedule of meetings with management and those charged with governance to discuss the nature, timing, and extent of the audit work; expected type and timing of auditor's report; management letters; and other communications, both written and oral, throughout the engagement.	
• Expected nature and timing of communications and meetings among engagement team members.	
• Expected timing for performing and reviewing audit work.	
• Plan for communicating to engagement team members on the need to question management and exercise professional skepticism in gathering and evaluating audit evidence throughout the audit.	

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EXHIBIT 5–9 Continued

	Response/File Documentation Reference
Considerations applicable on most continuing audits of standalone financial statements (continued) *Preliminary Audit Activities* • Initial determination of appropriate materiality and performance materiality level for financial statements as a whole for planning purposes (and lower levels for specific financial statement elements, if required). • Reconsideration of materiality levels based on new information as audit procedures are performed during the course of the audit. • Identification of material business components and financial statement account balances. • Preliminary identification of significant audit issues (areas where there may be a higher risk of material misstatement). • Consider results of previous audits, including evaluation of internal control operating effectiveness, management's commitment to effective internal control, nature and magnitude of misstatements identified by the auditor, any restatements and corrections made by management. • Consider volume of transactions, complexity of information systems, availability of records, importance of internal control to successful business operations, and other relevant factors to determine whether it is more efficient for the auditor to test internal control effectiveness to obtain audit assurance. • Preliminary decision on whether a combined approach (using both control testing evidence and substantive evidence) should be used for any aspects of the audit. *Identification of Significant Audit Issues* • Consider significant business developments such as changes in information technology and business processes; key management changes; and acquisitions, mergers, and divestments. • Consider significant industry developments, such as changes in industry regulations, new reporting requirements, and the legal environment affecting the entity. • Consider significant changes in the applicable financial accounting standards. *Nature, Timing, and Extent of Required Resources* • Consider impact of assessed risk of material misstatement at the overall financial statement level on engagement staffing, direction, supervision, and review. • Selection of, and audit work assignment to, engagement team members; assigning appropriately experienced team members to areas with higher risks of material misstatement. • Engagement time budgeting, including considering adequate time for high risk areas, supervision, and review of less experienced team members.	
Additional Considerations for Specific Circumstances *Initial audits* • Consider: – if entity previously audited, consider matters raised in communications with predecessor and accessibility of previous audit working papers. – impact on engagement and audit report of availability of evidence regarding opening balances, consistency of accounting policies, and comparative figures if these are reported. *Group audits of consolidated entities* • Consider: – nature of the control relationships between a parent and its components that determine how the group is to be consolidated. – extent to which components are audited by other auditors. – need for a statutory audit of standalone financial statements in addition to an audit for consolidation purposes. – communication with auditors of components, regarding things such as the expected types and timing of reports to be issued and other communications. – setting and communicating materiality for auditors of components. – nature, timing, and extent of resources needed for engagement team to assess understanding, group-wide risks and controls, and consolidation process. **Source:** Adapted from CASs 300, 510, 600.	

A key purpose of the overall audit strategy is to pull together all relevant preliminary planning activities to guide the development of the detailed audit plan. The audit plan details the nature, timing, and extent of the risk assessment and further audit procedures planned to address the specific assertions for each component of the audit. The "nature" of audit procedures refers

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to evidence techniques they will use. The "timing" refers to when they will be performed, whether before (interim date), at, or after the auditee's year-end. Timing may have other aspects, such as surprise procedures (unannounced to auditee personnel) or the need to observe periodic auditee procedures, such as rotating inventory counts during the year. The "extent" usually refers to the sample sizes of data examined, such as the number of customer accounts receivable to confirm, or the number of inventory categories/products to count.

The planned procedures are often presented in a set of specific audit programs. An audit program is a list of audit procedures focused on a major financial statement component. The programs include specific audit objectives and procedures for determining inherent and control risk, obtaining the sufficient competent evidence that is the basis for the audit report, and producing the required documentation. In the following chapters we will examine how auditors develop the detailed audit plan and specific programs.

STANDARDS CHECK

CAS 300

9. The auditor shall develop an audit plan that shall include a description of:
   (a) The nature, timing, and extent of planned risk assessment procedures, as determined under 315.
   (b) The nature, timing, and extent of planned further audit procedures at the assertion level, as determined under CAS 330.
   (c) Other planned audit procedures that are required to be carried out so that the engagement complies with CASs. (Ref: Para. A12)

Source: *CICA Handbook—Assurance*, 2012.

STANDARDS CHECK

CAS/ISA 230

8. The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand: (Ref: Para. A2–A5, A16–A17)
   (a) The nature, timing, and extent of the audit procedures performed to comply with the ISAs and applicable legal and regulatory requirements; (Ref: Para. A6–A7)
   (b) The results of the audit procedures performed, and the audit evidence obtained; and
   (c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. (Ref: Para. A8–A11)

Source: *CICA Handbook—Assurance*, 2012.

REVIEW CHECKPOINTS

5-48 What audit planning activities are documented in the overall audit strategy?

5-49 How does the overall audit strategy relate to the audit plan and detailed programs?

APPLICATION CASE WITH ANALYSIS

Audit Engagement Acceptance Decision

DISCUSSION CASE

About a year ago, Jack joined a medium-sized local public accounting firm as a junior auditor. Early in his first year Jack got the opportunity to work on a new audit client acceptance decision with Hilda, one of the firm's top audit managers. The prospective client is a local company called Sweet Dreams Inc. Hilda had gathered information about Sweet Dreams as required to comply with the firm's quality

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control standards, and she asked Jack to review it and comment on her recommendation that the firm accept the audit engagement. Hilda saw this as a way for Jack to get familiar with the client as he was the junior member of the Sweet Dreams audit team, but it was also a way for Jack to learn the firm's procedures for new client acceptance decisions. Some of the key points Jack noted in reviewing the information Hilda had gathered follow:

- Sweet Dreams operates a chain of retail mattress stores across the city. It is privately owned by three sisters who inherited the company from their parents, the company's founders. The owners are not involved in managing the business, but it pays quarterly dividends that are their main source of income. The three sisters are all highly involved in local charitable associations and are well respected in the community.
- Sweet Dream's predecessor auditor, a partner in a small local firm, resigned from the audit because she is planning to retire from practice soon. Since all her partners also plan to retire in a few years, she felt it would be in Sweet Dreams' best interest to switch to another firm that could continue the audit for a longer time.
- The predecessor's response letter to Hilda also indicated that Sweet Dreams had been an excellent audit client over twenty years. Management is very competent and control conscious, ensuring employees keep accurate records and follow all control procedures. Misstatements uncovered by the auditor, even immaterial ones, have always been promptly corrected, and they have always paid the audit fees in full, promptly. The predecessor also noted that management has given its permission for her to give its new auditors access to her prior year's audit files to facilitate their familiarization to the company.
- The company is very profitable and the owners receive audited financial statements annually, as well as quarterly profit reports. Management provided Hilda with the company's most recent financial statements, and she notes that it uses an appropriate acceptable basis of accounting. Management and senior employees participate in a profit sharing plan that gives them above-average earnings.
- The company participates in many community fund-raising events, such as supplying new mattresses to homeless shelters. Sweet Dreams was the first business in the city to undertake a comprehensive waste and energy reduction program. Employees are proud to work for Sweet Dreams, and it has won awards from the city for its community and environmental initiatives.

After his review of Hilda's documentation, Jack felt he had a good introduction to Sweet Dreams and that he fully understood why Hilda recommended that the firm accept it as a new audit client.

Later that year, Hilda assigned Jack to assist on another new client acceptance decision, this time for Grouse Mines Limited. She was very impressed with Jack's progress, and decided to give him a little more rope this time by letting him gather some of the background information required. Jack was instructed not to contact Grouse management, as that would have to be done by one of the firm's partners, but to do any other information gathering that could be relevant to the firm's acceptance decision. Jack was happy to have this challenge and set about his work, gathering the following points:

- Grouse is a mining company that owns and operates several mines outside the city. Grouse also owns mining properties in South America and Indonesia, which are operated by local managers.
- Its shares are publicly traded on the over-the-counter market.
- After three attempts, Grouse's predecessor auditor responded to Jack by telephone. He explained that his firm has resigned from all its public company audits because "we are sick and tired of CPAB breathing down our necks about trivial issues like documentation." Further, he "can't give any reason why your firm shouldn't accept the audit. They always paid their audit fees, and we plan to continue to do consulting work for them on financing, management compensation, and environmental disclosure issues. Now that we don't have CPAB tying our hands, we should be able to provide much more valuable business advice to Grouse's management." When Jack enquired about the possibility of reviewing prior year working papers, the predecessor said it would not be possible since his firm's staff is "far too busy to spend the time it would take to get those old files ready for your firm to see."
- In reviewing Grouse's regulatory filings on SEDAR, Jack notes Grouse's profitability had been declining until two years ago when it hired a mining veteran as its new CEO to implement serious cost-cutting measures. The company's profits have increased modestly in the last two years, but it is late in filing its most recent quarterly report. The CEO and her management team have stock options that will vest next year.
- Grouse's recent annual report includes several pages of disclosure about its environmental management policies and its compliance with all environment regulations.
- News stories have appeared reporting that residents living near the mines in Canada and the other countries have organized protests after noting an increase in breathing problems as well as several serious fish kills in the rivers downstream of the mines' tailings ponds.
- Grouse issued a recent press release announcing it has preliminary assays indicating that one of the world's largest reserves of platinum exists in one of its South American mining properties. Further testing is being done and more certain estimates of the platinum reserve quantities are expected to be available sometime next year.

In trying to apply what he learned in his prior experience with Sweet Dreams, Jack is amazed at how different the Grouse situation is in just about every aspect. He is

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looking forward to a meeting with Hilda to discuss all the information. As he prepares for the meeting, what do you think are the key points for Jack to consider in this case?

ANALYSIS

Let us now consider the key points Jack has learned about these two different prospective audit clients by applying the list of acceptance decision procedures provided in this chapter.

1. *Obtaining and reviewing financial information about the prospective auditee organization to determine purpose, main users, and basis of accounting*

   Sweet Dreams provided Jack's firm with relevant reports, indicating its management has a good sense of the role and responsibilities of an auditor. Hilda also learned that the purpose and main users are the three sisters who own the shares, and she determined the basis of accounting appropriate for this purpose and these users.

   Grouse is publicly traded and Jack was thus able to obtain relevant information from the regulatory filings, which are available online. But additional information is needed from Grouse management in order to assess all the purposes and users of its financial statements. As a mining company, Grouse's basis of accounting may be complex, and discussions with management are needed to learn more details and establish the appropriateness of its accounting policies for estimates related to mineral reserves, revenue recognition, environmental liability estimates, and so on.

2. *Evaluating the public accounting firm and individual auditors' independence from the prospect*

   This would be done at the firm level as part of quality control procedures. Hilda and Jack can only know about their own independence: close relatives who are employees of these companies or holding shares or debts that could create a conflict of interest (self-interest threat). These factors need to be considered for all audit staff.

   Other independence threats relating to acceptance decisions need to be considered at the firm level. For example, any prior association with these companies involving promoting their position (assisting the company with obtaining a bank loan, a possible advocacy threat), personal or business relations making it difficult to exercise professional skepticism (a former audit partner now being on the prospect's management team, a potential familiarity threat), or any risk for intimidation of an auditor with respect to the financial statements or the conduct of the audit (management seems very aggressive and motivated to manipulate the financial statements, possibly an intimidation threat).

   Jack might have a concern about the likelihood of a Grouse management attempt at intimidation of the auditor, as there are indicators that their cost-cutting actions may have increased their risk of environmental liability (news reports), and there is motivation related to the stock options that will vest next year (reports of a huge platinum find would increase Grouse's share price at the time these options vest, and history has shown that such findings can easily be falsified or overstated). Not enough information is given in this case to go any further on these independence aspects, but remember they are critical to the firm's acceptance decision. Independence threats were explained in more detail in Chapter 3.

3. *Considering whether the public accounting firm has competency, resources, any special skills required*

   Sweet Dreams is a local business in a fairly straightforward industry, and its basis of accounting was appropriate, so it seems reasonable to assume Jack's firm has the staff and competency to do the job. Any specific information systems or tax expertise required would also be typical, so the required competencies would be readily available within the firm.

   Grouse is in a specialized industry with more complex operations to account for. Jack's firm may have other audits of mining companies in the area, and thus have the expertise to handle the mining-specific accounting issues. Grouse also has operations in foreign countries. If these are material, Jack's firm will need to obtain knowledge of foreign laws and regulations and be able to do audit work in those locations. Using the work of foreign auditors will increase the complexity and risk of this engagement. Jack's mid-sized local firm may not be able to manage that aspect of auditing Grouse.

4. *Obtaining information from management as to whether the prospect's management accepts responsibility for the financial statement preparation and implementing adequate controls to reduce risk of errors and fraud*

   The case suggests Sweet Dreams' management are aware of and have accepted their responsibilities for (1) preparing financial statements in accordance with an acceptable financial reporting framework and (2) implementing adequate internal control to reduce risk of error and fraud. Their most recent financial statements and information indicate strong control awareness at the management level and throughout the whole organization. Employee pride and community involvement suggest that integrity and responsibility, which are desirable qualities in an auditee, are part of the corporate culture at Sweet Dreams. Jack did not meet with Grouse management so information on these issues is missing, but there are hints in information Jack obtained from other sources, as is seen below.

5. *Considering whether the engagement would require special attention or involve unusual risks*

   Sweet Dreams does not appear to present any special concerns, but it is important that the owners depend on the audited financial statements for information about the financial position of the business. The preliminary analysis shows that Grouse presents many risks, such that the firm may already find the company and the engagement too risky to accept just on the basis of what Jack has learned.

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6. *Searching for news reports and, when possible, asking business associates about the organization*

   Some key information about both companies was obtained from news reports. These can be searched quite easily online using a search tool like Google. A firm partner may ask business associates about the prospective client, but this must be done carefully and in compliance with confidentiality rules of the profession or the firm. Partners often have a wide network of business associates where a lot of useful information can be obtained informally, possibly over a game of golf or a dinner, without breaking any confidence.

7. *For new audits, communicating with the previous auditor*

   Sweet Dreams' predecessor audit has provided Hilda with much useful information. The predecessor has good reasons for resigning and the fact that her partners are not taking over does not reflect badly on the integrity of management or the risk of Sweet Dreams as an auditee. She reports there were no disagreements with management about accounting matters in many years as the company's auditor. We also learn that management will be very cooperative and helpful to the auditor, which is a sign the audit can be done well within a reasonable amount of audit time.

   The information obtained from Grouse's predecessor auditor paints a rather risky picture. The predecessor appears to have lacked competence to do the audit, as evidenced by deficiencies in documentation found by CPAB's inspectors. The fact that it was doing consulting work on executive compensation, financing, and disclosure means it lacked independence. Public company auditors cannot consult on these areas as they will be involved with reporting decisions and, therefore, not be objective in assessing the company's financial statements. The fact that the auditor resigned and was not dismissed by the auditee suggests that management did not object to the predecessor's lack of competence and independence, further bringing management's integrity and competence into question.

   The predecessor's reluctance to respond to Jack's request and failure to do so in writing also cast doubt on the quality of that firm and its audits of Grouse. Since his only reply was by telephone, it is important that Jack make detailed notes right away so there is reliable documentation of the predecessor's responses. The refusal to provide Jack's firm with access to any working papers also suggests a poor quality audit, increasing the risk that Grouse's opening balance sheet is misstated—creating audit difficulties for the current year and potentially a scope limitation.

   Based on all the factors given, it seems likely that Sweet Dreams will be a great audit client, but Grouse appears at this stage to be a very undesirable one. Jack's firm may want one of its partners to obtain further information by contacting Grouse's management and enquiring in the local community, but it seems likely these will only confirm its undesirability.

   As a further exercise, we briefly give some thought to how these considerations might be different if these were decisions about continuing with existing audit client relationships instead of about new engagements.

   - There would be no predecessor.
   - Jack's firm would need to consider whether any changes in the economy, operating environment, ownership structure, accounting standards, or other factors could affect the risk of the auditee, the firm's ability to complete the audit, independence, appropriateness of the financial reporting framework, and adequacy of internal control, and so on. Such changes could affect the risk of material misstatement at the financial statement level, or at the assertion level.
   - The information would be obtained from the same sources as those used above: management enquiry, research, and enquiries to associates. The main difference is that now the firm is starting with a high level of knowledge of the auditee and factoring in new information about any significant changes to assess acceptability.

SUMMARY

This chapter covered the following material to achieve the learning objectives:

- An overview of the financial statement audit process as required by Canadian GAAS (CAS) was presented, with links to the text chapters where the topics are covered. A more detailed flow diagram, which appears in the inside front cover of the text, was also discussed.
- The main characteristics of an independent audit engagement were reviewed, including various types of entities that require financial statement audits and why, who are the entity's management and those charged with its governance, who are the main stakeholders using financial statements, and the financial reporting frameworks that may be acceptable for management to choose for its financial statements. We noted that many

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concepts tools and activities will be similar for most types of financial statement audits, but that special entities such as public sector organizations or very small business may require special considerations. We noted that, for simplicity, most of the text would be based on the assumption that the entity under audit is a reasonably large corporation preparing financial statements for shareholders in accordance with a fair presentation framework, such as IFRS.

- The pre-engagement risk management activities auditors perform to decide whether to accept a financial statement audit engagement were discussed. The auditor's concerns for the risks a particular engagement might bring to the auditor and his or her success in practice, through potential impact on reputation, liability or cost recovery, were presented.
- The need for auditors to understand the auditee organization's business, its environment, and risks at the start of a financial statement audit was explained. The responsibilities of management for presenting financial statements that reflect the underlying economic performance and conditions of the entity were discussed. The key audit step of receiving management's draft financial statements, as the subject matter of the audit was pointed out. Then the analytical procedures auditors used for their preliminary risk assessment were described. Examples were provided showing the way they are used on management's draft financial statements to identify areas where misstatements are most likely.
- The materiality concept and the levels used for planning the audit were explained. These include materiality for the financial statements as a whole, performance materiality, as well as possible lesser amounts for each of these in certain engagement. An example of how these amounts are determined was provided by showing a sample form that might be used as a practice aid for calculating materiality levels on an engagement.
- The concept of assertions, or claims made, in management's financial statements were introduced. The assertions used by convention in the audit profession were explained in terms of the audit objectives related to them. In summary, the audit objectives are to prove with evidence whether each of these assertions, as defined, holds true or not.
- The preliminary planning decisions set out in the overall audit strategy (OAS) were listed, and the role of the OAS in developing the audit plan at a more detailed performance level was presented.

Finally, an application case with analysis was presented to illustrate an audit engagement acceptance decision in a realistic scenario.

KEY TERMS

analytical procedures
assertions
audit plan
audit program
auditor's risk from taking the engagement
compliance assertion
dangling debit
engagement letter
fairly present
horizontal analysis
interim audit work
materiality for the financial statements as a whole (overall materiality)
minutes
overall audit strategy
performance materiality
pre-audit risk management activities
predecessor
representational faithfulness
risk of material misstatement
significant risks
specific materiality
specific performance materiality
successor
those charged with governance
vertical analysis
year-end audit work

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EXERCISES AND PROBLEMS

EP 5-1 Analytical Review Ratio Relationships. LO5 The following situations represent errors and irregularities that can occur in financial statements.

Required:

Your requirement is to state how the ratio in question would compare (greater, equal, or less) to what the ratio "should have been" had the error or irregularity not occurred.

a. The company recorded fictitious sales with credits to sales revenue accounts and debits to accounts receivable. Inventory was reduced and cost of goods sold was increased for the profitable "sales." Is the current ratio greater than, equal to, or less than what it should have been?

b. The company recorded cash disbursements paying trade accounts payable but held the cheques past the year-end date—meaning that the "disbursements" should not have been shown as credits to cash and debits to accounts payable. Is the current ratio greater than, equal to, or less than what it should have been? Consider cases in which the current ratio before the improper "disbursement" recording would have been (1) greater than 1:1, (2) equal to 1:1, and (3) less than 1:1.

c. The company uses a periodic inventory system for determining the balance sheet amount of inventory at year-end. Very near the year-end, merchandise was received, placed in the stockroom, and counted, but the purchase transaction was neither recorded nor paid until the next month. What was the effect on inventory, cost of goods sold, gross profit, and net income? How were these ratios affected, compared with what they would have been without the error: current ratio, return on beginning equity, gross margin ratio, cost of goods sold ratio, inventory turnover, and receivables turnover?

d. The company is loath to write off customer accounts receivable, even though the financial vice-president makes entirely adequate provision for uncollectible amounts in the allowance for bad debts. The gross receivables and the allowance both contain amounts that should have been written off long ago. How are these ratios affected compared with what they would be if the old receivables were properly written off: current ratio, days' sales in receivables, doubtful account ratio, receivables turnover, return on beginning equity, working capital/total assets?

e. Since last year, the company has reorganized its lines of business and placed more emphasis on its traditional products while selling off some marginal businesses merged by the previous go-go management. Total assets are 10% less than they were last year, but working capital has increased. Retained earnings remained the same because the disposals created no gains, and the net income after taxes is still near zero, the same as last year. Earnings before interest and taxes remained the same, a small positive EBIT. The total market value of the company's equity has not increased, but that is better than the declines of the past several years. Proceeds from the disposals have been used to retire long-term debt. Net sales have decreased 5%, because the sales decrease resulting from the disposals has not been overcome by increased sales of the traditional products. Is the discriminant Z score (see Appendix 5A) of the current year higher or lower than that of the prior year?

EP 5-2 Understand the Business—Transactions and Accounts. LO4 In the table below, the left column names several "classes of transactions." The right column names several general ledger accounts.

CLASSES OF TRANSACTIONS	GENERAL LEDGER ACCOUNTS
Cash receipts	Cash
Cash disbursements	Accounts receivable
Credit sales	Allowance for doubtful accounts
Sales returns and allowances	
Purchases on credit	Inventory
Purchase returns	Capital assets
Uncollectible account write-offs	Accounts payable
	Long-term debt
	Sales revenue
	Investment income
	Expenses

Required:

Identify the general ledger accounts that are affected by each class of transactions.

Approach:

Match the classes of transactions with the general ledger accounts where their debits and credits are usually entered.

EP 5-3 Auditing an Accounting Estimate. LO5 Suppose management estimated the lower-of-cost- and net realizable value of some obsolete inventory at $99,000, and wrote it down from $120,000, recognizing a loss of $21,000. The auditors obtained the following information: the inventory in question could be sold for an amount between $78,000 and $92,000. The costs of advertising and shipping could range from $5,000 to $7,000.

Required:

a. Would you propose an audit adjustment to the management estimate? Write the appropriate accounting entry.

b. If management's estimate of inventory market (lower than cost) had been $80,000, would you propose an audit adjustment? Write the appropriate accounting entry.

EP 5-4 Risk of Misstatement in Various Accounts. LO4, LO5

Required:

Based on information you have available in Chapter 5:

a. Which accounts may be most susceptible to overstatement? to understatement?

b. Why do you think a company might permit asset accounts to be understated?

c. Why do you think a company might permit liability accounts to be overstated?

d. Which direction of misstatement is most likely: income overstatement or income understatement?

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EP 5-5 Audit Planning. LO3, LO7 Walter Wolf was pleased. He had been with the firm of Riding, Hood & Co. less than a year-and-a-half since graduation from university and had received excellent performance reviews on every engagement. Now he was being given "in charge" responsibility on an audit. It was a small client, but it felt good to have the firm show such confidence in him. He planned to show that the firm had made the right decision.

Walter thought back to some of the advice his seniors had given him. Two comments in particular stood out as key steps to a successful audit:

- Careful attention to planning the audit pays dividends. Time spent on audit planning is never wasted.
- Avoid being a mechanical auditor. Focus on the assertions embodied in the financial statements and the related audit objectives when planning audit tests.

Required:

a. Develop a list of tasks Walter should perform in planning this audit engagement, before any audit testing begins.

b. CAS 315 lists management assertions embodied in financial statements. List and briefly describe the audit objectives that relate to these assertions.

(ICAO adapted)

EP 5-6 Assertions. LO7 The assertions listed in CAS 315 (see box titled: "Assertions for Classes of Transactions, Account Balances, and Presentation and Disclosure" p. 169) are each cross-referenced to the five principal assertions.

Required:

Why are these different terms used to describe assertions in different audit guidance materials?

EP 5-7 Experts' Work as Audit Evidence. LO4, LO8 If expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence, an auditor may need to use the work of an auditor's expert. The need for special expertise may include such matters as:

- The valuation of complex financial instruments, land and buildings, plant and machinery, jewellery, works of art, antiques, intangible assets, and business combinations and conducting impairment reviews
- The actuarial calculation of liabilities associated with insurance contracts or employee benefit plans
- The estimation of oil and gas reserves
- The valuation of environmental liabilities, and site clean-up costs
- The interpretation of contracts, laws, and regulations
- The analysis of complex or unusual tax compliance issues

Required:

How does an auditor determine the need to use an expert when developing the overall audit strategy? What additional work does an auditor need to perform if planning to use an expert's work as audit evidence to form an audit opinion?

EP 5-8 LO3, LO4

Required:

As an exercise in using the CAS, see if you can link up the related CAS requirements and application and other explanatory material to the steps Jack has taken in the Analysis section of the Application Case and Analysis at in this chapter. Also explain how Jack is applying the standards.

DISCUSSION CASES

DC 5-1 Communications Between Predecessor and Successor Auditors. LO2, LO3 Your firm has been contacted by the president of Lyrac Inc. about becoming the company's auditor. Lyrac was audited last year by PA Diggs and, while generally pleased with the services provided by Diggs, the president of Lyrac thinks the audit work was too detailed and interfered excessively with normal office routines. You have asked Lyrac's president to inform Diggs of the decision to change auditors, but he does not wish to do so.

Required:

List and discuss the steps to follow in dealing with a predecessor auditor and a new audit client before accepting the engagement. (*Hint:* Use the independence rules of conduct for a complete response to this requirement.)

DC 5-2 Audit Engagement Acceptance. LO2, LO3 You are a PA in an accounting firm that has 10 offices in three provinces. Mr. Shine has approached you with a request for an audit. He is president of Hitech Software and Games Inc., a five-year-old company that has recently grown to $40 million in sales and $20 million in total assets. Mr. Shine is thinking about going public with a $17 million issue of common shares, of which $10 million would be a secondary issue of shares he holds. You are very happy about this opportunity because Mr. Shine is the new president of the Symphony Society board and has made quite a civic impression since he came to your medium-size city seven years ago. Hitech is one of the growing employers in the city.

Required:

a. Discuss the sources of information and the types of enquiries you and the firm's partners can make in connection with accepting Hitech as a new client.

b. Do professional conduct/ethics codes require any investigation of prospective clients?

c. Suppose Mr. Shine also told you that 10 years ago his closely held hamburger franchise business went bankrupt, and you learn from its former auditors (your own firm) that Shine played fast and loose with franchise-fee income recognition rules and presented such difficulties

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that your office in another city resigned from the audit (before the bankruptcy). Do you think the partner in charge of the audit practice should accept Hitech as a new client?

DC 5-3 Pre-engagement and Preliminary Analysis Activities. LO2, LO3, LO4, LO5, LO6, LO7, LO8 Sunrise Solar Inc. (SSI) is a medium-sized company that is developing solar energy systems for private residences and small businesses. It is privately owned, with the majority of the shares held by the company's president, Shu Mingfei. Started up two years ago, to date, it is mostly involved in research and development, but this year it completed its first customer sales and installation. Ms. Shu has engaged your firm to do the current year's audit because she plans to obtain $20 million in debt financing from outside investors to allow further commercialization of the SSI systems. You are now reviewing SSI's preliminary general ledger trial balance in order to begin preparing the audit planning.

The following is a summary of the accounts that appear in this trial balance as at year end:

ACCOUNT	BALANCE DR/(CR)
Cash	$ 101,209
Accounts receivable	85,019
Allowance for bad debts	(15,000)
Inventory, finished goods	900,550
Inventory, work-in-progress	44,666
Inventory, raw material	67,890
Deferred development costs	34,445
Property, plant, and equipment	3,700,990
Accumulated amortization, PPE	(901,108)
Patents, at cost	1,010,000
Accounts payable	(198,009)
Warranty provision	(30,000)
Shareholder loan, non interest bearing	(11,000,000)
Share capital, common shares	(1,000)
Retained earnings	1,364,767
Revenue	(812,202)
Cost of goods sold	666,502
General and administration expenses	1,002,500
Research and development expenses	3,990,000
Other expenses	89,990

Required:

a. Identify three factors that your firm should consider before agreeing to conduct the audit.

b. What are the economic and industry risks affecting this business? How would these risks affect the company's financial statements and your overall audit strategy?

c. State the dollar amount you would consider an appropriate materiality level for planning this audit, giving your supporting reasons. Explain why the materiality judgment is one of the first important decisions your team must make in planning this audit.

d. List two analytical procedures you could perform using the trial balance data above (you are not required to calculate any ratios). Explain what each procedure can tell you about the risks in SSI's financial statements. Give one example of additional information you would want to obtain to perform analytical procedures in this audit, and a reason why it would be useful.

DC 5-4 Predecessor and Successor Auditors. LO2 The president of Allpurpose Loan Company had a genuine dislike for external auditors. Almost any conflict generated a towering rage. Consequently, the company changed auditors often.

Wells & Ratley (W&R), PAs, was recently hired to audit the 2013 financial statements, the firm succeeding the firm of Canby & Company which had obtained the audit after Albrecht & Hubbard (A&H) had been fired. A&H audited the 2012 financial statements and rendered a report that contained an additional paragraph explaining an uncertainty about Allpurpose Loan Company's loan loss reserve. Goodbye, A&H! Canby, & Company then audited the 2013 financial statements, and Art Canby started the work. But, before the audit could be completed and an audit report issued, Canby was fired, and W&R was hired to complete the audit.

Required:

Does W&R need to initiate communications with Canby & Company? with A&H? with both? Explain your response in terms of the purposes of communications between predecessor and successor auditors.

DC 5-5 Calculate a Planning Materiality Amount. LO6 The auditors were planning the work on the financial statements of the Mary Short Cosmetics Company. The unaudited financial statements showed $515,000 net income after providing an allowance of 35% for income taxes. The company had no debt and no interest expense. Mary Short's shares are traded over the counter, and investors have generally assigned a price-earnings multiple of 16 to the shares. Press releases by the company have enabled analysts to estimate the income for the year at about $515,000, which was forecast by the company at the beginning of the year. There are 750,000 shares outstanding, and the last quoted price for them was $11.

The auditors have decided that a 6% mispricing error in the shares would not cause investors to change their buying and selling decisions.

Misstatements totalling $13,000 were discovered in the previous year's audit but were not corrected.

Required:

Calculate the materiality for the financial statements as a whole and the performance materiality the auditors might use in the current year audit, based on the income before income taxes.

DC 5-6 Preliminary Analysis, Materiality, Assertions. LO2, LO3, LO4, LO5, LO6, LO7 Your firm has been engaged to do the current year's audit of Dawood Ltd., a medium-sized business involved in manufacturing television screens and monitors. Dawood is privately owned and its two shareholders have requested that the annual financial statements be audited for the first time this year. One of the shareholders manages the business; the other is not involved. You are now reviewing

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Dawood's preliminary general ledger trial balance, shown below, to begin the audit planning.

ACCOUNT	BALANCE DR/(CR)
Cash	$ 10,009
Accounts receivable	167,090
Allowance for bad debts	(25,000)
Inventory, finished goods	200,550
Inventory, work-in-progress	94,601
Inventory, purchased components	199,800
Inventory, parts	34,400
Property, plant, and equipment	9,700,100
Accumulated amortization, PPE	(3,607,597)
Accounts payable	(222,400)
Warranty provision	(87,000)
Bank loan, long-term	(1,000,000)
Share capital, common shares	(1,500,000)
Retained earnings	(1,738,442)
Revenue	(9,005,800)
Cost of goods sold	4,696,600
General and administration expenses	1,902,500
Other expenses	180,589

Required:

a. When planning this audit, explain why it is important for Dawood's auditor to understand its business, its environment, and its risks.

b. Determine an appropriate materiality level for preliminary audit planning purposes. Explain your reasons for selecting this materiality level.

c. List two analytical procedures you could perform using the trial balance data above. Explain what each procedure can tell you about the risks in Dawood's financial statements and what further investigation the analytical results may suggest.

d. Identify two accounts that you feel would have the high risk of material misstatement, and two that you think would have the lowest. Explain the reasons for your risk assessments.

e. Assume you have determined that Dawood's inventory account is a high risk item. Assess the risk of material misstatement for the inventory account, using the five principle assertions as the basis for your assessment. (You will probably have to make some assumptions since little information is available in the case. In a real audit, these assumptions are points you would want to enquire to obtain the information needed.) Give the reasons supporting your assessment.

DC 5-7 Materiality Level Reduced. LO6 Your firm has done the audit of Rhea Fashions Inc. for many years. You are in charge of the fieldwork for the current year's audit. Rhea is a manufacturer of high-fashion clothing. Its shares are publicly traded, but a majority of the common shares are held by the members of the family that started the business during the 1950s. During the current year, Rhea's business shrank substantially because of losing a major customer, a country-wide department store chain that went out of business. Rhea has not been able to replace the lost business. Since many of Rhea's long-time employees were happy to take an early retirement offer, Rhea management's strategy now is to continue to operate only a few unique clothing brands that represented about 50% of its sales volume in prior years. The materiality level used in the prior years was $80,000. The audit partner has determined that the appropriate materiality for the current year financial statement audit is $40,000.

Required:

a. Discuss the factors that the audit partner would have considered in deciding to reduce the materiality level.

b. What impact will the lower materiality level likely have on your audit procedures in the current year?

c. While reviewing the previous year's audit file, you note that last year's staff uncovered one error. Rhea had failed to accrue approximately $50,000 of customer volume discounts because of a calculation error in computing the customer's total sales. Since the error was less than materiality, no adjustment was made to the prior year's financial statements. Explain the impact this error had on the prior year's financial statements, the impact it will have on the current year's financial statements when it reverses, and on your audit, given your new materiality level.

DC 5-8 Materiality Approaches in Audit Practice. LO6 Three former university classmates are meeting for dinner to celebrate completing their first year as junior auditors at three different public accounting firms. After reminiscing about the time they all skipped their auditing class to go to a playoff hockey game, one of them recalls, "It was great the Canucks won that game, even though they didn't make it to the next round. But the auditing class we missed that night was on materiality. I have learned a lot on the job, but materiality is still the one decision we make at work that makes no sense to me. And that makes me nervous because materiality is such a key factor in deciding what accounts to focus our audit work on and how much testing to do."

During the ensuing discussion they realize that their three firms use three different approaches to setting materiality for planning purposes. In Firm 1, the level of materiality is set for the whole audit based on 5–10% of normal earnings, or other benchmarks if earnings are not useful. In Firm 2, a similar method is used to come up with the starting materiality amount but then adjustments are made for anticipated misstatements and prior year misstatement reversals, resulting in using a smaller amount for the purpose of planning the audit. In Firm 3, a similar starting point is used but the amount is then allocated to different accounts based on their size and any special user-based considerations, such as whether the amount is used in a debt covenant.

Required:

Discuss the implications for audit practice of having so much variability in setting materiality. What is the impact of the CAS 320 on the three different approaches described in this scenario?

DC 5-9 Materiality and Misstatements in Estimates. LO6 The auditors of Letron Inc. have set an overall materiality

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level of $900,000 and a performance materiality level of $800,000 for the current year audit, 20X2. They used the same materiality levels in their 20X1 audit. Letron is in the telecommunication equipment business and its inventory value is subject to fluctuations due to changes in supply and demand as well as technological obsolescence, creating considerable measurement uncertainty. Management's point estimate of the inventories' value as of the end of 20X2 is $15.9m, after reversal of a write-down that was taken in 20X1. The auditors have established a range of estimates for the inventory value of $14–16 million, so management's point estimate is within the auditors' range. In 20X1, poor market conditions prevailed and Letron wrote down its inventory to net realizable value, estimated to be $12.3. Management and the auditor had a disagreement regarding inventory valuation for 20X1, because it fell outside of the auditors' range of $13–15 million. However, this difference and the aggregated misstatements for 20X1 were less than the performance materiality, so these misstatements were not corrected. Letron initiated a bonus plan in 20X0 that would reward top management if the company reported positive profits. Letron reported losses in 20X0 and 20X1. In 20X2, Letron reported a small profit, giving rise to a substantial bonus to its management team.

Required:

Assume the role of Letron's auditor, and explain the actions you would take in this situation, based on applying the requirements and guidance in CAS 450 and CAS 540.

DC 5-10 Quantitative and qualitative materiality criteria. LO6, LO7 You are performing the audit of the Pirouette Systems Inc. (PSI) financial statements for its year ended November 30, 20X0. PSI is a private company that sells and installs computer networks for businesses in the Toronto area. PSI's has four shareholders who are all actively involved in the business. PSI's audited financial statements are used mainly by its bank, which has made a large operating loan. The bank requires PSI to maintain a current ratio of at least 1.2 to 1, based on its year-end financial statements, otherwise the bank can require PSI to repay the loan in full immediately.

PSI's accounting policy for recognizing revenue is to recognize 50% of the sales contract amount when the customer signs a sales contract and the balance when the network installation is complete. All sales are on account. During 20X0, PSI hired a new sales manager who has focused on making sales to larger companies. On November 30, 20X0, the sales manager reported to the PSI's accountant that $250,000 should be recorded as sales revenue. This amount is 50% of the revenue on a large sale to a new customer. This is the largest single sale in PSI's history. In January 20X1, while doing the audit you have discovered that the sales manager had been premature in reporting this contract as a sale, since the customer did not actually give the final approval of the contract purchase of the network until December 15, 20X0.

Before correcting this error, PSI's draft financial statements show the following:

Net income before taxes of $6,200,000
Accounts receivable, net of allowance for bad debts, of $850,000,
Total current assets of $1,100,000 and
Total current liabilities of $860,000

Required:

a. Explain how the accounts in the PSI financial statements will be affected by this error. In your explanation identify the assertion(s) violated by this error.
b. Calculate the impact of this error on PSI's current ratio (*Note:* Current ratio = Current assets / Current liabilities)
c. Would you consider this error material? Justify your response.

DC 5-11 Overall Audit Strategy, Retail Industry. LO8 Using the SEDAR database (www.sedar.com), find the most recent annual reports for two Canadian retailers (e.g., Loblaw, Rona, Danier Leather).

Required:

a. Based on the information provided in the companies' audited financial statements and the Management Discussion and Analysis (and, optionally, other Internet research you may wish to do), use the planning document shown in Exhibit 5–9 to identify and list key information items that should be documented in the "Engagement Characteristics" section of the overall audit strategy for each these companies.
b. What do you think would be the most significant audit issues in each company? Explain issues that would be similar in each audit. For any issues you identify that would differ between the companies, explain why you think these differences would exist.

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APPENDIX 5A

Selected Financial Ratios

BALANCE SHEET RATIOS	FORMULA*
Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$
Days' sales in receivables	$\frac{\text{Ending net receivables}}{\text{Credit sales}} \times 360$
Doubtful account ratio	$\frac{\text{Allowance for doubtful accounts}}{\text{Ending gross receivables}}$
Days' sales in inventory	$\frac{\text{Ending inventory}}{\text{Cost of goods sold}} \times 360$
Debt ratio	$\frac{\text{Current and long-term debt}}{\text{Shareholder equity}}$
OPERATIONS RATIOS	
Receivables turnover	$\frac{\text{Credit sales}}{\text{Ending net receivables}}$
Inventory turnover	$\frac{\text{Cost of goods sold}}{\text{Ending inventory}}$
Cost of goods sold ratio	$\frac{\text{Cost of goods sold}}{\text{Net sales}}$
Gross margin ratio	$\frac{\text{Net sales 2 Cost of goods sold}}{\text{Net sales}}$
Return on beginning equity	$\frac{\text{Net income}}{\text{Shareholder equity (beginning)}}$
FINANCIAL DISTRESS RATIOS (ALTMAN, 1968)	**FORMULA***
**Discriminant Z score (Altman, 1968)	$Z = 1.2\,X_1 + 1.4\,X_2 + 3.3\,X_3 + 0.6\,X_4 + 1.0\,X_5$
where:	
(X_1) Working capital ÷ Total assets	$\frac{\text{Current assets 2 Current liabilities}}{\text{Total assets}}$
(X_2) Retained earnings ÷ Total assets	$\frac{\text{Retained earnings (ending)}}{\text{Total assets}}$
(X_3) Earnings before interest and taxes ÷ Total assets	$\frac{\text{Net Income} + \text{Interest expense} + \text{Income tax expense}}{\text{Total assets}}$
(X_4) Market value of equity ÷ Total debt	$\frac{\text{Market value of common and preferred shares}}{\text{Current liabilities and long-term debt}}$
(X_5) Net sales ÷ Total assets	$\frac{\text{Net sales}}{\text{Total assets}}$

*These ratios are shown to be calculated using year-end numbers, rather than year average, for balances, such as accounts receivable and inventory. Other accounting and finance reference books may contain formulas using year-average numbers. As long as no unusual changes have occurred during the year, the year-end numbers can have much audit relevance because they reflect the most current balance data. For comparative purposes, the ratios should be calculated on the same basis for all the years being compared. In the Anycompany example in Exhibits 5–4 and 5–5, the market value of the equity in the calculations is $3 million.

**The discriminant Z score is an index of a company's "financial health." The higher the Z-score, the better the financial health of the company. The lower the score, the closer the company is to financial failure. The Z-score that predicts financial failure is a matter of debate. Research suggests that companies with scores above 3.0 never go bankrupt. Generally, companies with scores below 1.0 can be expected to experience financial difficulty of some kind. The score can be a negative number. It should be stressed that these ratios are indicators only, and therefore need to be combined with in-depth analysis before any final conclusions can be reached.

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CHAPTER 6

Assessing Risks and Internal Control

This chapter looks at how auditors gain an understanding of the auditee's risks and controls to assess the risks of a material misstatement occurring because of error or fraud. Auditors use this understanding to develop a detailed audit plan that addresses the assessed risks and provides reasonable assurance that the financial statements are not materially misstated.

EcoPak Inc.

Tariq is very excited about becoming the engagement partner for the EcoPak audit. He has only recently been promoted to partner at Meyer & Gustav (M&G), and the EcoPak engagement will give him a good starting point to build his practice in the growing sustainable materials industry. He has known Ella for many years and has a lot of respect for her good judgment and integrity, so her recommendation of EcoPak as a good client carries a lot of weight. He is very grateful to Ella for giving him full access to a review of Pettit and Foure, LLP (P&F)'s prior audit files, as that has given him confidence in EcoPak's management's integrity and willingness to accept responsibility for fair presentation of the company's financial statements. Ella's files also gave Tariq a lot of insight into EcoPak's business, management, and operating environment.

Still, Tariq now needs to make some important judgments of his own in relation to the risks he is taking on with this audit. He needs to make his own enquiries about Kam, Mike, and Nima

LEARNING OBJECTIVES

After completing this chapter, you will be able to do the following:

LO1 Describe the conceptual audit risk model and its components.

LO2 Explain the usefulness and limitations of the audit risk model in conducting the audit.

LO3 Explain how auditors assess the auditee's business risk through strategic analysis and business process analysis.

LO4 Outline the relationships among the business processes and accounting processes (or cycles) that comprise an organization's information system and management's general purpose financial statements.

LO5 Illustrate how business risk analysis is used to assess the risk of material misstatement at the financial statement level and at the assertion level.

LO6 Describe the five components of the internal control framework: the control environment, management's risk assessment process, information systems and communication, control activities, and monitoring.

LO7 Explain how the auditor's understanding of an organization's internal control helps the auditor to assess and respond to the risk that its financial statements are misstated.

CHAPTER APPENDICES

Appendix 6A: Business Risk Factors

Appendix 6B: Risk and Internal Control Frameworks *(online)*

Appendix 6C: Strategic Systems Auditing (SSA) Approach to Understanding Business Risk *(online)*

Appendix 6D: E-commerce: Implications for Auditors *(online)*

Appendix 6E: Corporate Governance *(online)*

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in the business community, even though Ella vouching for their integrity is a good start. They have some governance strength—separate Chair and CEO—but Zhang also owns another business that sells preprocessed materials to EcoPak, so there are some related-party issues to be concerned about. They also lack independent directors with financial expertise, and this may make his job a bit more difficult when he has to explain any complex financial reporting problems to those charged with governance. And while EcoPak has been very successful, recently its growth has involved investing in plant expansions but financing them with fairly short-term bank debts with tight covenants. That situation increases the risk of EcoPak running into some financial difficulties, although at this time there is not a high risk that it cannot continue as a going concern into next year. The infusion of cash EcoPak hopes to obtain from its IPO is crucial to strengthening its balance sheet. So an IPO makes business sense, but it also creates a lot more risk for Tariq, since many more users will rely on the audited financial statements to make decisions about buying EcoPak shares.

Fortunately, Tariq can confer with more senior partners in his firm, some of whom were involved in M&G's decision to accept the EcoPak engagement. One of these partners, Phil Amana, helps Tariq reach the conclusion that the risk of material misstatement at the financial statement level appears to be at a moderate level, subject to further analysis that Tariq will be doing himself as part of his audit planning. Phil also notes that given EcoPak's plan to go public in three years, the audit should be done to reduce audit risk to the minimum. This means a high level of audit work will need to be done to make sure the staff do a thorough examination and obtain a lot of independent evidence to support the numbers in EcoPak's financial statements.

Tariq starts to analyze EcoPak's monthly financial statements for the current year to date in relation to the audited financial statements of last year, to determine more specifically which accounts have the highest risk of being misstated by an amount large enough to be significant to people who might get these financial statements. His eyes light on the inventory—there are some unusual fluctuations in relation to cost of sales in comparison to last year. He also notes that the relatively flat trend in the plant and equipment asset account balances do not seem consistent with his knowledge of what happened in the operations during the year. His next step is to arrange a visit with Nima to learn more about the results and to make some enquiries to help understand how effective EcoPak's internal controls would have been in reducing the risks that misstatements could occur and not be detected and fixed in their accounting records.

When Tariq calls Nima to set up a meeting, she seems a bit agitated, and he asks her if everything is alright. "Tariq, I don't know how to say this . . . so I'll just spit it out. I am becoming suspicious that there might be some kind of fraud going on in our raw materials purchasing department! We had a good control system set up a few years ago, but things just haven't been adding up in the past few months." Tariq arranges to come out the next week to go over Nima's concerns. He also makes a note that the risk of taking on this audit engagement may have just gone way up!

ASSESSING RISKS AND CONTROL TO PLAN AN AUDIT

Chapter 6 will start with a key tool of audit fieldwork planning: a conceptual audit risk model that defines and relates the main types of risks an auditor must manage. Next, we discuss the business risk–based approach to auditing, a key component of generally accepted auditing standards (GAAS). This chapter will also introduce internal control by describing the components the organization's management has put in place. The chapter stresses that management is responsible for identifying and assessing business risk, and for implementing effective internal control to reduce business risk to an acceptable level. Thus, risk and control are closely related and auditors must consider them together. While the need to integrate the concepts of risk and control makes this chapter very challenging, this integration is essential to understanding the business risk–based approach to auditing. Auditors must understand the auditee's risks and controls to assess the risks of a material misstatement occurring because of error or fraud. This risk assessment is used

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reasonable assurance: a high, but not absolute, level of assurance; also referred to as *positive assurance* in the context of audit reporting

to develop a detailed audit plan that includes procedures needed to address the assessed risks and provide **reasonable assurance** that the financial statements are not materially misstated. Assurance is the complement of audit risk.

AUDIT RISK: AN ESSENTIAL AUDIT PLANNING DECISION

LO1 Describe the conceptual audit risk model and its components.

Auditing is fundamentally a risk management process. Audit risk is related to the information risk (discussed in Chapter 1) that audited financial statements that are materially misstated will go out to users. Assurance is the complement of audit risk—the higher the assurance, the lower is the audit risk. Auditors strive to lower audit risk by performing audit work that gives a high level of assurance that the statements are fairly presented. Audit risk is associated with gathering evidence on the facts of the auditee's economic reality; it exists because the auditor will always have less than all the possible corroborating audit evidence. This is why Chapter 4 noted that review engagement do not provide as much assurance as an audit engagement: With less corroborating evidence in a review engagement, the risk associated with providing a review engagement report is higher than it is for an audit opinion. Similarly, compilation engagements provide no assurance, because the evidence risk associated with having no corroborating evidence is 100%.

Understanding the auditee's business and performing preliminary analytical procedures help auditors to identify problem areas and make an overall business risk assessment. The organization's management is responsible for addressing business risk by implementing effective internal control. Thus, business risk and internal control are inseparable concepts that exist within an auditee organization. To develop the audit work programs, auditors need to assess risk specifically in audit-related terms: inherent risk, control risk, and detection risk. We will discuss the auditor's decision on what audit risk level needs to be achieved, the conceptual model that relates audit risk to its main its components, and then elaborate on these components. In auditing, the term "risk" should always be used with a modifier (business, engagement, audit, inherent, control, detection, and so on) to specify the one you mean.

Audit Risk: An Essential Audit Planning Decision

In an overall sense, audit risk is the probability that an auditor will fail to express a reservation of opinion on financial statements that are materially misstated. Let us start by reviewing and integrating some of the concepts we've already covered.

Chapter 5 explained how auditors must first consider the engagement's risks to make a decision whether or not to take it on. We saw that auditors may even take on a fairly high risk engagement if they believe they can manage the risks down to a tolerable level. Earlier, we also saw that, according the Canadian Accounting Standard (CAS) 200, a financial statement auditor's overall objective is "to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. . . ."[1] CAS 200 also notes that the term "reasonable assurance" should be taken to mean a high level of assurance.

STANDARDS CHECK

CAS 200

5. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level.

Source: *CICA Handbook—Assurance,* 2012.

Taking all these ideas together we see that to provide high enough assurance to support an audit opinion, the auditor needs to manage the audit risk down to a low enough level to offset the engagement's risks.

To illustrate, consider the following possibilities:

1 CAS 200, paragraph 11(a).

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AUDITOR'S ASSESSMENT OF RISK FROM ACCEPTING ENGAGEMENT	AUDIT RISK THAT CAN BE ACCEPTED	AUDITOR DECISION
Extremely high	Extremely low level, near zero	It is probably impossible to achieve a near zero risk, so do not accept the engagement.
High	Lowest	Accept engagement only if auditor can achieve a very low audit risk by performing extensive auditing work.
Moderate	Moderate	Accept engagement, plan to achieve a moderate audit risk level, and perform a less extensive level of audit work.
Low	Highest	Accept audit, plan to achieve a somewhat higher audit risk, and perform a relatively lower level of audit work.

The logic of this illustration is that as the likelihood of negative consequences for the auditor's practice get smaller, the auditor can take a bit more chance of missing a material misstatement and so can accept a somewhat higher audit risk. Since achieving a lower audit risk involves more audit effort than does a higher audit risk, it costs more. Therefore, an auditor's decision on what audit risk level to accept comes down to a cost-benefit analysis. Audit risk can at best be controlled at a low level but not eliminated, even when audits are well planned and carefully performed. The risk of audit failure is much greater in poorly planned and carelessly performed audits. Planned audit risk varies according to engagement circumstances. Generally, the more risky the auditee or the more users rely on the audited financial statements, the lower is the planned audit risk. As the risk of being sued for material misstatement increases, an auditor will decrease planned audit risk to compensate for the increased risk associated with the engagement. Many auditing firms have developed internal guidelines for setting planned levels of audit risk.

The auditing profession has no hard standard for an acceptable level of audit risk, except that it should be "appropriately low" and involve the exercise of professional judgment. At one time, the Canadian Institute of Charted Accountants (CICA) guidance suggested that most auditors should strive to limit such risks to no more than 5%. However, auditors would be appalled to think that even 1% of their audits would be bad. For a large auditing firm with 2000 audits per year, accepting 5% audit risk makes it look as though the firm will have 100 failed audits every year! But that would only be the case if every auditee had financial statements that were materially misstated, and not all do. So, even with using 5% planned audit risk on every engagement, it is likely there will be audit failures much less than 5% of the time. As an example, if we assumed there is a material misstatement in 6% of a firm's audit engagements, then, with 5% audit risk, the percentage of failed audits would be $0.06 \times 0.05 = 0.003 = 0.3\%$.

The concept of audit risk also applies to individual account balances, transactions, and disclosures. Here, the risk is that material misstatement is not discovered in an account balance (e.g., the inventory total), transaction stream (e.g., total revenues), or in a disclosure (e.g., pension liability). Audit risk is often used in practice with regard to individual balances and disclosures. In summary, audit risk is the same whether applied to financial statements as a whole or to individual accounts. Thus, for example, if audit risk is set at 5%, it is used for all accounts as well as for financial statements as a whole.

The Audit Risk Model

Why do auditors care about what audit risk level is acceptable? Intuitively, audit risk is the probability that the audit fails to detect a material misstatement. Starting with a target level of acceptable audit risk allows auditors to plan their evidence-gathering work by taking into account various different audit-related risks in a systematic way. As noted in CAS 200, "Audit risk is a function of the risks of material misstatement and detection risk."

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STANDARDS CHECK

CAS 200

Audit Risk

A32. Audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

A33. For purposes of the CASs, audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant. Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks, such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

Source: *CICA Handbook—Assurance,* 2012.

To aid in planning the audit, the main risks elements can be expressed conceptually by developing a simple model that assumes the elements of audit risk are independent. Thus, the risk elements are multiplied as follows:

$$\text{Audit risk (AR)} = \text{Risk of material misstatement (RMM)} \times \text{Detection risk (DR)}$$

We can make the model more precise by noting that the risk of material misstatement will occur when (1) there is a material misstatement to start with (inherent risk) and (2) the internal controls fail to detect and correct the material misstatement (control risk), and (3) the audit procedures also fail to detect the material misstatement (detection risk). The audit fails only if all three events occur. So, in expanded form, the audit risk model is:

$$\text{Audit risk (AR)} = \text{Inherent risk (IR)} \times \text{Control risk (CR)} \times \text{Detection risk (DR)}$$

Audit risk is, thus, the probability that the audit fails. The probability of audit success is one minus the probability that it fails; therefore, audit assurance equals 1 minus audit risk. Thus, reducing acceptable (or planned) audit risk, say from 5% to 1%, is equal to increasing acceptable (or planned) audit assurance, from 95% to 99%, in this example.

In their work, auditors want to hold the audit risk (AR) to a relatively low level (e.g. 0.05, or an average 5% of audit decisions when there is a material misstatement will be wrong). After the AR is decided, the AR model is used to plan the audit work effort required. The auditor accomplishes this by first assessing the levels of IR and CR that exist in the auditee organization, solving for the level of DR that needs to be achieved to reduce AR to the acceptably low level. In summary, AR is a quality criterion based on professional judgment, while all the other risk assessments are estimates based on professional judgment and evidence, as discussed next.

REVIEW CHECKPOINTS

6-1 What are the four risks included in the audit risk model? How are they related?

6-2 What factors influence the auditor's decision on an acceptable audit risk level?

Inherent Risk

inherent risk (IR): the probability that material misstatements could have occurred

Inherent risk (IR) is the probability that material misstatements affecting one or more assertions could have occurred in transactions within the accounting system used to develop financial statements, or in an account balance.[2] Put another way, inherent risk is the risk of material misstatements occurring in the first place. It is a characteristic of the auditee's business, the major types of transactions, and the effectiveness of its accountants, so understanding the auditee's business risk is important for assessing inherent risks. Auditors do not create or affect inherent risk; they can only try to assess its magnitude. It is important to understand that audit care should be greater where inherent risk is greater.

2 CAS 315, CAS 200.

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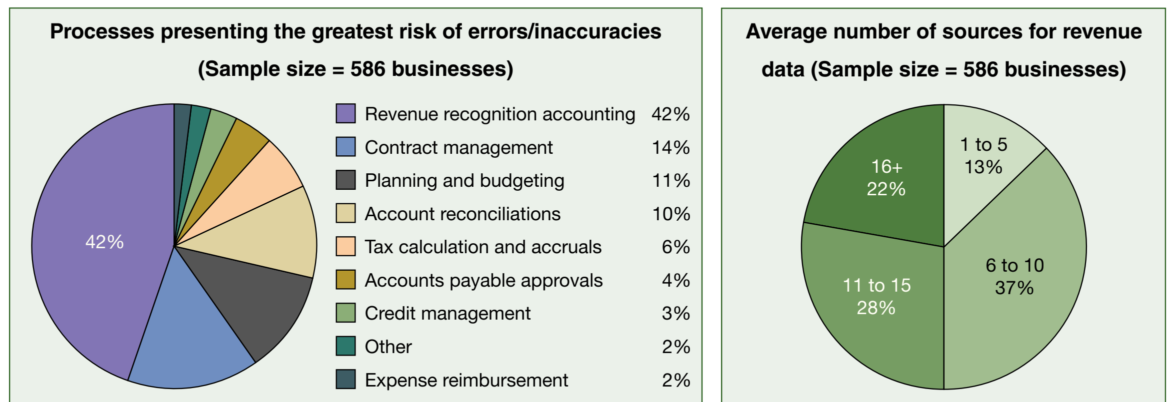
An assessment of inherent risk can be based on a variety of information. If material misstatements were discovered during the last year's audit, inherent risk will be considered higher than it would be if last year's audit had no material misstatements. Auditors may believe that the organization's accounting clerks tend to misunderstand generally accepted accounting principles (GAAP) and the organization's own accounting policies, thus suggesting a significant probability of mistakes in transaction processing. The nature of the auditee's business may produce complicated transactions and calculations known to be susceptible to accounting treatment error (e.g., real estate, franchising, oil and gas transactions). Some kinds of inventories (e.g., coal, grain, cocoa) may be harder to count, value, and keep accurately in perpetual records than are others (e.g., cars, jewellery). Some accounts (e.g., cash and inventory) are more susceptible to embezzlement, theft, or other losses than are other accounts (e.g., land or prepaid expenses).

Revenue accounting can have high inherent risk. Exhibit 6–1 shows the main results of a survey of 586 businesses that finds revenue recognition is the process most vulnerable to material errors; this is because of the complexity of revenue accounting. Businesses often use information from many sources and compile the revenue numbers in spreadsheets, rather than by an automated system, which increases the inherent risk of material errors and inaccuracies.

Auditor experience has also shown that because of management optimism and bias, asset and revenue accounts tend to have a higher inherent risk of overstatement than understatement, while liability accounts have a higher inherent risk of understatement than overstatement. Because of this, auditors tend to use procedures that are more effective in detecting overstatements for auditing revenues and assets. At the same time, audit procedures that are more effective in detecting understatements are more likely to be used with liability and expense accounts. Thus, the inherent risks determine the importance of various procedures for different accounts.

EXHIBIT 6–1 Revenue Reporting Risk



Source: Gerry Murray, "Revenue reporting risk remains high," *CA Magazine,* December 2008, p. 10.

A summary of some of the key factors that go into the inherent risk assessment are listed below. Consider business factors and events that could occur that could lead to a material misstatement in the financial statements.

Inherent risk factors:

- Accounting policies requiring complex calculations, valuation estimates, and judgment
- Accounting staff competency, experience
- Assets that are susceptible to theft
- Business involving complicated transactions, assets, or liabilities
- Business subject to complex or changing laws or regulations, including foreign laws
- Changes in technology that can affect operations, product obsolescence
- Complex contracts with customers or suppliers
- Economic conditions that affect business negatively
- Knowledge of actual or suspected or alleged fraud affecting the entity

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- Management incentives that may induce them to manipulate accounting information
- Management integrity (willingness to override controls)
- Material misstatements of past years, how they were handled
- Operations in multiple locations
- Organizational changes, especially in accounting personnel and systems
- Other relevant risk factors

Control Risk

control risk (CR): the risk that the client's internal controls will not prevent or detect a material misstatement

Control risk (CR) is the probability that the auditee's internal control policies and procedures will fail to detect or prevent material misstatements. Auditors do not create or affect the control risk. They can only evaluate an organization's control system and assess the probability of material misstatements. Auditors are mainly concerned with "internal control relevant to the audit"—those policies and procedures established and maintained by management that affect control risk relating to specific financial statement assertions at the account balance, class of transactions, or disclosure level.

Internal control is a key component of an organization's overall risk management framework. Auditors use the risk management frameworks for assessing risks at the company level, as well as for auditing controls over financial reporting. These risk and control frameworks include CICA's *Criteria of Control Committee* (CoCo), *Committee of Sponsoring Organizations of the Treadway Commission* (COSO), *Internal Control—Integrated Framework and Enterprise Risk Management—Integrated Framework,* and *Control Objectives for Information and Related Technology* (COBIT), published by the information technology (IT) Governance Institute. These frameworks are all further described in Appendix 6B on Connect. The internal control components will be discussed later in the chapter, and again in Chapter 9. Frameworks are a useful tool to help improve audit quality.[3]

The control frameworks define control broadly. The CoCo framework includes an organization's resources, systems, processes, culture, structure, and tasks that work together to support the organization's objectives. Effective management, therefore, needs an integrated structure of control processes—processes for strategic control, management control, and business process control. Strategic and management control processes encompass controls for that entity as a whole. These controls often rely on long-term and strategically relevant criteria to evaluate overall corporate performance at the division or unit level by management. Business process controls operate at the specific process level.

Thus, management control systems are much broader than are "internal controls relevant to the audit." Internal controls relevant to the audit would be a subset of this broader view of controls. Auditors are mainly concerned with accounting controls and systems. There are many other controls present in organizations that may not be relevant to the auditor.

An auditor's assessment of control risk is based on the study and evaluation of the company's control system. Exhibit 6–2 illustrates the function of controls by showing the combinations of original errors and control effectiveness, or lack thereof.

anchoring: preconceived notions about control risk that auditors carry over when they perform an audit on a client year after year, a potential pitfall if conditions have changed

Preliminary control effectiveness conclusions and risk assessments are made for planning purposes. Auditors often carry preconceived notions about control risk when they audit the same organization year after year. Starting with knowledge of last year's conclusions on control risk assessment is known as **anchoring**, and it represents (1) a useful continuity with the auditee and (2) a potential pitfall if conditions worsen and the auditor fails to acknowledge the deterioration of control.

control testing (compliance testing): performing procedures to assess whether controls are operating effectively

Note that control risk assessment provides only an indirect assessment of the monetary amount of misstatement of financial statements. As a result, special labels, such as **control testing (compliance testing),** are given to the procedures used in the control risk assessment.[4] Control risk should not be assessed so low that auditors place complete reliance on controls and do not perform any other audit work. Many auditors conclude their control risk assessment decisions with descriptive assessments (e.g., high, moderate, low), and some auditors put probability numbers on them (e.g., 1.0, 0.50, 0.30).

3 For audits of internal control that are integrated with a financial statement audit, use of a control framework is mandated by PCAOB Auditing Standard No. 5 and by the *CICA Handbook*—Assurance, OCS 5925.

4 Stay tuned: This process is covered in more detail in Chapter 9.

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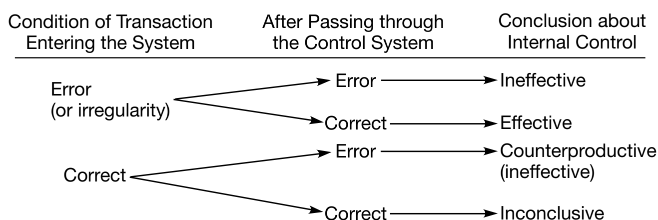
EXHIBIT 6–2 Internal Control Conditions and Conclusions



Source: Adapted from Lynford. E. Graham, "Audit risk-Part III," *CPA Journal,* October 1985, p. 39. Reprinted from *The CPA Journal,* October 1985, © 1985 with permission from the New York State Society of Certified Public Accountants.

risk of material misstatement: assessed on the financial statements overall and based on pervasive factors such as fraud, going concern, or other significant business-level risks; the auditor's assessment of combined inherent and control risk

Combined Inherent and Control Risk: The Risk of Material Misstatement

As discussed above, inherent risk and control risk are different in nature but related, so auditors can combine their assessment of these two risks into what is called the **risk of material misstatement**. The standards emphasize understanding an auditee's business and assessing the risk of material misstatement in planning the audit.

STANDARDS CHECK

CAS 200

13(n). Risk of material misstatement—The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level.
- (i) Inherent risk—The susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
- (ii) Control risk—The risk that a misstatement that could occur in an assertion about a class of transaction, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

A40. The CASs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement." However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

Source: *CICA Handbook—Assurance,* 2012.

Inherent and control risks can be difficult to assess separately because some internal controls "work" only when errors, irregularities, and other misstatements occur, while others are preventive in nature and so tend to reduce inherent risk. An auditor may make separate or combined assessments of inherent and control risk, depending on preferred audit procedures and practical considerations.

The risks of material misstatement at the financial statement and assertion levels are a basis for designing further audit procedures. When the auditor's assessment of the risk of material misstatement includes an expectation of the operating effectiveness of controls, the standards state that there must be supporting tests of those controls. Internal control is a complex and critical consideration in every audit.[5]

Changes in the economic environment can affect the risk of material misstatement. The CICA issues *Risk Alert* notices on its website that highlight current risk areas that public accountants (PAs) should take into account in their risk assessments and audit planning. An example of a *Risk Alert* concerning the 2008 credit crunch related to asset backed

5 Stay tuned: Control evaluation and testing will be explained in more detail in Chapters 9 and 10.

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commercial paper (ABCP) is found in the following box. It gives some good examples of the kinds of special risks auditors need to be focusing on during financial crises that arise from time to time, such as the European government debt crisis that began to emerge around 2010.

AUDITING IN THE CREDIT CRUNCH ENVIRONMENT

The Credit Crunch in Canada—CICA *Risk Alert,* February 2008

The global financial markets have been in turmoil over the last few months. In Canada, there has been particular concern about non-bank-sponsored asset backed commercial paper (ABCP), for which the market remains suspended as at the date of this *Risk Alert.* Largely because of the deepening of the U.S. sub-prime credit crisis, many non-bank trust issuers of ABCP have been unable to repay maturing paper, causing a liquidity crisis. In addition, the terms of the derivative transactions have placed further constraints on some trusts' operations. The mix of assets and exposures (e.g., collateral calls) in the trusts differs from trust to trust and the extent to which any impairment in value exists could vary significantly among the population of trusts.

The purpose of this *Risk Alert* is to highlight matters for auditors to consider when responding to higher risks of material misstatement of financial statements of entities that have invested in ABCP and other financial instruments affected by the credit crunch. Related matters, including the entity's statutory disclosures and auditor independence, are also noted.

Auditing Financial Instruments in the Credit Crunch

The fundamental question for an auditor to address is whether the reporting entity's financial statements have been prepared in accordance with Canadian GAAP. An impact of the credit crunch may be a severe curtailment or even cessation of trading in a particular investment. In such an event, management may have difficulty in establishing the value of the instruments, increasing the risk that such valuation may be materially misstated.

Auditing Accounting Estimates, Including Fair Value Accounting Measurements, and Related Disclosures,

CAS 540 provides requirements and supporting guidance related to matters such as:

- Obtaining audit evidence about management's intent to carry out specific courses of action (when intent is relevant to the use of fair value measurements) and management's ability to carry out its intended courses of action; and
- Evaluating whether the method of measurement is appropriate, considering changes in the environment or circumstances affecting the entity.

Due to the impact of the credit crunch on valuation of financial instruments, entities holding ABCP may be required to have more extensive disclosures compared with prior years. For example, such entities may have to disclose the extent of measurement uncertainty if it is reasonably possible that the recognized amount of ABCP could change by a material amount in the near term. In some cases, the auditor may need to use a specialist possessing particular knowledge in the valuation of the financial instruments. The auditor would follow the Recommendations and guidance in CAS 620, *Using the Work of an Auditor's Expert.*

Concerns about Going Concern

In the credit crunch environment, banks face rising loan defaults and are becoming more cautious when considering whether to provide or renew finance facilities. They may also establish new criteria or increase interest rates. As a result, the audited entity's prior ability to obtain necessary financing may not be a reliable indicator of an entity's ability to obtain financing in the future. Conditions within the auditee entity may cast doubt on the ability of an enterprise to continue as a going concern are noted in CAS 570, *Going Concern.* Two of the conditions that are particularly relevant to the credit crunch environment are:

- Inability to obtain financing sufficient for continued operations and
- Inability to comply with terms of existing loan agreements.

Other such conditions include:

- Recurring operating losses;
- Serious deficiencies in working capital;
- The possibility of an adverse outcome of one or more contingencies;
- Insufficient funds to meet liabilities;
- A plan to significantly curtail or liquidate operations; and
- External factors that could force an otherwise solvent enterprise to cease operations.

Independence Issues

In the credit crunch environment, auditors need to be alert to the possibility of prohibitions and self-review threats. For example, the auditor may be asked to perform a valuation of the entity's financial instruments, including ABCP. If the auditor undertakes such an engagement, his or her objectivity and independence may be impaired or may be perceived to be impaired.

In Conclusion

This *Risk Alert* does not address all issues that might arise when auditing in the environment of a credit crunch. Auditing in this environment will present challenges and higher risks. The auditor needs to ensure that those assigned to the engagement team collectively have the necessary competencies, resources, and time to meet these challenges and risks. Appropriate and timely consultations on complex or contentious matters, as well as clear communications with management and those having oversight responsibility for the financial reporting process, will also be particularly important when auditing in this environment.

Source: Adapted from CICA *Risk Alert,* "Auditing in the Credit Crunch Environment: The Credit Crunch in Canada," February 2008, http://www.frascanada.ca/assurance-and-related-services-standards/resources/reference-material/item16927.pdf.

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Detection Risk

Detection risk is the risk that any material misstatement that has not been prevented or corrected by the auditee's internal control will not be detected by the auditor. In contrast to the inherent and control risks, it is the auditor's responsibility to reduce detection risk to an acceptably low level by performing evidence-gathering procedures. These **substantive audit procedures** are the auditors' opportunity to detect material misstatements that can cause financial statements to be misleading. Substantive procedures provide a *direct* assessment of the monetary amount of misstatement in the auditee's proposed accounting. In this way, they differ from control testing procedures which only provide *indirect* evidence about whether material misstatement might have arisen due to control deficiencies. As a result, substantive procedures are highly effective in detecting material misstatements and are therefore considered the most important audit procedures. Thus, at least some substantive procedures must be performed in every audit to comply with the CAS. The two categories of substantive procedures are (1) tests of the details of transactions, balances, and disclosures and (2) analytical procedures applied to produce circumstantial evidence about specific monetary amounts in the accounts. Detection risk is the probability that these substantive procedures will fail to detect material misstatements.

detection risk (DR): the risk that the auditor's procedures will fail to find a material misstatement that exists in the accounts

substantive audit procedures: designed to detect material misstatements at the assertion level; comprised of tests of details (classes of transactions, account balances, and disclosures) and substantive analytical procedures

STANDARDS CHECK

CAS 330

18. Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure. (Ref: Para. A42–A47)

Source: *CICA Handbook—Assurance,* 2012.

At this point, it may be helpful to use an analogy to compare the auditor's risk assessment to something you are probably more familiar with, like a hockey game, as set out in the following box.

THE RISK OF MATERIAL MISSTATEMENT—THEY SHOOT! THEY SCORE!

Think of a "material misstatement" in audited financial statements as the unfortunate event of the opposing team getting the puck into a hockey team's net. The "risk of material misstatement" is the probability of the opposing team's getting a shot on the defending team's net. The "inherent risk" of this happening depends on the skill, effort, and luck of the opposing team's players in shooting the puck towards the net. The defending team cannot affect this inherent risk—it can only try to prevent it. The team's defencemen provide the "internal control," skating backwards furiously and swinging their sticks to prevent the puck from getting through to the net. The "control risk" is the probability that the defencemen will fail to stop the puck from getting through. If they fail, the goalie is there to detect the incoming puck and stop it. The risk of the goalie's failing to stop the puck after it gets through the defence is like the "detection risk," and if the goalie works effectively this risk is reduced. To be successful, the team needs a goalie that can lower the risk of the puck's getting into the net. The goalie in this analogy is like the auditor, the final line of defence to detect the incoming "puck"—material misstatement—and stop it. If the puck gets past the goalie, the analogy to financial statement auditing is that audited statements go out containing a material misstatement, which is referred to as "audit risk." Bringing the analogy back to the audit context, we see that audit risk is realized when a material misstatement exists (inherent risk), controls fail to stop it (control risk), and the auditor's work fails to discover it (detection risk).

Note that this illustration is based on an objective fact—a goal, or a misstatement. It says nothing about subjective facts like possible future misstatements or possible goals before the end of the hockey game. Such forecast errors are not explicitly covered in the misstatements concept of current auditing standards. It is important to keep this distinction in mind when thinking about audit risk and its components in the audit risk model. Forecast errors are a distinguishing feature of GAAP financial reporting,[6] and we discuss some implications of this for auditors after reviewing the current audit risk model. Note also that in this analogy the opposing team is deliberately trying to score, but in reality the auditor is concerned about both unintentional and intentional misstatements.

6 For example, see J. C. Glover, Y. Ijiri, C. B. Levine, and P. J. Liang, "Separating facts from forecasts in financial statements," *Accounting Horizons,* December 2005, pp. 267–282.

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REVIEW CHECKPOINTS

6-3 Give an example of one account with high inherent risk and one with low inherent risk.

6-4 What is the purpose of a control framework?

6-5 Identify two control frameworks that can help in the auditor's preliminary control risk assessment.

6-6 How are auditors' judgments about the quality or effectiveness of internal control affected by anchoring?

6-7 In the hockey game analogy used to explain the audit risk factors, whom do the hockey team's fans represent?

WORKING WITH THE AUDIT RISK MODEL

LO2 Explain usefulness and limitations of the audit risk model in conducting the audit.

This section works through various examples, using hypothetical numerical values, to illustrate how the relations in the audit risk model work.

First, it is insightful to look at the audit risk model dynamically, by comparing its values at the start of an audit, before any work is done, to its values at the end of an audit where the auditor has determined that a clean opinion can be given on the financial statements.

Before the audit starts, DR would be 100% (DR = 1.0), since nothing has been done yet about reducing the risk of not detecting material misstatements. Similarly, CR would be 1.0, since the auditor has no evidence yet about whether controls are effective enough to reduce risk of misstatement. The auditor will have done some preliminary risk assessment and may have enough knowledge to assess IR at less than 100%, and let's assume for the illustration it is about 0.50. At this point then, AR essentially equals the inherent risk of a material misstatement being in the financial statements in the first place:

$$AR = IR \times CR \times DR$$
$$AR = 0.50 \times 1.0 \times 1.0 = 0.50 \text{ or } 50\%$$

Clearly, 50% is much too much risk for an auditor to give a clean opinion on the financial statements! The whole objective of the audit is to get this risk down to an acceptable low level as judged by the auditor based on the risks in the engagement. For this illustration, the auditor wanted the audit risk to be no higher than 0.05. How is that achieved? Well, the auditor is going to have to do some work! First, the auditor may decide to assess controls and test them to establish evidence that control risk is less than 1.0; say, this work results in an assessed CR of 0.20. Where are we now? Recalculating the risk model shows that at this point the AR achieved is:

$$AR = 0.50 \times 0.20 \times 1.0 = 0.10$$

This is still higher than the auditor's goal of AR = 0.05, and now the auditor has to do some substantive work that can detect any material misstatement in the accounts. Using the hypothetical values in the illustration, we can calculate that the auditor needs to do enough detection work to reduce DR from 1.0 to a level that leaves only a 5% risk of giving the wrong audit opinion. Note how the audit risk model can be used for planning the required extent of audit work by rearranging it to solve for DR:

$$DR = AR / (IR \times CR)$$
$$= 0.05 / (0.50 \times 0.20) = 0.50$$

Conceptually, the model indicates that as long as the auditor feels substantive evidence gathering procedures have at least a 50% chance of detecting material misstatement, the required AR level of 0.05 is achieved—the auditor will be taking only a 5% chance of giving a clean opinion on statements that are materially misstated.

As another illustration at the account level, assume that in a another audit, the auditor thought the inventory balance had a high inherent risk of material misstatement (say, IR = 0.90) and that the auditee's internal control was only somewhat effective—say, CR = 0.70. If the auditor wanted audit risk at a 5% level (AR = 0.05), planned audit

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procedures would need to achieve DR that did not exceed 0.08 (approximately). In other words, the model indicates that the auditor in this case can only afford to take an 8% chance of missing a misstatement.

$$\begin{aligned} AR &= IR \times CR \times DR \\ DR &= AR / (IR \times CR) \\ &= 0.05 / (0.90 \times 0.70) \\ &= 0.08 \end{aligned}$$

In a different audit, say, the auditor has assessed IR to be very low for accounts receivable—for example, IR = 0.20—and, further, has tested the internal controls and found them to be very effective, so CR is also very low—say, CR = 0.20. Say this auditee is a high-profile public company, so the auditor wants to achieve a very low audit risk of .01. Solving for DR in this case yields:

$$\begin{aligned} DR &= AR / (IR \times CR) \\ &= 0.01 / (0.20 \times 0.20) \\ &= 0.25 \end{aligned}$$

These are hypothetical illustrations only. In practice, it is difficult to know if the audit has been planned and performed well enough to hold the detection risk as low as 8, or 25, or 50%. Despite its simplicity, the audit risk model is only a conceptual tool, but it is helpful for planning audits. Intuitively, to be 92% confident (1.00-0.08) of finding any material misstatement in the inventory seems to require gathering more persuasive evidence than to be only, say, 80% confident. Auditors have few ways to calculate detection risk, however, and this model is more a way to think about audit risks than a way to calculate them. However, some auditors use this model in practice to calculate risks and the related extent of audit testing (sample size). Chapter 10 gives more details on the audit risk model as applied to audit sampling.

The model produces some insights, including these:

1. Auditors cannot rely on an estimate of zero inherent risk without other evidence-gathering procedures, which would appear as follows:

$$AR = IR\,(= 0) \times CR \times DR = 0$$

2. Auditors cannot rely only on internal control, which would appear as follows:

$$AR = IR \times CR\,(= 0) \times DR = 0$$

3. Audits would not be exhibiting due audit care if the risk of failure to detect material misstatements were too high; for example:

$$AR = IR\,(= 0.80) \times CR\,(= 0.80) \times DR\,(= 0.50) = 0.32$$

4. Auditors could rely almost exclusively on evidence produced by substantive procedures, even if they think inherent risk and control risk are high. For example (provided AR = 0.05 is acceptable):

$$AR = IR\,(= 1.00) \times CR\,(= 1.00) \times DR\,(= 0.05) = 0.05$$

Even though the conceptual audit risk model appears to be precise when presented this way, in reality, applying it is difficult and highly judgmental. However, it can help auditors decide whether they have obtained sufficient appropriate audit evidence. The objective in an audit is to limit AR to a low level, as judged by the auditor. This is done by assessing IR and CR along a spectrum; often auditors will use three broad levels: high, moderate, or low risk. The greater the inherent and control risks are, the lower the detection risk needs to be, resulting in more audit procedures (more in number, effectiveness, and extent). The objective is to limit AR to an appropriately low level, thereby achieving reasonably high assurance that the financial statements are free of material misstatement.

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To integrate some of these concepts, recall that assurance is the complement of risk. To consider a numerical example, if audit risk of 5% was achieved, then the assurance obtained would be 95%. Put another way, the auditor would be 95% sure that the financial statements do not contain a material misstatement. Essentially, the auditor has obtained this assurance from the three factors in the audit risk model. The sources of assurance are the inherent nature of the item, the control exercised over the item, and the results of the various substantive detection procedures performed. Remember, too, that the audit risk model incorporates the concept of materiality and that materiality enters throughout the risk assessment process, as further explained in the next section.

How Materiality and Audit Risk Are Related

Materiality refers to the magnitude of a misstatement, while audit risk refers to the level of assurance that material misstatement does not exist in the financial statements. The materiality decision is based on how misstatements will affect financial statement users. Understanding the business and its environment helps the auditor to identify financial statement users and assess what is significant to their decisions. For example, the shareholders of a medium-sized private company may be relying on the audited income number for calculating the managers' bonuses. A smaller misstatement might affect them more than would be the case in a large public company where a user's decision is less directly related to the audited income figure. An auditor decides on the materiality level independently of audit risk considerations.

Acceptable audit risk is determined by how much assurance the auditor requires. For example, say venture capital investors are basing their financing decisions on the audited information; if the audit fails to uncover a material misstatement, these investors will lose money and there is a high risk they will sue the auditor, so high assurance is required. High-profile companies, such as banks require high assurance, as audit failure affects many people and generates a lot of bad news coverage, seriously damaging an auditor's reputation. As audit risk is the complement of audit assurance, requiring a high level of assurance means setting audit risk low. The auditor is only willing to accept a small risk of missing a material misstatement.

Audit risk and materiality thus both deal with the sufficiency of evidence. If the AR is set lower, or materiality is set smaller, the evidence required will increase. Both audit risk and materiality levels will be planned early in the engagement. These planned levels are used throughout the audit for financial statements as a whole, as well as for individual accounts, unless situations discovered during performance of the audit indicate they should be adjusted. Inherent risk, control risk, and detection risk, on the other hand, will vary assertion by assertion for each account balance, transaction stream, and disclosure, depending on the conditions for each assertion. Nonetheless, as long as the risk model is used so that the audit risk for each financial statement assertion is at or below the planned levels, the auditor is reasonably certain that sufficient appropriate evidence has been obtained to support the audit opinion. However, there are practical limits to the evidence decision, so tradeoffs have to be made; not all the evidence can be obtained at a reasonable cost or quickly enough to provide a timely audit report, and not all evidence has the same level of reliability. The concepts of materiality and audit risk are important elements in exercising professional judgment about the sufficiency and appropriateness of audit evidence, and both affect the quality of the audit.

The materiality and audit risk decision's main impact is on the extent of audit evidence that needs to be gathered. To be systematic and consistent, auditors try to keep the planning for the users' materiality separate from the assurance level decision. But when an auditor believes a high level of assurance is needed, choosing a low audit risk level or a low materiality level have the same impact: both will increase the amount of evidence the audit will need to gather. The underlying considerations of materiality and audit risk concepts are, however, different in nature, so it is good practice to keep these decisions separate in planning an audit.

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Business Risk and Extensions of the Audit Risk Model

Now that we have reviewed the risk model auditors use to identify and manage the risks element in an audit engagement, you may be wondering: How does an auditor get a handle on all these different risks? Canadian GAAS set out a **business risk–based audit approach**, and business risk is a pervasive consideration throughout the audit process. Backing up a bit to the topics in Chapter 5, we saw that the early stages of the audit involve auditors doing a lot of preliminary research to understand the auditee's business and its risks, determine materiality levels, identify significant issues that can affect its financial statements, and set out an overall audit strategy. Business risk is the main driver of the auditor's risk assessments.

business risk–based audit approach: the requirement for the auditor to understand the client's business risks and strategy in order to assess the risks of material misstatement in the financial statements and design appropriate audit procedures in response to those risks

Business risk is defined as any event or action adversely affecting an organization's ability to achieve its business objectives and execute its strategies. For examples, the introduction of the automobile replaced horse and buggy in the 1930s, the development of the personal computer (PC) and its word-processing capabilities dramatically reduced the market for electric typewriters in the 1980s, and digital video discs (DVDs) replaced video cassette tapes in the 2000s. More recently, the capability for downloading and streaming music and video files over the Internet severely challenged business models of the music and movie industries and their methods of making profits. Auditing standards emphasize the financial statement auditor's need to understand and respond to business risk.[7]

STANDARDS CHECK

CAS 315

4(b). Business risk—A risk resulting from significant conditions, events, circumstances, actions, or inactions, that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.

Source: *CICA Handbook—Assurance,* 2012.

The current business risk–based audit approach of the auditing standards emerged in the 1990s in response to increasingly complex businesses, operating environments, systems, and financing techniques. In the past, audit partners' personal experience, knowledge, and practice skills were sufficient to perform effective audits for relatively simple businesses. As businesses became more complex, it became evident that auditors, especially less experienced ones, needed more guidance and formalized structure for exercising good auditor judgment. Auditors were not always able to assess the many ways that events and conditions of a business increase the risk that its financial statements do not fairly present the business's financial realities. **Strategic Systems Auditing (SSA audits)** was developed in the 1990s as rigorous top-down business risk–based audit methodology to meet this need (see further description in Appendix 6C on Connect). SSA presented quite radical changes for auditors used to the traditional, more-bottom-up process of verifying transactions in the search for processing errors. Some people believe that the SSA philosophy was not properly implemented, or even that its intent was to increase audit profitability by justifying doing little substantive testing. Some attribute grave audit failures, such as Enron and WorldCom, to the ineffectiveness of SSA.[8]

Strategic Systems Auditing (SSA audits): an auditing approach that has a top-down focus, starting with an in-depth understanding of the auditee's business; enables the auditor to understand the strategic objectives of the auditee, the risks the auditee faces in relation to these objectives, and the controls necessary for the business to respond to these risks; obtaining an understanding of the business as a whole, then proceeding to look at the details of the risky transactions in the context of the knowledge gained at the broader level

Still, supporters of SSA's risk-based philosophy believe that its goal was always to improve audit effectiveness. Use of a risk-based audit approach in Canadian and international auditing standards places business risk assessment at the heart of the audit process. Appendix 6A provides a summary of the risk factors set out in the auditing standards as an example of the comprehensive aspects of business risk that a financial statement auditor considers when assessing the risk of material misstatement. This debate about SSA's value has led to recent research within the audit profession to better understand how auditors

7 CAS 315.

8 See W. R. Knechel, "The business risk audit: Origins, obstacles, and opportunities," *Accounting, Organizations, and Society,* 32 (2007) pp. 383–408 for further exploration of this issue.

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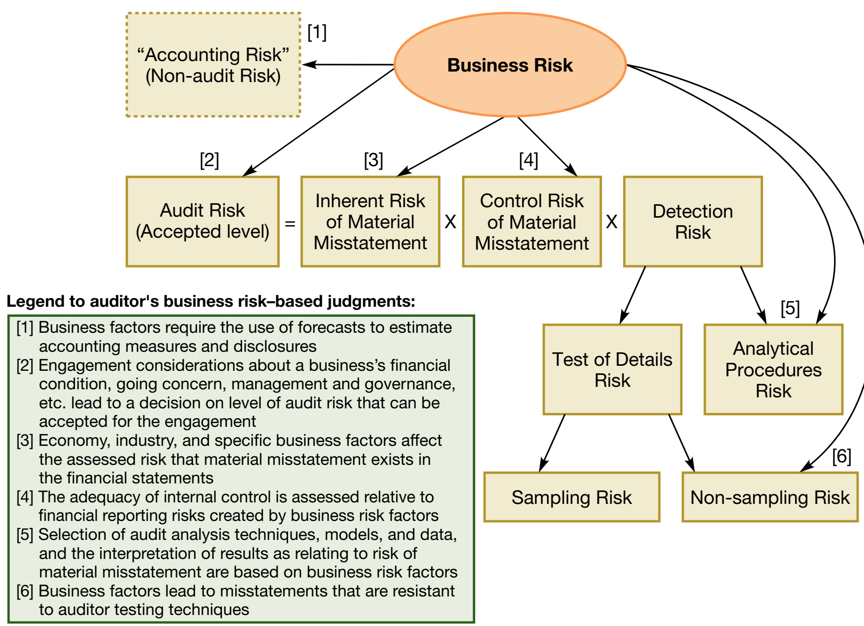
address business risk to manage audit risk. Being familiar with the traditional, simple audit risk model, it is useful to look at what researchers are exploring through further analysis of the risks in a financial statement audit.

We saw that AR is a function of the risk of material misstatement (RMM) after application of internal control (RMM = IR × CR) and the risk that the auditor does not detect it (DR). As noted above, DR is a difficult risk to assess, and we can view it as having several layers. The first layer shows that detection can be achieved either by analytical procedures or by tests of details. With both substantive approaches, there is risk that the procedures will not detect a material misstatement.

In the case of tests of details, auditors recognize that when using samples there is a risk, called *sampling risk*. This is the risk that the sample result will not truly reflect the population the sample was taken from.[9] Even with a rigorously selected random sample, bad luck can still strike, and only correct items are selected when, in fact, there is a very high rate of errors. There are techniques for ensuring that sampling risk is reduced to a reasonable level, so there should be only a small sampling risk if it is done properly. If reducing sampling risk to get to the desired DR was the only concern, the limitations of audits would be tiny. But there is also non-sampling risk—the risk that the wrong conclusion will be reached from a sample for other reasons that do not relate to sampling risk. For example, the auditor may be careless in performing the test and misinterpret the results, or the test procedure may be poorly designed such that it is not relevant to the audit objective. A similar type of non-detection risk also exists for analytical procedures, since these may use inappropriate methods or ignore relevant data and fail to pick up significant indicators of misstatement. Exhibit 6–3 summarizes and illustrates how business risks and an auditor's judgments based on them can permeate every aspect of the risk modelling exercise.

EXHIBIT 6–3 The Audit Risk Model Expanded—Illustrating Auditor's Business Risk–Based Judgments



9 Stay tuned: Chapter 10 will explain audit sampling in detail, but for our purposes a few basic ideas are introduced here.

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This extension of the audit risk model to incorporate business risk and accounting risk is discussed further in the following box.

The remainder of this chapter will focus primarily on how the auditor's business understanding is used to assess inherent risk, and how understanding internal control and information systems helps to assess control risk. These risk assessment procedures are the basis of developing a detailed plan to gather evidence to reduce the risk of material misstatement to an acceptable level given the level of audit risk the auditor has decided is acceptable for the engagement.

NEW PERSPECTIVES ON BUSINESS RISK, ACCOUNTING RISK, AND AUDIT RISK*

Knechel (2007) proposes a non-sampling risk concept that includes many risks of material misstatement that simply can never be identified through substantive testing, and he argues that these risks can be reduced by incorporating business risk analysis in audits to provide insight into how significant non-detectible misstatements might be. If the auditor assesses such risks as unacceptably high, then, effectively, the scope of the audit is too limited to allow the auditor to provide reasonable assurance on the financial statements.

A further perspective on this problem is the concept of accounting risk discussed in Smieliauskas (2008). Accounting risk arises mainly from the fact that forecasting is used to generate accounting estimates. For example, an estimate of the fair value of a financial instrument can require forecasts of factors such as future interest or exchange rates. The limits and deficiencies that audit detection work cannot remove from the underlying accounting are accounting risk. If management must make accounting estimates under a great deal of measurement uncertainty, there is a risk these estimates are misstated, and increasing the extent of audit testing or analytical procedures cannot reduce this risk. The accounting risk concept is explained in more depth elsewhere, where a critical-thinking exercise illustrates how it relates to but differs from audit risk. Again, business risk analysis is a way for the auditor to distinguish accounting risk from audit risk.

Perhaps if Enron's auditors had realized that accounting risk for Enron's special-purpose entities was extremely high, they could have realized that deficiencies in GAAP were allowing billions of dollars of liabilities to go unreported such that Enron's financial statements were not fairly stated. Their audit evidence might not have been sufficient to support an adverse opinion, but they could have realized that their scope was too limited to provide the clean opinion they issued! The important point is that when accounting risks are too high for GAAP to provide fair presentation, the auditor is not doing anyone any favours by effectively accepting this as higher audit risk and issuing a clean opinion anyway. The audit profession has always had a crucial public interest role in promoting high-quality financial reporting. Auditors' professional duty to protect the public can at times require auditors to refuse to provide assurance when accounting risk is too high to provide reliable financial information to users. Some people argue that IFRS's current trend toward providing more fair value accounting information for many types of assets and liabilities may produce unacceptably high accounting risks in some cases. If an auditor concludes the fair value accounting risk is too high, the responsibility is to flag the estimation uncertainty in the audit report so that financial statement users are not misled. This perspective also relates to the debate about whether the audit opinion is a two-part assertion on fair presentation and compliance with GAAP, or a one part statement only on GAAP compliance. Accepting the accounting risk as a real problem makes it impossible to see the audit opinion as anything but a two-part assertion. New audit reporting standards (CAS 706, Emphasis of Matter Paragraphs and Other Matter(s) Paragraphs in the Independent Auditor's Report) address this problem to some extent by giving auditors the option of using extra paragraphs in the audit report to provide (1) further emphasis on matters contained in the financial statements or (2) information on other matters the auditor believes are important for users in interpreting financial statements.

You might be wondering if risk of undetected factual misstatements and accounting risk make effective audits impossible. Reasonable assurance can be perplexing (even to experienced auditors!) but these perspectives on risk can make the limitations more concrete and easier to conceptualize. These viewpoints might also help outsiders understand the limitations better, and reduce the expectation gap discussed in Chapter 1. Overall, a fuller appreciation of business risk and its relation to both audit and accounting risk shows how business risk analysis can enhance audit effectiveness.

*This discussion on expanding the audit risk model is based on W. R. Knechel, "The business risk audit: Origins, obstacles, and opportunities," *Accounting, Organizations, and Society,* 32 (2007), pp. 383–408; W. Smieliauskas, "A framework for identifying (and avoiding) fraudulent financial reporting," *Accounting Perspectives,* 7(3) (2008), pp. 189–226; and M. E. Peecher, R. Schwartz, and I. Solomon, "It's all about audit quality: Perspectives on strategic-systems auditing," *Accounting, Organizations and Society* 32 (2007), pp. 463–485.

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REVIEW CHECKPOINTS

6-8 How do bad economic times increase the risks that auditors should be alert to in auditees' financial statements?

6-9 What is the difference between "audit risk in an overall sense" and "audit risk applied to individual account balances"?

6-10 How does the auditor's decision on materiality relate to audit risk?

6-11 What is the relationship between business risk and audit risk?

6-12 How can the risk model be expanded to incorporate limitations to the audit that arise from accounting and other business risks?

BUSINESS RISK–BASED APPROACH TO AUDITING

LO3 Explain how auditors assess the auditee's business risk through strategic analysis and business process analysis.

The business risk–based audit approach requires the auditor to understand the auditee's business risks and strategy and its related internal control; first, in order to assess the risks of material misstatement, and then to design and perform procedures that address the assessed risks. Business risk analysis allows auditors to learn about the risks the business faces, management's strategy for addressing those risks to meet organization goals, and the business processes it uses to implement the strategy. There are two parts of business risk analysis: strategic analysis and business process analysis.

At the end of the business risk analysis, the auditor should be able to answer the following questions:

1. What is the entity's strategy?
2. Is it sustainable?
3. What are the business risks/threats that can prevent the entity from achieving its strategic goals?
4. What business processes, internal controls, and information systems does the entity management use to manage those risks?
5. What are the gaps or weaknesses in the entity's risk management approach?
6. Do those gaps affect the financial statements?

Answers to these questions allow the auditor to identify significant risks that could result in material misstatements. In particular, the answer to question 4 requires an in-depth evaluation of the design and implementation of internal controls during the audit period—also known as assessing the **entity's risk assessment process**. Management uses the entity's risk assessment process to deal with uncertainty and associated risks and opportunities, thereby allowing the organization to meet its goals. A useful guide to entity risk assessment is COSO's *Enterprise Risk Management—Integrated Framework,* which provides the following definition:

entity's risk assessment process: management's process for identifying business risks that could affect financial reporting objectives and for deciding on actions to address and minimize these risks; understanding this process helps auditors to assess the risk that the financial statements could be materially misstated

> Enterprise risk management is a process, effected by an entity's board of directors, management, and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.[10]

The auditor's first step is understanding the entity management's own process for identifying business risks affecting financial reporting objectives and for deciding on actions to minimize these risks. Organizations approach risk assessment in various ways, and understanding management's assessment process helps the auditor, in turn, to assess the

10 Source: COSO website: http://www.coso.org/documents/COSO_ERM_ExecutiveSummary.pdf.

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risk that the financial statements could be materially misstated. In this text, the need for the auditor to understand the auditee's business risks and strategy is called the business risk–based approach to auditing.

Having an understanding of business risks, auditors exercise professional judgment by using mental models and systems thinking. A mental model "consists of organized knowledge, integrated data about the patterns and cues, and rules for linking knowledge and cues."[11] The audit risk model and the underlying risk assessments is an example of a "mental model" used in audit practice. A *World of Warcraft* player's knowledge of the environment, tools, and players, and the strategy used in the game is another example of a mental model. These models are used throughout the audit, or the game, and updated continuously for new information. The systems thinking used in business risk analysis involves viewing the organization in a complex web of relationships between the auditee and relevant features of the auditee's external environment. In systems thinking, the auditor considers not only cause-and-effect relationships that affect the auditee's business but also how random shocks, such as the softwood lumber duties example in Chapter 5, can change its dynamics. This allows the auditor to get a deep understanding of the business risks facing the auditee organization, and their potential consequences. Similarly, systems thinking in *World of Warcraft* involves the player understanding the dynamics of the game and the other players, watching out for clues about what will happen next, and planning the next successful move. The next part of this section explains a systems thinking–based methodology for analyzing business risk.

Strategic Analysis

The audit team begins the strategic analysis by learning from senior auditee management (for example, the chief executive officer or chief operating officer) about the business objectives and the key strategies and risks in achieving those objectives. In for-profit entities, objectives are normally some combination of profitability and growth. In a not-for-profit entity, objectives might be, for example, an inner city health clinic's goal of providing medical services to homeless people underserved by the mainstream medical service delivery.

Strategies are the systems and processes an organization implements to achieve the business objectives. Common strategies include being an industry cost leader (i.e., having the lowest costs), or differentiating your products from your competitor's (i.e., deliver an element of the product that purchasers value).

The following box illustrates the risks faced by a company that enjoyed market leadership from selling highly popular hand-held devices. Competitors were constantly in the wings looking for ways to take away some of BlackBerry's market share. Different aspects of its strategy will present a variety of risks to the company, so auditors must take a broad view of the business environment to identify all important risks. The more successful the company, the more complex and varied its risks may be.

APPLE iPHONE LATEST THREAT TO BLACKBERRY

Apple may have been planning to use its iPhone for a major assault on Research In Motion (RIM), the dominant maker of the BlackBerry smartphones for business users. RIM stock fell about 8% after Apple CEO Steve Jobs introduced the iPhone at the company's annual technology showcase in January 2007, saying it would eventually surpass the BlackBerry.

The iPhone has a touch screen instead of a keyboard, plays music like the popular Apple iPod, surfs the Internet, does email, and runs on the Macintosh computer operating system. It went on sale in the U.S. in June 2007, in Europe in late 2007, and Asia in 2008 at prices ranging from U.S. $499 to $599, depending on the model. The iPhone's innovative design and features, and its move to 3G technology, made it a strong competitor to RIM in the consumer segment of the market, which was expected to be the next source of growth for RIM.

11 T. Bell and I. Solomon, *Cases in Strategic-Systems Auditing* (KPMG and University of Illinois, 2002).

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Throughout July 2008, Apple's media blitz over its first 3G iPhone mobile device dominated the news. In a battle for higher-end consumers, RIM began sprucing up the multimedia handling abilities of its plain, but functional, BlackBerry business phones. The BlackBerry Pearl and Curve models began the trend. The BlackBerry Bold, available in August 2008, challenged Apple's new 3G iPhone as RIM's first 3G offering, complemented by a set of consumer-oriented features including a 2-megapixel camera with video recording capability, a music player, global positioning system (GPS), and WiFi.

In 2010, the battle ground shifted to the tablet market, with Apple launching its iPad product to huge fanfare and massive demand. While RIM's BlackBerry retained market dominance in its flagship BlackBerry line, it had nothing ready to compete with Apple's iPad. Thrown into a "catch-up" strategy, RIM had to rush the development and release of its own tablet product, the PlayBook, which came out in April 2011. Plagued by bugs and with only a limited availability of "apps" in comparison with the iPad's slick touch technology and hundreds of thousands of apps, the early PlayBook flopped. While many of the early deficiencies were corrected, RIM was forced to sell off the tablets at huge discounts to clear the backlog. This resulted in a huge write-down on inventory in the third quarter of 2011, and a plunge of 9.7% in its share price on the day it was announced. To make matters worse, continued assault from the iPhone and a growing family of Google Android devices and other smartphone competitors resulted in shrinking BlackBerry market share during 2011.

What does the future hold for RIM's competitiveness? RIM pledged a PlayBook software update for February 2012, complete with long-awaited features, such as integrated e-mail. The company promised to release a line of "superphones," loaded with a QNX-derived operating system named BlackBerry 10, during 2012 that it hoped would allow it to regain market in the smartphone arena. The ultimate goal is a refreshed ecosystem that appeals equally to consumers and businesses and elevates RIM back to a position of prominence. Since the PlayBook also utilizes a QNX-based operating system, some sort of heightened interoperability will presumably exist between the tablet and the new BlackBerry smartphones. But that does not necessarily mean that RIM needs to keep the PlayBook alive if the device refuses to sell. RIM could reorient its tablet as more of a niche device for enterprise users, or hang on and hope that the market dynamics shift in its favour—but whatever its eventual choice, RIM needs to do something radical with regard to the PlayBook.

"Whether you call the PlayBook an albatross or a yoke around the neck, management has not done a good job in bringing good products to the forefront and that's why the share price is suffering," one analyst commented.

Such is the current pace of change in the global economy that as of the time of writing, in mid-2012, RIM's fortunes were in serious decline; the business risks being assessed only a short time ago appear to being coming to pass.

Sources: David Paddon, The Canadian Press, "Apple handset gives BlackBerry new battle," *The Daily Herald-Tribune,* (Grande Prairie, Alberta), January 12, 2007. Computers, p. 48. © Sun Media Corporation. All rights reserved; Matt Walcoff, Record Staff, "Apple won't take big bite out of RIM—yet; analysts; shares of BlackBerry maker rebound after initial fears over new iPhone," *The Record* (Kitchener-Waterloo, Ontario) Business, p. D8. © 2007 Toronto Star Newspapers, Ltd. All rights reserved; "RIM begins BlackBerry Bold release," EWeek.com, August 11, 2008, Mobile and Wireless, © 2008 Ziff Davis Media Inc.; Jonathan Spicer, Reuters, "Investors keep faith in maker of the BlackBerry," The International Herald Tribune, Finance, p.15, © 2008 International Herald Tribune; Hugo Miller, "PlayBook 'albatross' harms RIM in an iPad world," *CFOworld,* December 5, 2011, http://www.cfoworld.com/strategic-finance/26675/playbook-albatross-drags-down-rim-ipad-world; Nicholas Kolakowski, "Should Research In Motion kill its PlayBook tablet?" eweek.com, December 12, 2011, http://www.eweek.com/c/a/Mobile-and-Wireless/RIMs-PlayBook-Needs-a-New-Strategy-704983/.

The strategic analysis begins the auditor's understanding of management's process for identifying business risks and making decisions about actions to address those risks. The business risk approach requires the auditor to enquire about business risks that management has identified and consider whether they may result in material misstatement.

In smaller businesses where management may not have a formal risk assessment process, the auditor should discuss with management how risks to the business are identified and how they are addressed.

Business Process Analysis

Management tries to minimize business risks by designing well thought-out business processes. Business processes are a structured set of activities designed to produce a specific output that matches business strategy. Examples include customer relations management in a consumer products distribution firm or processing income tax returns in the Canada Revenue Agency's operations. If the business process produces value-added output according to the strategy, it is more likely that the business will achieve its objectives and not fall prey to the various risks.

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STANDARDS CHECK

CAS 315

18. The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting.

A84. An entity's business processes are the activities designed to:
- Develop, purchase, produce, sell, and distribute an entity's products and services;
- Ensure compliance with laws and regulations; and
- Record information, including accounting and financial reporting information.

Business processes result in the transactions that are recorded, processed, and reported by the information system. Obtaining an understanding of the entity's business processes, which include how transactions are originated, assists the auditor obtain an understanding of the entity's information system relevant to financial reporting in a manner that is appropriate to the entity's circumstances.

Source: *CICA Handbook—Assurance,* 2012.

The business process view of the firm has become an important perspective in management in recent years. Interest in business processes follows the understanding that a firm's success ultimately depends on how well its management can execute the main aspects of its strategy, such as cost leadership, differentiation, or focus. (Appendix 6C on Connect includes details of types of strategies.)

Business processes work to create value for customers and thus achieve strategic objectives. Typically, they will cross boundaries between an organization's functional departments, such as sales, marketing, manufacturing, and research and development, and involve groups of employees from the different areas working together to complete the work. Exhibit 6–4 shows examples of some simplified business processes for an airline company and a manufacturing company, illustrating how the different functions combine to achieve the overall goal.

Business processes are each organization's unique ways of coordinating work, information, and knowledge to produce a value-added product or service. This business process–based management approach has been facilitated by the development of powerful information systems, called **enterprise resource planning systems (ERPS)**, that can integrate enterprise-wide resource and accounting information. These information systems can help organizations achieve efficiencies by automating parts of their business processes, but this still requires careful analysis and planning. More complex systems might strengthen the wrong process of business model, and the business can become more efficient at things it should not be doing. As a result, the business's strategy will not be achieved, and it will become vulnerable to competitors with better models. The most important strategic decisions involve understanding what business processes need improvement and how information systems can improve them, not simply buying the latest information technology.

enterprise resource planning systems (ERPS): an information system in which inputs and outputs from many or all the business processes will be processed in an integrated manner, so the accounting component of the information system will be closely related to many other functional areas, such as sales, inventory, human resources, cash management, etc.

EXHIBIT 6–4 Examples of Business Processes

A. BUSINESS PROCESSES IN A PASSENGER AIRLINE COMPANY

Market and sell services
1. Develop a marketing plan
2. Form and continue alliances with other airlines
3. Establish positive customer contact

Provide transportation services
1. Acquire, maintain, and manage assets: airplanes, parts, hangers
2. Manage safety and risk

B. BUSINESS PROCESSES IN A MANUFACTURING COMPANY

Production Processes

Planning production
1. Schedule production
2. Order materials

Manufacturing product
1. Assemble product
2. Test product
3. Record costs of materials, labour, and overhead used

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EXHIBIT 6–4 Continued

B. BUSINESS PROCESSES IN A MANUFACTURING COMPANY

Shipping products
1. Ship product ordered
2. Record inventory used

Order Fulfillment Processes

Process sales orders
1. Receive the order
2. Enter the order
3. Clear the order once shipped

Account for the sale
1. Check and approve credit
2. Generate invoice upon shipment
3. Post sales journal entry

REVIEW CHECKPOINTS

6-13 Explain the business risk–based approach to the audit. What is its purpose?

6-14 What are the two parts that make up business risk analysis? What is the goal of business analysis?

6-15 How does understanding the business's strategy help the auditor to assess business risk?

6-16 What is a business process?

6-17 How do business processes relate to strategy and business risk?

6-18 Give an example of one business risk that affects the airline industry and one that affects a manufacturing business.

The business process view also highlights the fact that business organizations differ in terms of the kinds of activities they perform and the technology they use. Some organizations use mainly routine tasks that can easily be reduced to simple formal rules that require little judgment (e.g., inventory ordering in a grocery business). These types of tasks can easily be programmed, and these organizations are more likely to be run hierarchically. In contrast, organizations with activities that are non-routine and require judgment (e.g., an engineering firm designing specifications for office towers) would have complex functions in their operation and thus would be run less hierarchically.

Effects of Information Technology and E-commerce on Business Risk

electronic commerce (e-commerce): any trade that takes place by electronic means

Changes in information technology and expansion of **electronic commerce (e-commerce)** are affecting business risks and processes in many organizations. Business risk analysis includes analyzing the effects of e-commerce in the entity's business strategy. As a business becomes more involved with e-commerce, and as its information systems become more integrated and complex, it will change its business processes and introduce new business risks that could affect the financial statements. Managers responsible for the entity's e-commerce activities, such as the chief information officer, are a useful source of the necessary knowledge. E-commerce activities may be complementary to an entity's traditional business, such as an online order entry system run over the Internet, or it may represent a new line of business, such as when the firm uses its website to both sell and deliver digital products via the Internet. In an industry significantly affected by e-commerce, such as those in the box on the next page, the business risks that can affect the financial statements may be greater.

Further details on the impact of e-commerce activities on an organization's business processes and risk, the security of its payments made over the Internet, and the impact on the audit work and need for IT expertise are provided in Appendix 6D on Connect.

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BUSINESS RISKS AND E-COMMERCE

Many industries, in all business sectors, have been significantly affected by e-commerce. The following are some key industries being transformed:

a. Computer software
b. Financial services
c. Travel services
d. Books and magazines
e. Recorded music and movies
f. Advertising
g. News media
h. Education

To understand management's strategy and risk assessment process for e-commerce, the auditor would consider several factors:

- Alignment of e-commerce activities with the entity's overall business strategy.
- Sources of revenue for the entity and how these are changing (for example, whether the entity will be acting as a principal or agent for goods or services sold).
- Management's evaluation of how e-commerce affects the earnings of the entity and its financial requirements.
- Extent to which management has identified e-commerce opportunities and risks in a documented strategy that is supported by appropriate controls, or whether e-commerce is subject to ad hoc development responding to opportunities and risks as they arise.
- Management's commitment to relevant codes of best practice or web-trust programs.
- IT skills and knowledge of entity personnel.
- Risks involved in the entity's use of e-commerce and its approach to managing those risks, particularly the adequacy of the internal control system, including the security infrastructure and related controls, as it affects the financial reporting process.
- Information security issues arising from the firm's website, which can provide an access point to the entity's financial records. The security infrastructure and related controls can be expected to be more extensive where the website is used for transacting with business partners, or where systems are highly integrated.

Source: Adapted from *CICA Handbook,* Assurance Guideline AuG-32, and IAPS 1013, Electronic Commerce—Effect on the Audit of Financial Statements.

Summary

The business process analysis deepens the auditor's understanding that began in the strategic analysis. It should allow the auditor to identify risk areas that may affect the amounts and relations among the numbers recorded in the accounting system and the financial statements. The process analysis may also suggest disclosures that should be present in the notes to the financial statements. Business risks and audit risk assessment are an important consideration in applying the audit risk model components discussed above, in relation to developing the detailed audit plan, and in testing the internal controls.[12]

REVIEW CHECKPOINTS

6-19 How do organizational differences relate to strategies and business processes?

6-20 How do risks of IT and e-commerce affect the risks of financial statement misstatements?

6-21 What are the implications of a business using e-commerce on its business analysis?

Business Performance Analysis and Management's Financial Statements

This section expands on how the auditor applies an understanding of the business, its environment, and risks, as well as management's process for managing those risks, in assessing the risk of material misstatement of the financial statements.

The auditor's concern is that the financial statements will not capture the underlying business reality fairly and in accordance with GAAP because errors or fraud have occurred. The auditor considers whether the analysis of business performance is consistent with the performance portrayed in the financial statements. Business performance analysis ideally

12 Stay tuned: The detailed audit plan is discussed more in Chapter 8, and testing internal controls in Chapter 9.

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will consider financial and nonfinancial performance measures and the interrelationships between the two. The auditor should also consider how performance measures are used, both externally (e.g., key performance indicators reported to analysts, creditors, and shareholders) and internally (e.g., for personnel review and incentive programs). Pressures on the business managers increase the risk that they are motivated to deliberately misstate the financial statements, as illustrated by the audit guidance in the following box and further discussed in Chapter 7.

POTENTIAL TROUBLE SPOTS

Fraud is usually concealed, making it very challenging for an auditor to detect. Fraud by management, usually in the form of fraudulent financial reporting, is especially difficult for auditors to detect. When planning the audit, the auditor may notice certain events or conditions referred to as "fraud risk factors." These are events or conditions that suggest individuals in management may have an incentive or pressure leading them to commit fraud, a perceived opportunity to commit fraud, and the ability to rationalize committing a fraud.

These three factors are often referred to as the **fraud triangle** because fraud becomes very likely when all three are present. Some examples of risk factors often present in situations where frauds have occurred are:

a. *Incentives* arising from the availability of significant bonuses when profit targets are met, or pressures to meet earnings expectations or existing debt covenants to obtain additional debt financing;
b. *Opportunities* provided by an ineffective control environment with poor access controls that can allow management override; and
c. *Rationalization* of committing a fraud due to the individual's attitude, character or their particular set of ethical values (extreme pressures to report or conceal certain financial information can sometimes serve as the rationalization to commit fraud for people who are otherwise honest).

While fraud risk factors may not always lead to the occurrence of fraud, they should be considered in the auditor's assessment of the risks of material misstatement if they are present.

Source: Adapted from CAS 315 (paragraphs 25–27, A116) and CAS 240 (paragraphs 3, A1).

fraud triangle: a model of the three factors that make fraud likely: incentive, opportunity, and rationalization (or similar concepts)

Financial Performance Analysis

Financial performance analysis continues the analytical procedures discussion presented in Chapter 5. It includes examining key sets of financial statement ratios (e.g., short-term liquidity ratios—see Appendix 5A for details), examining trends over time in those ratios, and considering the interrelationships among the ratios for consistency. Based on previous audit findings and the business risk assessment, the auditor forms expectations about what the financial analysis should discover.

Financial performance analysis includes a review of management's significant accounting policy choices and benchmarking those with significant industry competitors. Here, the auditor is attempting to gain an understanding of the degree of conservatism of management's accounting policy selection. In particular, the auditor considers the revenue recognition policy in for-profit entities, as this has been a key area of abuse when apparently successful companies suddenly fail.[13] See Exhibit 6–5 for examples. If the accounting policies vary significantly from industry norms, the auditor adjusts the accounting policies to those normal to the industry and "reperforms" the quantitative financial performance analysis. The results are then compared with industry benchmarks. This may suggest areas of additional audit work to reduce audit risk to an appropriately low level, or that management should modify its accounting policies and practices.

EXHIBIT 6–5 Accounting "Gimmicks" for Earnings Manipulation

- Recording revenue before it is earned
- Creating fictitious revenue
- Boosting profits with nonrecurring transactions
- Shifting current expenses to a later period
- Failing to record or disclose liabilities
- Shifting current income to a later period
- Shifting future expenses to an earlier period

13 CAS 240.

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STANDARDS CHECK

CAS 240

The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.

Source: *CICA Handbook—Assurance,* 2012.

Part of the financial analysis in for-profit companies involves considering the quality of the earnings. **Quality of earnings** refers to the auditee's ability to replicate its earnings, both the amounts and the trends, over relatively long periods. Exhibit 6–6 lists factors indicative of high earnings quality. Indications of low-quality earnings may result in the auditor's performing additional audit procedures to reduce risk to an appropriately low level or suggest adjustments are required to management's financial statements.

quality of earnings: extent to which the reported earnings number represents actual economic performance, rather than selective accounting policy choices or management manipulation

EXHIBIT 6–6 High-Quality Earnings

1. Earnings management practices that are not used by firms with high-quality earnings:
   a. Using accounting accruals to smooth income increases over time
   b. Structuring business transactions to ensure an outcome desired by management on accounting income for the period
   c. Making management choices based primarily on short-term profitability
2. High-quality earnings have operating cash flows and income recognized closely together over time.
3. Indicators of high-quality earnings include:
   a. Consistency of accounting accruals from year to year
   b. Accounting policy changes reduce income
   c. Short time lag between income recognition and the related cash being received by the business

Auditing standards require the auditor to communicate on a timely basis with the audit committee, or with those having oversight responsibility for the financial reporting process, on matters that are significant qualitative aspects of the entity's accounting practices, including accounting policies, estimates, and disclosures.[14] This communication should be open and frank discussions among the auditor, audit committee, and management on all items that have a significant effect on the understandability, relevance, reliability, and comparability of the financial statements, including the following:

- Impact on earnings of implementing changes in accounting policies
- Effect of significant accounting policies in controversial or emerging areas or those unique to an industry
- Estimates, judgments, and uncertainties
- Existence of acceptable alternative policies and methods, the acceptability of the particular policy or method used by management, the financial statement amounts that are affected by the choice of principles, as well as information concerning accounting principles used by peer group companies, and the auditor's views on whether management has chosen the most appropriate practice
- Unusual transactions
- Timing of transactions that affect the recognition of revenues or avoid recognition of expenses

The auditor must also ask management and those charged with governance about any known or suspected frauds affecting the auditee.[15] The auditor has an ongoing responsibility to communicate any suspicions or evidence of fraud to a level of management higher than the employees involved, or with those charged with governance if high-level managers are suspected.

14 CAS 260, paragraphs 16(a).

15 CAS 240, paragraphs 40–41.

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STANDARDS CHECK

CAS 260

Significant Findings from the Audit

16. The auditor shall communicate with those charged with governance: (Ref: Para. A16)
    - (a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates, and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity; (Ref: Para. A17)
    - (b) Significant difficulties, if any, encountered during the audit; (Ref: Para. A18)
    - (c) Unless all of those charged with governance are involved in managing the entity
      - (i) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and (Ref: Para. A19)
      - (ii) Written representations the auditor is requesting; and
    - (d) Other matters, if any, arising from the audit that in the auditor's professional judgment are significant to the oversight of the financial reporting process. (Ref: Para. A20)

Source: *CICA Handbook—Assurance,* 2012.

STANDARDS CHECK

CAS 240

41. Unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspects fraud involving (a) management, (b) employees who have significant roles in internal control, or (c) others where the fraud results in a material misstatement in the financial statements, the auditor shall communicate these matters to those charged with governance on a timely basis. If the auditor suspects fraud involving management, the auditor shall communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit. (Ref: Para. A61–A63)

Source: *CICA Handbook—Assurance,* 2012.

REVIEW CHECKPOINTS

6-22 What are some examples of external and internal business performance measures? How can these performance measures motivate management to misstate the financial statements?

6-23 What are some "gimmicks" that management can use to manipulate earnings?

6-24 What is earnings quality, and what are some indicators of high-quality earnings?

6-25 What are the auditor's communication responsibilities when he or she suspects or finds evidence of fraud? How do his or her responsibilities differ if the fraud involves low-level employees or high-level managers?

6-26 What are the three components of business performance analysis? Why does the auditor conduct business performance analysis?

Nonfinancial Performance Analysis

Through the key business process analysis discussed previously, the auditor has developed a deep understanding of the nonfinancial performance measures employed in various business processes. Nonfinancial performance analysis builds on that by analyzing the relationships among the business's resources, the processes for using those resources, and the firm's ability to compete in the markets for its products or services. Based on the business analysis, the auditor already has information about the business's processes and available resources. The auditor collects information on the entity's market performance. For this analysis, the auditor can develop a "**balanced scorecard**" for the entity and compare with others in the industry. Exhibit 6–7a explains the concept of a balanced scorecard, and your management accounting classes will provide more in-depth understanding. The scorecard reflects non-financial measures of resources (learning and growth), processes (internal business), markets (customer related), and balances these with financial performance measures. Exhibit 6–7b includes a detailed example of a balanced scorecard that would be appropriate in a regional airline type of business, and shows how the other three measures relate to financial performance.

balanced scorecard: a tool used to analyze business performance that measures resources (learning and growth), processes (internal business), and markets (customer relations), relating all three to financial performance; an approach that the auditor can use for comparing the client firm with others in its industry

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EXHIBIT 6–7a The Balanced Scorecard

The balanced scorecard is a strategic planning and management system that is used extensively in business and industry, government, and nonprofit organizations worldwide to align business activities to the vision and strategy of the organization, improve internal and external communications, and monitor organization performance against strategic goals. It is a performance measurement framework that adds strategic nonfinancial performance measures to traditional financial metrics to give managers a more "balanced" view of organizational performance.

The balanced scorecard contains measures related to four perspectives: financial performance, customer relations, internal business processes, and measures related to learning and growth in the organization. Each of these is explained in the table below. An example of a balanced scorecard for a regional airline business follows:

BALANCED SCORECARD PERSPECTIVES	RELEVANT MEASURES
Financial	
To meet its financial goals, how should the organization report performance to its stakeholders?	Measures relevant to each business unit (e.g., revenues per employee for a sales unit, or research and development expense for a pharmaceutical division)
Customers	
To achieve its strategic goals, how should it relate to its customers?	Customer surveys, sales from repeat customers, and customer profitability
Internal business processes	
What business processes must the organization perfect to satisfy stakeholders and customers?	Measures specific operational processes of each business unit (e.g., investment in product development and dealer quality for a petroleum distributor)
Learning and growth	
To achieve its strategic goals, how will it sustain the ability to change and improve?	Employee capabilities, information systems capabilities, and employee motivation and empowerment

The scorecard is a strategic management tool that should reveal the drivers of performance as well as provide measures of performance.

EXHIBIT 6–7b Example of a Balanced Scorecard for a Regional Airline

Mission: Dedication to the highest quality of customer service delivered with a sence of warmth, friendliness, individual pride, and company spirit.
Vision: Continue building on our unique position—the only short-haul, low-fare, high-frequency, point-to-point carrier in America.

Simplified Strategy Map	Performance Measures	Targets	Initiatives
Financial: Increase Profitability; Lower costs; Increase Revenue	• Market Value • Seat Revenue • Plane Lease Cost	• 25% per year • 20% per year • 5% per year	• Optimize routes • Standardize planes
Customer: More Customers; On-time flights; Lowest Prices	• FAA On-Time Arrival Rating • Customer Ranking • No. Customers	• First in industry • 98% satisfaction • % change	• Quality management • Customer loyalty program
Internal: Improve Turnaround Time	• On Ground Time • On-Time Departure	• <25 minutes • 93%	• Cycle time optimization program
Learning: Align Ground Crews	• % Ground Crew Stockholders • % Ground Crew Trained	• yr. 1 70% • yr. 4 90% • yr. 6 100%	• Stock ownership plan • Ground crew training

Developed from material by the Balanced Scorecard Collaborative and Harvard Business Review (Kaplar & Norton).

Sources: ©1998-2011 Balanced Scorecard Institute, a Strategy Management Group company, http://www.balancedscorecard.org/Portals/0/PDF/Regional_Airline.pdf. Table @ 2008 Balanced Scorecard Institute, a Strategy Management Group company. All rights reserved. Do not copy without permission.

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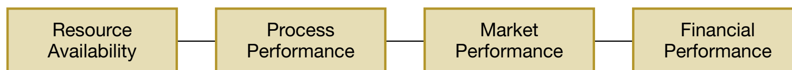
A key part of the nonfinancial performance analysis is determining if the resources available to the entity and the relative efficiency and effectiveness of the business processes are consistent with marketplace results. For example, a business entity is competing in a technological industry with a high rate of change. The entity does not have up-to-date equipment or top engineers (both examples of resources). Its business processes are benchmarked as below industry average in performance. Therefore, the entity should have below-average market performance in terms of market share or customer satisfaction. This pattern would reflect a set of consistent results and increase the auditor's confidence in the assessment of business risk.

Interrelationships between Financial and Nonfinancial Performance

The auditor considers whether the financial results and the nonfinancial performance measures each portray the same picture of the auditee's business. If the auditee's financial statements show increasing sales and increasing gross margins, there should be market share increases, resource advantages, or process efficiencies in the nonfinancial measures that support these financial results. If discrepancies are found, there is a risk of material misstatement, and additional substantive audit work may be needed to lower this risk to an acceptable level. This analysis also allows the auditor to consider going-concern uncertainties and other issues in completing the audit and forming an opinion.

The process of relating nonfinancial and financial performance can be illustrated with a simple theoretical model like the one in Exhibit 6–8. For example, consider an auditee company with limited financial resources and minimal investment in new production capability (Resource Availability). The company is producing its products with the technology that the company founder used 10 years ago. An analysis of the nonfinancial performance measures is made; for example, measures of machine downtime are increasing each year (Process Performance), the company's sales of the product remain as strong as in the last two years (Market Performance), but the financial statements show a lower percentage of repairs and maintenance expense to gross fixed assets than in previous years (Financial Performance). This is an inconsistency that needs to be resolved through additional substantive audit of details of repair expenses and additions to productive asset balances.

EXHIBIT 6–8 Relating Nonfinancial and Financial Performance



To determine the acceptable level of audit risk, business risk needs to be considered: the higher the auditee's business risks, the greater the need to report them accurately. At the same time, the higher the business risk, the higher is the engagement risk due to higher risk if misstated financial statements go out to users. That means the auditor will want to take less chance that the financial statements do not adequately communicate those business risks to users and decision makers. As explained earlier, when the auditor cannot take a lot of risk of giving a clean opinion on financial statements that are misstated, the auditor sets the acceptable audit risk at a low level.

Summary

The business risk–based approach to auditing starts with a business risk analysis that provides an understanding of the auditee's business, its environment, and the risks it faces. The auditor's strategic and business process analyses involve a critical assessment of the strategic goals of the business, the risks of not meeting those goals, and the process the entity's management uses to manage those risks. The auditor then examines the financial and nonfinancial performance of the entity to assess whether the performance reported in management's financial statements is consistent with the auditor's strategic and business process analyses. The link from the business risk to the financial statements is covered in the next section. Internal control, the main aspect of an entity's risk management process, and the auditor's procedures to understand risks related to internal control are discussed in the following section.

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REVIEW CHECKPOINTS

6-27 What are the activities in a financial performance analysis? When would the auditor design and carry out additional substantive audit procedures as a result of performance analysis?

6-28 What are the activities of nonfinancial performance analysis?

6-29 Why does the auditor examine the relationship between financial and nonfinancial performance measures?

ACCOUNTING PROCESSES AND THE FINANCIAL STATEMENTS

LO4 Outline the relationships among the business processes and accounting processes (or cycles) that comprise an organization's information system and management's general purpose financial statements.

After performing preliminary analysis of the financial statements and expanding this with an in-depth analysis of the entity's business risk, we can consider how management's financial statements are created with a more informed perspective. Two points need to be stressed about management's financial statements: (1) They are the responsibility of the organization's management; and thus, they contain management's assertions about economic actions and events; and (2) the numbers in them are produced by the organization's control system, which includes the accounting system that generates the trial balance. The relationship between the accounting system and the trial balance is shown in Exhibit 6–9, and the relationship between the trial balance and the financial statements is illustrated in Exhibit 6–10.[16] These exhibits show the trial balance of the Kingston Company, a fictional company that will be used in various examples throughout Parts II and III of this text.

The Kingston trial balance is shortened and simplified; real trial balances are more complex, with hundreds of accounts. To simplify the audit plan, auditors apply one of a fairly standard set of business processes, each of which has a set of accounts and an **accounting process** related to it. There are four simplified accounting processes:

accounting process: transactions streams and related account balances used to capture financial data about a business process in the accounting information system; also referred to as an *accounting cycle*

1. Revenue process dealing with accounting for the sales activities of the firm
2. Purchasing process dealing with accounting for purchasing
3. Production process dealing with accounting for manufacturing and inventory costing
4. Financing process dealing with the accounting for all the financing activities of the firm

An accounting process can be thought of as a cycle. The accounts go together in the accounting information system because they record transaction information from the same business activity and run through the same accounting process over and over, in a cycle. These routine transactions are recorded by the organization's accountants using journal entries involving the same set of accounts. The cycle perspective looks at accounts grouped according to the routine transactions by which all are normally affected. The revenue cycle starts with a sale and the recording of an account receivable, which is later collected in cash, provided for in an allowance for doubtful accounts, or written off. The typical journal entries used in the revenue cycle are as follows:

Dr. Accounts Receivable
 Cr. Sales Revenue
To record sales made on account

Dr. Cash
 Cr. Accounts Receivable
To record collection of receivables

Dr. Bad Debt Expense
 Cr. Allowance for Bad Debts
To provide for accounts receivable likely to be uncollectible

Dr. Allowance for Bad Debts
 Cr. Accounts Receivable
To write off uncollectible accounts receivable previously provided for

16 The term *amortization* is the general term for allocating capital asset costs over the years benefited. Historically and internationally, specialized names for amortization have evolved in practice. Depreciation is amortization applied to tangible capital assets, such as machinery and buildings, while the term depletion tends to be used for natural resources. In practice, amortization tends to be used in the more restricted sense of applying to intangible assets and premium or discount on long-term debt. For simplicity, in Exhibit 6–9 and thereafter, we treat all these allocations as specialized names for amortization.

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EXHIBIT 6–9 Kingston Company Trial Balance, December 31, 20X2

Revenue process	Purchasing process	Production process	Financing process		Debit	Credit
X	X	X	X	Cash	484,000	
X				Accounts receivable	400,000	
X				Allowance for doubtful accounts		30,000
X				Sales		8,500,000
X				Sales returns	400,000	
X				Bad debt expense	50,000	
	X	X		Inventory	1,940,000	
	X			Capital assets	4,000,000	
	X			Accum amortization		1,800,000
	X			Accounts payable		600,000
	X			Accrued expenses		10,000
	X			General expense	1,955,000	
		X		Cost of goods sold	5,265,000	
		X		Amortization expense	300,000	
			X	Bank loans		750,000
			X	Long-term notes		400,000
			X	Accrued interest		40,000
			X	Share capital		2,000,000
			X	Retained earnings		900,000
			X	Dividends declared	0	
			X	Interest expense	40,000	
			X	Income tax expense	196,000	
					15,030,000	15,030,000

Auditors find it easier to audit the related accounts with a coordinated set of procedures instead of attacking each account as if it stood alone, as predictable relationships should exist among these accounts. For example, if sales decrease but accounts receivable increase it may be a warning sign of financial difficulties. Also, the audit evidence available for one part of the accounting process often also contains information for other parts; for example, recording collection of a receivable involves recording the invoice information as well as the information about the cash collected. The cycle concept is part of the relation-based analytical procedures discussed in the following section.

In Exhibit 6–9, to illustrate the idea of the accounting processes, the Kingston accounts are put into an order not normally seen in a trial balance. Some accounts are in more than one process. For example, the cash account is represented in all the processes because (a) cash receipts are involved in cash sales and collections of accounts receivable (revenue process), (b) cash receipts arise from issuing shares and loan proceeds (finance process), (c) cash disbursements are involved in buying inventory and capital assets and in paying for expenses (purchases process), and (d) cash disbursements are involved in paying wages and overhead expenses (production process).

When placed in the financial statements, the accounts and their descriptive titles contain the assertions that are the focal points of audit procedures. Exhibit 6–10 carries the accounts forward to the financial statements. Exhibit 6–11 illustrates the relationships among business activities, accounting processes, and the financial statements. These accounting processes will be covered in more detail in Chapters 11 through 14.

To summarize the business process view of an organization, Exhibit 6–12 provides a big picture overview showing how all the entity's activities and business processes flow through to its financial statements.

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EXHIBIT 6–10 Kingston Company Unaudited Financial Statements

BALANCE SHEET

Cash	$ 484,000	Accounts payable	$ 600,000
Accounts receivable	370,000	Accrued expenses	10,000
Inventory	1,940,000	Accrued interest	40,000
Current assets	$2,794,000	Current liabilities	$ 630,000
Capital assets (gross)	$4,000,000	Long-term debt	$1,150,000
Accumulated amortization	(1,800,000)		
		Share capital	$2,000,000
Captial assets (net)	$2,000,000	Retained earnings	1,194,000
Total Assets	$4,994,000	Total Liabilities and Shareholder Equity	$4,994,000

STATEMENT OF INCOME

Sales (net)	$8,100,000
Cost of goods sold	5,265,000
Gross Profit	$2,835,000
General expenses	$2,005,000
Amortization expense	300,000
Interest expense	40,000
Operating Income Before Taxes	$ 490,000
Income Tax Expense	196,000
Net Income	$ 294,000

NOTES TO FINANCIAL STATEMENTS
1. Accounting Policies
2. Inventories
3. Plant and Equipment
4. Long-term Debt
5. Stock Options
6. Income Taxes
7. Contingencies
8. Etc.

CASH FLOWS

Operations:	
Net Income	$ 294,000
Amortization	300,000
Decrease in Accounts receivable	90,000
Increase in Inventory	(440,000)
Increase in Accounts payable	150,000
Decrease in Accrued expenses	(40,000)
Decrease in Accrued interest	(20,000)
Cash Flow from Operations	$ 334,000
Investing Activities:	
Purchase Capital assets	$ (1,000,000)
Financing Activities:	
Bank Loan	$ 750,000
Repay Notes payable	(200,000)
Financing Activities	$550,000
Increase (Decrease) in Cash	$ (114,000)
Beginning Balance	600,000
Ending Balance	$ 484,000

REVIEW CHECKPOINTS

6-30 What are four of the major accounting processes? What accounts can be identified with each? Why can an accounting process be described as a cycle?

6-31 Why is the cash account involved in more than one accounting process?

6-32 Why do auditors tend to find it easier to look at accounting processes rather than individual trial balance accounts?

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EXHIBIT 6–11 Relationships among Business Processes, Accounting Processes, and Financial Statements

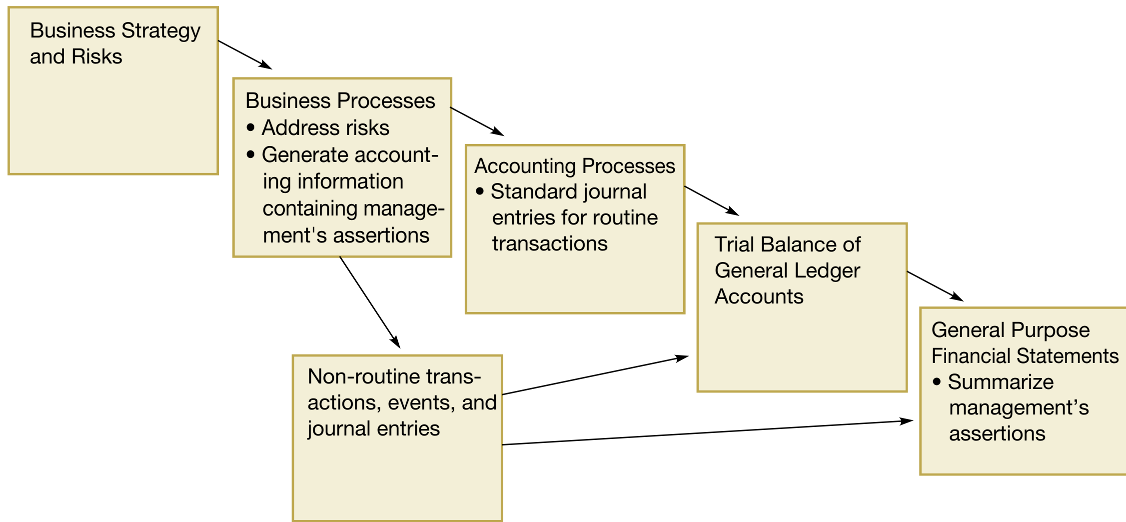
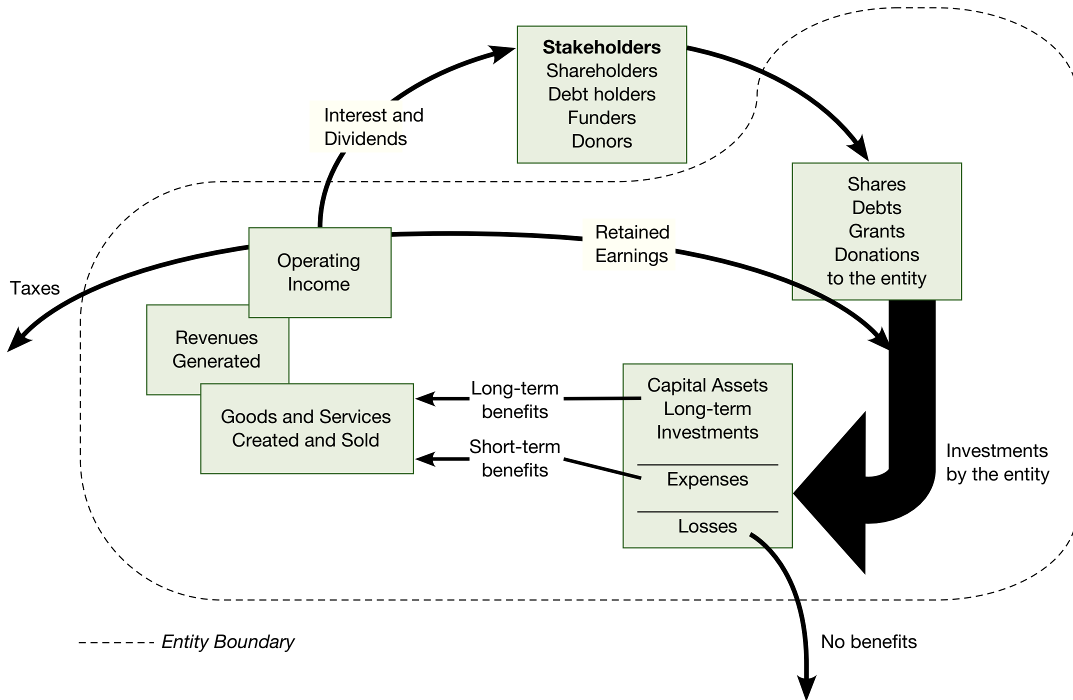


EXHIBIT 6–12 Capturing an Organization's Business Processes in its Financial Statements



BUSINESS RISK AND THE RISK OF MATERIAL MISSTATEMENT

LO5 Illustrate how business risk analysis is used to assess the risk of material misstatement at the financial statement level and at the assertion level.

The ultimate objective of a financial statement audit is to render an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework (e.g., GAAP). The term "material" in auditing refers to a misstatement that is significant enough to affect a decision that someone might make that could be affected by the financial statement information, as explained in Chapter 5. That is, a misstatement is material if it could lead someone to make the wrong decision and suffer

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a loss from it, when they probably could have made a good decision if they used information that was not misstated. To determine the risk that the financial statements could be materially misstated, the auditor learns about management's understanding of the business and its risks, and independently assesses the business risk and management's risk assessment process. This section describes a process the auditor may use to make this risk assessment.

The auditor knows that management has to take certain risks to achieve rewards in the marketplace. Those are the risks management accepts from being in business; in effect, these risks are tolerated on a cost-benefit basis. Risks can be managed in any of four ways:

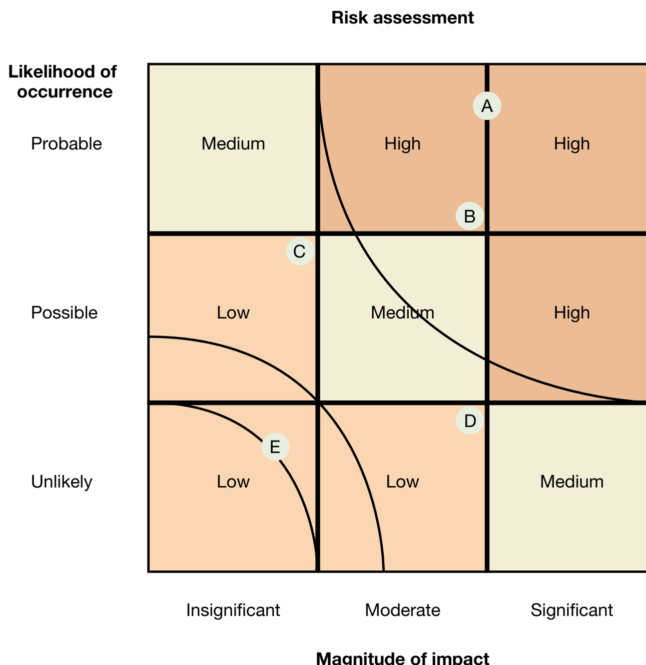
1. Avoided by not performing those business activities that would cause the risk to occur
2. Monitored to ensure costs continue to be less than benefits
3. Reduced to an acceptable level via management controls embedded in business processes
4. Transferred to another party via a contract (e.g., insurance)

After understanding the business risks, the auditor needs to consider which risks are high. He examines two factors in this analysis: the likelihood the risk will occur and the magnitude of the risk. Each risk is qualitatively judged according to a three-point scale on likelihood of occurrence (unlikely, possible, or likely) and magnitude of risk (insignificant, moderate, and significant). When considered together, these two assessments allow the auditor to classify a risk as low, medium, or high.

Exhibit 6–13 is a graphical representation of an auditor's risk assessment process. For example, point A indicates a business risk that will probably occur and, if so, will have a significant effect. Therefore, the auditor would classify point A as a high risk. Using a smartphone company such as Apple as an example, point A could be the risk of technological obsolescence of iPhones. Point E indicates a business risk that is unlikely to occur, and if it did it would be insignificant in size. Hence, the auditor would classify this risk as low. For a smartphone company, point E might be the risk that it will be required to change its packaging materials to comply with new environmental regulations.

Most business risks are managed through an effective risk-management process and well-designed business processes, although some fall into the transferred category. The auditor considers any of the risks that might prevent the entity from carrying out its processes

EXHIBIT 6–13 Initial Risk Assessment



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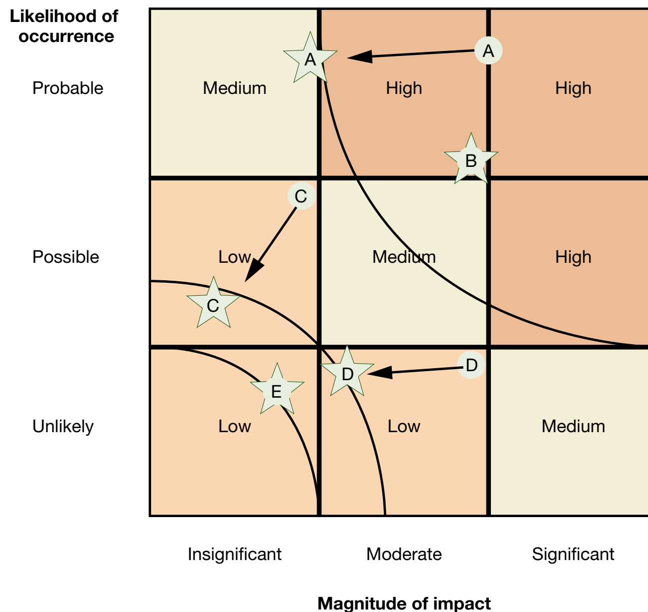
effectively, and then identifies the risk management techniques in place to ensure efficient and effective functioning of those business processes. The risk-management process can be broadly defined as the elements of an organization, including its resources, culture, structure, processes, systems, and tasks, that work together to help its people achieve the organization's objectives. See Exhibit 6–14 for examples of risk management techniques.

EXHIBIT 6–14 Examples of Risk Management Techniques

- Budget systems
- Forecasting systems
- Physical measures of process performance (e.g., defect rates)
- Quality enhancement programs
- Performance indicators (both financial and nonfinancial)
- Process monitoring activities
- Accounting internal controls

The auditor can consider these risk management techniques by determining if the key performance indicators are effective at controlling the process and if management is actually using these techniques. At this point, the auditor makes a preliminary assessment of whether the risk management process is appropriate for producing reliable financial statements. The auditor then evaluates the results that effective risk management has had on the original risk analysis. Exhibit 6–15 shows the auditor reassessing business risk after examining management's risk reduction process. The auditor has reclassified point A from a high risk to a medium-to-high risk. For the smartphone company example, say, the auditor finds the company's product development process is effective in staying ahead of the technological developments in the industry, and its sales forecasting is linked closely to production to ensure slow-moving models are taken out of production quickly. This lowers the assessed risk of obsolescence in the inventory valuation assertion. Note, however, that controls did not reduce the risks associated with point B. Point B might be the risk that smartphone production equipment assets will not last as long as planned. If the management has not addressed this risk, it increases the risk that the value of those assets is impaired. Risks that

EXHIBIT 6–15 Risk Assessment after Considering Management Controls



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are not moved into the low category by management controls represent categories for which the controls fail to reduce the risks that the financial statements do not portray the actual business performance. These are areas that need to be audited with the greatest care.

To illustrate how risk assessment works in practice, let us consider the case of a business in the food manufacturing industry. The story in the box below illustrates the kinds of risks that a food manufacturing company has to manage, and the potential financial impact.

BUSINESS RISK IN THE FOOD INDUSTRY

On Sunday, August 17, 2008, Canada's largest food processing company announced it was recalling two types of packaged roast beef products because of concerns they may have been contaminated with bacteria known as *Listeria monocytogenes.* By August 29, there were 29 confirmed and 35 suspected cases of Listeriosis, 9 confirmed deaths, another 6 deaths under investigation, and more than 200-different products pulled from store shelves across the country. Ultimately, the deaths of 20 people were attributed to this outbreak.

Consumption of food contaminated with *Listeria monocytogenes* may cause Listeriosis, a food-borne illness that can be fatal in as many as one in three cases. Listeria is very common in the environment, and fortunately it is not dangerous to most people. Very young children, the elderly, pregnant women, and people with weakened immune systems are at the greatest risk. Listeria is a particular concern in refrigerated meat-packing plants because, unlike other types of bacteria, it has adapted to survive in colder temperatures. Using a genetic identification technique called *pulsed field gel electrophoresis,* health officials were able to match the strain of Listeria people got sick from to meat products produced in Maple Leaf's Toronto plant.

Recalls can be disastrous for a company that processes food, potentially damaging its brand equity and sales volumes, but they are not uncommon. The Canadian Food Inspection Agency website lists dozens of recalls and alerts. Maple Leaf's president is credited with saving his company from ruin by responding quickly and candidly. He held news conferences and accepted responsibility for the situation, noting that the company has excellent systems and processes in place, but that in this crisis its best efforts had failed to ensure food safety. He stressed that the company's priority at this time was not cost or market share, its priority was to do the right thing for its customers. The Toronto plant was immediately shut down to be fully sanitized and all aspects of the processing system were examined by outside experts. It voluntarily expanded the recall of products manufactured at in this plant (Establishment No. 97B) as a precautionary measure.

The company reported that its protocol is to test the Toronto plant's surfaces for contamination 3000 times a year. If any contamination is found, the area would be sanitized and then retested until three negatives in a row are found. While positive results for Listeria inside a food plant are common, the president told reporters at the time that nothing out of the norm had been reported in the period leading up to the outbreak in the Toronto plant.

Stock market analysts who cover Maple Leaf remained positive about the company in the midst of the crisis, finding the company's transparency and prompt handling of the situation to be consistent with best practices in crisis management and corporate public relations. Reported estimates indicated the company spent around $5 million to deal immediately with the crisis, the company's massive recall is thought to have cost $20 million, and the potential class action suits may have cost even more.

Maple Leaf's trend to consolidate into larger processing plants can be a strength as new efficiencies can be leveraged. On the other hand, it can sometimes create a weakness, especially when something like a Listeria outbreak occurs. Centralization can increase the impact of a bacterial outbreak because any breakdown in control can affect more products. Instead of recalling 20 or 30 products, Maple Leaf had to recall hundreds that may have been affected.

Improvements in information technology that allow products to be tracked through a meat-packing plant have made recalls more effective in the meat industry. A bar code is given to each individual cut, and it can be used to trace back to the animal and the farm it came from. This can help companies to manage food safety risks. This also can help reassure the public, as many customers can now be expected to look for greater assurance about where their food originates.

While Maple Leaf was able to weather this storm, future challenges are always waiting ahead. In 2010, the company undertook an ambitious $1 billion plant modernization plan, closing down many old plants and making strategic investments in building new ones, such as the massive bakery opened in Hamilton in September, 2011. A rising Canadian dollar against the U.S. currency had a significant impact on its sales and profitability. In 2011, unprecedented global food inflation resulted in skyrocketing prices for corn and wheat, the main raw materials for many Maple Leaf products. Food prices were up 4.4% in August, including a 5% jump at stores, according to Statistics Canada. Both are a serious concern for the company—one that consumers will have to help bear.

Michael McCain, chief executive with Maple Leaf Foods Inc., said, "We have the ability to pass on that inflation through responsible pricing in the marketplace and we have done that. We do it responsibly. We look for every opportunity to reduce costs first." These issues also serve to emphasize why Maple Leaf needs to spend heavily to modernize its business lines.

Sources: Steve Buist, "from food recall to deadly outbreak," *The Hamilton Spectator,* August 30, 2008, p. A01; Robert Cribb, Record News Service, "Listeriosis reporting rule dropped before deadly outbreak," *Waterloo Region Record,* October 6, 2008, p. A1; "Maple Leaf expands product recall from Toronto Plant as a precautionary measure," *Market News Publishing,* August 25, 2008; Peter Epp, "Food origin questions arise again," *Chatham This Week,* September 3, 2008, p. 6; CP Toronto, "Maple Leaf Foods CEO admits even after intensive sanitization of the plant, 'We will never, never eliminate it . . .,'" *London Free Press,* October 10, 2008; Eric Lam, "Higher food inflation to force Maple Leaf to raise prices," FinancialPost.com, September 28, 2011 at http://business.financialpost.com/2011/09/28/high-food-inflation-to-force-maple-leaf-to-raise-prices/.

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As the story shows, a food manufacturing company's success depends on delivering wholesome, tasty foods at reasonable prices for consumers and at a cost that ensures the company remains profitable. Since food products spoil very easily, if management does not implement effective controls, the risk of delivering spoiled food would be assessed as probable. Since spoiled food can make people ill, and even be fatal, this risk would have very significant negative impact on the company. In the risk assessment matrix, this risk would be assessed as high. It would affect the financial statements because of the product liability contingency if consumers decide to sue the company; this risk relates to the liabilities completeness assertion. If the brand reputation is damaged, this could even result in the company's being unable to continue as a going concern; this risk is at the overall financial statement level.

Management's risk assessment needs to ensure appropriate control techniques are embedded in the business processes; in the Maple Leaf case, this includes its safety inspection protocols and its product identification and tracking processes. The company also uses insurance as a risk transferring management tool, though it is unlikely that all its risks can be fully insured because of the uncertainty of when food contamination or other business risks might occur. The auditor of a food manufacturing company would look for strong management controls related to these risks and would obtain first-hand information to verify them. If strong controls are in place, the assessed risk would be lower. How much lower? This is a judgment call, but there is so much uncertainty about these risks it is unlikely it can be reduced below a moderate level.

Another business risk in this industry, and in many others, arises from the use of commodity product as raw materials. Commodity prices fluctuate significantly, making it difficult to budget accurately. This can result in cost overruns that make inventory costs higher than market values, affecting the financial statement inventory valuation assertion. A risk management technique to reduce this risk is entering forward contracts with fixed prices for commodities, effectively transferring this risk to the other party in the contract.

Summary

In the business risk–based approach to auditing, the auditor must understand the auditee's business risk and its management risk assessment processes and control techniques to assess the risk of material misstatement in the financial statements overall and at the assertion level. The examples above illustrate how business risk and control are linked, and how auditors develop a full understanding of the auditee's business by considering them together. To provide a better understanding of the procedures companies use to implement control over financial reporting, the next section of the chapter gives an overview of the entity's internal control structure. Here, we start thinking about designing audit work so that it gives reasonable assurance that the financial statements are not materially misstated.

REVIEW CHECKPOINTS

6-33 How can business risks be managed?

6-34 What is the relationship between business risks and business processes?

6-35 What are some examples of management controls? What are the purposes of management controls?

6-36 Why does the auditor consider management's controls of business processes?

6-37 How does business analysis relate to the auditor's goal of assessing the risk that the financial statements might be materially misstated?

UNDERSTANDING INTERNAL CONTROL

So far, this chapter has covered the business risk–based approach to auditing by explaining the audit risk model and how auditors analyze the auditee's business risk to assess the risk of material misstatement. This is the most challenging part of financial statement auditing, requiring integration of complex concepts and the application of professional

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judgment. Congratulations for sticking it out to this point in the chapter! The chapter has also stressed that business risk and internal control are so tightly linked that auditors need to consider them together. At this point in an audit, the audit team would begin considering internal control in relation to their understanding of the business risk in order to assess the risk of material misstatement for the purpose of designing audit procedures that respond appropriately to the assessed risks. For study purposes, we will conclude this chapter's discussion of risk and control by giving an overview of internal control as it exists in most organizations, and then consider how internal control relates to the risk that the financial statements are materially misstated. In Chapter 7, we will give specific consideration to the risk of misstatement due to fraud (intentional misstatements). In Chapter 8, we will introduce you to some key audit tools: the concepts of evidence and the types of audit procedures used to gather it. These procedures are designed in response to the auditor's assertion-level risk assessments. With these tools in hand, you will be ready for Chapter 9, where we will discuss how auditors assess control risk and test controls.

LO6 Describe the five components of the internal control framework: the control environment, management's risk assessment process, information systems and communication, control activities, and monitoring.

Internal Control Framework and Its Components

For financial statement audit purposes, internal control is defined as the process designed, implemented, and maintained by management and other auditee personnel to provide reasonable assurance about the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The auditing standards CAS 315, paragraph A51, describes internal control. An overview of COSO's internal control framework is given in Exhibit 6–16; in this text we focus on the financial reporting part of this framework.

STANDARDS CHECK

CAS 315

A51. The division of internal control into the following five components, for purposes of the CASs, provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit:

(a) Control environment;
(b) Entity's risk assessment process;
(c) The information system, including the related business processes relevant to financial reporting and communication;
(d) Control activities; and
(e) Monitoring of controls.

The division does not necessarily reflect how an entity designs, implements and maintains internal control, or how it may classify any particular component. Auditors may use different terminology or frameworks to describe the various aspects of internal control, and their effect on the audit than those used in this CAS, provided all the components described in this CAS are addressed.

Source: *CICA Handbook—Assurance,* 2012.

These components provide a useful basis for considering how different aspects of an entity's internal control may affect the financial statements. Control components (a), (b), (c), and (e) of CAS 315, paragraph A51, shown, comprise the **company-level controls**. These controls permeate the organization and can have a big impact on whether its financial reporting and disclosures objectives are met. As discussed earlier, control component (b) includes the risk assessment processes and management control techniques implemented to assess adherence to management policy, promote operational efficiencies, and address strategic risks. The auditor's examination of these management risk assessment processes and controls are particularly useful for identifying accounting items with the highest risk of material misstatement. As discussed in Chapter 5, these are areas that will be flagged in the overall audit strategy as "significant risk areas" or "key audit issues" for the purpose of planning the resources required to do the audit.

company-level controls: internal control framework components that permeate the organization and affect the quality of its financial reporting and disclosures, consisting of the control environment; entity's risk assessment process; the information system, including the related business processes, relevant to financial reporting, and communication; and monitoring of controls

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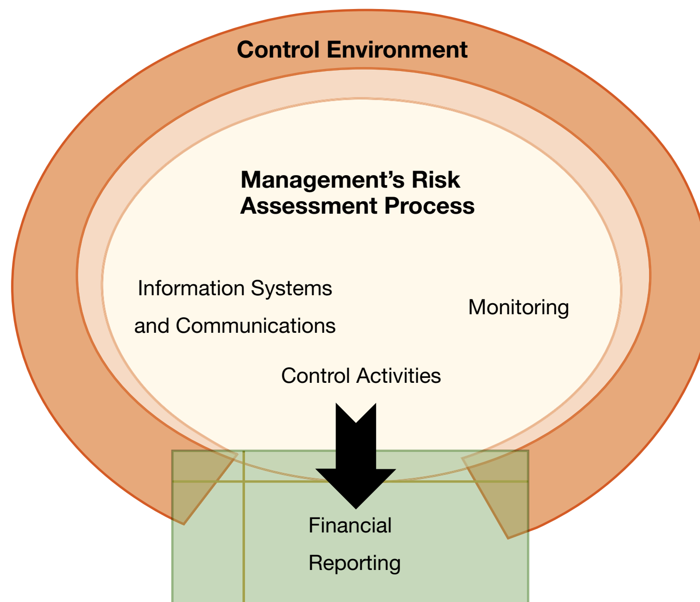
EXHIBIT 6–16 Internal Control Framework—Overview



control activities: specific company procedures designed to control processes, transactions, and applications that affect accounting information; consisting of general control activities and application-based control activities

Component (d), the **control activities**, are controls over processes, applications, and transactions more closely related to accounting information; these are the internal controls most relevant to the audit. The auditor is primarily interested in how these accounting control activities help a company safeguard its assets and prepare financial statements in conformity with generally accepted accounting principles.[17]

Audits of small entities may require different control considerations than audits of large ones do. In a small entity, there is a concentration of ownership and management in one person or a small number of people. There are likely also few sources of income, unsophisticated record keeping, and limited internal controls, together with the potential for management override of controls.[18]

The five control components are illustrated in Exhibit 6–16, and further described below, and in Appendix 6B. Special internal control considerations of small entities are also addressed. Exhibit 16–17 (Control Framework for Risk Assessment) summarizes the key elements of the company-level controls that drive the effectiveness of the control activities.

Control Environment

Management's and directors' attitudes, awareness, and actions concerning the company's internal controls set the tone for the control environment. The way that integrity and ethical values are communicated and enforced in the company are also part of the control environment because the controls cannot be more effective than the integrity levels and ethical values of the people who create, administer, and monitor them. Management must act to remove or reduce incentives and temptations motivating people in the organization to act unethically. It must assess requisite skills and knowledge for particular jobs, ensuring that people in those positions are competent. Directors or others charged with governance of the organization should be independent from management and experienced and knowledgeable

17 As noted in previous chapters, the regulations in SOX 404 and PCAOB Auditing Standard 5 for audits of management's internal control reporting and the similar standards now introduced in Canada for audits of control effectiveness (*CICA Handbook*, "An Audit of internal control over financial reporting that is integrated with an audit of financial statements") require the internal control assessment at the company level and the control activity level.

18 CAS 315, paragraphs A46, A49 and A50.

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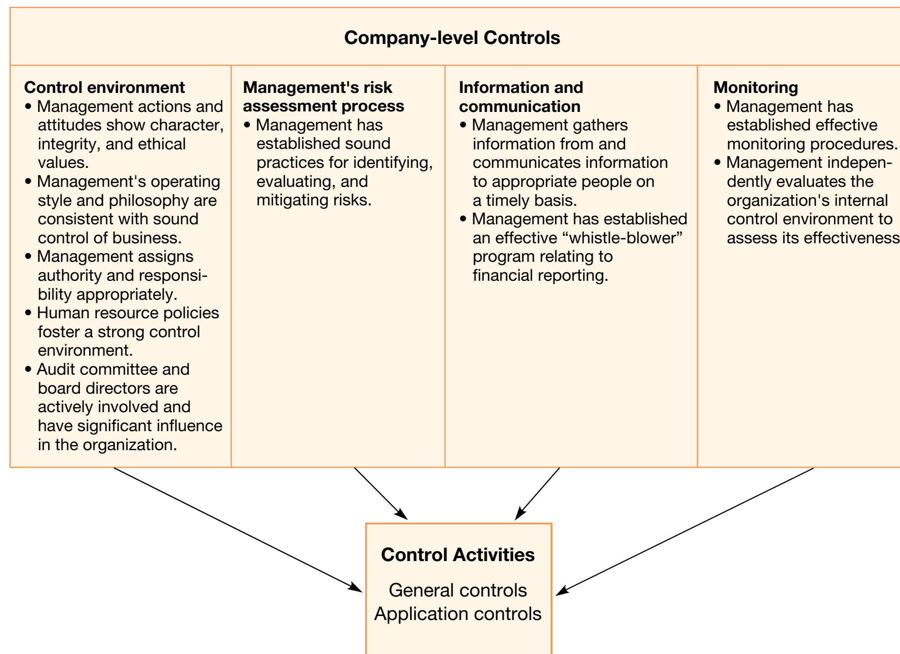
EXHIBIT 6–17 Control Framework for Risk Assessment



Source: Adapted from J. S. McNally, "Assessing company-level controls," *Journal of Accountancy* 199 (6), June 2005, pp. 65–68. © 2005 by the American Institute of Certified Public Accountants Inc. All rights reserved. Used with permission.

enough to pursue difficult questions with management as well as internal and external auditors. They should be responsible for the design and effective operation of whistle-blower procedures, and engaged in a process for assessing internal control effectiveness.

Management's approach to taking and monitoring business risks, attitudes toward financial reporting (conservative or aggressive selection of accounting principles and use of accounting estimates), and controls are critical to the strength of the control environment. To set the right example, management should react immediately and appropriately to control violations. Clear policies relating to appropriate business practices, knowledge and experience of key personnel, and resources for carrying out duties should be in place. Policies should ensure that all personnel understand the entity's objectives, know how their individual actions interrelate, contribute to those objectives, and are aware of what they will be held accountable for.

The control environment is concerned with management attitudes, structure (organization chart), effective communication of control objectives and supervision of personnel and activities, as noted previously. The elements of internal control environments are summarized in the following box.

KEY ELEMENTS OF THE INTERNAL CONTROL ENVIRONMENT

- Management's philosophy and operating style
- Entity's organization structure
- Functioning of the board of directors, particularly its audit committee
- Methods of assigning authority and responsibility
- Management's monitoring methods, including internal auditing
- Personnel policies and practices
- External influences (e.g., examinations by bank regulatory agencies)
- Control environment for information systems, which includes the organizational and logical controls of system development, access to computers and computer files, authorization of changes to program and data files, storage and maintenance of data, and emergency planning for backup and recovery of systems and data

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Two categories of controls are preventive controls and detective, controls. Generally, environmental controls can be characterized as preventive controls, since they are there to prevent misstatements from arising in the first place. Preventive controls are more effective than controls designed to detect and correct misstatements after they have entered the system. Auditors tend to focus their preliminary evaluation on environmental controls for this reason and also because they have such a pervasive impact on the accounting processes affected.

Since the mid-1980s when management fraud in financial statements became an acceptable topic for discussion, "tone at the top" has become a catchphrase for the foundation of good internal control; company tone is virtually identical to control environment. A wide variety of activities characterize the control environment, some of them obvious, such as who has the immediate responsibility to authorize payments in payroll processing. Other aspects of the control environment, such as management's philosophy, are hard for auditors to understand and document. The following box illustrates some criteria to consider in evaluating the human factor in the control environment.

TONE AT THE TOP

All control rests ultimately on people assuming responsibility for their decisions and actions. Organizational values that people find acceptable encourage them to assume responsibility for the continuous improvement of their organization.

Shared ethical values influence all behaviour in an organization. Together with an understanding of mission and vision, they constitute the basic identity that will shape the way an individual, group, organization, or board will operate, and they provide stability over time. Shared values contribute to control because they provide a guide for individual, group, or team decision making, action, and policy.

The values and preferences of senior management and the board of directors greatly influence an organization's objectives and systems. These values and preferences address issues such as:

- Good corporate citizenship
- Commitment to truth and fair dealing
- Commitment to quality and competence
- Leadership by example
- Compliance with laws, regulations, rules, and organizational policy
- Respect for the privacy of auditee, organization, and employee information
- Fair treatment of and respect for individuals
- Fair relationships with competitors
- Integrity of transactions and records
- A professional approach to financial reporting

Ethical values are part of an organization's culture and provide an unwritten code of conduct against which behaviour is measured. A formal written code of conduct offers a means for consistent communication of the standards of ethical behaviour. People can periodically be asked to confirm their understanding and observance of the code.

Source: CoCo, *Guidance on Control* (November 1995), pp. 14–15.

The board of directors and the audit committee are critical corporate governance elements of high-level internal control. Among the board's key functions is monitoring that traditionally least-monitored group of employees—top management. In the wake of the Enron and other accounting scandals, the role of the board and audit committee in monitoring management and financial reporting rose to unprecedented levels. The audit committee, usually a subcommittee of the board's members, helps the board by overseeing the financial reporting as well as external and internal auditing functions. The audit committee's prime role is to act as intermediary between management and the auditor in the external audit, helping make it function more independently. Appendix 6E on Connect further explains the traditional responsibilities of the board and audit committee, as well as their expanded corporate governance responsibilities in today's environment.

Small entities may use the control environment elements differently than larger entities; for example, rely on oral communication and personal relations to establish ethical standards, rather than use more formal methods. Directors of small entities are less likely to be independent of management, and owners are more likely to be involved in managing day-to-day operations.

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Management's Risk Assessment Process

As explained earlier, management's risk assessment process is used to identify risks relevant to misstatements occurring in the preparation of financial statements and to estimate the risks' significance and likelihood. This is the starting point of the auditor's business risk analysis discussed at the start of the chapter. It helps management to decide how to manage the business risk efficiently and effectively. Risks can arise or change with changing circumstances, so risk assessment is a continuous process. The operating environment, personnel changes, growth, new technologies, new business lines, structural changes in the organization, and new accounting pronouncements can affect the risk assessment.

Even small entities are expected to have a risk assessment process, but it is likely to be quite basic and informal. Management may be aware of risks related to financial reporting mainly through personal involvement with employees and outside parties.

Information System, Related Business Processes, and Communication

An information system can be broadly defined as a set of interrelated functions that collect, process, store, and distribute information in an organization. They are used to support management decisions and to help people in the organization perform analysis, develop models, collaborate on projects, and create knowledge. An information system has three main activities: input, processing, and output. The input is mainly data, the raw facts collected from the environment. Processing coverts data into output in an understandable and useful form referred to as information. Many information systems are highly automated, making extensive use of IT. The components of an information system consist of hardware, software, people, procedures, and data.

Information Systems and Business Processes

The information system is related to all of the key business processes. It is important that the auditor understands how the information system relates to financial reporting, and how it is used to communicate information within the organization. In organizations with enterprise resource planning systems, the information inputs and outputs from many or all the business processes will be processed in an integrated manner, so the accounting component of the information system will be closely related to many other functional areas, such as sales, inventory, human resources, cash management, and so on. Within the business process view, logical links exist between information generated in various processes and the accounting component of the information system.

The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and in preparing reliable financial reports. The auditor needs to understand how the auditee's information system is used in its financial reporting process, and identify the risk associated with IT use. Financial reporting objectives rely on information system procedures and records established to initiate, record, process, and report entity transactions (and events and conditions) as well as to maintain accountability for the related assets, liabilities, and equity.[19]

Communication

Communication helps ensure that information system control procedures are implemented correctly and exceptions are reported and acted on appropriately. Good communications procedures help ensure that important tasks do not just "fall between the cracks" because no one was sure whose job it was to do them.

The auditor must understand how the information system facilitates communications within the organization, in particular those aspects that relate to implementation of internal control. Internal control involves activities, policies, and procedures ensuring that threats that may prevent the business from achieving its strategy are addressed. Control activities occur within both IT and manual processes, have various objectives, and are applied at

19 Stay tuned: These functions will be discussed in detail in Chapter 9.

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various organizational and functional levels; thus, effective communication is essential for internal control to work properly.

Open communications enhance internal control effectiveness. Employees involved in financial reporting must understand their individual roles and responsibilities in implementing internal control, as well as how their activities relate to the work. Communications policies show the importance of employees reporting and acting on control exceptions immediately, and establish appropriate channels for reporting these to appropriate levels within the organization. Communication media include accounting and financial reporting manuals, policy manuals, and internal memoranda. Communications can be performed electronically, orally, and through management's actions.

Business processes and information systems in small entities are likely to be less formal than in larger organizations, but they are just as important. In small entities, accounting procedures, records, or controls may not be in writing but will exist informally if the organization has a good risk assessment process and related internal controls. If management is highly involved in the business processes, there may be no need for extensive written descriptions of company policies or accounting procedures. Communication also may be less formal and easier to achieve as fewer people are involved and management tends to be more accessible to other employees than is the case in a larger, more hierarchical organizations.

REVIEW CHECKPOINTS

6-38 What are the five basic components of internal control?

6-39 What are the basic functions and components of an information system? How do information system functions relate to financial statement assertions?

6-40 How does the information system facilitate communication within an organization? Why is this communication important?

6-41 What are some of the important characteristics of "tone at the top" and control environment?

6-42 Are environmental controls preventive or detective/corrective? Explain.

Accounting Control Activities

general controls: organizational features that have a pervasive impact on accounting processes and applications and the effectiveness of application-level control procedures

application controls: control procedures performed at the application level relating to input, processing, and output of the accounting information system

Companies have many policies and procedures that help achieve and ensure necessary actions are taken against risks threatening the entity's financial reporting objectives. As explained previously in this chapter, the auditor uses a control framework to understand and evaluate the auditee's internal control. Control policies and procedures make up the control activities component of the company's control framework. All control procedures are directed, one way or another, toward preventing or detecting, and correcting, misstatement that may arise due to error or fraud. Note that detection controls must always be accompanied by corrective actions in order to be effective. The two broad groups of accounting control activities are **general controls** and **application controls**. These will be introduced briefly here and described in more detail in the context of testing controls in Chapter 9.

General Controls

General controls include organizational features, such as capable personnel, segregation of responsibilities, controlled access, and periodic comparison. Like environmental controls, general controls are primarily preventive and have a pervasive impact on the various accounting processes. For these reasons, auditors' preliminary evaluation of internal controls tends to focus on environmental and general controls.

Application Controls

Application controls are viewed in terms of whether they relate to input, processing, or output of the accounting system. They help ensure that all recorded transactions really occurred, are authorized, and are completely and accurately entered and processed through the system. The different accounting processes—revenues/receivables/receipts, purchases/payables/payments, production/payroll, and investing/financing—will each have their own

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risks that lead to errors or make the business susceptible to fraud or other illegal acts. Thus, specific control procedures are designed to address the risks and control objectives for each accounting process.

Examples of application controls include:

1. Authorization checks prior to data input
2. Arithmetical checks of the accuracy of records
3. Maintenance and review of accounts and trial balances
4. Automated information processing controls such as validity checks of input data and numerical sequence checks
5. Manual follow-up of exception reports

Application controls are explained in more detail in Chapter 9, where we look at control testing, and in Chapters 11 through 14, where they form part of the detailed audit programs applied to the accounting processes.

Higher-level policies established by management or those charged with governance are the basis for certain control activities. For example, authorization controls may be delegated under established guidelines or under non-routine transactions, such as major acquisitions may require specific high-level approval, in some cases that of shareholders. This further illustrates the relationship between the control environment, other company-level controls, and the specific control activities that auditors may test and rely on for audit evidence purposes.

Control activities in small entities are likely to be similar to those in larger entities, but less formal. Certain types of control activities may not be relevant in a small owner-managed entity because of controls applied by management. For example, if management retains authority for approving credit sales, significant purchases, and draw-downs on lines of credit, this can provide strong control over those activities, reducing the need for more structured control activities. Note, however, that in a less structured control system, the risk of management overriding controls is greater, which auditors need to consider when assessing fraud risk. An appropriate segregation of duties often presents difficulties in small entities. Even companies with only a few employees, however, may be able to assign responsibilities so that there is appropriate segregation or, if that is not possible, use management oversight of the incompatible activities to achieve control objectives.

Monitoring Controls

An important management responsibility is establishing and maintaining internal control on an ongoing basis. This includes considering whether controls are operating as intended and modifying them as appropriate for changes in conditions. It may include reviews of the timeliness of bank reconciliations, evaluation of sales personnel's compliance with entity policies by internal auditors, and oversight of compliance with entity ethical or business practice policies by the legal department.

Monitoring of controls assesses the quality of internal control performance over time and involves considering the design and operation of controls, including taking necessary corrective actions to ensure their continued effective operation. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them. Monitoring of controls is accomplished through ongoing monitoring activities, separate evaluations, or a combination of the two.

These activities are built into an entity's regular, recurring activities and include regular management and supervisory activities. Managers of sales, purchasing, and production at divisional and corporate levels stay in touch with operations and question reports that differ significantly from what they know of operations. Internal auditors or personnel performing similar functions may contribute to the monitoring of an entity's controls through separate evaluations of the design and operation of internal control. They communicate information about strengths, weaknesses, and recommendations for improving internal control.

Information from external parties may be part of monitoring activities, if it indicates problems or highlights areas in need of improvement. Customers corroborate billing data by either paying their invoices or complaining about their charges. Outside regulators may communicate with the entity concerning matters affecting the functioning of internal

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control, for example, examinations by bank regulatory agencies. Management monitoring activities may consider information relating to internal control from external auditors.

Ongoing monitoring activities of smaller entities are likely to be informal and performed as a part of the overall management of the entity's operations. Through close involvement in operations, management might identify significant variances from expectations and inaccuracies in financial data, and ensure corrective action is taken.

REVIEW CHECKPOINTS

6-43 What is the auditor's main purpose in understanding the auditee's internal control system?

6-44 What are monitoring controls?

6-45 Distinguish among the control environment, general controls, and application controls.

6-46 What organizational features can act as general controls?

6-47 What is the purpose of application controls? How does it differ from the purpose of general controls?

HOW INTERNAL CONTROL RELATES TO THE RISK OF MATERIAL MISSTATEMENT

LO7 Explain how the auditor's understanding of an organization's internal control helps the auditor to assess and respond to the risk that its financial statements are misstated.

Audit work related to internal control involves understanding control in the context of the business and its risks, assessing significant risks of financial statement misstatement, and performing tests of controls if needed to further assess risks or provide audit evidence. This section discusses how the auditor's understanding of internal control helps in assessing the overall risk of material misstatement. It reviews the key components of internal control, with a particular focus on the controls that relate to financial reporting and disclosure.

As discussed above, the internal control framework includes company-level controls (control environment, risk assessment process, information systems and communication, and monitoring) and control activities (general and application). Exhibit 6–16 showed how these components are related and work to support each other.

To assess the risk of material misstatement at the financial statement level, the auditor needs a detailed knowledge of internal control components relevant to financial reporting; these components are the control environment elements that affect financial reporting, and the information system.

The auditor gains knowledge mainly by making enquiries of auditee personnel. This provides an understanding of the flow of transactions through the accounting information system and the elements of the control environment that affect it. The auditor gathers information about the following features: (a) the organizational structure; (b) the methods used by the auditee to communicate responsibility and authority; (c) the methods used by management to supervise the accounting information systems, including the existence of an internal audit function; and (d) the accounting information system. A questionnaire is sometimes used to guide the enquiries. An example of a questionnaire summarizing some key questions an auditor asks is provided in Exhibit 6–18. It is important to note that, while standardized questionnaires and other audit forms are helpful starting points, the auditor must always use care to adapt them to the specific circumstances of the auditee's business and risks, by adding any missing considerations and omitting any items that are not applicable to the engagement.

Through the enquiries noted in Exhibit 6–18, the audit team gains an understanding of the control environment, the accounting information system, and the flow of transactions. Auditors consider the auditee's methods for processing significant accounting information, including the use of outside organizations such as data-processing service centres. The auditee's methods influence the design of the accounting system, the nature of its control procedures, and the extent to which its internal control effectively reduces its financial reporting risks. This, in turn, affects the auditors' assessment of the risk of material misstatement and how they plan to conduct their audit.

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EXHIBIT 6–18 Internal Control Questionnaire

	RESPONSE/FILE DOCUMENTATION REFERENCE
Purpose: This questionnaire is used to document information gathered through enquiries about the key internal control elements related to financial reporting. This information supports an assessment of the risk of material misstatement at the overall financial statement level.	
Consider the effectiveness of the following internal control elements to reduce the risk of material misstatement of the financial statements. Consider the impact of internal control effectiveness on the audit plan to obtain evidence.	
The Organizational Structure The organizational structure defines how the organization plans, executes, controls, and reviews the activities that it undertakes to achieve its strategic objectives. Obtain information about the key organizational structure aspects that relate to accounting information systems: • The corporate structure, whether there are subsidiaries or other components in different locations and how their information systems are integrated • Management's attitudes and actions toward financial reporting, information processing, accounting functions, and personnel • Ownership and relations between owners and other parties; how the information system identifies related party transactions • How authority and responsibility for information system operating activities are assigned • How reporting relationships and authorization hierarchies are established • Policies and practices for hiring, training, evaluation, promotion, and compensation as well as for remedial actions for accounting and IT personnel • A description of the company's information system and IT resources, including personnel within the IT department, interaction with personnel in other departments, details of computer equipment used, the use of an outside services centre, if any, and locations from which the computer resources can be accessed	
Consider: • Is access to information systems used to process accounting information controlled? Are the company policies regarding access only by authorized personnel adequate? • Are responsibilities segregated appropriately between systems and programming staff and operations personnel? • Is the information systems function integrated with the overall organization structure?	
Methods Used to Communicate Responsibility and Authority Obtain information about: • Accounting and other policy manuals, including IT operations and user manuals • Formal job descriptions for accounting and IT personnel • Related-user personnel job descriptions that may also be helpful • How information system resources are managed and how priorities are determined • How other non-accounting departments within the company understand how they must comply with financial information processing-related standards and procedures	
Consider: • Are communications between user departments and the information systems department open and adequate to determine whether system controls are effective and to detect and correct any processing errors that arise?	
Methods Used by Management to Supervise the System Obtain information about the procedures used to supervise the information system, including: • Existence of systems design and documentation standards and the extent to which they are used • Existence and quality of procedures for system and program modification, systems acceptance approval, and output modification (such as changes in reports or files)	

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EXHIBIT 6–18 Continued

- Procedures limiting access to authorized information, particularly with respect to sensitive information
- Availability of financial and other reports, such as budget/performance reviews for use by management
- Existence of an internal audit function and the degree of its involvement in reviewing computer-produced accounting records and related controls, and its involvement in systems development control evaluation and testing

Consider:

- Are management supervision procedures adequate to maintain the overall accuracy and authorization of the information processed and reports generated by information systems?

The Accounting Information System

The accounting information system includes the accounting processes as well as procedures and records that the organization uses to meet its financial reporting objectives. These objectives include reporting financial transactions, events, and conditions, and maintaining records needed for accountability for the organization's assets, liabilities, and equity, and compliance with laws and regulations.

Obtain information about the accounting information system and the flow of transactions to understand the information systems relevant to financial reporting, including:

- Significant classes of transactions arising from the organization's business processes, such as selling, purchasing, producing goods and services, and recording financial and nonfinancial information for reporting and management control purposes
- IT and manual procedures that initiate, record, process, and report transactions, including period end cutoff procedures
- Electronic or manual accounting records and supporting information supporting transactions
- Use of information system to capture significant events and conditions other than transactions
- Financial reporting processes, significant accounting estimates and disclosures
- Procedures to transfer information from processing systems (e.g., accounts receivable subledger) to general ledger or financial reporting systems
- Use of standard, recurring journal entries to record transactions, such as sales, purchases, and cash disbursements in the general ledger (e.g., daily sales journal entries), or to record periodic accounting estimates (e.g., amortization).
- Use of nonstandard journal entries to record nonrecurring, unusual transactions, or adjustments (e.g., changes in estimated uncollectible accounts receivable, asset disposals or asset impairment estimates, consolidating adjustments) for manual, paper-based general ledger systems identified through inspection of ledgers, journals, and supporting documentation or for automated general ledger systems, where such entries may exist only in electronic form identified through the use of computer-assisted audit techniques
- Procedures that ensure information for disclosures required by the applicable financial reporting framework is accumulated, recorded, processed, summarized, and appropriately reported
- How the incorrect processing of transactions is resolved (e.g., a suspense file, how it is cleared on a timely basis)
- How authorized system control overrides are processed and accounted for
- Risks of material misstatement associated with inappropriate override of controls over journal entries and the controls surrounding nonstandard journal entries, including automated journal entries that produce no visible evidence of intervention in the information systems

Consider:

- Is the accounting system designed and operated to ensure the organization's financial reporting objectives are met, such that all relevant financial transactions, events, and conditions are captured and reported, accurate records needed for accountability for assets, liabilities, and equity, and to comply with laws and regulations are maintained?

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REVIEW CHECKPOINTS

6-48 What kinds of knowledge does the auditor gather to understand internal control and assess the risk of material misstatement?

6-49 Compare and contrast company-level controls to internal controls relevant to the audit.

6-50 What are the two main types of control activities that are used in information systems?

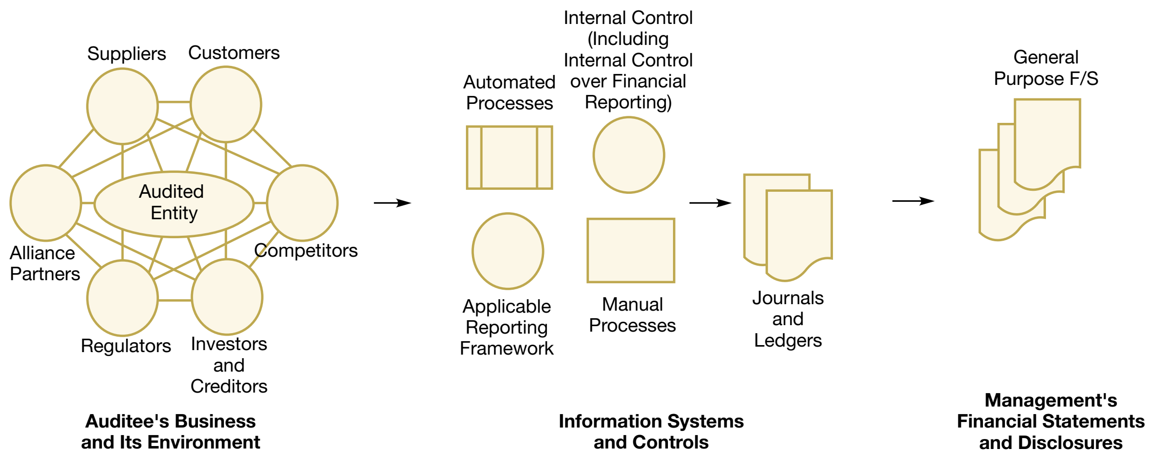
6-51 What aspects of the accounting system are relevant to financial reporting objectives?

6-52 What misstatement risks might not be eliminated by automated control procedures? How does this possibility affect the audit?

6-53 Why do auditors seek information about the use of nonstandard journal entries?

This section concludes the introduction to the business risk–based audit approach and the knowledge-gathering work auditors perform to identify the main risks of material misstatement at the overall financial statement level. Exhibit 6–19 summarizes the components of the financial reporting process explained in Chapter 6. It illustrates how the auditee's business risk, processes, information systems, and controls result in production of the information reported in management's financial statements. The auditee's business and its environment generate the activities that are captured, monitored, and controlled by the information systems, which include manual and automated processes. The information systems are based on a financial reporting framework, usually GAAP, and internal control elements related to financial reporting.

EXHIBIT 6–19 **The Financial Reporting Process in an Auditee Company**



Source: Timothy B. Bell, Mark E. Peecher, and Ira Solomon, *The 21st Century Public Company Audit: Conceptual Elements of KPMG's Global Audit of Methodology,* p. 4, (KPMG International © 2005).

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APPLICATION CASE WITH ANALYSIS

Business Risk Analysis and Audit Implications

DISCUSSION CASE

Jack has recently joined your public accounting firm as a junior auditor and has been assigned to the audit team for SOL Technologies Corporation (SOL). Based on a review of previous years' audit working papers and permanent files, SOL's 20X7 quarterly reports, and its draft 20X7 Management Discussion and Analysis, Jack learned the following:

SOL is a Canadian-based solar energy technology company that currently has three distinct operations focusing on (1) development and commercialization of photovoltaic (PV) cell technology, (2) development of a PV silicon processing technology, and (3) sales and installation of PV systems. SOL's goal is to make solar energy a cost-effective, mainstream energy solution. The company was incorporated in October 1993 and began trading on the TSX Technology Exchange in 20X3. In March 20X6, SOL started trading on the Frankfurt Open Market System. Jack's firm has audited the company since 20X2.

Governance

SOL currently has a six-member board of directors. The president and CEO is the only officer or employee of the company on the Board and is also a member of the Audit Committee. In April 20X7, the company hired a chief financial officer who had previously worked as chief accountant for another technology company. Prior to this, the company had a limited number of qualified accounting staff and relied mainly on an outside accounting firm to prepare its financial statements. The key employees are scientists and engineers, and most of the financial forecasts have been generated by them, not the accounting staff.

Operations

According to Photon Consulting, a leading solar energy industry research company, the solar energy market is growing at 40% annually and with an upward trend that management expects will continue. Details of SOL's three main business lines are:

PV Cell Technology

SOL's PV cell technology operation is currently developing a high-efficiency silicon wafer PV solar cell. The company's wholly owned German subsidiary SOL Technologies Deutschland GmbH (SOL Germany) is constructing a PV cell manufacturing plant in Germany with an initial capacity of 80MW per year. The PV cell manufacturing plant is expected to commence operations in the second fiscal quarter of 20X8. The plant is sized for three fully automated process lines that start with silicon wafers and finish with PV cells ready to be sold to PV module manufacturers. SOL's manufacturing strategy is to initially build two production lines. The first line will use turnkey, "off the shelf," technology to produce PV cells with a targeted efficiency of 15%. The second line will produce PV cells based on SOL's proprietary technology with a targeted efficiency of 18%.

PV Silicon Processing Technology

SOL's PV silicon operation is developing a new PV silicon processing technology to produce solar grade silicon (also known as "polysilicon"). PV silicon is currently in tight supply worldwide and it is a key input required for manufacturing PV cells. In 20X6, SOL received funding from the Canadian government to build and equip a pilot plant on the campus of a top engineering university and formed a consortium with other technology firms to conduct this research and development. Provided the current research and development is completed and funding is sourced, the silicon processing operation is expected to remove a barrier to growth (silicon wafer shortage) for the company's PV technology operation.

PV Systems

SOL's systems operation focuses on the design, distribution, installation, and support of PV systems on residential, industrial, commercial, and institutional buildings as well as the installation of PV systems on open land, so-called solar parks. The availability of 20-year fixed-price energy supply contracts in Ontario under the Ontario Power Authority's standard offer program has increased interest in solar energy generation facilities. SOL's systems operation has entered into six nonbinding letters of interest related to supplying PV systems for proposed solar park developments.

Business Strategy

SOL's ability to successfully manufacture PV cells depends on securing silicon wafers, a key raw material input. In the current tight silicon market, well-positioned companies will have an advantage. SOL's strategy is to pay higher prices for silicon and to secure silicon supply in the spot market because of its highly efficient use of it. The larger competitors in the industry are expected to rely on buying power and strong relationships with feedstock suppliers for their supply and, thus, market share. Other well-capitalized competitors may be able to quickly expand non-silicon technologies (such as cadmium telluride) and thereby gain market share. Industry experts estimate that production of non-silicon based solar power products will increase from 150MW in 20X5 to 1.1GW in 20X8, a 22% market share.

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In the short term, SOL is planning to secure a supply of silicon wafers for 20X8 with a combination of supply contracts, proprietary refining, and spot market purchases. Several industry estimates suggest a significant increase in silicon supply during 20X8. No contracts for silicon supplies are in place at this time, in anticipation of falling prices. In the long term, the company expects to produce its own silicon.

There is a trend toward vertical integration in the solar industry. SOL is targeting the high-efficiency end of the market and believes that it will have a competitive cost advantage. Downstream module manufacturers and system integrators appear to be willing to pay a premium for high-efficiency cells. SOL's management believes that this combination is a unique approach that will generate superior margins once the German plant is operational. SOL's value proposition is the combination of high-efficiency cells produced at a lower cost, with a focus on selling to existing module manufacturers by demonstrating that they can increase their profit with SOL's product. SOL has a thin-film technology approach that reduces risk and provides the potential for a broader product line. It gives SOL the option to produce a lower efficiency thin-film-only product in the face of continued silicon shortages.

The systems operation functions in a highly competitive market, both in Ontario and the rest of North America—especially in terms of e-commerce competition. The competitors are very fragmented in both location and size, creating niche opportunities that can be exploited through developing strategic supply and customer relationships.

Intellectual Property

SOL relies on a combination of patents, internally developed know-how, and trade secrets to protect its proprietary technology and PV cell prototypes. Much intellectual property and expertise is being created at the laboratory and manufacturing levels.

Marketing and Distribution Methods

The main distribution channel is a value-added distributor of solar products and solutions with a limited Web presence. Under direction of its new Vice-President of Business Development (hired in 20X7), the company plans to market its own brand of key solar technology components and services (including repairs) on the Internet. The target market is solar professionals (e.g., knowledgeable power end users, dealers, and trades people), commercial customers (e.g., solar farms), and energy efficient home builders.

The SOL name is well-known to customers desiring a broad assortment of PV products, within its home market of southern Ontario. The company has an extensive contact database of customers, channel partners, builders, and government bodies.

Financial Performance

SOL has incurred losses since its inception and may be unable to generate net sales that achieve or sustain profitability for the future. For example, the company's cash requirements increased significantly in 20X7, and construction costs of the German plant will increase them in 20X8. In addition, operating expenses will increase as it expands its operations.

The company's ability to reach and sustain profitability depends on factors such as the growth rate of the solar energy industry, market demand for solar modules, competitiveness of its products and services, and its ability to increase production volumes. The solar energy market is at a relatively early stage of development, and the extent of its acceptance is uncertain. Many factors may affect the demand for solar modules, including the following:

- Cost-effectiveness, performance, and reliability of solar modules compared with conventional and other non-solar energy sources and products
- Government incentives that support the solar energy industry
- Success of other renewable energy generation technologies, such as hydroelectric, wind, geothermal, solar thermal, concentrated photovoltaic, and biomass
- Economic and market conditions such as change in fossil fuel prices
- Capital expenditures by end-users of solar modules, which tend to decrease when the economy slows and interest rates increase.

In September 20X7, SOL issued 21 million additional common shares for cash, to raise approximately $28 million in new equity. The net proceeds of the offering will be used primarily for (1) securing additional supplies of silicon wafers, (2) accelerating the research and development on silicon processing, and (3) providing additional working capital to the company's systems operating unit. In the interim, the $28 million will be invested in government securities or other short-term, interest-bearing, investment-grade securities as approved by the company's audit committee.

Regulatory Actions

On May 28, 20X4, and May 9, 20X5, the Ontario Securities Commission issued Cease Trade Orders (CTO) against SOL for failing to file annual statements within the required time frame. The CTOs were lifted in each case within two weeks, once the audited statements were filed.

Auditor's Approach

To analyze SOL's business, environment, and risks, Jack organizes his information with these steps:

(a) Identify the key business factors, explaining why auditors must understand each factor to assess the risks of material misstatements. As a guide, consider:
   - Industry, regulatory, other external risk factors;
   - Nature of SOL's business (operations, investments, financing); and
   - SOL's objectives and strategy to address business risks.

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(b) Link these business risk factors to specific risks of material misstatement of the SOL financial statements. Explain clearly how the risks could lead to material misstatements.

(c) A key item in SOL's draft 20X7 balance sheet assets is patents with a cost of $439,000 and accumulated amortization of $310,000. The financial statement notes state that "Patent costs include legal fees incurred to obtain patents for technology developed or acquired by the company, and are being amortized over a period of five years." Assess the inherent risk for the patents balance, basing the assessment on the five principle assertions and giving the reasons supporting the assessment. How does this inherent risk assessment relate to the auditor's expectations regarding management's risk assessment processes and internal controls over patent assets, as well as to the planned approach for obtaining audit evidence for this account?

ANALYSIS

Note: The following is one way to analyze the case, but other valid approaches and points are possible.

(a) Risk Factors

Governance—The CEO is on the audit committee. There is little financial expertise on the Board and in the accounting department. The new CFO's competency and qualifications are not known yet. The corporate culture is dominated by scientists, so finances may not be well managed.

Controls over financial reporting—There have been two CTOs for late filing; thus, financial reporting control weakness is a major risk factor. Control risk appears high. CFO/CEO certifications on financial statements and internal control effectiveness may be misstated.

Industry, regulatory, other external risk factors—The company operates in a highly competitive technological market:

1) New product market acceptance risk: Market risk exists for new products, such as the PV cell technology and solar-grade silicon technology. There is no assurance that new products will be accepted, desired volumes will be realized, or product will not become obsolete. In addition, new product offerings will also require significant marketing and sales efforts to gain market acceptance.
2) Competition: Many of SOL's current and potential competitors have greater financial, marketing, technical, and other resources. There can be no assurance that SOL will be able to compete successfully with its existing or new competitors.
3) Availability of solar-grade silicon and manufacturing inputs: Inability to secure raw materials and other inputs to meet sales demands could negatively impact sales and earnings. The current shortage of silicon has increased the price significantly. There may be shortages of solar grade silicon, wafers, and certain specialized manufacturing tools and fixtures at any time, especially in periods of strong market demand. Few suppliers and quickly changing demand may also limit availability of inputs. With commercialization of the SOL PV cell technology, the inconsistent supply of solar grade silicon could seriously impact SOL's sales and prospects.
4) Government subsidies for solar products: The solar market is somewhat dependent on government subsidies and programs that change with the political situation, with resultant changes in demand and pricing.
5) Foreign exchange risk: SOL's effort to sell its PV cells and solar grade silicon in foreign markets will create exposure to exchange rates, primarily the U.S. dollar and the euro, which may negatively impact SOL's future financial performance.

Operations—Risks and uncertainties associated with operations:

1) Product development risk: SOL PV technology and solar-grade silicon technology development are expending research resources but are not yet commercialized. There is no guarantee that the PV technology will achieve the solar cell efficiency necessary for success in the market. Commercializing any product includes the risk that full-scale production may not be at an acceptable cost level. In addition, the solar grade silicon technology is in early stages of development and there is no guarantee that technical milestones can be achieved.
2) Limited protection of patents and proprietary rights: The company relies on a combination of patents, trademarks, trade secrets, and know-how to protect its proprietary technology and rights. The company might not have resources to repair or protect current or future patents against infringements and challenges. Its trade secrets might be independently developed by competitors.
3) Expansion risk: Bringing the SOL PV cells to market may require SOL to invest in new production equipment and systems and put manufacturing plants on tight time schedules, often without guaranteed revenue volumes. Bringing investments into production quickly may expose SOL to integration risks, depending on the size of the investment, the schedule, the technology involved, and the nature of the products to be produced.
4) Manufacturing risk: SOL's production of PV cell manufacturing operations in Germany will require acquisition of land, development of manufacturing plans and production equipment, hiring of managerial personnel and skilled labour, and adequate financing arrangements. There is no assurance the company will be able to obtain these input factors or meet its implementation timeline.
5) Dependence on key personnel: SOL's success depends on attracting and retaining highly skilled personnel in key areas, including management. Unexpected loss of SOL's key employees could be detrimental to future operations. There is no assurance that the company will be able to engage or retain necessary personnel.

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6) Financial position: While SOL has raised additional capital in 20X6 and early 20X7, additional funds are required to complete the commercialization of the SOL PV technology and the SOL solar-grade silicon technology.
7) Dependence on government funding: SOL's short-term business plan is based on securing government funding, including from SDTC and the Province of Ontario's OCE. Its plan for a manufacturing plant in Germany depends on government funding as well. Failure to finalize the funding agreements would have a materially adverse impact on the company's short-term plans.

(b) Link Business Risks to Risk of Material Misstatement (RMM)

Industry, regulatory, other external risk factors:

- RMM: Commodity prices and currency fluctuations are risk factors that may affect inventory valuation (lower of cost and net realizable value); contingent losses due to regulatory violations are probable and require disclosure (there may be other points linked to industry and external risk factors).

Nature of SOL's business (operations, investments, financing):

- RMM: Inventory valuation affected by changes in costs imposed by suppliers and marketability; valuation of PPE and intangibles may be affected negatively by poor investment management risk or inadequate capitalization to complete construction, or by inability to protect intellectual property rights; contingent liability disclosures may be incomplete if unreported product liability or patent infringement issues occur (there may be other points linked to operating/investing/financing risk factors).

SOL's objectives and strategy to address business risks:

- RMM: Strategies to address its risks may fail and the company may go bankrupt given the risky nature of its industry; alternative energy market is at very early stage; other points related to management's strategic risk assessment factors.

(c) Levels of Risk

The inherent risk assessments take into consideration the nature of the item and the risk that an error can have occurred in accounting for that item in the first place. The assessment will indicate low, moderate, and high levels.

Patents are a critical asset in solar technology, so development businesses tend to have higher inherent risks. Thus, auditors expect management to have strong risk assessment processes and strong controls in place to offset and reduce these risks.

Referring to the Five Principal Assertions

- *Existence:* Low IR, because it is unlikely a patent would be set up in the books unless it existed, and this can be verified quite reliably by examining legal documents, cash disbursements, etc.
- *Completeness:* Moderate IR, as management may have patents that it didn't inform accounting staff about; some R&D expenses may have actually been to create patents; little reliable audit evidence is available for this.
- *Valuation:* Very high IR, because if the technology is not successful it creates high risk that the patent is worthless or overvalued; future earnings potential is very subjective and management could be biased; cost itself has fairly low IR since the payments to create patents are quite objectively determined and clearly linked to creation of legal patent rights.
- *Ownership:* High IR, related to the legal enforceability and protection of patents from infringement by others; relates to the valuation of the patents as well.
- *Presentation:* Low to moderate IR, appropriate policies for Intangibles are set out in *IAS 38* so it is clear for auditors to verify that the presentation is acceptable, but appropriate amortization may be an issue as it is subjective (useful life, etc.), increasing IR.

If there are strong controls, it may be feasible and efficient for the auditor to test these controls and obtain some assurance from them that will lower the amount of assurance required from substantive tests. On the other hand, if the controls are not very strong, the RMM will be very high for high inherent risk items and the auditor will need extensive substantive evidence to be able to get reasonable assurance to form an opinion about whether the financial statements are fairly stated.

SUMMARY

Chapter 6 extended the preliminary understanding of the auditee's business introduced in Chapter 5.

- The concept of audit risk was explained as being the probability that a clean audit opinion is given on financial statements that contain a material misstatement.
- The components of audit risk, inherent, control and detection risks, were described in terms of a conceptual model for managing audit risk in an audit engagement. The relation of business risk to audit risk was explained to show various important judgments that auditors must make and that are supported by a deep understanding of the auditee's business and its risk.

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- Examples were presented using theoretical risk assessments to demonstrate the usefulness of the audit risk model. Challenges and limitations of using the conceptual audit risk model were also discussed. The relation between materiality and audit risk were also explained in terms of the different nature of these two concepts and their similar impact on the extent of audit work planned.
- The chapter provided a description of businesses processes, how they are used to implement the business strategy, and how auditors can assess the auditee's business risk through strategic analysis and business process analysis. The relationships among business processes, accounting processes (or cycles), and management's general purpose financial statements were presented.
- The chapter introduced internal control, an important component of the auditor's understanding of the auditee's business: the information systems that management has in place for running the business and meeting its information needs. A conceptual framework useful for understanding internal control was introduced. Understanding internal control is critical to assessing the possibility that management controls have not addressed the business risks that could lead to the financial statements being misstated. This is because the financial statements result from its business processes and information systems, and thus they are vulnerable to any control deficiencies and weaknesses that might exist. This framework consists of company-level controls and specific control activities. Company-level controls include the control environment, management's risk assessment processes, information systems related to business processes and communications policies, and management's monitoring activities. Control activities, a component of internal control which consists of general and application controls, were also briefly introduced here for completeness but will be explained in more detail in Chapter 9.
- The chapter ended with a discussion of how auditors use their internal control understanding to make a preliminary assessment of the risk of material misstatement at the financial statement level, including an integrated overview of the business, its processes, and how these are captured in financial statements through the internal control and information systems.

KEY TERMS

accounting process
anchoring
application controls
balanced scorecard
business risk–based audit approach
company-level controls
control activities
control risk (CR)
control testing (compliance testing)
detection risk (DR)
electronic commerce (e-commerce)
enterprise resource planning systems (ERPS)
entity's risk assessment process
fraud triangle
general controls
inherent risk (IR)
quality of earnings
reasonable assurance
risk of material misstatement
Strategic Systems Auditing (SSA audits)
substantive audit procedures

EXERCISES AND PROBLEMS

EP6-1 Business risk understanding. LO1, LO2, LO3 Super Natural Foods Limited manufactures, distributes, and sells all-natural grocery products.

Required:
Describe three business risks for this company and explain why they are important considerations for the auditor of its financial statements.

EP6-2 Significant audit issues, audit risk decision. LO1 LO2 and LO3 You are the auditor of Royal Health Limited (Royal). Royal is a public company that grows medicinal plants and sells them across North America, Europe, and the Far East. Its largest expense is marketing. All its marketing is done by another company that is owned by one of Royal's directors.

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Required:
Identify three (3) key audit issues in this company and explain how these will affect your audit risk, using the audit risk model.

EP6-3 Business processes, accounting processes/cycles. LO4

Required:
Explain what an accounting process/cycle is and how it relates to business processes and to the entity's financial statements. Why is the approach of identifying accounting processes/cycles useful in planning an audit?

EP6-4 Business Processes, Different Industries. LO4

Required:
What business processes would be related to each of the four accounting processes, discussed on p. 213 of the chapter, in the following businesses?

a. a bicycle manufacturing business
b. an architectural firm
c. a retail grocery store

EP6-5 Performance Measures in Risk Assessment. LO3, LO5

Required:
In assessing the risk of material misstatement in the financial statements as a whole, why should auditors pay particular attention to external and internal performance measures that are used to evaluate the management, and to the impact of material misstatements on the quality of earnings?

DISCUSSION CASES

DC6-1 Audit Risk Model. LO3 Audit risks for particular accounts and disclosures can be conceptualized in this model: Audit risk (AR) = Inherent risk (IR) × Internal control risk (CR) × Detection risk (DR).

Required:
Use this model as a framework for considering the following situations and deciding whether the auditor's conclusion is appropriate:

a. Ohlsen, PA, has participated in the audit of Limberg Cheese Company for five years, first as an assistant accountant and the last two years as the senior accountant. He has never seen an accounting adjustment recommended. He believes the inherent risk must be zero.

b. Jones, PA, has just (November 30) completed an exhaustive study and evaluation of the internal control system of Lang's Derfer Foods, Inc. (fiscal year ending December 31). She believes the control risk must be zero because no material errors could possibly slip through the many error-checking procedures and review layers used by Lang's.

c. Fields, PA, is lazy and does not like audit jobs in Toronto, anyway. On the audit of Hogtown Manufacturing Company, he decided to use detail procedures to audit the year-end balances very thoroughly to the extent that his risk of failing to detect material errors and irregularities should be 0.02 or less. He gave no thought to inherent risk and conducted only a very limited review of Hogtown's internal control system.

d. Shad, PA, is nearing the end of a "dirty" audit of Allnight Protection Company. Allnight's accounting personnel all resigned during the year and were replaced by inexperienced people. The controller resigned last month in disgust. The journals and ledgers were a mess because the one computer specialist was hospitalized for three months during the year. Shad thought thankfully, "I've been able to do this audit in less time than last year when everything was operating smoothly."

DC6-2 Planning, Inherent and Control Risk, Manufacturing Business. LO3, LO4 Darter Ltd. is a medium-sized business involved in manufacturing and assembling consumer electronic products, such as DVD players, radios, and satellite receivers. It is privately owned. Its minority shareholders requested that the annual financial statements be audited for the first time this year. Your firm is engaged to do the current year's audit. You are now reviewing Darter's preliminary general ledger trial balance in order to begin preparing the planning memorandum. Consider the following accounts that appear in this trial balance:

Cash
Inventory, finished goods
Inventory, work-in-progress
Inventory, unassembled components
Inventory, spare parts
Property, plant and equipment
Deferred development costs
Goodwill
Accounts payable
Warranty provision
Bank loan, long term
Share capital, common shares
Retained earnings
Revenue
Cost of goods sold
General and administration expense

Required:

a. Evaluate the inherent risk for each of the above accounts. List two accounts that you think would have the highest inherent risks, and two that would have the lowest. Indicate whether there are any particular assertions (i.e., existence, completeness, ownership, valuation, presentation) that the risks mainly relate to. Give reasons that support your assessments and state any assumptions you need to make.

b. For one of the high risk accounts you identified in part (a), explain how the inherent risk level will relate to the types of controls that Darter's management implements for each of these accounts? Consider costs and benefits of implementing effective controls.

c. For one of the high risk accounts you identified in part (a), describe the procedures you would use to assess the control risk.

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d. How would you expect the company's accounts to differ, and how would your inherent risk assessment differ if the company's business was:
- An iron mine
- A piano manufacturer
- A bank
- A shipping line

DC6-3 Business Risk Analysis. LO3, LO4 Assume you have recently been assigned to the audit team working on the financial statement audit of Town Groceries Limited (TGL). As a member of the team you are now in the process of gaining an understanding of the company's business, environment, and risks.

From the 20X4 Town Groceries Limited Annual Report you have learned the following about this business and its strategy:

TGL is Canada's largest food distributor and a leading provider of general merchandise products and services. TGL is committed to providing Canadians with a one-stop destination in meeting their food and everyday household needs. This goal is pursued through a portfolio of store formats across the country.

It operates across Canada under various operating banners (including Maritime Grocery, Western Groceries, and other banners). These banners are set up as 658 corporate-owned stores, 400 franchised stores, and 519 associated stores. The store network is supported by 32 warehouse facilities located across Canada. Some 130,000 full-time and part-time employees execute its business strategy in more than 1000 corporate and franchised stores from coast to coast. TGL is known for the quality, innovation, and value of its food offering. It also offers a strong private label program, including the unique Choice of Choice and OurTown brands.

While food remains at the heart of its offering, TGL stores provide a wide, growing range of general merchandise products and services. In addition, their Town Financial Inc. offers personal banking, a popular credit card, auto and home insurance, plus the Town Points loyalty program.

TGL seeks to achieve its business objectives through stable, sustainable, and long-term growth. It seeks to provide superior returns to its shareholders through a combination of dividends and share price appreciation. Its willingness to assume prudent operating risks is equalled by its commitment to the maintenance of a strong balance sheet position.

In executing its strategies, TGL allocates the resources needed to invest in and expand its existing markets. It also maintains an active product development program.

TGL is highly selective in its consideration of acquisitions and other business opportunities. Given the competitive nature of its industry, TGL also strives to make its operating environment as stable and as cost effective as possible. It works to ensure that its technology systems and logistics enhance the efficiency of its operations.

It strives to contribute to the communities it serves and to exercise responsible corporate citizenship.

Required:

a. Based on the preceding information, discuss the industry, regulatory, and other external factors that are relevant in understanding TGL's business and its environment. Use the risk factors outlined in Appendix 6A as a guide.

b. Link the risk factors you identified in part (a) to the risks in TGL's operations. Link these operating risks to risks of TGL's financial statements being materially misstated.

c. Outline TGL's strategy and describe, in general terms, the business processes you expect to find the company using to achieve its strategy. Consider the four typical business processes discussed in this chapter to develop your response.

d. While reading through the business section of the newspaper, you also came across the following article on TGL's third-quarter results for 20X5 (see box below). What strategic risks are illustrated in the results being described in the article? Speculate on what strategic errors and/or business process deficiencies at TGL have contributed to these "woes." What impact do you expect these events to have on TGL's financial results for 20X5?

TGL PROFIT SLUMPS, CEO VOWS TO CONTINUE RETOOLING THE GROCERY OPERATIONS

July 30, 20X5

TGL Cos. Ltd. will stick to its current retooling strategy, the grocery chain CEO said yesterday, even though its third-quarter profit slumped by 26%. Profit was dragged down by supply-chain hiccups, and higher-than-expected costs related to TGL's retooling strategy.

The supermarket operator reported its summer-quarter profit fell to $192-million, or 7 cents a share, from $258-million or 9.4 cents, a year ago. Analysts were expecting a profit of 10 cents per share, even though the company had previously warned that its planned retooling of supply chains, systems, and administration would likely result in some short-term profit decreases.

TGL's CEO said that retooling the national supply chain and converting to a common-information systems platform has taken longer and been more disruptive than planned, negatively affecting TGL's performance in the short term. The CEO expressed disappointment with the progress to date, but vows that the company is taking strong action to resolve the problems, and will be a stronger and much more competitive player as a result of these changes.

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Another issue affecting profit arose from TGL's new third-party-operated general merchandise warehouse and distribution centre for the western region failing to reach the planned operating efficiency and capacity on schedule.

The profit declines come despite TGL's sales growing 6.4 per cent from a year earlier, to $8.7-billion from $8.1-billion, with growth across all regions. Sales at older stores, and sales of the general and beauty product lines tended to be flat, however, as they were most affected by the supply chain disruptions.

TGL reported that $30-million of the profit decline was due to the flat sales; restructuring and other charges reduced it by another $27-million; and a special charge relating to a re-assessment by the Canada Revenue Agency relating to sales taxes on certain new lines of merchandise brought it down by another $20-million.

DC6-4 Business Understanding, Retail Industry. LO3, LO4 The following newspaper article (see box below) discusses strategic issues related to two large Canadian retailers: HBC and Winners.

Required:

Based on the information provided (and, optionally, other Internet research you may wish to do), identify the strategies being followed in these two businesses. Apply the strategic systems approach outlined in the chapter, as follows:

a. Explain management's objectives, strategies, and risks in the two businesses. What similarities and differences did you notice?

b. In your opinion, did the managers in both businesses fully analyze the risks involved and take action to address them? Support your opinions with facts from the article (and your additional research, if any).

c. Do you think it is possible that any of the risks you have identified might have a material effect on the businesses? If so, what financial implications might these risks have, and could they affect the financial statements?

COST-CONSCIOUS STRATEGY SCORES WINNER FOR HBC

Hudson's Bay Co. (HBC), in the midst of an unfriendly takeover battle, appears to be having success in at least one area: its push to woo the value-conscious shopper. Indeed, the efforts may even be hurting a key competitor.

Winners, the discounter known for big-box stores and brand-name goods at lower prices, has experienced a drop in same-store sales at outlets open a year or more—an indication that the business is suffering. And some observers say it may be getting a bit more difficult for Winners to find quality goods from suppliers.

Why? Because a few years ago, HBC chief executive officer George Heller decided to take aim at Winners' thriving "off-price" business. He wanted to ensure that his regular suppliers provided HBC with the same type of low-priced, end-of-season, and excess goods that have made Winners such a destination.

"They've choked off the supply a little bit to Winners," says David Howell, president of consultancy Associate Marketing International. "It's probably one of the smarter things that George has done. It's a good strategy and it seems to be working."

HBC, which owns the Bay, Zellers, and Home Outfitters, has increased its selection of the so-called "off-price products"—everything from jackets to housewares—and marketed them heavily through flyers and in-store signs as "power buys." It opened special in-store boutiques called Style Outlets for discount items and, last year, began opening separate Designer Depot outlets similar to Winners stores.

In the midst of the push, late last month, HBC became the target of a $1.1-billion hostile takeover bid from U.S. financier and HBC shareholder Jerry Zucker, who is unhappy with the company's performance and says he can run it better.

Despite HBC's struggles, its off-price strategy stands out as a rare glimmer of hope. Executives did not like to see their vendors supplying their stores with full-price products under well-known labels and then selling those very items—perhaps a little later in the season—to Winners at a fraction of the price.

"There's such a big appetite in the Canadian marketplace for off-price product and it's so underserviced," says Marc Chouinard, chief operating officer at HBC. "It's not surprising that this strategy is giving us what we want."

Sherry Lang, vice-president of investor relations at TJX Cos., the large U.S.-based parent of Winners, rejects any suggestion of overly tough competition with HBC for supplies. "Winners has enormous clout in sourcing globally," she says.

Rather, Winners' difficulties began in the last half of 2004 when its buyers purchased too much inventory too far in advance of the season, she says. It was forced to mark down prices heavily after other retailers began to do so, she says.

The weak results continued into the first half of 2005 as Winners' merchants attempted to correct the situation, she says. They purchased less inventory, and lowered all pricing at the stores, although she would not say to what extent.

The results this year are soft, as well, because they are being compared to an "exceptionally" strong first half of last year, she adds.

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Last week, TJX reported that October same-store sales at its Canadian division, which also includes HomeSense, fell 5% and in the third quarter 4%.

Ms. Lang says Winners' latest sales were short of expectations and hurt by unseasonably warm fall weather. She says the outlook is better for the remainder of the year.

Robert Johnston, a vice-president at Mr. Zucker's U.S. company, says Mr. Zucker is pleased that HBC is making inroads in its off-price strategy. But it took too long to get it off the ground, he says, adding Mr. Zucker would accelerate the off-price program if he took over HBC.

And while TJX has faltered of late, it has been vastly more successful over the past few years in its financial performance, compared with that of HBC, he adds.

Winners and sister off-price chain HomeSense still enjoy a comfortable lead in the category, generating more than $1.3-billion (U.S.) in annual sales.

HBC has about $250-million (Canadian) of annual "power buy" sales today, and aims to double that over the next three years, Mr. Chouinard says.

Source: Marina Strauss, "Cost-conscious strategy scores winner for HBC," *The Globe and Mail,* November 14, 2005, p. B4. Reprinted with permission from *The Globe and Mail.*

DC6-5 Business Risk and Risk of Material Misstatement. LO3, LO4, LO5, LO6, LO7 You have joined a public accounting firm as a junior auditor and have been assigned to the audit team for one of your firm's largest audit engagements, Cold Beverages Corp. (CB), a large public company. CB was incorporated in Canada several decades ago. Your firm has audited CB for many years. Based on your review of previous years' audit working papers, CB's 20X3 quarterly reports, and its draft 20X3 Management Discussion and Analysis, you have learned the following.

CB is one of the world's largest non-alcoholic beverage producers, providing about 65% of the world's retailer branded soft-drinks, bottled water, juice drinks, and teas. Approximately 90% of its output is sold to retailers for sale under the retailers' brands, with the remainder sold under CB's own brand names. The company operates in North America, Mexico, the U.K., and Europe. In the past four years, CB has expanded its production and distribution capabilities mainly through acquisitions of other businesses. It plans to grow in future mainly by leveraging existing customer relationships, developing new products and distribution channels, and obtaining new customers in new markets. During 20X1 and 20X2, CB rationalized its business by focusing on its highest performing production facilities, resulting in plant and warehouse closures in North America.

CB's products are sold primarily to a small group of very large customers, including large grocery and retail chains. One customer, Tram-Mart, accounts for about 40% of CB's total 20X3 revenues, and its nine next-largest customers account for about 30% of 20X3 revenues. Products are delivered by third-party carriers or are picked up by customers at CB's plants.

The main raw material used in production is water. Other materials required are mainly plastic bottles, aluminum cans, packaging materials, sweeteners, and flavourings. CB typically enters into annual arrangements with its suppliers rather than long-term contracts. At the end of each one-year period CB must renegotiate with the suppliers or find new suppliers. The prices of these materials fluctuate on world markets, but generally there are adequate supplies available and this is expected to continue in future. During 20X2, the price of aluminum cans increased substantially and CB's management decided to enter a five-year agreement with a supplier at a fixed cost. During 20X3, the price of aluminum fell quite substantially. Because of growing demand for corn-based products, the costs of the main sweeteners used by CB have increased substantially in 20X3. CB does not use derivatives to manage the risks of these price changes.

A key to CB's success is its intellectual property, consisting of trade secrets, beverage formulas, and trademarks for its beverage brands. These intangibles are protected mainly by registration, contractual agreements, employee confidentiality agreements, and rigorous prosecution of any infringements using all available common and statutory laws.

Competition in the soft-drinks industry is fierce. Three huge multinationals control about 85% of the consumer sales, and spend heavily on promotion. Other competitors are local independent producers who sell at aggressively discounted prices, and some large U.S. retail chains that manufacture their own soft-drinks and actively seek new customers to expand their sales. CB's management addresses these competitive threats by offering efficient distribution choices, top-quality products, attractive packaging, effective marketing strategies, and superior service.

CB's business is subject to many federal, state, provincial, and local laws and regulations that govern product manufacturing, distribution, labelling, and safety. It is also subject to a number of environmental laws relating to fuel use and storage, water use and treatment, waste disposal, and employee safety. Failure to comply with these laws and regulations can have very negative consequences including penalties and fines. Currently, CB is not in compliance with the Ontario Environmental Protection Act requirements that set a minimum percentage of its products that must be sold in refillable containers. At this time, the Ontario government is not enforcing this law. CB's management believes that none of its main competitors is in compliance either, and so it could not remain competitive if it attempted to comply.

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During 20X3, CB's management identified material weaknesses in the company's internal controls over financial reporting. The main issues related to controls over periodic inventory counts and credit notes. Inventory counting procedures were not properly executed because employees were not properly trained and supervised, resulting in an inability to produce a complete and accurate physical count. Lack of segregation of duties in the issuing of credit notes to customers permitted a fraud to occur. An accounts receivable clerk was discovered to be colluding with a warehouse employee to divert cases of high value beverages from legitimate customer orders, and cover up the shortages by issuing phony credit notes. The stolen beverages were sold by the warehouse employee to small local restaurants and variety stores. Both employees have been fired, and management is in the process of redesigning its inventory control and credit note issuing procedures. Another weakness was found in the global material acquisition function, where supplier contracts were not being properly authorized,-resulting in improper agreements being entered into, and increased risk of employees in different countries accepting bribes from suppliers or engaging in other illegal acts.

Early in 20X4, CB reported its fourth quarter of 20X3 performance, a large loss that was worse than financial analysts expected and much worse than the fourth quarter of 20X3. CB management blames the poor performance on price competition and on declining soft-drink consumption in developed countries. Over the 20X3 year, the company has reported very poor quarterly results and its share price has fallen dramatically all year. The analysts have also expressed concern that CB is close to violating its debt covenants and may have difficulty obtaining the financing it will require to succeed unless its profitability improves substantially in the early part of 20X4. To try to please investors, CB's new CEO, a respected industry veteran, recently held a press conference to show off the company's new head office in Arizona and its innovative new products, and to explain how it is changing the company culture to focus on a turnaround strategy.

Required:

a. Identify key business factors in the CB case and explain why its auditors must understand each factor to assess the risks of material misstatements. As a guide, consider the following categories:
- Industry, regulatory, other external risk factors
- Nature of CB's business (operations, investments, financing)
- CB's objectives and strategy to address business risks

b. Link the business risk factors you identified in part (a) to some specific risks of material misstatement of the CB financial statements. Explain clearly how the risks could lead to the financial statements being materially misstated.

c. What information relevant to understanding internal control is indicated in the case? Consider control environment and accounting controls relevant to financial reporting. How would you assess the effectiveness of CB's internal control to reduce the risk of material misstatement?

DC6-6 Obtaining a "Sufficient" Understanding of Internal Control. LO5, LO6 The 12 partners of a regional PA firm met in special session to discuss audit engagement efficiency. Jones spoke up, saying:

"We all certainly appreciate the firmwide policies set up by Martin and Smith, especially in connection with the audits of the large companies that have come our way recently. Their experience with a large national firm has helped build up our practice. But I think the standard policy of conducting reviews and tests of internal control on all audits is raising our costs too much. We can't charge our smaller clients fees for all the time the staff spends on this work. I would like to propose that we give engagement partners discretion to decide whether to do a lot of work on assessing control risk. I may be an old mossback, but I think I can finish a competent audit without it."

Discussion on the subject continued but ended when Martin said, with some emotion: "But we can't disregard generally accepted auditing standards like Jones proposes!"

Required:

What do you think of Jones's proposal and Martin's view of the issue? Discuss.

DC6-7 Management Controls, Impact on Audit. LO6, LO7 Jabiru Inc.'s senior management recently obtained a new decision-support database system that allows the managers to generate standard reports and also customize enquiries that use data from all functional areas of their company. Before this system was in place, reports to senior managers were generated manually by the operations managers in the various departments, such as purchasing, marketing, inventory control, production, human resources, and administration. The senior managers are much happier with the new system because now they can generate reports as soon as the period ends; they can draw the data directly from the company's computer databases; they can control the content and format of the reports; and the operating managers have less opportunity to manipulate the information in the reports. For example, in the first two months of the new system, senior managers were able to identify a discrepancy in the production department that was resulting in significant shrinkage and were able to correct the control weakness quickly. The previous report, which had been designed and produced by the production manager, did not include the data needed to identify the shrinkage problem.

Required:

a. Discuss how the new decision-support database system affects Jabiru's internal control and its risk of material mistatement.

b. Comment on the potential audit planning implications of the new decision-support database system.

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DC6-8 Comprehensive Audit Planning Decisions. **LO1, LO3, LO4, LO5 (and from Chapter 5: LO4, LO5, LO6, LO7)** You have been assigned to the audit of the financial statements of Office Moving and Storage Limited (OMS) for its year ending December 31, 20X2. The company started 10 years ago and is in the business of moving furniture and equipment for company offices across Canada, and also providing storage for companies requiring that service. The company is owned by three shareholders who are all involved in operating the company.

OMS owns four properties outside of major urban centres; this is where it has warehouse buildings for storing customers' furniture and garages for parking its own moving trucks. OMS has a force of salespeople who follow commercial real estate construction and leasing reports to identify sales prospects: large and medium companies that are planning to move offices. The prospects are assigned to salespeople who then follow up and try to sell a moving and storage contract to the company, along with other services to facilitate the office move. The salespeople prepare a cost quote for doing the move, and this must be approved by the regional sales manager prior to giving it to the prospect company. The regional sales managers have the authority to lower the quoted price if a competing moving company undercuts OMS's quote. Once a move has been started, in many cases the customer requires extra services beyond those contracted for (such as extra boxes, packing, disassembling furniture, removal of trash, etc.), and these are billed as extra charges. The moving employees on the job record the types of extra services provided in a Customer Moving Job Report. These extras are then priced by the assistance sales managers, and added to the amount billed to the customer.

Customers with approved credit ratings are required to pay 25% of the contracted price as a deposit, and are billed for the remaining contract cost and any extras after the move is completed. They have 10 days to pay in full. Customers without approved credit ratings are required to pay the full contract price and any extra charges in advance before the moving employees can start the move.

In the preliminary audit planning done to date, your audit manager has determined that revenues are the class of transactions with the highest risk of material misstatement. You have been assigned to continue the OMS audit planning work by finalizing and documenting various risk assessment and planning decisions so the audit team can move on to developing the detailed audit plans.

It is now January 20X3, and you are at the OMS offices to begin your audit work. In discussion with the company's management, you have learned that OMS currently has about 10% of the office moving market in Canada, and typically does about 30-40 moves per month, with 40 being about the maximum number it can handle with its current employees and trucks. About 80% of its sales are on account to customers with good credit ratings, the balance of its sales are paid in advance. Starting in the current year, the company has purchased future contracts to lock in fuel prices, since fuel is a major operating expense. The company's policy is to value these future contracts at fair value in its year end balance sheet, with unrealized gains included in Revenues, and unrealized losses included in operating costs. The company is planning to expand its operations in the next two years by acquiring another established moving company that specializes in smaller company moves. The acquisition and expansion will be financed by issuing shares to other investors who will not be actively involved in the business.

Below is the December 31, 20X2 adjusted trial balance listing that you have obtained from OMS's management:

OFFICE MOVING AND STORAGE LIMITED		
TRIAL BALANCE AS OF DECEMBER 31, 20X2	**DEBITS**	**CREDITS**
Cash	275,090	
Accounts receivable	1,596,540	
Allowance for bad debts		167,957
Financial instruments, fuel futures contracts, at fair value	670,329	
Prepaid insurance	293,509	
Land	1,500,000	
Buildings, cost	1,881,356	
Accumulated amortization, buildings		411,545
Moving trucks, at cost	2,430,230	
Accumulated amortization, moving trucks		1,175,871
Accounts payable		1,169,191
Income taxes payable		201,104
Estimated damage liabilities, uninsured portion		81,549
Bank loan, long term		1,650,000
Share capital, common shares		1,500,000
Retained earnings, beginning of year		1,147,668
Revenue		43,304,071
Operating costs	25,184,877	
General and administration expenses	12,578,787	
Other expenses	3,943,738	
Income tax expense	454,500	
Totals	50,808,956	50,808,956

Required:

Continue audit planning for OMS based on answering the following questions:

a. Identify three factors your audit firm would have had to consider in order to decide to accept the OMS audit

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engagement for the current year, and explain how each factor affects this acceptance decision.

b. Using the trial balance data above, analyze OMS's financial statements by calculating its current ratio and accounts receivable turnover ratio.
(*Note:* Current ratio = Current Assets / Current Liabilities and Accounts Receivable Turnover = Credit Sales Revenue for the year / Net Accounts Receivable at year end)
Explain what this analysis can tell you about the risks in OMS's financial statements, and what further investigation the analytical results may suggest.

c. What materiality levels would you use for planning this audit? Show your calculations and justify your decision. You can assume your audit firm has the following policy: Performance materiality should be 70% of the Overall Materiality level for financial statements as a whole, unless specific information indicates a different value should be used.

d. What audit risk level would you be willing to accept for this engagement? Describe your choice in terms of one of these levels: *low*, *lower*, *lowest*. Explain the factors that support your decision.

e. Based on the business risk analysis for OMS, your audit manager believes the OMS revenue class of transactions has the highest risk of material misstatement. Identify and explain three business risk factors in OMS that would support your manager's assessment.

f. Your manager has asked you to assess the inherent risk of misstatement at the assertion level for the revenues. Use the levels *high*, *medium*, or *low* to describe your assessments, and explain the factors that support your assessments.

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APPENDIX 6A

Business Risk Factors

Business risks that the auditor considers when assessing the risk of material financial statement misstatement include the following:

UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT, INCLUDING INTERNAL CONTROL

Industry, regulatory, and other external factors, including the applicable financial reporting framework

Industry conditions

a. The market and competition, including demand, capacity, and price competition
b. Cyclical or seasonal activity
c. Product technology relating to the entity's products
d. Energy supply and cost

Regulatory environment

a. Accounting principles and industry-specific practices
b. Regulatory framework for a regulated industry
c. Legislation and regulation that significantly affect the entity's operations
   (i) Regulatory requirements
   (ii) Direct supervisory activities
d. Taxation (corporate and other)
e. Government policies currently affecting the conduct of the entity's business
   (i) Monetary, including foreign exchange controls
   (ii) Fiscal
   (iii) Financial incentives (e.g., government aid programs)
   (iv) Tariffs, trade restrictions
f. Environmental requirements affecting the industry and the entity's business

Other external factors currently affecting the entity's business

a. General level of economic activity (e.g., recession, growth)
b. Interest rates and availability of financing
c. Inflation, currency revaluation

Nature of the entity

Business operations

a. Nature of the business
   (i) Profit-oriented (e.g., financial or other services, manufacturer, wholesaler, importer, exporter)
   (ii) Government (e.g., federal, provincial, territorial, local)
   (iii) Government organization (e.g., department/ministry, Crown corporation, fund, agency)
   (iv) Not-for-profit organization (e.g., an entity established for social, educational, religious, health, or philanthropic purposes)
b. Nature of revenue sources (e.g., manufacturer, wholesaler, banking, insurance or other financial services, import/export trading, utility, transportation, technology products and services)
c. Products or services and markets (e.g., major customers and contracts, terms of payment, profit margins, market share, competitors, exports, pricing policies, reputation of products, warranties, order book, trends, marketing strategy and objectives, manufacturing processes)
d. Conduct of operations (e.g., stages and methods of production, business segments, delivery of products and services, details of declining or expanding operations)
e. Alliances, joint ventures, and outsourcing activities
f. Involvement in electronic commerce, including Internet sales and marketing activities
g. Geographic dispersion and industry segmentation
h. Location of production facilities, warehouses, and offices
i. Key customers
j. Important suppliers of goods and services (e.g., long-term contracts, stability of supply, terms of payment, imports, methods of delivery such as "just-in-time")
k. Employment (e.g., by location, supply, wage levels, union contracts, pension and other post-employment benefits, stock option or incentive bonus arrangements, and government regulation related to employment matters)
l. Research and development activities and expenditures
m. Transactions with related parties
n. Nature of expenditures, including programs and activities of not-for-profit and government entities

Investments

a. Acquisitions, mergers, or disposals of business activities (planned or recently executed)
b. Investments and dispositions of securities and loans

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c. Capital investment activities, including investments in plant, equipment, and technology, and any recent or planned changes
d. Investments in nonconsolidated entities, including partnerships, joint ventures and special-purpose entities

Financing

a. Group structure—major subsidiaries and associated entities, including consolidated and nonconsolidated structures
b. Debt structure, including covenants, restrictions, guarantees, and off-balance sheet financing arrangements
c. Leasing of property, plant, or equipment for use in the business
d. Beneficial owners (local, foreign, business reputation, and experience)
e. Related parties
f. Use of derivative financial instruments
g. Form of ownership (e.g., private company, public company, partnership, joint venture, government owned or controlled, member owned)

Financial reporting

a. Accounting principles and industry-specific practices
b. Revenue recognition practices
c. Accounting for fair values
d. Inventories (e.g., locations, quantities)
e. Foreign currency assets, liabilities, and transactions
f. Industry-specific significant categories (e.g., loans and investments for banks, accounts receivable and inventory for manufacturers, research and development for pharmaceuticals)
g. Accounting for unusual or complex transactions including those in controversial or emerging areas (e.g., accounting for stock-based compensation)
h. Financial statement presentation and disclosure

Objectives and strategies and related business risks

a. Existence of objectives (e.g., how the entity addresses industry, regulatory, and other external factors) relating to, for example, the following:
   (i) Industry developments (e.g., the entity might not have the personnel or expertise to deal with the changes in the industry)
   (ii) New products and services (e.g., potential for increased product liability)
   (iii) Expansion of the business (e.g., demand might not have been accurately estimated)
   (iv) New accounting requirements (e.g., potential incomplete or improper implementation, or increased costs)
   (v) Regulatory requirements (e.g., there might be increased legal exposure)
   (vi) Current and prospective financing requirements (e.g., potential loss of financing due to the entity's inability to meet requirements)
   (vii) Use of IT (e.g., systems and processes may be incompatible)
b. Effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (e.g., potential incomplete or improper implementation)

Measurement and review of the entity's financial performance

a. Key ratios and operating statistics
b. Key performance indicators
c. Employee performance measures and incentive compensation policies
d. Trends
e. Use of forecasts, budgets, and variance analysis
f. Analyst reports and credit rating reports
g. Competitor analysis
h. Period-on-period financial performance (revenue growth, profitability, leverage)

Internal control components

a. Control environment
b. Risk assessment process
c. Information system, including the related business processes relevant to financial reporting and communication
d. Control activities
e. Monitoring of controls

Source: Adapted from CAS 315.

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CHAPTER 7

Fraud Risk Assessment

Users of audited financial statements generally believe that one of the main objectives of audits is fraud detection. External auditors know the issue is very complex; moreover, they are constantly being challenged by the users' perceptions that the auditor's work should uncover all manner of fraud and misstatement in financial statements. This difference in viewpoints is one of the chronic expectation gaps between external auditors and users of published financial statements. However, in the today's environment, this expectation gap is increasingly being closed. Financial statement auditors need to understand fraud and potential fraud situations, and they need to know how to ask the right kinds of questions during an audit. This chapter's purpose is to heighten your familiarity with the nature, signs, prevention, detection, and reaction to fraud that can enable you to perform financial statement audits with awareness of fraud possibilities.

EcoPak Inc.

Mike gets involved right away in investigating EcoPak's suspected fraud since it relates to the production operations. He and Nima describe to Tariq various changes they implemented during the prior year to make their production much more efficient in terms of the conversion of raw biomass material into finished packaging stock. EcoPak's engineers developed an innovative new process that increases the air component of the final packaging material without increasing its volume or reducing its strength. This process has now been patented. They expected the new process would drastically increase their overall contribution margin but were puzzled about why it seemed to just stick around the same percentage as before. When Mike and Nima start to really dig into the production cost records and variances, they notice that the volume usage of the key raw material had decreased as they had expected, but its costs have increased, thus offsetting any volume gains. On further investigation, they find that main cost increases are in the raw material that is purchased solely from the plant that Zhang owns.

When they tell Zhang about these discrepancies, she immediately launches an investigation that reveals that the accounts receivable manager at her plant has been adding a percentage to the selling prices of the material above the approved price list. Mike and Nima investigate on the EcoPak side and find their accounts payable manager was approving the payments for these higher amounts. When they ask her why she was approving what amounted to unauthorized overpayments, she breaks down in tears, and says she is so sorry! She had been using her authority to override the controls but never thought it would amount to a big enough difference to hurt EcoPak's profitability. She relates how the accounts receivable manager at Zhang's plant was her boyfriend. When she told him about EcoPak's

LEARNING OBJECTIVES

After completing this chapter, you will be able to do the following:

- **LO1** Differentiate among frauds, errors, and illegal acts that might occur in an organization.
- **LO2** Outline the auditing standards related to external, internal, and governmental auditors' responsibilities to detect and report frauds, errors, and illegal acts.
- **LO3** Describe some of the conditions that lead to frauds.
- **LO4** Explain the audit procedures for detecting common employee fraud schemes.
- **LO5** Explain the audit procedures for detecting common fraudulent financial reporting.
- **LO6** Describe documents that auditors use for fraud risk assessment and detection.

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new process that would lead to them purchasing lower quantities of the material his company supplies to them, it gave him the idea for the scam. A lack of segregation of duties at his company allowed him to inflate the selling prices and then skim off the excess amounts when he received the inflated payments from EcoPak. But for his scam to succeed, he needed his girlfriend to override the controls at EcoPak. She said they used the money at first to do a bit of gambling and take a luxury cruise. Then, about two weeks ago, she started to talk to him about stopping the whole scheme because it was starting to seem really bad, and he left her.

Zhang is absolutely outraged when she hears the whole story: "Both these people are stealing from our company. They must be fired instantly, and I will do everything I can to see they never work again in our industry!" While Tariq feels very bad that EcoPak had to experience such a tawdry fraud, he realizes that the incident shows EcoPak does have some strong management level controls: Mike and Nima's monitoring of the costs and variances allowed them to notice right away that their reported results did not mesh with what was going on in their operation. And there was a control over paying the authorized prices—it had to be overridden by collusion for the fraud to proceed. However, he also realized that even the best controls can be overridden by those given authority, who are trusted to apply them. For Tariq, this is a good reminder that fraud risk always needs to be kept in mind in auditing a company (and managing it, too!)

Tariq takes Nima out for lunch one day soon after the dust settles. They start comparing stories about their university accounting courses when they first learned about fraud, and Nima exclaims, "I never thought it would actually happen to my company!' She then tells Tariq an amazing story. "A couple of weeks ago, I got a call from a guy who claimed to be an 'IFRS consultant' from one of the big investment firms. He said he'd heard we were planning to do an IPO soon, and he could really help us 'make our financial statements shine.' He said he could really help us get significantly higher price for our shares when we first issue them to the public. He said he knew lots of tricks 'to plump up your balance sheet' that he'd learned from companies such as WorldCom and Enron. He said those stories happened so long ago that nobody remembers them anymore, not even the auditors, so they will work again. I couldn't believe my ears! I tried to find out more about who he works for, but he cut me off saying he had another important call. I even tried to trace the number but it was blocked. Wow, it takes all kinds, I guess!"

As Tariq was travelling home, he reflected on all these events, and the business relations he has been building with Nima, Mike, Kam, and Zhang. It all made him realize he was getting a good feeling about "management's integrity" at EcoPak.

DEFINITIONS RELATED TO FRAUD

LO1 Differentiate among frauds, errors, and illegal acts that might occur in an organization.

There are several kinds of fraud. Some are defined in laws, while others are matters of general understanding. Exhibit 7–1 shows some acts and devices often involved in financial frauds. Collectively, these are known as **white-collar crime**—the misdeeds done by people who wear business suits to work and steal with a pencil or a computer. White-collar crimes involve ink stains instead of blood stains.

white-collar crime: misdeeds committed by business and government professionals, typically non-violent

Fraud is knowingly making material misrepresentations of fact, with the intent of inducing someone to believe the falsehood, act upon it, and thus suffer a loss or damage. This definition includes all the ways in which people can lie, cheat, steal, and dupe others. Auditors are mainly concerned with two types of fraud: employees misappropriating company assets, or management making false and misleading claims in financial statements.

fraud: in financial statement auditing, an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage

Employee fraud is dishonestly taking money or other property from an employer. It usually involves falsifications of some kind—falsifying documents, lying, exceeding authority, or violating an employer's policies. It consists of three phases: (1) the fraudulent act, (2) the conversion of the money or property to the fraudster's use, and (3) the cover-up. Perpetrators of this type of fraud against the corporation can be anyone from the lowest level employee to an executive manager.

Embezzlement is employees or non-employees wrongfully taking money or property entrusted to their care, custody, and control. It is often accompanied by false accounting entries and other forms of lying and cover-up. **Defalcation** is another name for employee

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employee fraud: the use of dishonest means to take money or other property from an employer

embezzlement: fraud involving employees or non-employees wrongfully taking money or property entrusted to their care, custody, and control; often accompanied by false accounting entries and other forms of lying and cover-up

defalcation: fraud in which an employee takes assets (money or property) from an organization for personal gain; may be due to corruption or asset misappropriation

fraudulent financial reporting: intentional manipulation of reported financial results (by manipulation of accounting records or supporting documents, misrepresentation or omission of significant information, or intentional misapplication of accounting principles) to portray a misstated economic picture of the firm by which the perpetrator seeks an increase in personal wealth gain through a rise in stock price or compensation

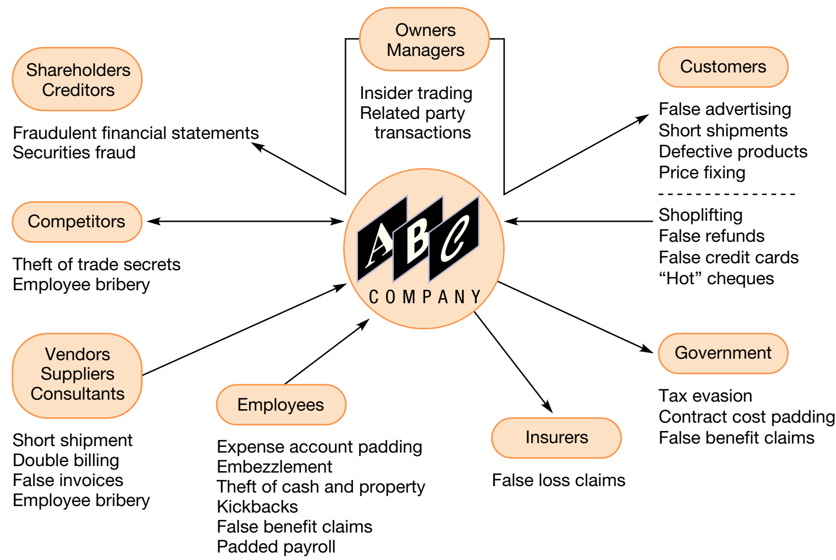
error: in financial statement auditing, unintentional misstatement or omission of amounts or disclosures in financial statements

misappropriations of assets: the theft or misuse of an organization's assets (a type of defalcation)

fraud and embezzlement. Technically, the term is used when somebody in charge of safekeeping the assets is doing the stealing.

Fraudulent financial reporting is a type of fraud perpetrated by management through exploitation of its authority. The United States National Commission on Fraudulent Financial Reporting (1987) defined it as intentional or reckless conduct, whether by act or omission, that results in materially misleading financial statements. Weaknesses in corporate governance create opportunities for management fraud. The perpetrators are management, the victims are investors and creditors, and the instruments of perpetration are corporations.[1]

EXHIBIT 7–1 An Abundance of Frauds



Canadian Auditing Standards (CAS) 240 notes that misstatements in the financial statements can arise from either fraud or error. **Errors** are unintentional misstatements or omissions of amounts or disclosures in financial statements. Frauds are intentional misstatements or omissions in financial statements, including fraudulent financial reporting (usually a type of management fraud) and **misappropriations of assets**. Fraud also involves the following:

1. Use of deception such as manipulation, falsification, or alteration of accounting records or documentation;
2. Misrepresentation or intentional omission of events, transactions, or other significant information; or
3. Intentional misapplication of accounting principles relating to amount, classification, or manner of presentation of disclosure.

The word *fraud* is used in this chapter, but in practice, the auditor is concerned with a suspected fraud rather than a proven one. Final determination of whether fraud has occurred is a legal matter to be decided by a court of law.

1 R. K. Ellott and J. J. Willingham, *Management Fraud: Detection and Deterrence* (New York: Petrocelli Books, Inc., 1980), p. 4.

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Illegal act refers to acts of non-compliance with the laws and regulations of the country or countries in which the auditee organization operates. A range of acts could be considered "illegal" in various different countries. Illegal acts may have a direct effect on financial statement amounts, such as understating a tax liability, or an indirect effect, such as not complying with health and safety regulations. Like fraud, in practice, auditors do not determine whether an illegal act has occurred because this can only be decided by a court of law. Auditors are concerned with suspicions of illegal acts that can directly or ultimately affect fair presentation of the company's financial statements, and raise questions about management's integrity.

illegal act: in financial statement auditing, non-compliance with a domestic or foreign statutory law or government regulation attributable to the entity under audit, or to management or employees acting on the entity's behalf; this does not include personal misconduct by the entity's management or employees unrelated to the entity's business activities

STANDARDS CHECK

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2. Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.
3. Although fraud is a broad legal concept, for purposes of the CASs, the auditor is concerned with fraud that causes a material misstatement in the financial statements.Two types of intentional misstatements are relevant to the auditor—misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred. (Ref: Para. A1–A6)

Source: *CICA Handbook—Assurance,* 2012.

Fraud auditing is described in Association of Certified Fraud Examiners course material as a proactive approach to detect financial frauds using accounting records and information, analytical relationships, and an awareness of fraud perpetration and concealment schemes. A good overview of the nature and scale of the fraud problem in Canada is provided by KPMG's Annual Fraud Report. For example, the 2004 report included the findings listed in the following box.

KPMG 2004 SURVEY ON THE RISK OF MANIPULATION OF FINANCIAL STATEMENTS

In a survey sent to the directors of 75 of Canada's largest corporations, 84% said that they thought it was likely they would hear of a public company in Canada that had been involved in financial statement manipulation in 2004, according to the *2004 Survey on the Risk of Manipulation of Financial Statements* published by KPMG Forensic.

A further 46% thought it possible that such manipulation could occur in the company of the Board on which they themselves sat.

"It's illuminating that our survey results show that this type of fraudulent behaviour carried out as a conspiracy by a group of senior people to deceive corporate directors, auditors, lenders, and other stakeholders to line their own pockets, has come to be seen as commonplace," says James Hunter, President, KPMG Forensic.

Sixty-two percent of directors said that compensation models based on profitability encourage manipulation by CEOs and CFOs. However, directors also argued that the CEO and CFO both bear the greatest responsibility for protecting stakeholders against fraud.

Only 28% of respondents thought the Board of Directors are ultimately responsible for ensuring that financial statements have not been deliberately manipulated. However, 47% felt that it is the CEO who bears the greatest responsibility for protecting against such manipulations.

Source: www.kpmg.ca/en/services/advisory/forensic/manipulationSurvey2004.html. © 2006 KPMG LLP, the Canadian member firm of KPMG International, a Swiss cooperative. All rights reserved. Reprinted with permission of KPMG LLP (Canada).

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A more specific illustration of potential fraudulent financial reporting in Canada is given in the box below.

FRAUD CHARGES AGAINST NORTEL EXECUTIVES CONFIRM THEIR SPECTACULAR FAILURE OF CORPORATE GOVERNANCE

Nortel Networks Corp., Canada's former tech star and once the 12th most valuable company in the world, is now recognized as a spectacular failure in corporate governance with few equals in any nation or industry.

The RCMP made the status official yesterday, laying fraud and other criminal charges against former Nortel chief executive Frank Dunn, erstwhile chief financial officer Douglas Beatty, and Michael Gollogly, former corporate controller. Nortel thus joins the pantheon of disgraced high-fliers that includes WorldCom, Parmalat, Enron, and Tyco.

Dunn was one of seven top executives abruptly fired by Nortel in April 2004, setting off a long running financial scandal at the once revered firm.

Canadians need little reminding of the crash and burn of the widely held Nortel, whose shares peaked at $124.50 in July 2000 before nose-diving to a low of 67 cents by October 2002, erasing $385 billion in shareholder value—more than the GDP of Switzerland, Australia, or Malaysia.

Dunn was the obscure certified management accountant who joined Nortel after graduating from McGill University with a BCom and was tapped to replace retiring CEO John Roth in 2001.

Dunn's task was to revive an enterprise whose revenues had collapsed by two-thirds in the aftermath of the "irrational exuberance" of the late 1990s tech and telecom bubble and that had laid off probably more employees more quickly—about 80,000—than any other firm in history.

In what turned out to be the false spring of 2004, with Nortel showing signs of recovery, Dunn was talking proud.

"We climbed a hill no one thought could be climbed," he boasted to the *Financial Times* early that year. "We've got a business model that everybody feels great about."

Dunn was in the habit of referring to himself as Nortel. "I am becoming a software/data company and less like a big car manufacturer," Dunn said in 2003.

The career bookkeeper with no previous CEO or tech experience had broken ground on an Oakville lakefront castle with 10,800 sq. ft of living space, later dumped on the market with an asking price of $9.5 million after Dunn's firing.

What Nortel was becoming during Dunn's brief tenure was never clear. But Dunn undeniably was becoming rich; Nortel's board had agreed to a ludicrous bonus plan tied to profit targets designed to "incentivize" Dunn and his crew. In short order, Dunn obliged in January 2004 with a reported 2003 annual profit—Nortel's first in seven years, and, as agreed, Dunn, Beatty, and Gollogly pocketed a quick $13 million for meeting the target.

Alas, the "profits" justifying the bonus payouts turned out to be phantom, inflated by a staggering $3.4 billion (U.S.) between 1999 and 2005; during about half of that period, Dunn was chief financial officer, in charge of the firm's financial reporting. Today, Dunn claims he "rescued" Nortel, and that the accounting discrepancies over six years were all "innocent errors."

Nortel has paid a stunning $2.4 billion (U.S.) to settle class-action lawsuits and has spent many more millions of dollars in re-examining its own books.

But the principal culprit is a Nortel board of blue-chip luminaries so easily gulled into thinking Nortel was in vastly better shape than it was.

On June 19, 2008, there was a sort of "perp walk" scenario Nortel investors have waited years to see.

In a scene more reminiscent of high-profile U.S. fraud prosecutions against top executives from Enron to WorldCom, former Nortel chief executive Frank Dunn walked past a phalanx of cameras yesterday after facing criminal charges in a Newmarket courtroom.

Dunn is charged with two counts of falsifying accounts, three counts of being involved in issuing a false prospectus used to sell shares, and two counts of fraud affecting the public securities market.

After years of civil fraud allegations, investigations, lawsuits, and multi-million dollar settlements over the accounting scandal at Nortel Networks Corp., yesterday's move by the Royal Canadian Mounted Police marks the first criminal charges to be laid.

But it remains hotly debated whether the arrests will mark a turning point in Canada's reputation for loose oversight of stock markets and an inability to make prosecutions stick—what former Bank of Canada governor David Dodge once called our "wild west" notoriety among global investors.

It took police four years and more than more than 50 people sorting through some 20 million electronic documents to make the case against the former Nortel executives.

Claude Lamoureux, former president of the Ontario Teachers' Pension Plan Board, said the fraud charges are a good sign.

"Every investor should be happy these charges are being laid," he said. "Clearly it shows IMET (fraud unit of RCMP) was active and many of us had doubts about it."

Source: *The Globe and Mail,* June 20, 2008, pp. 1, 15; *The Toronto Star,* June 20, 2008, p. 1; CTV News, June 19, 2008, at www.ctv.ca/servlet/ArticleNews/story/CTVNews/20080619/rcmp_nortel_080619/20080619?.

Nortel's problems are not unique to Canada, or to the rest of the world, as the following PwC study indicates.

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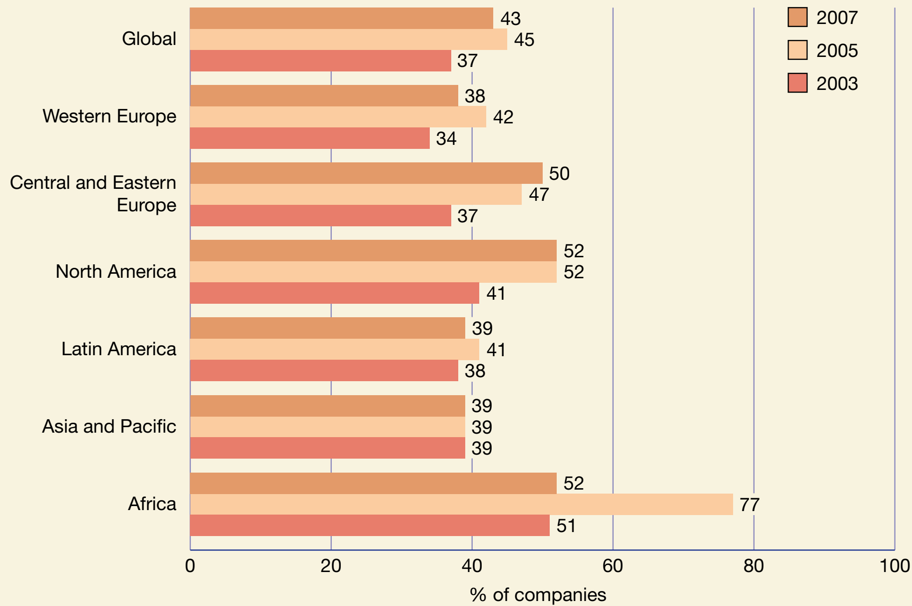
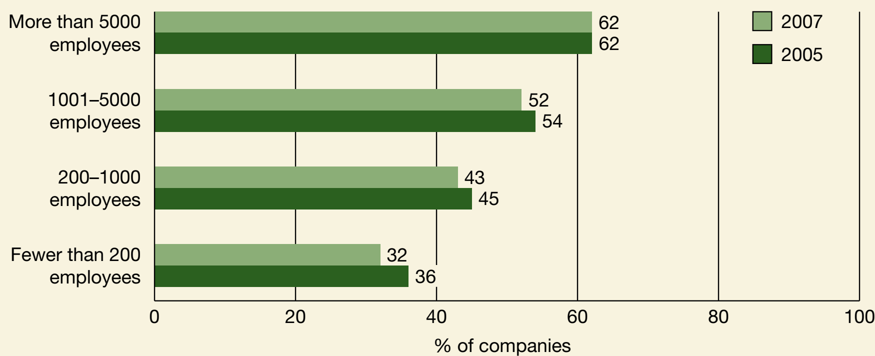
FRAUD—A MOST PROBLEMATIC BUSINESS RISK

Our 2007 survey reveals that fraud remains one of the most problematic issues for businesses worldwide, with no abatement, no matter what a company's country of operation, industry sector, or size. Of the 5428 companies in 40 countries that took part in our research project,[1] over 43% reported suffering one or more significant[2] economic crimes during the previous two years—an essentially static level compared with 2005 and an increase of six percentage points over 2003.[3]

Companies reporting fraud (2003–2007)



Companies reporting fraud, according to their number of employees



1 The 2007 Crime survey is the fourth multi-national survey conducted by PricewaterhouseCoopers and our data stretches over eight years.

2 The term "significant" was left to the discretion of the individual respondent with the proviso that it should relate to economic crimes that had a definite impact on the business, whether direct tangible damage or collateral and psychological damage.

3 Copies of our previous global economic crime surveys can be found at www.pwc.com/crimesurvey.

Source: © 2007 PricewaterhouseCoopers. All rights reserved. "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

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CAS 240

4. The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior which can be reinforced by an active oversight by those charged with governance. Oversight by those charged with governance includes considering the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability.

Source: *CICA Handbook—Assurance,* 2012.

What may turn out to be one of the biggest frauds ever was first made public in December 2008. It was the Madoff fraud described in the box below.

PONZI SCAM ARTISTS SHARE CHARM, RESPECTABILITY

Why they are called con men? They are smart, have an aura of success about them, exude charm and respectability, and, most of all, they instill "CONfidence." Bernard Madoff, the Wall Street trader convicted for running the biggest Ponzi scheme in history, shares many of the basic qualities of Ponzi swindlers through history, according to law enforcement authorities and others who study scams. Scam artists portray confidence, charm and, a command of finance that makes them appear trustworthy.

The original Ponzi schemer, Charles Ponzi, was an Italian immigrant who worked as a waiter, bank teller, and nurse before he talked investors into sinking their money into his short-lived swindle, a complex, but completely bogus scheme involving postal currency. In 1920, Ponzi began advertising that he could make a 50% return for investors in only 45 days. Ponzi began taking in money from all over New England and New Jersey as people mortgaged their homes and handed over their life savings to invest in this bonanza. Some tens of millions of dollars were invested with him before the fraud was discovered. Ponzi's scheme was hugely lucrative for some early investors (he was even lauded as a hero in the Italian community!) but ultimately he cheated thousands of people out of $10 million. He was imprisoned for mail fraud before being deported in 1934.

A Ponzi scheme, also known as a pyramid scheme, is a scam in which people are enticed to invest in a fraudulent operation that falsely promises exceptionally high returns. The earliest investors are paid their big "returns" out of the money put in by later investors, thus giving the false impression of good returns. These schemes collapse once the promoter can no longer bring in enough money to pay existing investors who seek to redeem out their investments. Ponzi's scheme was one of the most famous con games of his time, and his name has been given to similar scams ever since.

People who run Ponzis can fall into two types. There are the con artists like Ponzi who set out to cheat investors quickly and run. Then, there are those who started a legitimate investment business but lost money, so they use new investors' money improperly to cover up the losses, which piled up as more new money was used to pay "returns" to earlier investors. (Perhaps if Madoff had not faced $7 billion in redemptions, his Ponzi scheme might not have been discovered.) Some speculate that Madoff was of the second type—once highly respected on Wall Street and a former Nasdaq chairman. While appearing bookish and unassuming, he maintained a lavish lifestyle with luxurious homes, expensive cars, and exclusive club memberships and also donated millions to charity. He was widely considered to have the magic touch as an investor.

When Madoff confessed and was arrested in 2008, he told F.B.I. agents that the losses might be $50 billion, according to court filings. Various institutions and individuals so far have reported losses totalling more than $20 billion, but it is unclear how much of that is cash they actually invested and how much represents paper profits based on the falsified returns Mr. Madoff said investors were earning.

Madoff regularly delivered returns of 10–17% to investors, a very good year-in, year-out return but on the low end of the 10–100% a year typically offered in more aggressive Ponzi schemes. Returns such as those Madoff reported should have been a major warning signal because assets guaranteeing such high returns year after year without risk simply do not exist. Ponzi schemes can pay initial investors these returns by raising more money from new investors instead of the legitimate way of making profitable investments.

Yet, even Madoff's most fortunate clients, the early investors, may wind up having to give back some of their gains, as investors in another recent financial fraud, the Bayou Group hedge fund in 2005, might have to do. In the Bayou case, investors lost $400 million and the bankruptcy judge ruled that investors who withdrew money before Bayou collapsed might have to return their profits, and possibly even some of their initial investments, to the bankruptcy trustee overseeing the unwinding of Bayou. The returned money is to be distributed among all investors, who are expected to receive only about 20–40% of their original investments. Madoff's winning clients are likely to face similar legal challenges; New York State laws may allow the receiver, or bankruptcy trustee, to "clawback" money investors received from the scheme any time in the last six years, even if the investors were completely unaware that the scheme was fraudulent. But determining which investors made money is extremely complicated.

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Madoff's practices appear to have gone on for many years and involved thousands of clients who invested both directly with him and through third-party hedge funds. Investors across the New York area clamoured to invest with Madoff because of his continual double-digit returns and the reports of serious wealth creation. Some of those investors never took out a cent of what they invested, while others took out only a fraction, and a few took out more than they put in. His arrest and conviction is seen as a serious black eye for the hedge fund industry and for all non-transparent investment vehicles as the scandal reveals the inner workings of the hedge fund industry, whereby intermediary feeders bring in their clients and take fees for putting clients with an investment manager.

Sources: Denise Lavoie, "Ponzi scam artists through history share charm, respectability," *Pittsburgh Post-Gazette,* Dec. 20, 2008: A.8; Alex Berenson, "Even winners may lose with Madoff," *New York Times,* Dec. 19, 2008, at www.nytimes.com; and Robert Lenzner, "Bernie Madoff's $50 billion Ponzi scheme," forbes.com, April 26, 2008, at http://www.forbes.com/2008/12/12/madoff-ponzi-hedge-pf-ii-n_rl_1212croesus_inl.html.

REVIEW CHECKPOINTS

7-1 What are the defining characteristics of white-collar crime, employee fraud, embezzlement, defalcation, management fraud, errors, and illegal acts?

7-2 What does a fraud perpetrator look like? How does he or she act?

AUDITORS' RESPONSIBILITIES FOR DETECTING FRAUD

In response to the growing problems of fraud, auditors have taken on increased responsibility for detecting fraud and other illegal acts in recent years. As indicated in the auditor's report (Chapter 4), auditors have the responsibility "to obtain reasonable (i.e., high) assurance as to whether the financial statements are free of material misstatements," including misstatements due to fraud. The Canadian auditing standards are rigorous.

LO2 Outline the auditing standards related to external, internal, and governmental auditors' responsibilities to detect and report frauds, errors, and illegal acts.

STANDARDS CHECK

CAS 240

17. An auditor conducting an audit in accordance with CASs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the CASs.

Source: *CICA Handbook—Assurance,* 2012.

Auditors' Responsibility to Consider Fraud and Error in an Audit of Financial Statements

CAS 240 requires the auditor to make enquiries of management about fraud and to consider **fraud risk** on every audit engagement. The auditor should document fraud risk factors identified as being present during the auditor's assessment process and document the auditor's response to the assessed risks of material misstatement due to fraud at the financial statement level. This includes the nature, timing, and extent of audit procedures and how the procedures link to with the assessed fraud risks at the assertion level. The auditor should also obtain written management representations about management's suspicions or knowledge of any actual fraud and its extent. Findings should be communicated to management, the audit committee or equivalent, and, where required or permitted, to outside agencies. CAS 240 also makes clear that the primary responsibility for the prevention and detection of fraud rests with management and those charged with governance of the reporting entity. This responsibility includes designing and implementing internal controls and other corporate governance mechanisms to deter fraud. Misappropriation of assets

fraud risk: in financial statement auditing, the possibility that fraud has resulted in intentional misstatement in the financial statements; two types of intentional misstatements are relevant to the auditor: those resulting from fraudulent financial reporting and those resulting from misappropriation of assets

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fraud is frequently termed fraud against the company because it is usually carried out by lower-level employees, and management and auditors have a common interest in detecting such fraud. In contrast, fraudulent financial reporting (misreporting fraud) is a fraud *for* the company but against new investors that pits the auditor against management and its corporate governance. Ponzi schemes are a misreporting fraud.

STANDARDS CHECK

CAS 240

5. The auditor shall make inquiries of management regarding:
(a) Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments; (Ref: Para. A12–A13)
(b) Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist; (Ref: Para. A14)
(c) Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and
(d) Management's communication, if any, to employees regarding its views on business practices and ethical behaviour.

Source: *CICA Handbook—Assurance,* 2012.

CAS 240 requires auditors to maintain professional skepticism, and make no assumption about management's honesty.[2] For example, auditors would now presume a risk of fraudulent revenue recognition, a presumption that is "rebuttable" by the audit evidence. That is, if the auditors can convince themselves that the risk is appropriately low (the Public Company Accounting Oversight Board [PCAOB] suggests it should be "remote") then the presumption is rejected. This logic is similar to the burden of proof concept in law and critical thinking.

STANDARDS CHECK

CAS 240

12. In accordance with CAS 200, the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. (Ref: Para. A7–A8)

Source: *CICA Handbook—Assurance,* 2012.

How does the auditor justify that the fraud risk is sufficiently low? Under CAS 240, the rebuttable presumption requires auditors to perform analytical procedures on revenues, make enquiries, and scan for unusual entries (especially at year-end), and the audit team should have brainstorming sessions to identify and share information on fraud risk factors during the audit. Auditors also need to identify biases in management accounting estimates and be able to understand the business rationale of transactions. If the auditors cannot reject the rebuttable presumption, then they need to raise the matter with the audit committee (or equivalent) and take it from there.

The traditional role of the investigative or forensic auditor was to get involved when the risk of fraud was not sufficiently low (i.e., when there was predication or cause for concern because there were too many fraud risk factors, and the audit committee authorized further investigation). However, forensic auditors are increasingly being used to perform proactively the initial fraud risk assessments in planning the audit. They may be used to screen clients and be involved in the initial meetings with audit committees and management. There are several reasons for this trend. First, it acts as a fraud deterrent and makes the client aware of how seriously the profession takes its fraud detection responsibilities. Second, forensic auditors are specially trained in techniques to indicate when people are lying. Finally, forensic auditors are more familiar with legal requirements

2 For example, see D. Selley and E. Turner, "Detecting fraud and error," *CA Magazine*, August 2004, p. 38.

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regarding documentation of frauds, such as witness statements, confessions, control of chain of custody of evidence, and preparation of written reports for use as evidence in a court of law. Forensic auditors have little in the way of standard programs or materiality guidelines to limit their attention for fraud possibilities. They float on a sea of observations of exceptions and oddities that may only hint at the fraud beneath the surface.

Illegal Acts by Auditees

The ISA 250, on which CAS 250 is based, is written to apply in a wide variety of legal environments around the world. While it notes that some laws and regulations will have a direct effect on the financial statements as they determine the reported amounts and disclosures, others must complied with to allow the entity to conduct its business but do not have a direct effect on its financial statements. This auditing standard uses a fairly broad term, "non-compliance with laws and regulations" to cover a range of acts that could be considered "illegal" in various different countries. We will use the term "illegal acts" in our discussion of this topic. By way of contrast, U.S. SAS 54 explicitly distinguishes between two kinds of illegal acts in the specific context of the U.S. legal environment:

> **Direct-effect illegal acts** have direct and material effects on financial statement amounts (e.g., violations of tax laws and government contracting regulations for cost and revenue recognition), and they are dealt with in the same manner as errors and irregularities.
>
> **Indirect-effect illegal acts** refer to violations of laws and regulations that are far removed from financial statements (e.g., those relating to securities trading, occupational health and safety, food and drug administration, environmental protection, and equal employment opportunity).

direct-effect illegal acts: violations of laws or government regulations by the company, its management, or the employees that produce direct and material effects on dollar amounts in financial statements

indirect-effect illegal acts: violations of laws and regulations that are far removed from financial statements

In the United States, indirect-effect illegal acts come under the general awareness responsibility, particularly in matters of contingent liability disclosure, but they are not part of the routine responsibility for detection and reporting. CAS 250, on the other hand, requires auditors to consider the consequences of the illegal acts very broadly, and the best way of disclosing these. If failures to disclose would result in a material misstatement, then the auditor should attempt to reduce this risk to an appropriately low level. CAS 250 acknowledges that illegal acts may be difficult to detect because of (1) efforts made to conceal them and (2) questions about whether an act is illegal, which are complex and may only be resolved by a court of law. For these reasons, the engagement letter should inform management of the audit's limitations in detecting illegal acts.

STANDARDS CHECK

CAS 250

8. The auditor is required by this CAS to remain alert to the possibility that other audit procedures applied for the purpose of forming an opinion on financial statements may bring instances of identified or suspected non-compliance to the auditor's attention. Maintaining professional skepticism throughout the audit, as required by CAS 200 is important in this context, given the extent of laws and regulations that affect the entity.

Source: *CICA Handbook—Assurance,* 2012.

CAS 250, paragraph 12, notes that the auditors' knowledge of the business and enquiries of management help to identify laws and regulations that, if violated and not reported, could result in material misstatements. In addition, auditors should enquire and obtain representations about awareness and disclosure of possibly illegal acts (CAS 250, paragraph 16). Material, possibly illegal, acts should be communicated to the audit committee and appropriate levels of management

From a critical thinking perspective, the most important development regarding the fraud and illegal acts auditing standards was dropping the assumption that management is honest, a change that took place in 2004. Now, auditors must explicitly address the risks of fraud in revenue recognition. If risk is present, the auditor must perform further

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STANDARDS CHECK

CAS 250

12. As part of obtaining an understanding of the entity and its environment in accordance with CAS 315, the auditor shall obtain a general understanding of:
    (a) The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates; and
    (b) How the entity is complying with that framework. (Ref: Para. A7)

16. The auditor shall request management and, where appropriate, those charged with governance, to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor. (Ref: Para. A12)

Source: *CICA Handbook—Assurance,* 2012.

procedures, but even without this risk auditors must now document the reasons (i.e., from a critical thinking perspective, the auditor must use audit evidence to argue that fraud risk is at an acceptable level). If sufficient risk of material fraud exists (i.e., fraud risk is high), then a fraud auditor should be called in, with the approval of the auditee's directors, audit committee, or management. If the risk of material fraud or non-compliance is not acceptably low, then the auditor cannot issue clean audit opinion.

Auditing Accounting Estimates and Fair Value Accounting

CAS 540 relates to manipulation of estimates in fraudulent financial reporting. This is especially a concern in fair value accounting for securities in illiquid markets, such as those of the global credit markets during the crisis in 2008 (as can be seen in the "Madoff Economy" box in Chapter 14). This area is difficult as accounting estimates are an approximation of a financial statement element, item, or account made by an organization's management; for example, for allowance for loan losses, net realizable value of inventory, percentage-of-completion revenue, and fair value accounting estimates.

CAS 540 deals with estimation uncertainty and the need to address significant risks associated with this uncertainty by ensuring that they are adequately disclosed. Disclosure may be through appropriate accounting adjustments, by the notes to the financial statements, or possibly through Emphasis of Matter paragraphs in the auditor's report. Critical thinking concepts that make use of conceptual frameworks in accounting and auditing can help guide the appropriate auditor response.

Management is responsible for making the accounting estimates, and auditors are responsible for evaluating the reasonableness of these within the financial statements as a whole. Auditors are supposed to keep track of the differences between management's estimates and the closest reasonable estimates supported by the audit evidence. Uncorrected differences between the two causes increased estimation uncertainty. Auditors are also supposed to evaluate both the total of the differences for indications of a systematic bias and the combination of the differences along with other likely errors in the financial statements.

STANDARDS CHECK

CAS 540

20. For accounting estimates that give rise to significant risks, the auditor shall also evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework. (Ref: Para. A122–A123)

Indicators of Possible Management Bias

21. The auditor shall review the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias. Indicators of possible management bias do not themselves constitute misstatements for the purposes of drawing conclusions on the reasonableness of individual accounting estimates. (Ref: Para. A124–A125)

Source: *CICA Handbook—Assurance,* 2012.

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Communication with Audit Committees (or Equivalent)

CAS 260 requires that those charged with governance (audit committees or equivalent) are informed about the scope and results of the independent audit. The auditing standards place great faith in audit committees and boards of directors, although their effectiveness has, at times, been questioned.[3] This CAS requires oral or written communication from the auditors on the following: (a) misstatements other than trivial errors; (b) fraud; (c) misstatements that may cause future financial statements to be materially misstated; (d) illegal or possibly illegal acts, other than ones considered inconsequential; and (e) significant weaknesses in internal control.

There is some inconsistency in the CASs between responsibility for detecting material misstatements due to error and those due to fraud. Specifically, CAS 240 states that an auditor is responsible for obtaining reasonable assurance whether the financial statements are free of material misstatement without qualifying the sources of that misstatement, while later the same CAS 240, paragraph 6, explains that an auditor is less likely (because of concealment) to detect misstatement due to fraud than he or she is to detect that resulting from error. In addition, CAS 250 suggests that some illegal acts, specifically those corresponding to indirect-effect illegal acts, such as building code violations, may have an even lower chance of being detected by an external auditor.

The American Institute of Certified Public Accountants (AICPA) Statement on Auditing Standards (SAS) No. 99 *(Consideration of Fraud in a Financial Statement Audit)* was issued in the environment prevailing in 2002. It is the first standard to require forensic procedures on all financial statement audit engagements. The AICPA views SAS 99 as the "cornerstone" of its comprehensive antifraud and corporate responsibility program. The goal of the program is to "rebuild the confidence of investors in our capital markets and re-establish audited financial statements as a clear picture window into corporate America." These words acknowledge the extensive harm done to the profession by accounting and auditing scandals, such as Enron, Andersen, and WorldCom.

SAS 99 significantly extended audit requirements in a number of ways. These requirements are also incorporated in CAS 240 and can be summarized via the extensive documentation that supports compliance with the standard. Auditors must document the following items in relation to the risk of material misstatement due to fraud:

- Discussion among audit team members regarding the auditee entity's susceptibility to fraudulently misstated financial statements, including how and when the discussion occurred, who participated, and the subjects discussed
- Procedures to identify and assess the risks (This includes knowledge of auditee business risks and their effect on audit risk as per the international exposure draft on audit risk. This requirement suggests use of risk-based audit approaches as explained in Chapter 6.)
- Specific risks identified and a description of the auditor's response to those risks
- Reasons supporting that conclusion, unless a particular improper revenue recognition has been identified
- Results of procedures performed to address the risk of management override of controls
- Conditions and analytical relationships causing the auditor to believe additional auditing procedures were required, and any further responses deemed appropriate to addressing such risks
- Nature of communications about fraud made to management, the audit committee, and others[4]

External auditors assess the risk of fraud through warning signs. A study by American researchers provides guidance on these: "The lack of awareness of the warning signs of fraud is a frequently cited cause of audit failure. If auditors better understood the signs and applied professional skepticism, they would decrease their risk of not detecting fraud.

3 Wechsler reported the findings of the National Commission on Fraudulent Financial Reporting: of the 120 fraudulent financial reporting cases brought by the SEC between 1981 and 1986, two-thirds involved companies that had audit committees. This caused Professor Briloff to remark, "Now I see that they are not functioning as they should." (D. Wechsler, "Giving the watchdog fangs," *Forbes*, November 13, 1989, p. 130.) However, these observations beg the question of the thousands of companies with and without audit committees that did not get involved in fraudulent financial reporting.

4 M. Ramos, "Auditors' responsibility for fraud detection," *Journal of Accountancy*, January 2003, pp. 29, 35—36.

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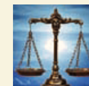
Knowing the most important warning signs should help auditors do a better job of assessing fraud risk."[5] A survey of 130 auditors asked them to rank thirty commonly cited fraud warning signals according to their significance. The auditors ranked client dishonesty as the most important factor. The survey revealed that auditors generally perceived "attitude" factors to be more important warning signs of fraud than "situational" factors. The top fifteen warning signs are listed in the following box (see also the two boxes that follow).

AUDITORS' RANKING OF THE RELATIVE IMPORTANCE OF FRAUD WARNING SIGNS

1. Managers have lied to the auditors or have been overly evasive in response to audit enquiries.
2. The auditor's experience with management indicates a degree of dishonesty.
3. Management places undue emphasis on meeting earnings projections or the quantitative targets.
4. Management has engaged in frequent disputes with auditors, particularly about aggressive application of accounting principles that increase earnings.
5. The client has engaged in opinion shopping.
6. Management's attitude toward financial reporting is unduly aggressive.
7. The client has a weak control environment.
8. A substantial portion of management compensation depends on meeting quantified targets.
9. Management displays significant disrespect for regulatory bodies.
10. Management operating and financial decisions are dominated by a single person or a few persons acting in concert.
11. Client managers display a hostile attitude toward the auditors.
12. Management displays a propensity to take undue risks.
13. There are frequent and significant difficult-to-audit transactions.
14. Key managers are considered highly unreasonable.
15. The client's organization is decentralized without adequate monitoring.



Source: V. B. Heiman-Hoffman, K. P. Morgan, and J. M. Patton, "The warning signs of fraudulent financial reporting," *Journal of Accountancy,* October 1996, pp. 76—77. Copyright 1996. American Institute of Certified Public Accountants, Inc. All rights reserved. Used with permission.

NO SEPARATION OF DUTIES

An electronic data processing employee instructed the company's computer to pay his wife rent for land she had allegedly leased to the company by assigning her an alphanumeric code as a lessor and then ordering the payments. The control lesson: Never let a data entry clerk who processes payment claims also have access to the approved vendor master file for additions or deletions.

Source: G. J. Bologna and R. J. Lindquist, *Fraud Auditing and Forensic Accounting* (New York: John Wiley & Sons, 1987), pp. 70—71.

MONEY, MONEY, MONEY CASE

Brian Molony, a 29-year-old assistant branch manager and lending officer of a large downtown Toronto bank, defrauded the bank of some $10.2 million over a 20-month period. He fabricated loans to real and fictitious customers and gambled away the proceeds at an Atlantic City casino. Molony was such a valued customer that the casino flew its corporate jet to Toronto to pick him up for weekend jaunts.

The defalcation came to light when Canadian law enforcement authorities arrested Molony for a traffic violation on his return from a trip to Atlantic City. A search of his person disclosed that he was carrying about $29,000 in currency. That information was passed on to the bank, which then conducted an audit and found the fictional loans and transfers of funds to the casino. The bank is suing the casino to recover at least part of its loss.

Molony used a *lapping scheme* to keep auditors off his trail—that is, he paid off earlier loans with subsequent loans so that no delinquencies would show. However, the fictional loan balances grew and grew. Molony's superior at the branch had approved the larger loans because "he had no reason to mistrust him." The branch manager was subsequently suspended, along with the assistant branch manager for administration, a credit officer, and an auditor.

Source: G. J. Bologna and R. J. Lindquist, *Fraud Auditing and Forensic Accounting, 2nd ed.* (New York: John Wiley & Sons, 1995), pp. 230—231. Reprinted by permission of John Wiley & Sons Inc.

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5 V. B. Heiman-Hoffman, K. P. Morgan, and J. M. Patton, "The warning signs of fraudulent financial reporting," *Journal of Accountancy*, October 1996, pp. 76—77.

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Materiality and Fraud

Standards of materiality thresholds for external auditors are related to the reporting auditors' knowledge of errors, fraud, and illegal acts. Immaterial errors are supposed to be reported to management at least one level above the people involved. Small matters can be kept in the management family, but errors material to the financial statements must be adjusted and handled by management responsible for the financial statements, to the satisfaction of auditors, or else the audit report will be qualified.

Frauds, both suspected and known, receive a slightly different treatment, but there is still a materiality consideration, in effect. The auditors should inform the audit committee of all suspected fraud, except those that are "clearly inconsequential." Those involving senior management are never inconsequential. In the CASs, discretion is used to determine whether something is minor enough not to matter or report. However, auditors must be satisfied with how management and directors deal with frauds. If uncertainties persist about the frauds and management's actions, the audit report should be qualified, with reasons, or the auditors may withdraw from the engagement.

The "clearly inconsequential" materiality standard also applies to clients' illegal acts. Ones that are more than inconsequential are reported to the organization's audit committee and disclosed in the financial statements. External auditors always have the option to withdraw from the engagement if management and directors do not take satisfactory action in the circumstances.

STANDARDS CHECK

CAS 260

16. The auditor shall communicate with those charged with governance: (Ref: Para. A16)
    - (a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity; (Ref: Para. A17)
    - (b) Significant difficulties, if any, encountered during the audit; (Ref: Para. A18)
    - (c) Unless all of those charged with governance are involved in managing the entity:
        - (i) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and (Ref: Para. A19)
        - (ii) Written representations the auditor is requesting; and
    - (d) Other matters, if any, arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process. (Ref: Para. A20)

A18. Significant difficulties encountered during the audit may include such matters as:

- Significant delays in management providing required information;
- An unnecessarily brief time within which to complete the audit;
- Extensive unexpected effort required to obtain sufficient appropriate audit evidence;
- The unavailability of expected information;
- Restrictions imposed on the auditor by management; and
- Management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested.

In some circumstances, such difficulties may constitute a scope limitation that leads to a modification of the auditor's opinion.

Source: *CICA Handbook—Assurance,* 2012.

Under the CASs, disclosures of irregularities and clients' illegal acts to outside agencies are limited. If the auditors are fired, the provincial securities commission may require an explanation. A fired auditor can inform the successor auditor of any professional matters regarding the firm when the successor makes the enquiries required by professional ethics. Auditors must respond to a subpoena issued by a court or other agency with authority, which will happen in a lawsuit or prosecution. When performing work under public sector audit standards, auditors are required to report irregularities and illegal acts to the client agency under the audit contract, which may be an agency other than the one being audited.

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Former Securities and Exchange Commission (SEC) chairman Arthur Levitt was critical of the profession for allowing "hocus-pocus accounting" that facilitates financial statement fraud. The following box summarizes the most common forms of hocus-pocus accounting.

HOCUS-POCUS ACCOUNTING

Executive Summary

- Public companies that fail to report quarterly earnings that meet or exceed analysts' expectations often experience a drop in their stock prices. This can lead to practices that sometimes include fraudulent overstatement of quarterly revenue.
- One of the most common schemes is the bill-and-hold sales transaction. While it is not necessarily a GAAP violation, it is often associated with financial frauds and calls for deeper investigation. The SEC says that all of the following conditions must be met for revenue recognition to be appropriate:
  - The risks of ownership must have passed to the buyer.
  - The customer must have a commitment to purchase, preferably in writing.
  - The buyer must request the bill-and-sale transaction and substantiate a business purpose for it.
  - A fixed delivery date must exist.
  - The seller must not retain any significant specific performance obligations.
  - The goods must be complete and ready for shipment and not subject to being used to fill other orders.
- Deals called sham transactions refer specifically to sales schemes that appear genuine but actually are rigged for the purpose of letting the seller recognize revenue. Other indicators that fraudulent financial reporting might exist include bogus shipping dates, revenue figures that always meet analysts' expectations, and transactions with unusual payment terms.
- Auditors with a good understanding of the client, the business, and its products are well prepared to see the warning signs of revenue-recognition fraud.

Source: D. R. Carmichael, "Hocus-pocus accounting," *Journal of Accountancy,* October 1999, p. 60. Copyright 1996. American Institute of Certified Public Accountants, Inc. All rights reserved. Used with permission.

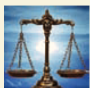
Characteristics of Fraudsters

White-collar criminals are not like typical bank robbers, who are often described as "young and dumb" because of comical mistakes like writing the holdup note on the back of a probation identification card, leaving the getaway car keys on the convenience store counter, using a zucchini as a holdup weapon, and timing the holdup to get stuck in rush-hour traffic. Then there is the classic story about the robber who ran into his own mother at the bank (she turned him in!).

Burglars and robbers average about $400–$500 for each hit. Employee frauds average $20,000, or up to $500,000 if a computer is used. Yet employee frauds are not usually the intricate, well-disguised ploys of espionage novels. Who are these thieves wearing ties? What do they look like? Unfortunately, they look and are like most everybody else, including you and me: likely married, well-educated, between 20 and 60 years old, and long-term employees. They are probably socially conforming, without an arrest record, and possibly even church members. In most instances, the fraudster will act alone.

White-collar criminals do not make themselves obvious, although there may be telltale signs, described later as behavioural "red flags." Unfortunately, the largest frauds are committed by people who hold high executive positions, have long tenure with an organization, and are respected and trusted employees. After all, these are the people who have access to the largest amounts of money and have the power to give orders and override controls (see the following boxes).

WHO DOES IT?



Alex W. was a 47-year-old treasurer of a credit union. Over a seven-year period, he stole $160,000. He was a good husband and the father of six children, and he was a highly reputed official of the credit union. His misappropriations came as a stunning surprise to his associates. He owed significant amounts on his home, cars, university for two children, two side investments, and five different credit cards. His monthly payments significantly exceeded his take-home pay.

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THE CASE OF THE EXTRA CHECKOUT

The district grocery store manager could not understand why receipts and profitability had fallen and inventory was hard to manage at one of the largest stores in her area. She hired an investigator who covertly observed the checkout clerks and reported that none of the nine had shown suspicious behaviour at any of the nine checkout counters. Nine? That store has only eight, she exclaimed! The store manager had installed another checkout aisle, not connected to the cash receipts and inventory maintenance central computer, and was pocketing all the receipts from that register.

FREE PARKING?

Outside the Bristle Zoo, there is a parking lot for 150 cars and 8 buses. For 25 years, its parking fees were managed by a very pleasant attendant. The fees were for $5 for cars and $20 for buses. Then, one day, after 25 solid years of never missing a day of work, he just did not show up, so the Zoo Management call the city council and asked it to send them another parking agent. The council did some research and replied that the parking lot was the zoo's own responsibility. The zoo advised the council that the attendant was a city employee. The city council responded that the lot attendant had never been on the city payroll.

Meanwhile, sitting in his villa somewhere on the coast of Spain or France or Italy, is a man who had apparently had a ticket machine installed completely on his own and then simply began to show up every day to collect and keep the parking fees, estimated at about $560 per day—for 25 years. Assuming 7 days a week, this amounts to just over $7 million . . . , and no one even knows his name.

This is one that fraud that really "slipped between the cracks" from an internal control perspective!

External and internal auditors get credit for finding about 10–20% of discovered frauds. Voluntary confessions, anonymous tips, and other haphazard means uncover a larger percentage. Fraud examiners have a still higher success rate because they are called in for a specific purpose when fraud is known or highly suspected.

Some aspects of audit methodology make a big difference in fraud discovery success. Financial auditors use inductive reasoning: sample accounting data, derive audit findings, and project the finding to a conclusion about the population. Fraud examiners use similar reasoning but with a focus on individual responsibility: identify the suspects from tip-offs, make clinical observations (stakeouts), conduct interviews and interrogations, eliminate dead-end results, and concentrate on running the fraudster to ground. They can conduct covert activities not in the financial auditors' tool kit. The luxury of the forensic approach involves surveying a wide array of information and sources, eliminating the extraneous, and retaining the selection that proves the fraud. However, as critical thinking recognizes, proof is a relative concept. While a signed confession to fraud may be considered the most conclusive evidence one can get, courts are skeptical of evidence that purports to overcome the presumption of innocence until proven guilty in the Anglo-Saxon system of law. This aspect of fraud auditing and critical thinking is discussed later in this chapter.

REVIEW CHECKPOINTS

7-3 What are the CAS requirements regarding (*a*) fraud risk assessment (*b*) procedural audit work, (*c*) professional skepticism, and (*d*) reporting?

CONDITIONS THAT MAKE FRAUD POSSIBLE, EVEN EASY

LO3 Describe some of the conditions that lead to frauds.

When can fraud occur? Imagine probability of fraud as a function of three factors: motive, opportunity, and lack of integrity. When one or two of these factors weigh heavily in the direction of fraud, the probability increases. When three of them lean in the direction of

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fraud, it almost certainly will occur.[6] As Bologna and Lindquist put it, some people are honest all the time, some people (fewer than the honest ones) are dishonest all the time, most people are honest some of the time, and some people are honest most of the time.[7] Three fraud risk factors are discussed next.

The importance of the three risk factors—motive, opportunity, and lack of integrity—has also been acknowledged in CAS 240 and SAS 99. Both standards use these factors as a framework for linking sources of these risks to audit procedures. CAS 240 and SAS 99 refer to motive as incentives or pressures and lack of integrity as rationalization or attitude. These can also be viewed as social, economic, and moral incentives. The three forms of **fraud incentive** are referred to as the **fraud triangle** or triangulation. Evidence or signs of these incentives are the fraud risk factors. For fraud to occur, all three types of factors need to be present. Hence, auditors use these risk factors as guides for evaluating whether the risk of material fraud is at acceptable levels.

fraud incentive: when management is under pressure, from sources outside or inside the entity, to achieve an expected (perhaps unrealistic) earnings target or financial outcome, particularly as the consequences to management for failing to meet financial goals can be significant; also, when individuals are tempted to misappropriate assets because, for example, they are living beyond their means

fraud triangle: a model of the three factors that make fraud likely: incentive, opportunity, and rationalization

Fraud Incentive

Pressure a person experiences and believes cannot be shared with friends and confidants leads to committing fraud or can serve as the motive for fraud. *Psychotic* motivation is relatively rare and is experienced by "habitual" criminals who steal simply for the sake of stealing. *Egocentric* motivations drive people to steal to achieve more personal prestige. *Ideological* motivations are held by people who think that their cause is morally superior and that they are justified in making someone else a victim. *Economic* motive is far more common than the other three in business frauds, and is simply a need for money. At times, it can be intertwined with egocentric and ideological motivations. Ordinarily honest people can fall into circumstances where there is a new or unexpected need for money and when the normal options for talking about it or going through legitimate channels seem to be closed. Consider these needs:

- College or university tuition
- Gambling debts
- Drugs
- Alimony and child support
- Expensive lifestyle (homes, cars, boats)
- Business or stock speculation losses
- Taxation on good financial results

Probably the most important motive that external auditors consider is compensation tied to accounting measures of performance. This situation creates incentives to manipulate the accounting measurements.

Fraud Opportunity

fraud opportunity: when an individual believes internal control can be overridden to allow a fraud to be perpetrated; for example, when the individual is in a position of trust or has knowledge of specific deficiencies in internal control

A **fraud opportunity** is an open door for solving the unshareable problem by violating a trust. The violation may be a circumvention of internal control policies and procedures, or it may be taking advantage of an absence or lapse of control procedures. Everyone has some degree of trust placed on them in their job, and the higher the position in an organization, the greater the degree of trust; hence, the greater the opportunity for larger frauds. Here are some examples of opportunities:

- Nobody counts the inventory, so losses are not known.
- The petty cash box is often left unattended.
- Supervisors set a bad example by taking supplies home.
- Upper management considered a written statement of ethics but decided not to publish one.

6 For further references, see D. R. Cressey, "Management fraud, accounting controls, and criminological theory," pp. 117—147, and Albrecht et al., "Auditor involvement in the detection of fraud," pp. 207—261, both in R. K. Elliott and J. J. Willingham, *Management Fraud: Detection and Deterrence* (New York: Petrocelli Books Inc., 1980); J. K. Loebbecke, M. M. Eining, and J. J. Willingham, "Auditors' experience with material irregularities: Frequency, nature, and detectability," *Auditing: A Journal of Practice and Theory*, Fall 1989, pp. 1—28.

7 Bologna and Lindquist, *Fraud Auditing and Forensic Accounting*, p. 8.

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- Another employee was caught and fired, but not prosecuted.
- The finance vice-president has investment authority without any review.
- Frequent emergency jobs leave a lot of excess material just lying around.

I COULDN'T TELL ANYONE

An unmarried young woman stole $300 from her employer to pay for an abortion. Coming from a family that strongly disdained premarital sex, she felt that her only alternative was to have the secret abortion. Once she realized how easy it was to steal, however, she took another $86,000 before being caught.

Source: W. S. Albrecht, "How CPAs can help clients prevent employee fraud," *Journal of Accountancy,* December 1988, p. 113. Copyright 1988. American Institute of Certified Public Accountants, Inc. All rights reserved. Used with permission.

Probably the most significant opportunity as far as external auditors are concerned is lack of controls at the highest levels (corporate governance) to prevent management from overriding accounting controls.

Fraud Rationalization

Practically everyone, even the most violent criminals, can be assumed to know the difference between right and wrong. While unimpeachable integrity is the ability to act according to the highest moral and ethical values all the time, lapses and occasional lack of integrity permit pressure and opportunity to take form as fraud. People normally do not make deliberate decisions to "lack integrity today while I steal some money," but they sometimes do find ways to rationalize their act, by describing it to themselves in a way that makes it acceptable to their self-image. Some common examples of **fraud rationalization** are, "I need it more than they do (Robin Hood theory)," "I'll pay it back," "I'm not hurting anybody," "the company can afford it," and "everybody does it."

fraud rationalization: when individuals possess an attitude, character, or set of ethical values allowing them to knowingly and intentionally commit a dishonest act, or when otherwise honest individuals are in an environment that puts sufficient pressure on them to commit a fraudulent act

As was evident from the auditor survey results presented earlier, lack of integrity appears to be the most important factor affecting the risk of management fraud. This should not be surprising since—given managers' authority, responsibilities, and incentives—the other factors of pressure and opportunity are already largely present, and integrity is the only thing preventing fraud at the top levels of the organization. This may be a reason that "tone at the top" is one of the most important aspects of good internal controls.

SHE CAN DO EVERYTHING

Mrs. Lemon was the only bookkeeper for an electrical supply company. She wrote the cheques and reconciled the bank account. In the cash disbursements journal, she coded some cheques as inventory, but she wrote the cheques to herself, using her own name. When the cheques were returned with the bank statement, she simply destroyed them. She stole $416,000 over five years. After being caught and sentenced to prison, she testified to having continuous guilt over doing something she knew was wrong.

Source: "Auditing for internal fraud" training course © 2006 Association of Certified Fraud Examiners.

THE MOST COMMON COMPUTER-RELATED CRIMES

Whereas computer hacking (unauthorized breaking into computers) has received most of the recent media attention, the most prevalent computer crime is the fraudulent disbursement of funds, which is generally preceded by the submission of a spurious claim in one of the following forms:

- False vendor, supplier, or contractor invoice
- False governmental benefit claim
- False fringe benefit claim
- False refund or credit claim
- False payroll claim
- False expense claim

Fraudulent disbursement of funds usually requires a data entry clerk in accounts payable, payroll, or the benefits section, acting either alone or in collusion with an insider or

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outsider (depending on how tight the internal controls are). From an accountant's perspective, the claim is a false debit to an expense so that a corresponding credit can be posted to the cash account for the issuance of a cheque. Auditors assert that such disbursement frauds represent more than half of all frauds by lower-level employees.

At higher management levels, the typical fraud involves overstating profits by the fabrication of such data as sales, which are increased arbitrarily (sales booked before the sales transaction is completed), and the understatement of expenses, which are arbitrarily reduced or disguised as deferrals to the next accounting period. There are numerous variations on these two main themes: overstatement of sales, and understatement of expenses. One of the more common ploys to overstate profits is to arbitrarily increase the ending inventory of manufactured goods or merchandise held for sale. That ploy results in understating the cost of goods sold and thereby increasing the net profit.

The executive compensation system often provides the incentive to overstate profits. If bonus awards depend on profits, executives have an economic incentive to fudge the numbers. They may also be tempted to do so if they own a great many company shares, whose value depends on investors' perceptions of profitability. If profits are down, investors are unhappy and may rush to sell, thus causing a lowered share price and depressing the value of the executive's own shares.

Manipulations of this type often require line executives and personnel in accounting and data processing capacities to conspire together. Such conspiracies have become a recurring theme in business. The pressure on executives for high performance grows each year. We are therefore likely to see more such frauds in the future.

Source: G. J. Bologna and A. J. Lindquist, *Fraud Auditing and Forensic Accounting,* 2nd ed. (New York: John Wiley & Sons, 1995), pp. 176–179. Reprinted by permission of John Wiley & Sons, Inc.

STANDARDS CHECK

CAS 240

A1. Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, perceived opportunity to do so, and some rationalization of the act. For example:

- Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome—particularly since the consequences to management for failing to meet financial goals can be significant. Similarly, individuals may have an incentive to misappropriate assets, for example, because the individuals are living beyond their means.
- A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control.

- Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character, or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

Source: *CICA Handbook—Assurance,* 2012.

Appendix 1 of CAS 240 gives examples of factors relating to the two types of frauds: fraudulent financial reporting and misappropriation of assets. The factors are classified based on the three conditions generally present when material misstatements due to fraud occur: (a) incentives or pressures, (b) opportunities, and (c) attitudes or rationalizations. Appendix 2 of CAS 240 gives examples of audit procedures addressing higher than acceptable risks of fraud. These include revenue recognition procedures, such as confirming relevant contract terms and absence of side agreements with customers; inventory procedures, such as surprise inventory count observations; and procedures related to verifying management estimates by obtaining a comparable estimated from an independent expert. The Application Case in this chapter illustrates some fundamental issues related to acceptability of management estimates.

REVIEW CHECKPOINTS

7-4 What are some of the pressures that can cause honest people to contemplate theft? List some egocentric and ideological pressures, as well as economic ones.

7-5 What kinds of conditions provide opportunities for employee fraud and financial statement fraud?

7-6 Give some examples of some rationalizations to excuse fraud. Would you be able to use them?

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DETECTING EMPLOYEE FRAUD

Since an organization cannot prevent all fraud, its auditors, accountants, and security personnel must be acquainted with some detection techniques. Frauds consist of the act itself, the conversion of assets to the fraudster's use, and the cover-up. Catching people in the fraud act is difficult and unusual. The act of conversion is equally difficult to observe, since it typically takes place in secret away from the organization's offices (e.g., fencing stolen inventory). Many frauds are investigated through noticing the signs and signals and then following the trail of missing, mutilated, or false documents that are part of the accounting records cover-up.

This chapter has already mentioned the red flags, oddities, and unusual events that are signs and signals. Being able to notice these takes some experience, but this text can give some starting places.

Red Flags

LO4 Explain the audit procedures for detecting common employee fraud schemes.

Employee fraud usually, but not always, involves people below the top executive levels. Observation of persons' habits and lifestyle as well as changes in these may reveal some red flags. Fraudsters frequently exhibit these characteristics: defensive, argumentative, and blame-shifting behaviours; tiredness; agitation; inability to make eye contact; irritability; and excessive sweating. Some of these symptoms might lead to suspicions of drug and or alcohol abuse by the individual.

HIGH STYLE IN THE MAILROOM

A female mailroom employee started wearing designer clothes (and making a big deal about it). She drove a new BMW to work. An observant manager, who had known her as an employee for seven years and knew she had no outside income, became suspicious. He asked the internal auditors to examine her responsibilities extra carefully. They discovered she had taken $97,000 over a two-year period.

Source: "Auditing for internal fraud" training course © 2006 Association of Certified Fraud Examiners.

Personality red flags are problematic because (1) honest people sometimes show them and (2) they often are hidden from view.[8] It is easier to notice changes, especially when a person adopts a new lifestyle or spends more money than the salary justifies; for example, on homes, furniture, jewellery, clothes, boats, autos, vacations, and the like.

Telltale hints of a cover-up often appear in the accounting records. The key is to notice exceptions and oddities, such as transactions that are at odd times of the day, month, or season; too many or too few of them; in the wrong branch location; and in amounts too high, too low, too consistent, or too inconsistent. Exceptions and oddities can appear in the following forms:

- Missing documents
- Cash shortages and overages
- Excessive voids and credit memos
- Customer complaints
- Common names or addresses for refunds
- Adjustments to receivables and payables
- General ledger that does not balance
- Increased past due receivables
- Inventory shortages

8 Long lists of red flags can be found in Bologna and Lindquist, *Fraud Auditing and Forensic Accounting*, pp. 49—56; Albrecht et al., *Management Fraud*, pp. 223—26; Statement on Auditing Standard 82; "Auditing for Fraud" courses of the Association of Certified Fraud Examiners; and courses offered by other organizations, such as the CICA and the Institute of Internal Auditors.

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- Increased scrap
- Alterations on documents
- Duplicate payments
- Employees who cannot be found
- Second endorsements on cheques
- Documents that are photocopied
- Dormant accounts that have become active

Internal Control and Fraud Detection

A 2012 study by the Association of Certified Fraud Examiners showed that over 40% of all frauds are detected through tips from employees. This explains why the *Sarbanes-Oxley* Act (SOX) requires audit committees to encourage anonymous whistle blowing by employees. Almost 30% of frauds were detected by management review and internal audit, 9% by other internal controls, 7% by accident, and 3% by external auditors.[9]

THE TRUSTED EMPLOYEE

The owner of a small business hired his best friend to work as his accountant. The friend was given full access to all aspects of the business and was completely responsible for the accounting. Five years later, the owner finally terminated the friend because the business was not profitable. Upon taking over the accounting, the owner's wife found that cash receipts from customers were twice the amounts formerly recorded by the accountant "friend." An investigation revealed that the friend had stolen $450,000 in cash sales receipts from the business while the owner had never made more than $16,000 a year. (The friend had even used the stolen money to make loans to the owner and to keep the business going!)

NO LOCKS ON THE DOOR

Perini Corporation kept blank cheques in an unlocked storeroom, where every clerk and secretary had access. Also in the storeroom was the automatic cheque-signing machine. The prenumbered cheques were not logged or restricted to one person. The bookkeeper was very surprised to open the bank statement one month and find that $1.5 million in stolen cheques had been paid on the account.

Source: "Auditing for internal fraud" training course © 2006 Association of Certified Fraud Examiners.

Fraud awareness auditing involves awareness of employee perceptions of the controls in place (or not in place), plus "thinking like a crook" to imagine ways and means of stealing. When controls are absent, these may be obvious; otherwise, stealing from the company may take some scheming. Thinking like a crook involves critical thinking. It does not mean that you accept the crook's point of view, only that you understand it. It means visualizing how fraud risk factors become incentives for committing frauds, thereby putting the auditor in a better position to predict the fraud. This is also the essence of skepticism—requiring proof of management assertions. Insistence on proof is the essence of critical thinking.

REVIEW CHECKPOINTS

7-7 What might happen if a person could authorize medical insurance claims and enter them into the system for payment without supervisory review?

7-8 What might happen if the inventory warehouse manager also had responsibility for making the physical inventory observation and reconciling discrepancies to the perpetual inventory records?

9 Association of Certified Fraud Examiners, *2012 Report to the Nations–Key Findings and Highlights,* available at www.acfe.com/rttn-highlights.aspx.

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The importance of internal control in preventing and detecting fraud cannot be over estimated. In designing a system of controls, it is important to identify weaknesses or improper utilization of materials, people, or equipment. A good first step is investigating the company's history of losses and prevention of them, and designing a system of checks and balances to address these risks. To the extent possible, every transaction should be authorized, initiated, approved, executed, and recorded. No transaction should be handled by only one person. Preprinted, serial-numbered documents, such as purchase orders, sales and purchases invoices, receiving reports, cheques, and debit or credit memos, should be used. All policies and procedures should be documented, including procedures in the event of an internal control breakdown. Once implemented, the internal control system should be communicated orally and in writing to all employees. The policies should communicate firmly and clearly that fraud will not be tolerated and what the consequences of fraud involvement will be. The internal control system should be evaluated periodically for cost effectiveness, and employee feedback should be encouraged and rewarded.

A SIMPLE INTERNAL CONTROLS CHECKLIST FOR COMPANIES TO PREVENT FRAUD

- Allow for a system of checks and balances. Every transaction should be authorized, initiated, approved, executed, and recorded.
- Divide or segregate duties. Do not allow one person to handle all aspects of a transaction from beginning to end.
- Do not allow the same person to have custody of an asset (i.e., cash and inventory) and the responsibility to record transactions.
- Use serial numbers on debit or credit memos, sales and purchases invoices, cheques, tickets, purchase orders, and receiving reports.
- Use a safe, and maintain adequate safekeeping of all assets. Make deposits daily, and, if necessary, several times per day.
- Use a budget or forecast to detect whether goals are achieved. Investigate the differences: what happened and why.
- Incorporate hiring policies and practices that include drug testing and background checks. Subscribe to an ethics hot line, such as the Association's *Ethics Line,* to provide a way for employees to report, anonymously, suspected infractions or violations within a company to an independent party.

Safeguarding Small Businesses

The minimum controls for a small organization are as follows:

- Deposit all cash receipts intact daily.
- Make all payments by serial-numbered cheques with the exception of small transactions by petty cash.
- Reconcile bank accounts monthly.
- Record all cash receipts immediately.
- Balance ledgers at regular intervals.
- Prepare comparative financial statements in sufficient detail every month to disclose significant variations in revenue and expense categories.

Source: D. A. Sebert, "Repeat after me: Internal controls, internal Controls, Internal Controls . . ." *The White Paper,* Association of Certified Fraud Examiners, September/October 1998, p. 33.

DETECTING FRAUDULENT FINANCIAL REPORTING

LO5 Explain the audit procedures for detecting common fraudulent financial reporting.

Fraud that affects financial statements and causes them to be materially misleading often arises from the perceived need to "get through a difficult period." These difficult periods may include a cash shortage, increased competition, cost overruns, and similar events. Managers usually view these conditions as temporary and optimistically believe they can overcome them by getting a new loan, selling shares, or otherwise buying time to recover. In the meantime, falsified financial statements are used to "benefit the company."

Fraud is often accompanied the following conditions and circumstances:

- High debt
- Unfavourable industry conditions
- Excess capacity
- Profit squeeze
- Strong foreign competition
- Lack of working capital
- Rapid expansion

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- Product obsolescence
- Slow customer collections
- Related-party transactions

Through fraud and "creative accounting," companies create financial statements that are materially misleading by either (1) overstating revenues and assets, (2) understating expenses and liabilities, or (3) giving disclosures that are misleading or that omit important information. Generally, fraudulent financial statements show financial performance and ratios that are better than current industry experience or better than the company's own history. Sometimes, the performance exactly meets management targets announced months earlier.

Because of the double-entry bookkeeping system, fraudulent accounting entries always affect two accounts and two places in financial statements. Many frauds involve improper recognition of assets or a "dangling debit," which is an asset amount that is investigated and found to be false or questionable. Finding and investigating the "dangling credit" is normally very difficult, as these liabilities "dangle" off the books. Misleading disclosures are also difficult because they involve words and messages instead of numbers. Omissions may be hard to notice, and misleading inferences may be very subtle.

A mechanism that management can use for manipulating financial statements involves making false journal entries at the time of closing the books for year-end. For those with authority to make special journal entries, it can be fairly simple to slip in a journal entry at the eleventh hour that turns a disastrous year into a wildly profitable one! For this reason, considering whether there are any unusual transactions reflected in the financial statements is specific risk assessment procedure required by CAS 315, paragraph 28, and specific substantive procedures to examine the closing process are required by CAS 330, paragraph 20, as was discussed in Chapter 5.

A client's far-removed illegal acts may cause financial misstatements, and external auditors should be aware of possible indications of them:

- Unauthorized transactions
- Government investigations
- Regulatory reports of violations
- Payments to consultants, affiliates, and employees for unspecified services
- Excessive sales commissions and agent's fees
- Unusually large cash payments
- Unexplained payments to government officials
- Failure to file tax returns or pay duties and fees

Some Newer Approaches to Fraud Detection

The auditor's understanding of the business that was discussed in previous chapters has been promoted as a means of increasing the auditor's effectiveness in detecting fraud: "The use of complex analytical procedures comprising a business knowledge acquisition framework, coupled with an assessment of other fraud risk factors, should improve the auditor's ability to detect and diagnose anomalies associated with management fraud. And, a comprehensive knowledge decision frame will serve to heighten the auditor's level of professional skepticism when appropriate, for example, by enabling the auditor to develop his own hypotheses about unusual financial statement trends and fluctuations without relying exclusively on management's explanations."[10]

A sophisticated analysis tool called the "F-score" ("fudging" score) has been developed by some accounting academics, and has come to be considered a trusty tool by analysts. Research has found the F-score can predict 60% of misstatements in financial statements that eventually come to light as restatements. The box on the next page describes this technique and a reference to the paper that includes its underlying probability formula.

10 T. Bell, F. Marrs, I. Solomon, and H. Thomas, *Auditing Organizations Through a Strategic-Systems Lens* (KPMG, 1997), p. 69.

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FINANCIAL PROFILING: F-SCORE CAN DETECT ACCOUNTING FRAUD

How do investors, auditors, analysts and regulators detect material accounting manipulations? Not easily, says Weili Ge, an assistant professor of accounting at the University of Washington Foster School of Business.

But now Ge, along with researchers from the University of California at Berkeley and Washington University, has for the first time integrated the disparate warning signals of fraudulent accounting into a comprehensive measure called the “F-Score,” a scaled probability that a firm is cooking the books.

The F-Score (F is for “fudging”) assesses a firm along five dimensions—accrual quality, financial performance, nonfinancial measures, off-balance sheet activities and market-based incentives—and assigns a numerical value that suggests whether there is cause for further investigation. It is a straightforward measure: Data that are available from a firm’s public financial statements are entered, and the algorithm spits out a number. The average firm scores a 1. The higher the number, the higher is the probability of accounting misstatements.

“There is a lot of earnings management research out there,” Ge says, “but we wanted to develop a measure that’s simple enough for the average investor to use. Once you pick up a company’s annual report and put the relevant numbers into this formula, you get the likelihood of experiencing accounting problems in the coming year.”

A Pattern of Offense

The F-Score grew from a project, funded by the big four accounting firms’ Research Advisory Board, to learn more about “earnings quality” and the machinations of fraudulent accounting. The researchers examined 2190 Securities and Exchange Commission (SEC) Accounting and Auditing Enforcement Releases issued between 1982 and 2005, finding 676 firms alleged to have misstated their quarterly or annual financial statements.

Then they applied all of the various measures that people had been using to detect earnings manipulations and looked for patterns in the offending firms—as compared to the broader population of public firms and to themselves during compliant years.

“We wanted to understand how and why firms window-dress earnings,” says Ge, “and whether there is anything unusual about these firms compared to others.”

They found that overstatement of revenues was the most frequent type of misstatement. The likeliest offenders were growth companies trying to disguise a dip in operating performance by reporting unusually high accruals and cash and credit sales while their return on assets and number of employees declined. Other characteristics of these firms—some desperate to meet investor expectations—were abnormally high increases in financing and related off-balance sheet activities, such as operating leases.

Giving Firms an F

Inspired by the “Z-score,” a widely used predictor of bankruptcy, Ge’s team decided to convert these tendencies into a credible predictor of future accounting misstatements. Put to a historical test, the F-Score accurately identified over 60% of the misstating firms that had been investigated by the SEC during the period studied. Enron in 2000, for instance, registered a 2.2 on the scale, more than two times the average firm’s probability of engaging in earnings manipulations.

But Ge cautions that a higher-than-average F-Score is not proof of wrong-doing; it is merely cause for suspicion. There are certainly firms that register a high score without doing anything wrong. “But the F-Score can be a first-pass screening device for detecting possible misstatements,” she says.

In the high-stakes world of finance, it is beyond practical. For a 2007 article, Forbes asked Ge and her co-authors to identify the highest F-Scores among the largest companies listed on U.S. markets. Financial analysts and accounting firms have expressed interest. So have Ge’s students at the Foster School, investors (or soon-to-be investors), and all.

“Most valuation models are based on forecasting financial statements,” she says. “If the statements are manipulated, or do not reflect economic reality, then the outcome from that valuation is problematic. The F-Score can tell you whether you might want to think twice about investing in a firm.”

Ge adds that weeding out material accounting manipulations is of critical importance to the efficient functioning of capital markets: “For an investor it can lead to improved returns, for an auditor it can mean avoiding costly litigation, for an analyst it can mean avoiding a damaged reputation, and for a regulator it can lead to enhanced investor protection and fewer investment debacles.”

“Predicting material accounting misstatements” is the work of Ge, Patricia Dechow, and Richard Sloan of the University of California, Berkeley, Haas School of Business and of Chad Larson of Washington University’s Olin Business School. It appears in the journal *Contemporary Accounting Research;* Spring 2011, Vol. 28, Issue 1, pp.17–82.

Another development in fraud detection is the use of Benford’s Law to detect anomalies in the accounting records, as indicated in the following box.

BENFORD’S LAW AND AUDITING

Do financial statements universally “favour” some numbers over others? The idea seems to defy logic. In a random string of numbers pulled from a company’s books, each digit, 1–9, would seem to have one chance in nine of starting a given number. But, according to a 60-year-old formula making its way into the accounting field, some numbers really *are* more “popular” than others. A disruption in the pattern may reveal an inefficient process, an honest mistake, or outright fraud. Benford’s Law is the newest tool in the auditor’s arsenal.

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According to Mark J. Nigrini, PhD, "Benford's Law gives us the expected patterns of the digits in a list of numbers. . . . These patterns would appear in accounts payable invoices and accounts receivable numbers, for example." When patterns vary from those set down by Benford, there may be a problem. "Variations may reveal employees are listing expenses as $24 to avoid a $25 voucher limit. Or consider a manager who has a $3000 signing authority. Benford's Law tells me that, say, only 0.6% of all numbers should start with 29. If I get more than that, maybe a manager is approving too many $2900 invoices right under his limit." . . . "Maybe managers are breaking down one project into several pieces to circumvent a higher level of oversight for some reason. Clients want to know when employees are going around their control systems." . . . Sometimes, said Nigrini, patterns change because of an error. "Invoices entered more than once will change the frequencies."

"At other times we see spikes—digit frequencies that violate Benford's Law—at $15 or $25," said Ernst & Young (E&Y) partner James Searing. "Even though these are low-dollar items, that might mean a client is writing a separate cheque for each express-mail delivery. That is a very expensive way to process invoices and write cheques." By advising the client to arrange for monthly billing for express mail, E&Y can make the audit a value-added service.

Benford's Law may also catch fraud, thanks to psychology, said Nigrini. "People just don't think 'Benford-like.' If someone is cutting a $400 cheque every week for non-existent janitorial services, those cheques will skew the digit distribution. A thorough application of the law will find the fraud."

E&Y has developed proprietary software that applies Benford's Law to a client's data. "The more we use such analytical tools, the more we find," said Searing. "In the long term, advanced analytical tools, such as application of Benford's Law, will be part of the audit. They may very well help us reduce the overall risk of auditing, increase the reliability of the audit opinion, and increase value to the client."

Source: "Numerology for accountants," *Journal of Accountancy,* November 1998, p. 15. Copyright © 1998, 1999 from the *Journal of Accountancy* by the American Institute of Certified Public Accountants, Inc. Opinions of the authors are their own and do not reflect policies of the AICPA. All rights reserved. Used with permission.

REVIEW CHECKPOINTS

7-9 If the petty cash custodian was replaced and the frequency of fund reimbursement decreased from every two days to every four days, what might you suspect?

7-10 Give some examples of control omissions that would make it easy to "think like a crook" and see opportunities for fraud.

7-11 If sales and income were overstated by recording a false cash sale at the end of the year, what "dangling debit" might give the scheme away?

7-12 What three general descriptions can be given to manipulations that produce materially misleading financial statements?

DOCUMENTS FOR FRAUD RISK ASSESSMENT AND DETECTION

Content of Common Documents

LO6 Describe documents that auditors use for fraud risk assessment and detection.

To explain fraud risk assessment and detection procedures, textbooks on auditing often advise beginner auditors to "examine cheques," and to "check the employees on a payroll." It helps to know something about these common documents and the information that can be seen on them.

Cheques

Exhibit 7–2 describes the information found on a typical cheque. Knowledge of the codes for the Canadian banking system's identification numbers could enable an auditor to spot a crude cheque forgery. Similarly, mistakes with the optical identification printing or the magnetic cheque number might be a tip-off. If the amount of a cheque is altered after it has cleared the bank, the change would be noted by comparing the magnetic imprint of the amount paid (in the bank's records) against the amount written on the cheque face. The back of a cheque carries the endorsement(s) of the payee and others to whom the payee may have endorsed the cheque; and, in due course, the date, name, and routing

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number of the bank where the cheque was deposited; and the date, identification of the bank office, and its routing number for the cheque clearing. (There is no bank clearing identification when local cheques are cleared locally without going through a Bank of Canada office.) Auditors can follow the path of a cancelled cheque to note if it corresponds with the characteristics of the payee; for example, why would a cheque to a local business in Mississauga, Ontario, be deposited in a small Missouri bank and cleared through the St. Louis Federal Reserve office?

EXHIBIT 7–2 How to Read a Cancelled Cheque and Endorsement

Front

Cheque number

THIS CHEQUE CONTAINS SECURITY FEATURES SEE ATTACHED

SMITH & CHANG DEVELOPERS, INC.
4270 Regal Road
Scarborough, Ontario
M1M 1R6

1038

August 21, 20X3

PAY TO THE ORDER OF Mechanical Parts, Inc.

Four Hundred Seventy XX/100 DOLLARS $470.00

Re: Earnest Money Contract

Smith & Chang Developers, Inc.

PER *Jill Abbott*

PER

THE BANK OF NOVA SCOTIA
2479 KINGSTON ROAD AT MIDLAND
SCARBOROUGH, ONTARIO M1M 1V4

001038 21402 002 017526

Cheque number

Transit number identifies drawee bank

Bank identification number (parent bank)

Drawee's account number

Back

Bank where deposited
(Date, bank name, bank transit number)

Payee endorsement

FOR DEPOSIT ONLY
MECHANICAL PARTS, INC.
268 LAKESHORE AVENUE WEST
MISSISSAUGA, ON L5G 1H1

ROYAL BANK OF CANADA
MISSISSAUGA, ONTARIO
114911
Sept -3 X3

Bank Statements

Most of the information shown on the bank statement in Exhibit 7–3 is self-explanatory. However, auditors should be aware that the bank's count and dollar amount of deposits and cheques can be compared with the detail data on the statement; the account holder's business identification number is on the statement, and this can be used in other databases (for individuals, this is a place to get a person's social insurance number); and the statement itself can be studied for alterations.

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EXHIBIT 7–3 Small Business Bank Statement

27

North Country Bank

MISSISSAUGA, ON
P.O. BOX 908
MISSISSAUGA, ON L5G 2H3

ACCOUNT
--- 604017-526-5
--- ---
--- PAGE
--- 1

CAULCO INC
BLDG 1 OFFICE F
5450 BEE CAVE RD
MISSISSAUGA, ON
L5G 1H2

SIN/TAX ID
74-2076251

CYC MC FREQ
01 01 M0000

** YOUR CHEQUING ACCOUNT 01-29-X3 THRU 02-29-X3 **

TO YOUR PREVIOUS BALANCE OF - - - - - - - - - - - - -	7,559.06
YOU ADDED 1 DEPOSITS FOR - - - - - - - - - -	5,654.16
YOU SUBTRACTED 26 WITHDRAWALS FOR - - - - - - - - -	10,838.29
GIVING YOU A CURRENT BALANCE OF - - - - - - - - - - -	7,374.93
NUMBER OF DAYS USED FOR AVERAGES - - - - - - - - - -	31
YOUR AVERAGE LEDGER BALANCE - - - - - - - - - - - - -	4,014.67
YOUR LOW BALANCE OCCURRED ON 02-22 AND WAS - - - - -	2,374.93

THANK YOU

DEPOSITS AND OTHER ADDITIONS

DATE	AMOUNT
0204	5654.16 ✓

CHEQUES AND OTHER WITHDRAWALS

CHEQUE	DATE	AMOUNT	CHEQUE	DATE	AMOUNT	CHEQUE	DATE	AMOUNT
2201	0211	57.83 ✓	2214	0203	403.92 ✓	2225	0217	✓ 182.77
**			2215	0203	135.59 ✓	**		
2205	0222	16.72 ✓	2216	0216	6.16 ✓	2231	0205	✓ 254.37
2206	0203	533.28 ✓	2217	0217	138.43 ✓	2232	0210	✓ 60.61
2207	0203	1312.15 ✓	2218	0217	131.92 ✓			
**			2219	0217	82.97 ✓	2234	0217	✓ 64.69
2209	0203	247.10 ✓	2220	0217	87.49 ✓	2235	0218	✓ 279.97
2210	0203	249.98 ✓	2221	0217	85.68 ✓	**		
2211	0203	255.26 ✓	2222	0217	84.69 ✓	2238	0219	✓ 90.00
2212	0203	242.09 ✓	**					
2213	0203	384.91 ✓	2224	0217	449.71 ✓			

Valid Social Insurance Numbers

In Canada, social insurance numbers (SINs) have become universal identification numbers. They can be useful to auditors when checking the personnel files and the validity of people on the payroll. Here are some characteristics of SINs:[11]

- The SIN is a nine-digit number; the ninth digit is a check digit that is calculated using the first eight digits.
- There are two types of SINs: regular numbers and distinctive numbers. Regular numbers are issued to Canadian citizens, registered Native peoples, and permanent residents.

11 *Caution:* Human Resources Development Canada periodically adds numbers that have been issued and may use numbers assigned to one geographical area for another. If the validity of a SIN becomes important in an audit, check with Human Resources Development Canada to ascertain the current status of numbers issued. For further reference, see M. L. Levy, "Financial fraud: Schemes and indicia," *Journal of Accountancy*, August 1985, p. 85; E. J. Pankau, *Check it Out* (Houston: Cloak & Data Press, 1990), pp. 20—27.

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Distinctive numbers start with digit 9 and are issued to people who do not have status as above (e.g., foreign workers, visitors).

- The first digit, other than 9, indicates the province or territory where the number was issued.
- The middle seven digits are issued in generally ascending numerical order, making it feasible to apply Benford's Law to analyzing these digits.
- Working with Human Resources Skills Development Canada, an auditor may be able to detect fictitious SINs.

REVIEW CHECKPOINTS

7-13 How could you tell whether the amount on a cheque has been increased after it was paid by a bank?

7-14 If a false SIN for a new employee is entered in the payroll system and the employee receives a paycheque, what control in the system is not being used?

7-15 What might two endorsements on a cancelled cheque mean?

7-16 What three oddities might indicate fictitious employees on a payroll?

7-17 Is there anything odd about these situations? (1) Auditors performed a surprise payroll distribution, and J. Jones, S. Smith, and D. Douglas were absent from work. (2) A cheque to Larson Lectric Supply was endorsed with Larson Lectric above the signature of Eloise Garfunkle. (3) Numerous cheques were issued dated January 1, May 20, July 1, September 2, October 14, and December 25, 20X3?

7-18 What account could you audit to determine whether a company had recorded fictitious sales?

APPLICATION CASE WITH ANALYSIS

Overstate the Inventory, Understate the Cost of Goods Sold

DISCUSSION CASE

A division manager at Doughboy Foods wanted to meet his profit goals and simply submitted overstated quantities in inventory reports. The manager *(a)* inserted fictitious count sheets in the independent auditors' working papers, *(b)* handed additional count sheets to the independent auditors after the count was completed, saying "these got left out of your set," and *(c)* inserted false data into the computer system that produced a final inventory compilation (even though this ploy caused the computer-generated inventory not to match with the count sheets). Overstated inventory caused understated cost of goods sold, overstated net income and retained earnings, and overstated current assets, working capital, and total assets.

Audit Trail

In general, management reports should correspond to accounting records. The manager's inventory reports showed amounts larger than those in the accounts. He fixed the problem by showing false inventory that was "not recorded on the books." The food products inventory was overstated by $650,000. Through a two-year period, the false reports caused an income overstatement of 15% in the first year and would have caused a 39% overstatement the second year.

ANALYSIS

Audit Approach

Audit Objective

Obtain evidence of the existence, completeness, and valuation of inventory.

Controls Relevant to the Process

Inventory counts should be taken under controlled conditions, but not under the control of managers who might benefit from manipulation. (However, if these managers are present, auditors should nevertheless be prepared to

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perform the audit work.) Inventory takers should be trained and follow instructions for recording quantities and condition.

Audit Procedures

Tests of Controls

Auditors should attend the inventory-taking training sessions and study the instructions for adequacy. Observation of the inventory taking should be conducted by managers and by auditors to ensure compliance with the instructions.

Tests of Details of Balance

For evidence of existence, select a sample of inventory items from the perpetual records and test-count them in the warehouse. For evidence of completeness, select a sample of inventory items in the warehouse, test-count them, and trace them to the final inventory compilation. For evidence of valuation, find the proper prices of inventory for one or both of the samples, calculate the total cost for the items, and compare this with the amounts recorded in the books. Compare book inventory amounts with management reports. Control the working papers so that only members of the audit team have access. Analytical procedures gave some signals. The particular manager's division had the lowest inventory turnover rate (6.3%) among all the company divisions (comparable turnover, about 11.1%) and its inventory had consistently increased from year to year (227% over the two-year period).

AUDIT RESULTS

In the second year, when the manager handed over the count sheets "that got left out of your set," the auditor thanked him and then went to the warehouse to check them out. Finding them inaccurate, she compared book inventories with his management reports and found an overstatement in the reports. This prompted further comparison of the computer-generated inventory with the count sheets and more evidence of overstated quantities on 22 of the 99 count sheets.

SUMMARY

- Fraud awareness in auditing starts with knowledge of the types of errors, frauds, and illegal acts that can be perpetrated. Errors are unintentional misstatements or omissions of amounts or disclosures in financial statements. Frauds are intentional misstatements or omissions in financial statements, including fraudulent financial reporting (usually a type of management fraud) and misappropriations of assets (defalcations). "Illegal acts" refers to acts of non-compliance with the laws and regulations under which the organization operates.
- Auditors are responsible for the detection of fraud. This means being more aware of fraud and illegal acts. External, internal, and governmental auditors all have standards for care, attention, planning, detection, and reporting of some kinds of errors, fraud, and illegal acts. Auditors do not determine whether a fraud or illegal act has occurred as this can only be decided by a court of law. Auditors are concerned with suspicions of frauds and illegal acts that can directly or ultimately affect fair presentation of the company's financial statements, and raise questions about management's integrity. In contrast, forensic auditors are specifically charged with investigating fraud, and have little in the way of standard programs or materiality guidelines to limit their investigations.
- Individuals may contemplate fraud when they have a motive, usually a financial need, for stealing money or property. When there is a combination of motive with opportunity and a lapse of integrity, there is a high probability of fraud or theft. Opportunities arise when an organization's management is lax in setting an example of good behaviour and in maintaining a supportive control environment. The fear of getting caught by control procedures deters some fraudsters. Also, attentive management of personnel can ease the pressures people feel and, thus, reduce the incidence of fraud.
- Auditors need to know the red flags, the signs and indications that accompany many fraudulent activities. When studying a business operation, auditors need to "think like a crook" to uncover possibilities for theft, as this can help in the planning of procedures designed to determine whether fraud has occurred. Often, imaginative extended procedures will unearth evidence of fraudulent activity. However, technical and personal care

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must always be exercised because accusations of fraud are always taken very seriously. For this reason, after preliminary findings indicate possible fraud, auditors should enlist the cooperation of management and assist fraud examination professionals in bringing an investigation to a conclusion.

- Fraudulent financial reporting involves a high level of management overriding controls and taking advantage of their authority. It is viewed as fraud by the company against its investors, those who will be misled by the misleading financial statements. There is a heightened risk of this occurring when management is faced with challenges and wants to report financial conditions and results better than they actually are, or otherwise manipulate the reported information. Auditors need to analyze the financial statements to detect unexpected relationships and examine unusual transactions and journal entries to assess these risks.
- Various documents can be examined by auditors for unusual conditions, such as alterations, falsifications, and control overrides. These can indicate an increased risk of fraud.

KEY TERMS

defalcation
direct-effect illegal acts
embezzlement
employee fraud
error
fraud
fraud incentive
fraud opportunity
fraud rationalization
fraud risk
fraud triangle
fraudulent financial reporting
illegal act
indirect-effect illegal acts
misappropriations of assets
white-collar crime

EXERCISES AND PROBLEMS

EP 7-1 Give Examples of Errors and Frauds. LO1 This is an exercise concerning financial reporting misstatements, not employee theft.

Required:

Give an example of an error or fraud that would misstate financial statements to affect the accounts as follows, taken one case at a time. (*Note:* "overstate" means the account has a higher value than would be appropriate under GAAP, and "understate" means it has a lower value.)

a. Overstate an asset, under state another asset.
b. Overstate an asset, overstate shareholder equity.
c. Overstate an asset, overstate revenue.
d. Overstate an asset, understate an expense.
e. Overstate a liability, overstate an expense.
f. Understate an asset, overstate an expense.
g. Understate a liability, understate an expense.

EP 7-2 Overall Analysis of Accounting Estimates. LO1, LO5 Oak Industries, a manufacturer of radio and cable TV equipment and an operator of subscription TV systems, had a multitude of problems. Subscription services in a market area, for which $12 million cost had been deferred, were being terminated, and the customers were not paying on time ($4 million receivables in doubt). The chances are 50–50 that the business will survive another two years.

An electronic part turned out to have defects that needed correction. Warranty expenses are estimated to range from $2 million to $6 million. The inventory of the part ($10 million) is obsolete, but $1 million can be recovered as salvage or the parts in inventory can be rebuilt at a cost of $2 million (selling price of the inventory on hand would then be $8 million, with 20% of selling price required to market and ship the products, and the normal profit expected is 5% of the selling price). If the inventory were scrapped, the company would manufacture a replacement inventory at a cost of $6 million, excluding marketing and shipping costs and normal profit.

The company has defaulted on completion of a military contract, and the government is claiming a $2 million refund. Company lawyers think the dispute might be settled for as little as $1 million.

The auditors had previously determined that an overstatement of income before taxes of $7 million would be material to the financial statements. These items were the only ones left for audit decisions about possible adjustment. Management has presented the analysis below for the determination of loss recognition:

Provide for expected warranty expense	2,000,000
Lower of cost or market inventory write-down	2,000,000
Loss on government contract refund	—
Total write-offs and losses	$11,000,000

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Required:
Prepare your own analysis of the amount of adjustment to the financial statements. Assume that none of these estimates have been recorded yet, and give the adjusting entry you would recommend. Give any supplementary explanations you believe necessary to support your recommendation.

EP 7-3 Select Effective Procedures Responding to Fraud Risk. LO3, LO4, LO6 Below are some "suspicions." You have been requested to select some effective extended procedures designed to confirm or deny the suspicions.

Required:
Write out the procedure you would suggest for each case so that another person would know what to do.

a. The custodian of the petty cash fund may be removing cash on Friday afternoon to pay for his weekend activities.

b. A manager has noticed that eight new vendors have been added to the purchasing department approved list since the assistant purchasing agent was promoted to chief agent three weeks ago. She suspects that all or some of them may be phony companies set up by the new chief purchasing agent.

c. The payroll supervisor may be stealing unclaimed paycheques of people who quit work and don't pick up the last cheque.

d. Although no customers have complained, cash collections on accounts receivable are down, and the counter clerks may have stolen customers' payments.

e. The cashier may have "borrowed" money, covering it by holding each day's deposit until there is enough cash from the daily collection to make up the shortage, before sending the deposit to the bank.

EP 7-4 Horizontal and Vertical Analysis. LO2, LO4, LO5 Horizontal analysis refers to changes in financial statement numbers and ratios across two or more years. Vertical analysis refers to financial statement amounts expressed each year as proportions of a base, such as sales for the income statement accounts, and total assets for the balance sheet accounts. Exhibit EP 7-4–1 contains the Retail Company's prior year (audited) and current year (unaudited) financial statements, along with amounts and percentages of change from year to year (horizontal analysis) and common-size percentages (vertical analysis). Exhibit EP 7-4–2 contains selected financial ratios based on these financial statements. Analysis of these data may enable auditors to discern relationships that raise questions about misleading financial statements.

Required:
Study the data in Exhibits EP 7-4–1 and EP 7-4–2. Write a memo identifying and explaining potential problem areas where misstatements in the current year financial statements might exist. Additional information about Retail Company is as follows:

- The new bank loan, obtained on July 1 of the current year, requires maintenance of a 2:1 current ratio.
- Principal of $100,000 plus interest on the 10% long-term note obtained several years ago in the original amount of $800,000 is due each January 1.
- The company has never paid dividends on its common shares and has no plans for a dividend.

EXHIBIT EP7-4–1 Retail Company

	PRIOR YEAR AUDITED		CURRENT YEAR		CHANGE	
	BALANCE	COMMON SIZE	BALANCE	COMMON SIZE	AMOUNT	PERCENT
Assets:						
Cash	$ 600,000	14.78%	$ 484,000	9.69%	(116,000)	−19.33%
Accounts receivable	500,000	12.32	400,000	8.01	(100,000)	−20.00
Allowance doubt accts.	(40,000)	−0.99	(30,000)	−0.60	10,000	−25.00
Inventory	1,500,000	36.95	1,940,000	38.85	440,000	29.33
Total current assets	$2,560,000	63.05	2,794,000	55.95	234,000	9.14
Capital assets	3,000,000	73.89	4,000,000	80.10	1,000,000	33.33
Accumulated depreciation	(1,500,000)	−36.95	(1,800,000)	−36.04	(300,000)	20.00
Total assets	$4,060,000	100.00%	$4,994,000	100.00%	934,000	23.00%
Liabilities and equity:						
Accounts payable	$ 450,000	11.08%	$ 600,000	12.01%	150,000	33.33%
Bank loans, 11%	0	0.00	750,000	15.02	750,000	NA
Accrued interest	50,000	1.23	40,000	0.80	(10,000)	−20.00
Accurals and other	60,000	1.48	10,000	0.20	(50,000)	−83.33
Total current liab.	560,000	13.79	1,400,000	28.03	840,000	150.00
Long–term debt, 10%	500,000	12.32	400,000	8.01	(100,000)	−20.00
Total liabilities	1,060,000	26.11	1,800,000	36.04	740,000	69.81
Share capital	2,000,000	49.26	2,000,000	40.05	0	0
Retained earnings	1,000,000	24.63	1,194,000	23.91	194,000	19.40
Total liabilities and equity	$4,060,000	100.00%	$4,994,000	100.00%	934,000	23.00%

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EXHIBIT EP7-4–1 Continued

Statement of operations:						
Sales (net)	$9,000,000	100.00%	$8,100,000	100.00%	(900,000)	−10.00%
Cost of goods sold	6,296,000	69.96	5,265,000	65.00	(1,031,000)	−16.38
Gross margin	2,704,000	30.04	2,835,000	35.00	131,000	4.84
General expense	2,044,000	22.71	2,005,000	24.75	(39,000)	−1.91
Amortization	300,000	3.33	300,000	3.70	0	0
Operating income	360,000	4.00	530,000	6.54	170,000	47.22
Interest expense	50,000	0.56	40,000	0.49	(10,000)	−20.00
Income taxes (40%)	124,000	1.38	196,000	2.42	72,000	58.06
Net income	$ 186,000	2.07%	$294,000	3.63%	108,000	58.06%

NA means not applicable.

EXHIBIT EP7-4–2 Retail Company

	PRIOR YEAR	CURRENT YEAR	PERCENT CHANGE
Balance sheet ratios:			
Current ratio	4.57	2.0	−56.34%
Days' sales in receivables	18.40	16.44	−10.63
Doubtful accounts ratio	0.08	0.075	−6.25
Days' sales in inventory	85.77	132.65	54.66
Debt/equity ratio	0.35	0.56	40.89
Operations ratios:			
Receivables turnover	19.57	21.89	11.89
Inventory turnover	4.20	2.71	−35.34
Cost of goods sold/sales	69.96%	65.00%	−7.08
Gross margin %	30.04%	35.00%	16.49
Return on equity	6.61%	9.80%	48.26

DISCUSSION CASES

DC 7-1 Famous Fraud Case Analysis: Enron. LO1, LO2, LO3

Required:

Given the successful prosecution of CEOs in Worldcom, Tyco, and Adelphia through 2006, do a Web search on one of these cases and answer the following:

a. How was the fraud detected?

b. How was the fraud perpetrated? Was it a financial statement fraud?

c. What was the weakness in internal control or corporate governance that allowed the fraud to occur?

d. Should a financial statement audit have detected this fraud? Discuss CAS 240 requirements that could have detected the fraud.

e. Would an internal control audit have detected this fraud? Discuss.

DC 7-2 Detecting Fraud LO3, LO5 Play Green Inc. (PGI), is a public company that operates a number of sports facilities across Canada. Your friend Gildan is a junior auditor with the public accounting firm that has audited PGI for many years. Gildan is auditing the cash balance, and has found some discrepancies between the bank records and PGI's accounting records. The discrepancies add up to a total overstatement of $135,000, and materiality for this audit has been set at $150,000. After enquiring of the PGI accounting manager about these discrepancies, Gildan gets a call from the President's secretary—the President has asked to meet with the Gildan on this matter.

The President starts off by complimenting Gildan on his good accounting and auditing skills. He says he was very impressed that Gildan was able to discover the problems in the cash accounts. He provides Gildan with a written representation for his audit file stating that the cash discrepancies have been noted by company management, and the cash balance is fairly presented.

The President then tells Gildan that he is starting up a new golf course venture, separate from PGI, and really can use a talented accountant like Gildan to be his business partner in this new venture. Gildan would not be required to make any investment in the new business, but would receive 50% ownership in exchange for providing his accounting services to this business. The President would own the other 50%. Since the work on the new venture would only take Gildan about five hours per week, the President expects Gildan to keep his job with the auditing firm and continue working as the junior auditor on the PGI audit team.

Gildan has come to tell you about this offer from the President because he is very happy about it. At the same time he is a bit concerned that it seems too good to be true, and asks for your advice on what he should do.

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Required:

Analyze Gildan's situation and advise him on the best way to proceed.

DC 7–3 J. J. Barnicke Ltd.: Missing Millions and a Widow with a Lavish Lifestyle.[12] LO3, LO4, LO6 Elizabeth (Liz) Lake lives in a million-dollar mansion in Don Mills. She spends time with her three children at an 1134-square-metre waterfront "cottage" in central Ontario. The attractive widow also gets about $22,600 a month—or $270,000 a year—to maintain those properties and cover living expenses.

Prominent realtor Joe Barnicke says it's all possible with money her late husband stole from him, his firm J. J. Barnicke Ltd.—and a family trust fund. Liz Lake has kept that lifestyle for almost two years since her husband jumped in front of a train at York Mills subway station. Jim Lake committed suicide on the morning of March 18, 1996, less than an hour after Barnicke confronted him at the firm's downtown office about a lot of missing money. Lake, the firm's star chief financial officer, excused himself and never returned.

Barnicke and his company immediately filed a lawsuit in court against Liz Lake and her husband's estate to recover what was left of $19.8 million Lake allegedly swiped over a decade. But Barnicke, the firm's 74-year-old chairman, has found it isn't easy trying to get any of the alleged stolen money back. The courts are slow and Liz Lake is fighting him all the way for the mansion, country estate, cars, boats, snowmobiles, and life insurance proceeds. Barnicke won't talk publicly about the case but acquaintances say he's bitter and disillusioned over Liz Lake's continuing monthly "allowances" and the lengthy court proceedings. In the battle over the estate, Barnicke figures there's now only about $4 million to $5 million left—including life insurance proceeds—after all the spending.

No wonder. One of Lake's own accounting reports filed with the court reveals the couple spent almost $7 million after tax in the three years before his death. Lake fuelled that spending by jacking up his pay through misappropriation of Barnicke funds, according to documents filed in court. After a brief probe, Barnicke and top-flight forensic accountants Lindquist Avey McDonald Baskerville Inc. said a paper trail revealed that the likeable Lake moved money from the company's operating funds and the chairman's personal accounts to a payroll system. He then transferred the money into personal bank accounts at the Bank of Nova Scotia.

Lake ran the payroll system, from which he was paid. Investigators found a copy of Lake's T4 form to Revenue Canada in his briefcase showing a gross income of $2,468,938.63 for 1995. But Lake's annual salary never exceeded $110,000, Barnicke said in the claim. Barnicke's lawsuit also alleges Lake, who was 36 when he died, had improperly moved $1.5 million from a trust fund for Barnicke's three children to his own account. Barnicke said his signature on the transfer requests were forgeries.

Liz Lake denies her husband stole the money. If her husband did, it's Barnicke's own fault and he should suffer the losses, her statement of defence said. If the company had shown a minimal amount of diligence, it could have stopped any alleged losses and Lake might still be alive, she added. "The plaintiffs (Barnicke) by their gross negligence caused or contributed to the death of her husband and the father of her three children," the statement of defence said. She insists that all money received from the company was earned, "and was accurately recorded in J. J. Barnicke Ltd.'s books and records." Those books and records were kept at the company offices and in fact Lake paid taxes on the full amount. As well, Elizabeth Lake points out, the Barnicke books were made available to accountants Ernst & Young "at least annually" and that all her husband's earnings were deposited in their joint account at the Bank of Nova Scotia. (The bank is also named in the company's civil suit.)

Joe Barnicke, the blustery patriarch of the company, scoffs at the suggestion they are responsible for any financial loss. "He stole the money," he told *The Toronto Sun* this week. "He stole the money. That's all we can say." Meanwhile, Barnicke's lawyer, Chris Osborne, said the cost of paying for Liz Lake's lifestyle is "bleeding" the estate of hundreds of thousands of dollars. Reports placed on the public record suggest Liz and Jim Lake didn't hold back in the last years of his life. Lake collected annual paycheques ranging from $2.2 million to $4.3 million in gross income from 1990 to 1995. Lake's own printout of "inflows" and "outflows" covering July 1993 to February 1996 disclosed that income from work, interest, and revenue on property sales totalled about $7 million. But the outflows for expenses left them with only $35,000. Furthermore, (the receiver) said at one point the couple regularly rang up credit card charges of more than $43,000 a month. The Lakes had "very lavish spending habits," the receiver noted.

Required:

a. Comment on the apparent control weaknesses at J. J. Barnicke suggested by the events in the above story. Explain how these weaknesses increased the risk of fraud in the company.

b. Assume the role of the judge. Which party's arguments do you think are more convincing? What additional evidence could each party provide to you that would strengthen their case?

c. What audit procedures might have been used to uncover the transfer of company funds to Mr. Lake's bank account?

12 Tony Van Apphen, *The Toronto Star,* December 14, 1997, p. A1; Scott Burnside, *The Toronto Star,* June 23, 1996, p. 45.

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CHAPTER 8

Audit Evidence and Assurance

Chapter 8 expands on the concepts of audit evidence—the auditor's source of reasonable assurance that financial statements are not materially misstated. It covers evidence-gathering procedures and how auditors use them for risk assessment, control testing, and substantive testing.

EcoPak Inc.

Tariq and the audit team he has assembled are going at full speed now, developing their audit plan and audit programs for their first audit of EcoPak. Boris has been assigned as the audit manager for the EcoPak engagement, Donna is the senior audit assistant, and there will one junior assistant as well: Caleb. Boris is a very experienced manager, but Donna is doing her first audit in the senior's role. After a very helpful team meeting, in which Tariq and Boris presented the main information they have gathered so far, Donna is setting out to prepare the plan for the audit of the revenue, receivables, receipts (R/R/R) process. Meyer & Gustav (M&G) has standard planning forms that outline a basic audit program for each process in a typical company, and Donna's job today is to adapt it to the circumstances of EcoPak's revenue process. She is also explaining the plan to Caleb, who is in his first year with the firm and has never audited the R/R/R section before.

Most of EcoPak's revenues are generated through long-term contracts with large customers, such as companies operating fast food restaurant chains, or with buying groups for independent restaurants in major urban areas. The contracts provide for volume discounts at various sales levels, so there is some complexity in ensuring the discounts are calculated correctly. Donna's preliminary work indicates they can rely on some controls in this process, so a combined approach is being considered.

Because M&G was able to obtain copies of some of the predecessor auditor's working papers, they have the system description details on file. Donna and Caleb are studying these to get an idea of how it all works before they head over to EcoPak's head office next week to start the interim audit work. They note that there are two classes of transactions in this process, sales and cash receipts, and one main balance, accounts receivable. They set out to assess risk of material misstatement at the assertion level based on their business understanding and preliminary risk assessments. Boris instructed them to focus only on the most significant inherent risks of material misstatement and bring him their proposed plan by the end of the day.

LEARNING OBJECTIVES

After completing this chapter, you will be able to do the following:

LO1 Outline six general audit techniques for gathering evidence.

LO2 Identify the procedures and sources of information auditors can use to obtain evidence for understanding an auditee's business and industry, assessing risk, and responding to assessed risk.

LO3 Explain audit evidence in terms of its appropriateness and relative strength of persuasiveness.

LO4 Describe the content and purpose of the audit plan as well as the specific audit programs and detailed procedures it contains.

LO5 Evaluate audit working paper documentation for proper form and content.

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Donna and Caleb decide that for the account receivable balance, there is not much risk of error in the existence or completeness assertions, since the system is automated and generates invoices simultaneously with any delivery. However, the volume discounts seem complex and involve a large degree of manual calculation, so there could be a risk of measurement errors that will affect the valuation assertion. They also realize that sending letters to customers and getting them to confirm how much they owe EcoPak at year-end would be pretty easy because there are only a few large customers, so only a few letters could verify a large portion of the balance. That would provide evidence about whether there were any errors in the volume discount calculations. For the cash receipts, they assess the completeness assertion to be high risk, since cash could be misappropriated; so, they think they will need to try to test that by inspecting the supporting documentation for cash receipts, and tracing them through to the bank deposits and debit entries to the cash account. Donna realizes that if there is a risk that cash receipts are incomplete (understated), this will also flow through to cause an existence (overstatement) risk in the accounts receivable balance . . . so the confirmation procedure seems like an even better idea, since it will provide some really persuasive evidence about both these risks.

Caleb seems to be catching on, so Donna asks him what he thinks is the biggest risk in the sales transactions. Caleb considers that if some fictitious sales were recorded, it would lead to overstatements of both revenues and accounts receivable. Even though the audit team has not seen anything that might indicate EcoPak's management or accounting staff would inflate their sales, Caleb notes that they do have incentives to do it, since it makes the company look a lot more successful (AND they are considering doing an initial public offering [IPO]!). His gut feeling is that, as independent auditors, they should be skeptical about such things and not just assume that everything is okay. So, he feels they need to do some testing that the sales really occurred by inspecting shipping documents to vouch that the sales recorded are all supported by valid sales transactions with customers.

Donna is pleased: "Nice analysis Caleb! You are catching on. Let's enter all these assertion-level risk assessments and the evidence-gathering procedures we think we should do to respond to those risks into the R/R/R planning form now. That will document our work, and then we can go over to see what Boris thinks about our decisions before we start making arrangements to go to EcoPak's offices."

EVIDENCE-GATHERING AUDIT PROCEDURES

LO1 Outline six general audit techniques for gathering evidence.

Most of the auditor's work involves designing and performing audit procedures to obtain sufficient appropriate audit evidence, and then evaluating that evidence to draw reasonable conclusions on which to base the audit opinion. Chapter 8 explains how auditors apply judgment to determine the sufficiency and appropriateness of evidence as a source of reasonable assurance and to develop detailed evidence-gathering procedures in the audit plan.

STANDARDS CHECK

CAS 500

6. The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence. (Ref: Para. A1–A25)

Source: *CICA Handbook—Assurance,* 2012.

Finally, the chapter describes how audit working papers are used to document the nature and extent of the audit work performed, the evidence gathered, and the conclusions the auditors reached based on their work. Documentation is essential to provide a complete, accurate record of the auditor's work, judgments, and decisions supporting the audit opinion.

Auditors obtain six basic types of evidence and use six general techniques to gather it. The six techniques are: (1) recalculation/reperformance, (2) observation, (3) confirmation, (4) enquiry, (5) inspection, and (6) analysis. One or more of these techniques may be used no matter what account balance, class of transactions, control procedure, or other information is under audit. In Chapters 6 and 7, we showed how one of the evidence-gathering techniques, enquiry, is used to obtain information from auditee personnel or external

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sources for understanding the auditee's business and assessing the risk of material misstatement. Enquiry generates important audit evidence, but enquiry alone does not provide sufficient audit evidence that there is no material misstatement, or that internal control is effective. Auditors use a combination of evidence-gathering techniques to look for corroborating evidence, since that is more persuasive than a single piece of evidence. Auditors cannot obtain absolute assurance because of the limitations of audit procedures and accounting itself, so professional judgment is required in deciding when the evidence gathered is enough to provide reasonable assurance.

STANDARDS CHECK

CAS 500

A2. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, reperformance and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

Source: *CICA Handbook—Assurance,* 2012.

In practice, the general techniques are usually subdivided into more specific procedures. Auditors arrange these specific procedures into an audit program, basically a list of procedures. Exhibit 8–1 shows the six general techniques matched to the types of evidence each provides and gives some examples of specific procedures that could be included in an audit program.

EXHIBIT 8–1 Audit Techniques and Related Types of Evidence

AUDIT TECHNIQUES	TYPES OF EVIDENCE	EXAMPLES OF SPECIFIC PROCEDURES
1. Recalculation/ Reperformance	1. Auditor's calculations or performance	1. Recompute amortization expense using declining balance method. Recompute "price times quantity" on invoices. Recompute sales tax as a percentage of total sale amount on invoices. Reperform data entry procedure with automated missing data control.
2. Observation	2. Auditor's observations	2. Observe data entry procedures. Observe petty cash control procedures. Observe auditee's inventory counting procedures.
3. Confirmation	3. Statements by independent parties	3. Obtain written confirmation of accounts receivable (A/R) balance and detail from customer. Obtain written confirmation of loan amount, interest, collateral, and payment dates from lender.
4. Enquiry	4. Statements by auditee personnel	4. Enquire about frequency of bank reconciliation procedures. Enquire about which employee totals cash receipts and deposits them to the bank.
5. Inspection	5a. Documents prepared by independent parties	5a. Read terms of lease agreement for lessee.
	5b. Documents prepared by the auditee	5b. Review inventory variance analysis report prepared by production department.
	5c. Physical inspection of tangible assets	5c. Auditor's test counts of physical inventory quantities on hand at year-end. Auditor's examination of damaged inventory on hand.
6. Analysis	6. Data interrelationships	6. Analyze monthly gross margin by product line. Compare inventory turnover rate to previous year.

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Recalculation/Reperformance

recalculation: audit procedure that involves redoing calculations already performed by auditee personnel to determine if the result is accurate

Recalculation is redoing calculations already performed by auditee personnel. This produces compelling mathematical evidence as the auditee calculation is either right or wrong. Calculations made using computer programs can be recalculated using auditing software, with differences being highlighted for further audit investigation. Mathematical evidence can serve the objectives of both existence and valuation for financial statement amounts that result from calculations; for example, depreciation, pension liabilities, prepaid expenses, statutory bad debt reserves, and/or payroll liabilities. Recalculation, in combination with other procedures, is also used to provide evidence of valuation for all other financial data. It provides highly reliable evidence of mathematical accuracy, but the number generated is only as good as the components; the auditor must audit every significant part of the original computation if recalculation is to provide strong, persuasive evidence.

reperformance: audit procedure in which the auditor executes a procedure that is part of the auditee's internal control to assess its effectiveness

A related type of evidence is called **reperformance**. Usually applied in control testing, the auditor independently executes one or more of the auditee's internal control procedures. This can provide compelling evidence about the effectiveness of a control procedure.

Observation

Observation consists of looking at how policy or procedures are applied by others. It provides highly reliable evidence as to performance or conditions at a given point in time, but it does not necessarily reflect performance at other times or over long periods. The technique is used whenever auditors take an inspection tour, watch personnel carry out accounting and control activities, or participate in a surprise petty cash count or payroll distribution. Physical observation also produces a general awareness of events in the auditee's offices.

External Confirmation

Confirmation consists of an enquiry, usually written, to verify accounting records. Direct correspondence with independent external parties is a confirmation procedure widely used in auditing. For example, external confirmation is recommended for accounts receivable by Canadian Auditing Standard (CAS) 505.

STANDARDS CHECK

CAS 505

2. CAS 500 indicates that the reliability of audit evidence is influenced by its source and by its nature and is dependent on the individual circumstances under which it is obtained. . . . ; depending on the circumstances of the audit, audit evidence in the form of external confirmations received directly by the auditor from confirming parties may be more reliable than evidence generated internally by the entity.

Source: *CICA Handbook—Assurance,* 2012.

It can produce evidence of existence, ownership, valuation, and cutoff. Most transactions involve external parties and, theoretically, confirmation could be conducted even on such items as paycheques. Auditors do, however, limit their use of confirmation to major transactions and balances that external parties can provide information about. A selection of confirmation applications includes:

- Banks—account balances
- Customers—receivables balances
- Borrowers—note terms and balances
- Agents—inventory or consignment or in warehouse
- Lenders—note terms and balances
- Policyholders—life insurance contracts
- Vendors—accounts payable balances

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- Registrar—number of shares outstanding
- Legal counsel—litigation in progress
- Trustees—securities held, terms of agreements
- Lessors—lease terms

The important general points about confirmations are as follows:

- Confirmation letters should be printed on the auditee's letterhead, or a facsimile, and signed by an auditee officer.
- Auditors should be very careful that the recipient's address is reliable and not altered by auditee personnel so that it misdirects the confirmation.
- The request should seek information the recipient can supply, such as the amount of a balance or the amounts of specified invoices or notes.
- Confirmations should be controlled by the audit firm, not given to auditee personnel for mailing.
- Responses should be returned directly to the audit firm, not to the auditee. Direct communication is required by auditing standards, so there is no opportunity for auditee personnel to alter the confirmation responses.

Confirmations of receivables and payables may take several forms. Two of these are positive confirmation and negative confirmation. Positive confirmation requests a reply in all cases, whether the account balance is considered correct or incorrect. Negative confirmations request replies only if the account balance is considered incorrect. Auditors make second and third attempts to nonresponders of requests for positive conformation. If no response to a positive confirmation request appears, or if the response to either type of confirmation varies from the auditee's records, the auditors should investigate with other audit procedures, such as subsequent activity on the account or internal evidence supporting the recording of the receivable.[1]

Enquiry

Enquiry generally involves collecting oral evidence from independent parties, auditee officials, and employees. Auditors use enquiry procedures during the early office and plant tour and when conferences are conducted. Evidence gathered by formal and informal enquiry of auditee personnel generally cannot stand alone and must be corroborated by the findings of other procedures. Further enquiries could be made from other appropriate sources within the entity. Consistent responses provide an increased degree of assurance. Sometimes, however, conflicting evidence will come in the form of a negative statement by someone volunteering adverse information, such as an admission of theft, deliberate misstatement, or use of an accounting policy that is misleading. The auditor will have to use considerable judgment in reconciling the conflicting evidence or in deciding what additional evidence to gather. Skepticism and a critical attitude are, again, important aspects of professional judgment.

Enquiries, interviews, and other oral evidence are significant within the profession because management's explanations are an important part of obtaining an understanding of the business and the nature of specific transactions.[2] Management's explanations can be compared with those of other auditee employees, industry experts, and other sources of evidence. The explanations auditors obtain through good enquiry procedures can be very effective in detecting fraud and management motives (discussed in Chapter 7), and in assessing the reasonableness of management assumptions for accounting estimates (discussed in Chapter 19). Auditors must obtain statements from management in the written representation letter acknowledging all important enquiries.[3]

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1 Stay tuned: The uses and limitations of confirmations, as well as issues arising from procedures for obtaining them, are explained more fully in Chapter 11.

2 "A matter of evidence," *CA Magazine*, October 1994, pp. 57–58.

3 Stay tuned: Representation letters are covered in detail in Chapter 15.

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The audit standards rely heavily on audit enquiry evidence, and the Canadian Institute of Chartered Accountants (CICA) research report entitled *Audit Enquiry* identifies ways of making it more reliable. For example, for the assessments required by the balanced scorecard as discussed in Exhibit 6–7 (see page 211), an auditor's primary source of information is enquiries to auditee management, other employees, and perhaps others outside the auditee organization, such as regulators, former employees, or suppliers. Assessing the reliability of the auditee's accounting estimates process frequently involves discussions with senior management. The CICA report provides an illustration involving enquiries of senior management in customer service, manufacturing, quality controls, marketing, and finance to assess the adequacy of an allowance for warranty claims.

Team discussions required by audit standards at the planning and risk assessment stages of the audit enhance integration and synthesis of the whole range of audit evidence obtained by audit team members.[4] Timely, well organized audit discussions facilitate sharing of enquiry evidence and other corroborating evidence to identify inconsistencies that may indicate material misstatement due to error, and particularly to detect fraud.[5]

STANDARDS CHECK

CAS 300

5. The engagement partner and other key members of the engagement team shall be involved in planning the audit, including planning and participating in the discussion among engagement team members. (Ref: Para. A4)

CAS 240

15. CAS 315 requires a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion. This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity. (Ref: Para. A10–A11)

Source: *CICA Handbook—Assurance,* 2012.

A CICA research report makes this note about team meetings: "Debriefings following interviews and site visits should encourage perceptions and intuitive feelings to be brought out, and information challenged to help identify inconsistencies and gaps . . . and answer colleagues' questions about their findings and impressions. . . . The objective, of course, is an integration of findings, capitalizing on the synergy that can come from focused group effort."[6] Junior auditors have the opportunity to learn from more experienced auditors how to apply judgment in evaluating evidence, and they can also benefit the team by bringing in their own objective viewpoints.

Inspection

Inspection consists of looking at records and documents or at assets with physical substance. The procedures are of varying degrees of thoroughness: examining, perusing, reading, reviewing, scanning, scrutinizing, tracing, and vouching. Physically inspecting tangible assets provides reliable evidence of existence and may give some evidence of condition, and hence valuation, but it does not provide reliable evidence of ownership. Physical inspection of formal documents with intrinsic value, such as securities certificates, also provides reliable evidence about existence. Records and documents that do not have an intrinsic market value, such as invoices, purchase orders, or contracts, have varying degrees of reliability for different assertions, depending on their source. Much auditing work involves examining authoritative documents prepared by independent parties and by the auditee. These documents can provide at least some evidence regarding all the assertions.

4 CAS 300, 315.
5 CAS 240.
6 CICA, *Audit Enquiry* (CICA, March 2000), p. 24.

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Documents held by the auditee and available for auditors' inspection can be classified by whether they originate from external or internal sources, as distinguished below.

Documents Prepared by Independent External Parties

A great deal of documentary evidence is external-internal, that is, convincing documentation prepared or validated by other parties and sent to the auditee. The signatures, seals, engravings, and other distinctive aspects of formal authoritative documents make them difficult to alter and, therefore, more reliable than ordinary documents prepared by outsiders. Some examples of both types of documents are listed below:

FORMAL AUTHORITATIVE DOCUMENTS	ORDINARY DOCUMENTS
1. Bank statements	1. Suppliers' invoices
2. Cancelled cheques	2. Customers' purchase orders
3. Insurance policies	3. Loan applications
4. Notes receivable	4. Credit notes received
5. Securities certificates	5. Expense receipts
6. Loan and collateral agreements	6. Insurance policy applications
7. Elaborate contracts	7. Simple, standard contracts
8. Title papers (e.g., autos, real estate)	8. Correspondence
9. Income and payroll tax assessments	

Documents Prepared and Processed within the Entity under Audit

Documentation of this type is internal evidence. Some of these documents may be quite informal and not very authoritative or reliable. Generally, the reliability of these documents depends on the quality of internal control under which they were produced and processed. Some of the most common of these documents are as follows:

1. Sales invoice copies
2. Sales summary reports
3. Shipping documents
4. Credit notes issued
5. Purchase requisition slips
6. Purchase orders
7. Receiving reports
8. Cost distribution reports
9. Employee payroll information forms
10. Bank deposit listings and slips
11. Budgets and performance reports
12. Documentation of transactions with subsidiary or affiliated companies
13. General journal entry support forms

A Particular Inspection Procedure: Vouching—Examination of Documents

In vouching, an auditor selects a sample of financial information items from an account (e.g., the posting of a sales invoice in a customer's master file) and goes backward through the accounting and control system to find the source documentation supporting the items. For a sales invoice, the auditor finds the journal entry or data input list, sales summary, sales invoice copy and shipping documents, and, finally, customer purchase order. Vouching helps auditors decide if all recorded data are adequately supported (the existence/occurrence

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assertion), but it does not provide evidence that all events were recorded. This latter problem is covered by tracing.

A Particular Inspection Procedure: Tracing—Examination of Documents

Tracing takes the opposite direction to vouching. In tracing, the auditor selects samples of basic source documents and goes forward through the accounting and control system (whether computer or manual) to find the final record of the accounting transactions. For example, samples of payroll payments are traced to cost and expense accounts, sales invoices to the sales accounts, cash receipts to the accounts receivable subsidiary accounts, and cash disbursements to the accounts payable subsidiary accounts. Using tracing, an auditor can decide whether all events were recorded (the completeness assertion) and complement the evidence obtained by vouching. Auditors must also be alert to significant events that may not have been captured in the source documents and not entered into the accounting system.

A Particular Inspection Procedure: Scanning

scanning: audit procedure in which the auditor quickly reviews a whole report, account, journal or other listing in the auditee's records to look for any unusual items that require further investigation

Scanning makes use of auditors' alertness to unusual items and events in auditee documentation. A typical scanning directive in an audit program is, "Scan the expense accounts for credit entries; vouch any to source documents."

Scanning is looking for anything unusual. The procedure usually does not produce direct evidence itself, but it can raise questions for which other evidence must be obtained. Scanning can be accomplished on computer records, online or printed out, using audit software. Typical items discovered by the scanning effort include debits in revenue accounts, credits in expense accounts, unusually large accounts receivable writeoffs, unusually large pay cheques, unusually small sales volume in the month following the year-end, and large cash deposits just prior to year-end. Scanning can give some evidence of existence of assets and completeness of accounting records, including proper cutoff of material transactions.

Scanning is valuable when sampling methods are applied in audit decisions. When a sample is the basis for selecting items for audit, there is always the risk of choosing a sample that does not reflect the entire population of items, resulting in a decision error. Auditors subjectively reduce this risk by scanning items not selected in the sample.

REVIEW CHECKPOINTS

8-1 List six audit techniques used to gather evidence and the types of evidence related to them.

8-2 What are the strengths and limitations of recalculation-based audit evidence?

8-3 What are the strengths and limitations of observation-based audit evidence?

8-4 Why must the entire confirmation process be controlled by the audit firm?

8-5 What can auditors do to improve the effectiveness of confirmation requests?

8-6 Differentiate between authoritative and ordinary externally produced documents.

8-7 What is meant by each: vouching, tracing, and scanning?

Analysis

Auditors obtain evidence about financial statement accounts by methods of study and comparison called **analysis**. Auditing standards provide guidance on using analysis at the risk assessment and overall conclusion stages of the audit, and also for when auditors use analysis as an evidence-gathering procedure during the audit. We looked at the risk

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assessment role of analysis in Chapter 6 in relation to understanding the auditee's business and its risks. Analysis is the "other" category in the list of six auditing techniques, and includes "everything else an auditor can think to do" that does not meet the definitions of recalculation/reperformance, observation, confirmation, structured enquiry, or inspection. Analytical procedures range from simple comparisons to complex mathematical estimation models. They can be used to obtain evidence on any of the management assertions, but they are most useful for assertions of completeness, valuation, and presentation.[7]

analysis: audit procedures that involve evaluations of financial information by a study of plausible relationships among both financial and non-financial data to identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount and need to be investigated in order to assess risk of material misstatement, obtain substantive evidence, or form an overall opinion at the end of the audit

Analysis consists of:

(*a*) Identifying the components of a financial statement item so the characteristics of these can be considered in designing the nature, timing, and extent of other audit procedures; and

(*b*) Performing analytical procedures, which are techniques by which the auditor:

- (i) Studies and uses meaningful relationships among elements of financial and non-financial information to form expectations about what amounts recorded in the accounts should be;
- (ii) Compares expected with recorded amounts to identify fluctuations and relationships that are not consistent with other relevant information or that deviate significantly from expected amounts; and
- (iii) Uses the results of this comparison to help determine what, if any, other audit procedures are needed for obtaining sufficient appropriate audit evidence that the recorded amounts are not materially misstated.[8]

STANDARDS CHECK

CAS 520

5. When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with CAS 330, paragraph 18, the auditor shall: (Ref: Para. A4–A5)
   - (a) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions; (Ref: Para. A6–A11)
   - (b) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation; (Ref: Para. A12–A14)
   - (c) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and (Ref: Para. A15)
   - (d) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation as required by paragraph 7. (Ref: Para. A16)

Source: *CICA Handbook—Assurance,* 2012.

The difference between part (a) above and scanning is that analysis relates to a higher level of aggregation—a comparison of financial statement components—whereas scanning relates to the detailed records about a particular component.

Analytical procedures can be classified into the five general types discussed in Chapter 5.When analysis is used to provide substantive evidence, auditors need to be careful to use independent, reliable information for comparison purposes. Thus, the sources of information used in analytical procedures need to be assessed for independence and objectivity. Quantitative information must be verified by the auditor if a high level of reliance

7 D. G. Smith, Analytical Review (CICA, 1983), Chapter 2.

8 CAS 520.

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is placed on the evidence provided by analysis. Examples of the types of independent information sources, and how their reliability can be verified, are as follows:

INFORMATION SOURCE	EVIDENCE OF RELIABILITY OF INFORMATION SOURCE
Financial account information for comparable prior period(s)	Information agrees with audited financial statements, or information in prior year audit working papers (e.g., monthly results).
Company budgets and forecasts	Budgeting or forecasting process is reviewed by the auditor and found to be based on realistic assumptions and methods, and targets are achievable under normal business conditions. Budget and forecast information is produced by the company's information systems under internal controls monitored by senior management; auditor has assessed these controls to be strong. Budgets and forecasts are used by board of directors for decision making.
Financial relationships among accounts in the current period	Account balances used in analysis should be agreed/referenced to audit working papers in current year file where they are verified substantively.
Industry statistics	Sources should be well-known industry analysis services (e.g., Moody's, Standard and Poors) and reports used should be obtained directly by the auditors.
Non-financial information, such as physical production statistics	Non-financial information is prepared by the company's information systems under internal controls monitored by senior management; auditor has assessed these controls to be effective. The nonfinancial information is used by senior management and the Board for decision making.

Because analytical procedures are loosely defined, it is tempting for auditors, and people in general, to consider the evidence produced to be "soft." Therefore, they may tend to concentrate more on recalculation, observation, confirmation, inspection of assets, and vouching of documents that are perceived to produce "hard" evidence. However, analytical procedures can be very effective, because they integrate evidence from a variety of sources and often provide an independent way of gathering evidence about whether the financial statement assertions hold true. Some examples of using analytical procedures to detect misstatements are given in the following box.

FINDING MISSTATEMENTS WITH ANALYTICAL PROCEDURES

- Auditors noticed large quantities of rolled steel in the company's inventory. Several 30,000-kilogram rolls were entered in the inventory list. The false entries were detected because the auditor knew the company's fork-lift trucks had a 10,000-kilogram lifting capacity.
- Auditors compared the total quantity of vegetable oils the company claimed to have inventoried in its tanks with the storage capacity reported in national export statistics. The company's "quantity on hand" amounted to 90% of the national supply and greatly exceeded its own tank capacity.
- Last year's working papers showed that the company employees had failed to accrue wages payable at the year-end date. A search for the current accrual entry showed it had been forgotten again.
- Auditors programmed a complex regression model to estimate the electric utility company's total revenue. They used empirical relations of fuel consumption, meteorological reports of weather conditions, and population census data in the area. The regression model estimated revenue within close range of the reported revenue.

Auditing researchers studied a large number of audits where misstatements requiring financial statement adjustment were found.[9] They were interested primarily in describing the audit procedures used to detect the misstatements. Their definition of analytical procedures was broad and included data comparisons, predictions based on outside data, analyses of interrelationships among account balances, "reasonableness tests," "estimates," and cursory review of financial statements in the audit planning stage. They also had two procedure

9 R. E. Hylas and R. H. Ashton, "Audit detection of financial statement errors," *The Accounting Review*, October 1982, pp. 751–765.

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categories called *expectations from prior years* (which involve the carry-over of analytical and detail knowledge about continuing audit clients) and discussions with auditee personnel.

They found that auditors gave analytical procedures credit for discovery of 27.1% of all misstatements. They gave credit to "expectations" and "discussions" for another 18.5%. Altogether, these so-called soft procedures accounted for detection of 45.6% of the misstatements. All of these procedures are typically applied early in the audit, so we cannot infer whether other kinds of audit procedures would or would not have detected the same misstatements. The detection success of other procedures depends on the results of the early applied procedures because, as this study was designed, even a good physical observation procedure did not get credit for discovery of a misstatement that already had been discovered using analytical procedures.

Analytical procedures are a good value since they are usually less costly than the more detailed, document-oriented procedures. Also, the "hard evidence" procedures have their own pitfalls. Auditors may not be competent to "see" things they are supposed to observe. Auditee personnel can manipulate confirmations. The following box illustrates problems that can arise in evaluating evidence obtained with "hard evidence" procedures. An audit program makes use of several different types of procedures, and analytical procedures deserve a prominent place.

POTHOLES IN THE AUDIT PROCEDURE ROAD

Recalculation:
An auditor calculated inventory valuations (quantities times price) thinking the measuring unit was gross (144 units each), but the auditee had actually recorded counts in dozens (12 units each), thus causing the inventory valuation to be 12 times the proper measure.

Inspection of Assets:
While inspecting the fertilizer tank assets in ranch country, the auditor was fooled when the manager was able to move the tanks to other locations and place new numbers on them. The auditor "inspected" the same tanks many times.

Confirmation:
The insurance company executive gave the auditor a false address for a marketable securities confirmation, intercepted the confirmation, and then returned it with no exceptions noted. The company falsified $20 million in assets.

Enquiry:
Seeking evidence of the collectability of accounts receivable, the auditors "audited by conversation" and took the credit manager's word about the collection probabilities on the over-90-day past-due accounts. They sought no other evidence, and did not discover that reported "net realizable value" of accounts receivable was materially overstated.

Inspection by Examination of Documents:
The auditors did not notice that the bank statement had been crudely altered. (Can you find the alteration in the bank statement in Exhibit 7–3 in Chapter 7?)

Inspection by the Scanning Procedure:
The auditors extracted a computer list of all the bank's loans over $1000. They neglected to perform a similar scan for loans with negative balances, a condition that should not occur. The bank had data processing problems that caused many loan balances to be negative, although the trial balance balanced!

REVIEW CHECKPOINTS

8-8 What does analysis consist of?

8-9 What are three stages in an audit engagement when analysis is used?

8-10 What sources of information are useful for performing analysis?

8-11 If analysis is used to provide substantive audit evidence, what steps must be taken regarding the source information used in the analysis?

8-12 Discuss the effectiveness of analysis for discovering misstatements.

Effectiveness of Audit Procedures

Audits are supposed to provide reasonable assurance that misstatements which may be material to the financial statements have been detected. When misstatements exist, and auditors do a good job of detecting them, adjustments will be made to management's unaudited financial statements before an audit report is issued. How often does this happen? Audit firms seldom give auditing researchers access to their audit working papers, as they

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need to protect auditee confidentiality and also to protect themselves from the risk of litigation or loss of reputation. However, early audit research by Wright and Ashton does provide relevant insights into the nature and causes of misstatements and the role of audit procedures in detecting these.[10] The researchers obtained information on 186 audits performed by a large auditing firm and the reported frequency of audit adjustments is shown in Exhibit 8–2.

What kinds of misstatements did the auditors find? Wright and Ashton reported the data for 23 accounts. A selection of them is shown in Exhibit 8–3. The misstatements consisted of both understatements and overstatements. (Remember that these are not "good" and "bad" descriptions. Overstatement of assets and understatement of liabilities both cause shareholders' equity to be overstated.) Since they come from respondents in one public accounting firm, these data may not be generalized to all audits. In this case, however, problems within the current assets were a mix of overstatements and understatements; in the noncurrent assets the majority were understatements, while in the liabilities understatements were in the majority, and in the expense accounts most were understatements.

As you can see, discovery of misstatements in management's unaudited financial statements is not unusual. How do the auditors do it? What procedures do they find effective? Wright and Ashton also compiled data on seven "initial events" that identified misstatements in financial statements. They were called initial events instead of audit procedures because they were the first work that identified misstatements, and all of them did not correspond exactly with specific procedures auditors would list in an audit program. Exhibit 8–4 shows the initial events indicating misstatements.

EXHIBIT 8–2 Frequency of Audit Adjustments (samples of audits from one audit firm)

NUMBER OF AUDIT ADJUSTMENTS*	NUMBER OF AUDITS	PERCENT OF AUDITS
Zero or 1	22	12%
2–5	30	16
6–10	45	24
More than 10	89	48
Total	186	100%

*Total number of adjustments detected regardless of size or nature.

EXHIBIT 8–3 Summary of Misstatements (selected accounts)

	NUMBER OF MISSTATEMENTS	
ACCOUNT	OVERSTATEMENT	UNDERSTATEMENT
Cash	6	10
Securities	21	17
Accounts receivable	48	22
Inventory	24	32
Property, plant	14	23
Other noncurrent	11	24
Accounts payable	21	25
Accrued liabilities	17	40
Other current liabilities	10	13
Long-term liabilities	12	24
Revenue	32	30
Cost of goods sold	38	45
Selling expense	11	16
Gen and admin. expense	39	52

Note: The effect of adjustments on income was that 43% of the adjustments reduced the reported income, while 28% increased the reported income. The other 29% of the adjustments were reclassifications that neither reduced nor increased income.

10 Data for Exhibit 8–2 and the other related exhibits come from Wright, Arnold, and Robert H. Ashton, "Identifying audit adjustments with attention-directing procedures," *The Accounting Review*, October 1989, pp. 710–728.

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EXHIBIT 8–4 Initial Events that Identified Adjustments

INITIAL EVENT	NUMBER OF ADJUSTMENTS	PERCENT
Tests of details: examination of transaction amounts and descriptions, account balance details, workups to support account balances, data on various reconciliations	104	28.7%
*Expectations from the prior year	78	21.5
*Analytical procedures: comparison of current unaudited balances with balances of prior years, predictions of current balances based on exogenous data, analyses of interrelationships	56	15.5
*Auditee enquiry	48	13.3
Test of detail: checks for mathematical accuracy	35	9.7
General audit procedures	8	2.2

*These were the three "attention-directing procedures" that accounted for 50.3% of the identified adjustments.

The so-called "soft" information from expectations based on prior-year experience, analytical procedures, and auditee enquiry accounted for 50% of the discovered misstatements. Nevertheless, detail audit procedures also were effective. Wright and Ashton note that the "ordering effect" (the fact that the attention-directing procedures come first) biases the results against showing that detail procedures might have detected the misstatements if they had not already been detected. They note further that (1) few adjustments were initially signalled by confirmations or inventory observation and (2) simple methods of comparison and auditee enquiry detected many misstatements.

The research findings are consistent with the continuing emphasis in auditing standards on understanding the auditee's business, its environment, and its business risks by using analysis for risk assessment at the early stages of the audit.

REVIEW CHECKPOINTS

8-13 In auditors' experience, is there any pattern in finding overstatements and understatements in accounts?

8-14 List several types of audit work (initial events, audit procedures), and discuss their likely effectiveness for identifying financial statement misstatements.

BUSINESS INFORMATION SOURCES AND METHODS

LO2 Identify the procedures and sources of information auditors can use to obtain evidence for understanding an auditee's business and industry, assessing risk, and responding to assessed risk.

This section summarizes the application of audit procedures to obtain evidence in the risk assessment and risk response steps of the audit process that were set out in Exhibit 5–1. The audit process begins by obtaining an understanding of the auditee and its risks. Then the auditor performs risk assessment procedures to identify the risk of material misstatement at the overall financial statement level and the assertion level. From this, the auditor determines what procedures are necessary to address the assessed risks and reduce the risk of material misstatement to an acceptable level.

These further procedures may include tests of controls, if the auditor deems it necessary. The auditor always performs some substantive procedures so that there are reasonable conclusions on which to base the audit opinion. Substantive procedures give direct evidence about the financial amounts reported in the financial statements, while risk assessment procedures and control tests only provide indirect evidence about dollar misstatements. Substantive procedures can be either tests of details or substantive analytical procedures. The box on the next page matches up these stages of the audit with the main procedures used for evidence gathering.

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STEPS OF THE AUDIT PROCESS AND AUDITOR'S OBJECTIVES	AUDIT EVIDENCE-GATHERING PROCEDURES
RISK ASSESSMENT STEP	
Understanding the auditee and its risks	Enquiries of auditee personnel, including study of prior-audit working paper information Enquiries of external parties, including industry, and other research sources
Assessing the risk of material misstatement (inherent and control risks)	Enquiry of auditee personnel Observation, including operation of accounting information system and internal control
RISK RESPONSE STEP	
Tests of control effectiveness • obtain indirect assurance regarding material misstatements of monetary amounts in financial statements	Enquiry of auditee personnel Observation of controls performed by auditee personnel Recalculation/reperformance of controls
Substantive tests of details of transactions and account balances • obtain direct evidence regarding material misstatement of monetary amounts in financial statements	Inspection of documents, records, and assets Observation, including scrutiny External confirmation Recalculation/reperformance
Dual purpose tests of controls and substantive details of transactions	Recalculation/reperformance of controls and recording Inspection of documents and records
Substantive analytical procedures	Analysis of relations to other financial and nonfinancial information Comparison of actual and expected values

How do auditors obtain evidence? The following discussion of some information sources and methods auditors use to obtain evidence expands on audit procedures given above. These are examples of the wide variety of information sources auditors use to understand the auditee's business, industry, and environment in order to assess risks of material misstatement and respond to them with further auditing procedures.

Enquiry, Including Prior Working Papers

Enquiry and interviews with the company's management, directors, and audit committee brings auditors up to date on changes in the business and industry. Interviews with auditee personnel (which include observations about the cooperation and integrity of auditee managers) build personal working relationships and develop auditors' understanding of problem areas in the financial statements. In specialized industries, management may have experts on staff or consultants who are important sources of an understanding of the business and its risks.

Information gathered in prior audits, and documented in the working papers, can also provide relevant and reliable information as follows:

- The nature of the organization, its environment, and its internal control
- Significant changes that the entity or its operations may have undergone since the prior financial period, which help the auditor identify and assess new risks of material misstatement
- Misstatements discovered in past audits and the timeliness of their correction

To use prior-period information in the current year, the auditor has to determine its relevance. For example, changes in the control environment may cause information obtained in the prior year to be irrelevant, so the auditor needs to make enquiries and possibly perform other procedures, such as walk-throughs of relevant systems.

For first-time audits, there is often no prior working paper information, so this can require more work than in a repeat engagement. When it is a company's first audit but not its first year of operation, additional work includes establishing a starting place with reliable

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STANDARDS CHECK

CAS 330

14. If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit. The auditor shall obtain this evidence by performing inquiry combined with observation or inspection, to confirm the understanding of those specific controls, and:

(a) If there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor shall test the controls in the current audit; (Ref: Para. A36)

(b) If there have not been such changes, the auditor shall test the controls at least once in every third audit, and shall test some controls each audit to avoid the possibility of testing all the controls on which the auditor intends to rely in a single audit period with no testing of controls in the subsequent two audit periods. (Ref: Para. A37–A39)

Source: *CICA Handbook—Assurance,* 2012.

opening account balances for the audit. Inventory, fixed assets, and intangible assets accounts affect the current-year income and cash flows statements. If this information cannot be obtained, the scope of the current-year audit would be limited, and the opening balances and all the income statement amounts affected by them would require an audit report qualification.[11]

STANDARDS CHECK

CAS 510

10. If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements, as appropriate, in accordance with CAS 705. (Ref: Para. A8)

Source: *CICA Handbook—Assurance,* 2012.

Enquiry also brings a fuller understanding of the needs of the users of the auditee's financial statements than was obtained when assessing whether to accept the engagement. The information obtained from enquiries of management, when combined with analysis of management's draft financial statements, helps the auditor to assess what is significant to users.

Observation

At the same time that enquiries and interviews take place, the audit team can take a tour of the company's physical facilities to look for activities and things that should be reflected in the accounting records. For example, an auditor might notice a jumbled pile of materials and parts in the warehouse and make a mental note to check how these items are valued in the inventory account balance. The tour is the time for auditors to get personal knowledge by seeing company personnel doing their normal day-to-day tasks. Later, the auditors will meet these same people in more directed evidence-gathering circumstances.

Research Databases

Most industries have specialized trade magazines and journals, which are valuable for acquiring and maintaining industry expertise. Specific information about public companies can be found in registration statements and annual report filings with the provincial securities commissions. The CICA, the International Federation of Accountants (IFAC), and the American Institute of Certified Public Accountants (AICPA) industry accounting and auditing guides explain the typical transactions and accounts used by various kinds of businesses and not-for-profit organizations.

11 CAS 510.

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General business magazines and newspapers often contribute insights about an industry, a company, and individual corporate officers. Many are available, including *Canadian Business, Report on Business Magazine, Business Week, Forbes, Harvard Business Review, Barron's, The Wall Street Journal,* and the business sections of newspapers, such as *The Globe and Mail* and the *National Post.* Practising auditors typically read several of these regularly. A selection of other public information sources is shown in the following box.

SOURCES OF GENERAL BUSINESS AND INDUSTRY INFORMATION

Statistics Canada (including economic forecasts)
D&B Principal International Businesses
Hoover's
Standard & Poor's Register of Corporations, Directors, and Executives
CICA Audit *Risk Alert*s
Value Line Investment Survey
Moody's Investors Services (moodys.com)
CFO Magazine
Analysts' reports
D&B Key Business Ratios
Audit-firm libraries, universities, dissertations on specialized industry topics
LexisNexis
Auditee websites, trade associations, conferences

The Internet is a very important information source for auditors. An organization's website might have financial statements and other information. Using effective search engines, such as Google, industry information and comparisons can also be obtained, allowing auditors to improve their business knowledge and thus design more effective analytical procedures. For larger companies, analyst and credit rating coverage are invaluable sources of information. Many articles in the business press are based on changes in credit ratings or analyst recommendations concerning specific companies and industries. Brokerage firms' websites contain analysis of publicly traded companies. There are also investor websites, such as Motley Fool (www.fool.com), that can provide valuable clues of potential problems in an auditee's (or potential auditee's) business. Be aware, however, that Internet information may not always be reliable, and must be used with caution. A minimum knowledge of the auditee and its industry is necessary to properly interpret such information.

Internal Auditors

Audit efficiency can be realized by working in tandem with internal auditors. Independent auditors should understand a company's internal audit activities as they relate to the internal control system. Internal auditors can also assist by providing information for understanding the business and its systems and controls, and even by performing control or substantive testing under the supervision of the independent audit team.[12]

STANDARDS CHECK

CAS 610

8. The external auditor shall determine:
   (a) Whether the work of the internal auditors is likely to be adequate for purposes of the audit; and
   (b) If so, the planned effect of the work of the internal auditors on the nature, timing or extent of the external auditor's.

Source: *CICA Handbook—Assurance*, 2012.

Auditor's Experts

Auditors are not expected to be experts in all areas that may contribute information to the financial statements. In some cases, as noted above, enquiries to management experts hired by the auditee can offer key evidence. However, the auditor's understanding of the

12 CAS 610.

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business can signal a need for the audit firm to use its own experts on the audit. Experts are persons skilled in fields other than accounting and auditing, such as actuaries, appraisers, legal counsel, engineers, chemists, and geologists who are needed for obtaining the understanding and evidence necessary for a particular account or assertion. When external experts are engaged, they must have appropriate professional qualifications and good reputations. They are not part of the audit team but still should be unrelated to the auditee, in order to provide objective evidence. Auditor's experts may be employees of the audit firm, in which case they are subject to all the firm and engagement quality control standards like any other audit team member. Auditors must obtain an understanding of the expert's methods, assumptions, and source data and be able to evaluate whether the expert's work is adequate for the purposes of the audit, and whether the findings are reasonble.[13]

STANDARDS CHECK

CAS 620

7. If expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence, the auditor shall determine whether to use the work of an auditor's expert. (Ref: Para. A4–A9)

6(a). Auditor's expert—An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert. (Ref: Para. A1–A3)

Source: *CICA Handbook—Assurance*, 2012.

REVIEW CHECKPOINTS

8-15 What are some of the methods and sources of information the auditor can use to understand an auditee's business?

8-16 When does an auditor need to use the work of an expert? What additional requirements must the auditor meet to use an expert's work as evidence?

SUFFICIENT APPROPRIATE EVIDENCE IN AUDITING

LO3 Explain audit evidence in terms of its appropriateness and relative strength of persuasiveness.

After assessing the risk of material misstatement in the assertions in management's draft financial statements, auditors proceed to the task of planning specific procedures for gathering evidence related to these assertions. However, before studying these procedures, you need to understand some features of evidence in auditing.

Auditing standards require auditors to obtain sufficient appropriate evidence to be the basis for an opinion on financial statements.[14] The accounting records (journals, ledgers, accounting policy manuals, computer files, and the like) are evidence of the bookkeeping/accounting process but not sufficient appropriate supporting evidence for the financial statements. The auditor must find independent evidence corroborating these records through direct personal knowledge, examination of documents, and enquiry of company personnel. Evidence is gathered and analyzed in support of the decision on whether the financial statements are fairly presented and conform to generally accepted accounting principles (GAAP).

Identifying audit evidence is a key critical thinking activity in exercising professional audit judgment. To form an opinion on the fair presentation of the financial statements, the auditor requires evidence to (a) judge rationally whether the financial statement assertions are true and (b) provide logical support for the opinion expressed in the audit report.

13 CAS 620.

14 CAS 500, paragraph 6.

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Appropriateness of Evidence

Appropriateness of evidence relates to the qualitative aspects of evidence. To be considered appropriate, evidence must be relevant and reliable. Relevant audit evidence assists the auditor in achieving the audit objectives. This means that it must relate to at least one of the financial statement assertions; otherwise, it is not relevant to the auditor.

STANDARDS CHECK

CAS 500

5(b). Appropriateness (of audit evidence)—The measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

Source: *CICA Handbook—Assurance*, 2012.

The box below lists general audit techniques and indicates the financial statement assertion that each may provide relevant evidence about. Note that most evidence is not conclusive and corroborating evidence is often required to provide reasonable assurance, especially when the assessed risk of material misstatement is high. Consequently, the comparison below should be viewed as only a rough guide, subject to the specific considerations in each audit.

The reliability of audit evidence depends on its nature and source. The following hierarchy of evidential matter shows the relative reliability and, when combined with relevance, the overall persuasive power or appropriateness of different kinds of evidence. The hierarchy starts with the strongest form of evidence and proceeds to the weakest.

GENERAL AUDIT TECHNIQUES	FINANCIAL STATEMENT ASSERTIONS EVIDENCE MAY BE RELEVANT TO
Recalculation	Existence Valuation
External Confirmation	Existence Ownership/Rights and Obligations Valuation: partially, usually requires corroborating evidence Cutoff: partially, usually requires corroborating evidence
Enquiry	All assertions; partially, but responses typically yield more assertions, in turn subject to audit with corroborating evidence
Inspection of documents	Existence: vouching direction Completeness: tracing direction Valuation: partially Ownership/Rights and Obligations Presentation and Disclosure
Inspection of physical assets	Existence Valuation: partially, usually requires corroborating evidence Ownership: partially, usually requires corroborating evidence Presentation and Disclosure
Analysis: Scanning	All assertions: partially, perhaps raises questions that may be relevant to all assertions, but may not produce actual "evidence"; when performed on recorded amounts, evidence may be relevant to Existence, Valuation, Ownership, and Presentation/Disclosure; when performed on source documents, evidence may be relevant to the Completeness assertion
Analysis: Analytical Procedures on Financial Relationships	Existence: partially, usually requires corroborating evidence Completeness: partially, usually requires corroborating evidence Valuation: partially, usually requires corroborating evidence

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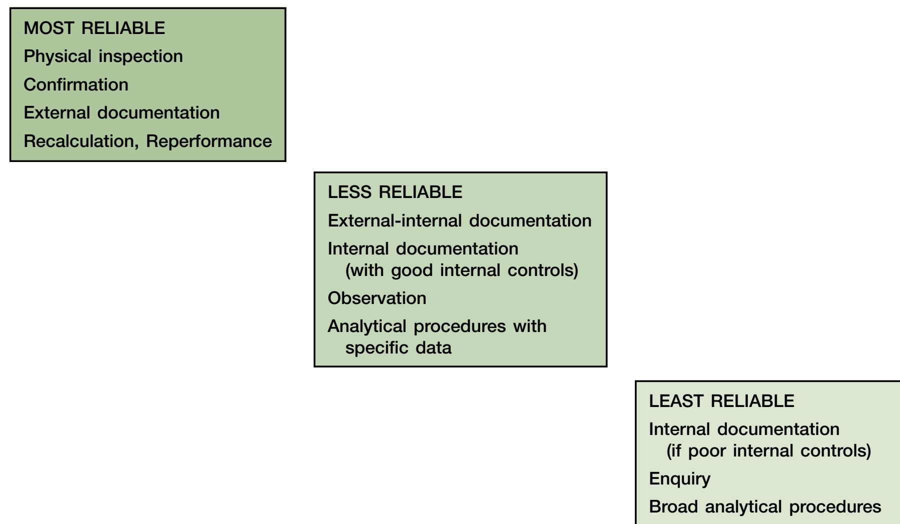
1. An auditor's direct, personal knowledge obtained through physical observation and his or her own mathematical recalculations or reperformance, is generally considered the most reliable evidence.
2. Documentary evidence obtained directly from independent external sources (external evidence) is considered very reliable.
3. Documentary evidence originating outside the auditee's data processing system but received and processed by the auditee (external-internal evidence) is generally considered reliable. However, the circumstances of internal control quality are important.
4. Internal evidence consisting of documents that are produced, circulated, and finally stored within the auditee's information system is generally considered low in reliability. However, internal evidence is used extensively if internal control is satisfactory. Sometimes, internal evidence is the only kind available. It is also generally easy to obtain and, therefore, tends to be less costly than other evidence.
5. Analysis using specific data that the auditor has verified is considered fairly reliable. While broad analytical procedures of a general nature are not considered highly reliable as substantive evidence, they are often used for preliminary risk identification and attention directing early in an audit.
6. Spoken and written representations given by the auditee's officers, directors, owners, and employees are generally considered the least reliable evidence. Such representations should be corroborated with other types of evidence.

   Exhibit 8–5 below illustrates this hierarchy.

EXHIBIT 8–5 Hierarchy of Audit Evidence Reliability



Auditors must be careful about the appropriateness of evidence and choose the audit procedure providing that evidence which is the most reliable. If physical observation and mathematical calculation are not relevant to the account, impossible, or too costly, then auditors move down the hierarchy to the procedure that will give the best evidence available—best in the sense of most appropriate or persuasive under the circumstances. It should be the most reliable evidence that can be obtained in a cost-effective manner, relative to a particular audit objective.

There may be situations, however, where no highly reliable source of evidence is available, such as cash donations received by a charity or online sales transactions that leave no

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visible trail. In these cases, there may be two or more less-reliable pieces of evidence that together may support the assertion. If the pieces of evidence are consistent with each other and are from two independent sources, the evidence may be persuasive enough in the auditor's judgment. For example, to combine evidence sources an auditor might observe employee procedures and test controls of these, plus review summarized sales reports prepared for marketing purposes. Another example is given in the following box.

RELATED PARTIES—A PERFECT STORM IN AUDITING

The existence of related parties poses considerable auditing challenges and can increase risks of material misstatement of the financial statements due to error and fraud. This note deals with the audit planning and evidence issues created by related parties.

Because the related party may have control or significant influence over the entity's operating, investing, and financing policies, transactions with them might not always be conducted under normal market terms. For example, assets could be transferred from the entity to a related party, such as a shareholder, for either no consideration or for an amount considerably below the assets' fair value, perhaps with no business justification. Related-party relationships might also limit an audit, as the relationships may be complex, the entity's information systems may not be designed to flag transactions with related parties (management may not even know about them!), and reliable audit evidence about the transactions may not exist.

The fact that the different financial reporting frameworks have different accounting standards for related-party transactions makes things even more complex. For example, Canadian GAAP (*CICA Handbook—Accounting, Part II,* section 3840) sets out recommendations for both measurement and disclosure, while IFRS (IAS 24) only deals with disclosure of related-party transactions. GAAS (CAS 550) requires auditors to understand the entity's related-party relationships and transactions well enough to be able to assess the risk of misstatement and to conclude whether the financial statements are fairly presented in accordance with the framework's requirements. For example, selling an asset to a controlling shareholder for far more than its fair value and then reporting the gain as a profit when it was intended as an equity contribution by the shareholder is not fair presentation. Not disclosing that an entity's ability to continue as a going concern is dependent on continuing financial support from a related party would also be misleading.

Finally, related parties can increase fraud risk as these relationships may present a greater opportunity for collusion, concealment, manipulation, or falsification of evidential records and documents by management.

How do auditors defend against this "perfect storm"? Maintaining professional skepticism throughout the audit is the auditor's strongest weapon in noticing the unusual transactions and relationships that have no apparent business purpose and may not be reflected appropriately in the financial statements. Another key tool is frequent discussion among audit team members, where observations and management enquiry responses are compared so that inconsistencies needing follow-up are highlighted. Inconsistent stories can indicate that the entity's financial statements are more susceptible to material fraud or error because of its related-party relationships and transactions, and the auditor has to dig deeper to find them. The audit problem with related parties is that evidence obtained from them should not be considered highly reliable in terms of persuasiveness. The source of the evidence may be biased. Hence, auditors should obtain evidence of the purpose, nature, and extent of related-party transactions and their effect on financial statements. Evidence should extend beyond management enquiry, and corroborating evidence should be obtained to increase persuasiveness.

Sources: CAS 550; *CICA Handbook* section 3840 "Related party transactions"; IAS 24 "Related party disclosures."

Sufficiency of Evidence

Sufficiency considers how much appropriate evidence is enough. The matter of sufficiency is an important application of auditors' professional judgment, as this will vary from situation to situation. The standards cannot really set out a specific amount of evidence required. Realistically, however, audit decisions must be based on enough evidence to stand the scrutiny of other auditors (supervisors and reviewers) and outsiders (such as critics, judges, or the Canadian Public Accountability Board [CPAB] inspectors).

The real test of sufficiency is whether your evidential base allows someone else to reach the same conclusions you reached. The fact that important evidence is difficult or costly to obtain is not an adequate reason for failing to obtain it. If an auditor has not been able to obtain sufficient appropriate audit evidence about a material financial statement assertion, CAS 330 states that the auditor should express a qualified opinion or a disclaimer of opinion, as was discussed in Chapter 4.

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STANDARDS CHECK

CAS 500

5(e). Sufficiency (of audit evidence)—The measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.

CAS 330

27. If the auditor has not obtained sufficient appropriate audit evidence as to a material financial statement assertion, the auditor shall attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements.

Source: *CICA Handbook—Assurance*, 2012.

With these aspects of evidence in mind, you will be ready to study the general processes for designing specific procedures in the detailed audit plan, which will be covered next.

REVIEW CHECKPOINTS

8-17 What is the relationship between assertions and the relevance of audit evidence?

8-18 What factors determine whether audit evidence is appropriate? What types of audit evidence are most reliable? least reliable?

8-19 How is an auditor's professional judgment applied in assessing the appropriateness of audit evidence?

8-20 How are external, external-internal, and internal documentary evidence generally defined?

8-21 What is the problem with evidence obtained from related parties?

8-22 Distinguish between the appropriateness of audit evidence and the sufficiency of audit evidence.

8-23 What action is required if an auditor cannot obtain sufficient appropriate audit evidence?

Exhibit 8–6 shows the interrelationships among the auditing concepts discussed in this and earlier chapters, and how these concepts underlie the auditor's judgment about what audit evidence is required to meet the sufficiency and appropriateness criteria. We start with the materiality considerations; these are shown along the left side of the exhibit. The auditor determines materiality levels based on assessments of how precise the financial statement need to be. As we have seen, this involves considering at what point the magnitude of misstatement would be large enough to start to be detrimental to users' decisions based on the financial statements. The audit risk model components are shown in the centre of the diagram. The auditor's assessments of risk determine how much evidence needs to be gathered to increase assurance to a high enough level to bring audit risk to an acceptably low level given the auditor's risks in taking on the engagement.

The right side of the diagram deals with the characteristics of potential audit evidence. Note that the evidence decision must take into account practical limitations—not all evidence can be obtained at a reasonable cost or quickly enough to provide a timely audit report. Not all evidence has the same level of reliability. Trade offs have to be made because of these limitations. The concepts of materiality and audit risk guide these trade offs. This diagram shows the kind of complex analysis that is at the heart of professional judgment about the sufficiency and appropriateness of audit evidence. Essentially, the auditor's evidence judgment results from the trade off among these three decisions: how small of an misstatement do we need to find (materiality), how sure do we need to be that we found it (audit risk to be accepted), and what evidence is available and practical to obtain that can that can provide a high enough level of assurance of finding misstatements that are above the materiality threshold.

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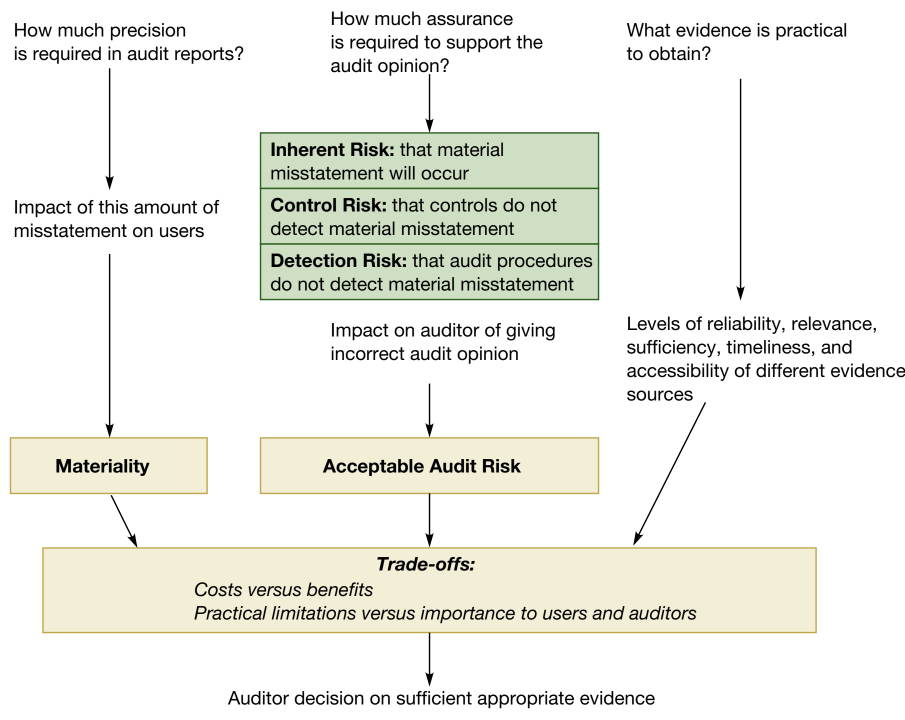
EXHIBIT 8–6 Auditor Judgments on Sufficiency and Appropriateness of Evidence



AUDIT PLAN AND DETAILED PROGRAMS

LO4 Describe the content and purpose of the audit plan as well as the specific audit programs and detailed procedures it contains.

As discussed throughout Part 2 of the text, audit planning is an on-going process. Planning is done at the start of the audit but continues throughout as new information results in revisions to the plan. Before, during, and after the field-work period, the auditor responsible for an audit engagement constantly monitors events that may affect an auditee's business risk, the client relationship, or the engagement. The box below gives an example of why auditors must read the news and consider the impact of new developments on their audit engagements—significant changes in an auditee's business risk can occur any time!

MONEY LAUNDERERS SPREAD THEIR NET

It was reported that automated teller machines (ATMs) located in small retail shops have become a prime vehicle for money laundering by organized crime gangs in the suburban areas around a major city. The shop's revenue is a percentage of the service charge paid by anyone taking cash out of the ATM, with the balance of the service fee going to the bank that provides the ATM. Shop employees are responsible for refilling the machine with cash taken in legitimately from customer sales. It was suspected that some employees would accept "dirty cash" (i.e., proceeds of crime) from criminals and use that to refill the ATMs instead of the clean cash from the cash register, which was given to the criminals. The dishonest employees receive a portion of the cash exchanged as their cut of the deal.

Now put yourself in the shoes of the auditor of a company that owns a chain of small retailers operating ATMs in this area. How does this development affect the business risk of this auditee? The auditor needs to determine if management has identified this risk and responded appropriately by ensuring employees are adequately screened before hiring and are trained to be aware of the money-laundering laws and criminal penalties. Are there controls over employee activities, and is management monitoring them to ensure they are working? Even if the auditor discovers this situation six months before the audit is set to start, the information should be documented in the planning file. The auditor also should contact the auditee management as soon as possible to discuss the impact of this development on their business risk and what actions they are taking. Management may be too busy running the day to day operations to monitor business risks continuously!

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The Planning Documentation

All the planning activities are recorded and summarized in planning documentation, sometimes referred to as a **planning memorandum**. While audit firms can use a variety of planning and documentation practices, the specific planning steps and documents outlined in the auditing standards are likely to be commonly used, so they are discussed here.[15]

planning memorandum: where all planning activities are recorded and summarized

STANDARDS CHECK

CAS 300

12. The auditor shall include in the audit documentation:
    (a) The overall audit strategy;
    (b) The audit plan; and
    (c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. (Ref: Para. A16–A19)

Source: *CICA Handbook—Assurance*, 2012.

Auditors prepare a document, called the overall audit strategy, summarizing the preliminary planning procedures and key decisions, as was introduced in Chapter 6. This document contains the results of analytical review, the decision on materiality levels, and the risk assessment. It gives specific attention to the effect of these on the nature, extent, and timing of audit resources needed to perform the work. The auditor's understanding of the business helps to assess inherent risk, and understanding the information systems and controls helps to assess control risk. These also aid in identifying what kinds of evidence are available and at what cost, the third component of the evidence decision outlined in Exhibit 8–6. The next planning decision to be documented is whether to use a combined approach or a substantive approach. As was discussed in Chapter 6, a combined audit approach involves testing effective controls to reduce risk of material misstatement, which can reduce the extent of substantive testing required. A substantive approach will assess controls for the purpose of the overall risk assessment but will not test the controls as a component of the audit evidence.

audit plan: document containing all the detailed auditing programs with procedures to be performed in response to the assessed risk of material misstatement on an audit, guided by the decisions made in the overall audit strategy

risk assessment program: an audit planning document listing the specific procedures for gaining understanding of the auditee's business transaction processing systems and controls, as well as for assessing the inherent risks and the control risk for the assertions in financial account balances and transaction streams

The risk assessment and audit approach decisions guide the development of the **audit plan**, which summarizes the details of how the work is to be done. An audit plan lists specific detailed audit programs. The practical considerations and the trade offs between the risk components and materiality guide decisions on what and how much evidence to gather through control tests, analytical procedures, and other tests of balances—the evidence-gathering techniques discussed above. These evidence decisions are the basis of the audit programs that make up the audit plan. These procedures are designed to result in sufficient appropriate evidence that addresses the audit objectives set out in the program. The programs usually look like a to-do list for audit staff, some of whom may have little prior audit experience. Also included in the planning documentation are the audit team's understanding of the auditee's business and risks that were relevant in developing the decisions.

internal control program: an audit planning document summarizing the auditor's understanding of internal control and the control testing procedures to be performed to assess control risk and control effectiveness

Auditors use three main types of audit programs: the **risk assessment program**, the **internal control program** and the **balance audit program**. The risk assessment program lists the specific procedures for gaining understanding of the auditee's business transaction processing systems and controls, as well as for assessing the inherent risks and the control risks. The risks are assessed for the assertions in financial account balances and transaction streams that result from the information system processes. The internal control program involves documenting the understanding of internal control and specifies the control testing procedures to be performed to assess control effectiveness and control risk—indirect evidence regarding the likelihood of monetary misstatements in the financial statements. The balance audit program lists the substantive procedures for gathering direct evidence on the assertions (i.e., existence, completeness, valuation, ownership, presentation) about monetary amounts in the account balances, transactions, and related disclosures.

balance audit program: lists the substantive procedures for gathering direct evidence on the assertions (i.e., existence, completeness, valuation, ownership, presentation) about dollar amounts in the account balances

15 CAS 300.

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These audit programs combine all the considerations of audit planning discussed up to this point:

- Understanding the auditee's business, its environment and risks, its information systems, and its internal control
- Preliminary materiality decisions
- Assertions and objectives contained in the auditee's financial statements
- Preliminary analytical procedures for identifying specific risk areas in the unaudited financial statements
- Preliminary risk assessments
- Persuasive strengths of evidence
- Audit procedures for obtaining evidence: control testing, substantive detail testing, and substantive analytical procedures

In actual field situations these audit programs can very lengthy. Program documents may include separate listings of procedures and questionnaires on the company's business strategies and risk, business processes, internal control environment, management controls, and control procedures. To put the sequence of topics you have read about up until now into perspective, the following box highlights typical components of audit programs.[16]

UNDERSTAND THE BUSINESS RISK, INHERENT RISK, AND CONTROL RISK

Risk Assessment Program

- Communicate with predecessor auditors (for new engagements).
- Study prior-year audit working papers, professional audit and accounting guides, and industry publications concerning the company and its industry.
- Interview management with regard to business risks, processes and controls, and accounting policies, and any significant changes in the current year.
- Evaluate the competence and independence of the company's internal auditors, if any.
- Determine the need to use the auditor's own experts on the engagement.
- Determine the extent of significant information technology (IT) applications in the company's accounting system.
- Obtain the draft financial statements and make decisions about the planning materiality appropriate in the circumstances.
- Perform preliminary analytical procedures to identify risk areas in the financial statement accounts.
- Assess the inherent risk in general and also with respect to particular accounts, transactions and disclosures, at the overall financial statement and the assertion levels.

Internal Control Program

- Obtain an understanding of the company's internal control through interviews, observations, and tests of controls (see Chapter 9).
- Perform detailed test of control procedures, if necessary (see Chapters 9 and 10).
- Assess the control risk (see Chapters 9 and 10).
- Use the control risk assessment to design the nature, timing, and extent of substantive audit procedures (see Chapters 9 and 10).

The balance audit program consists of several programs, each applicable to a particular account. Auditors first subdivide the financial statements into accounting processes or cycles (as explained in Chapter 6) then turn attention to the accounts in each. The procedures in these audit programs are designed to obtain evidence about the existence, completeness, valuation, ownership, and presentation assertions implicit in each account title and balance. The box on the next page contains a partial program in the revenue process, with brief specifications of procedures for auditing accounts receivable. The procedures

16 Stay tuned: The technical parts of internal control risk assessment programs are explained more fully in Chapter 9.

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contain many of the elements of the general techniques that were explained in the previous section (e.g., confirmation, recalculation, enquiry, inspection, and the assertions toward which they are directed).

EXAMPLE OF BALANCE AUDIT PROGRAM IN REVENUE, RECEIVABLES, RECEIPTS PROCESS

Accounts Receivable

- Obtain an aged trial balance of the receivables and agree it to the general ledger control account.
- Prepare and send confirmations on a sample of customers' accounts receivable. Analyze the responses.
- Calculate and analyze the age status of the accounts and the allowance for uncollectible accounts.
- Interview the credit manager concerning the past-due accounts, review credit reports for analysis of high risk overdue accounts.
- Vouch receivables balances to cash payments received after the confirmation date.
- Read loan agreements and make note of any pledge of receivables, sales with recourse or other restrictions, or contingencies related to the receivables.
- Read sales contracts for evidence of customers' rights of return or price allowance terms.
- Obtain written representations from the auditee management concerning pledges for collateral, related-party receivables, collectability, and other matters related to accounts receivable.

The detailed audit programs of the audit plan should contain detailed descriptions of the specific audit procedures to be performed. Each procedure's description should indicate its nature, timing, and extent, as well as a direct association with one or more financial statement assertions. The **nature (of audit procedures)** refers to the six general techniques: recalculation/reperformance, confirmation, enquiry, inspection, observation, and analysis. The **timing** of procedures is when they are performed: at the preliminary planning stage, at an "interim" point in the year (before the balance sheet date), or at "year-end," shortly before and after the balance sheet date. CAS 330, paragraph 22, explains what procedures the auditor needs to do to cover the remaining period to year-end when substantive procedures are done at at interim date. The **extent** of procedures refers to the amount of work done, such as the sample size for an audit test procedure (e.g., confirm 30 outstanding accounts receivable balances with customers), or the number of reports to be scanned (e.g., review the sales journal entries for three days randomly selected from each month to look for unusual items).

nature (of audit procedures): the six general techniques of an account balance audit program: recalculation/reperformance, confirmation, enquiry, inspection, observation, and analysis

timing: when the planned audit procedures are to be performed, either before, at, or after period end

extent: the amount of audit work planned, such as sample size for an audit test

STANDARDS CHECK

CAS 330

22. If substantive procedures are performed at an interim date, the auditor shall cover the remaining period by performing:
    (a) Substantive procedures, combined with tests of controls for the intervening period; or
    (b) If the auditor determines that it is sufficient, further substantive procedures only that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. (Ref: Para. A54–A57)

Source: *CICA Handbook—Assurance*, 2012.

REVIEW CHECKPOINTS

8-24 What information is summarized in the audit planning document or memorandum? How does it relate to the preparation of audit programs?

8-25 What are the kinds of audit programs, and what is the purpose of each?

8-26 What is meant by the terms nature, timing, and extent of audit procedures?

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AUDIT DOCUMENTATION WORKING PAPERS

LO5 Evaluate audit working paper documentation for proper form and content.

No audit is complete without proper working paper documentation. The planning document described above is a key component of the audit documentation, and additional documentation is required for the rest of the audit work. Documentation provides a record of the auditor's work for the purpose of file reviews, practice and regulatory inspections, or, in some cases, defence against a lawsuit. Working papers are the auditors' record of compliance with generally accepted auditing standards. They should contain support for decisions on procedures deemed necessary and all other important decisions made during the audit.[17] Even though the auditor is the legal owner of the working papers, professional ethics requires that there is auditee consent before transferring them because of the confidential information in them. Audit files must be retained for several years as required by professional accounting association rules and practice inspection procedures. Last year's file is a rich resource for the current year's engagement team on continuing audits. It provides valuable insights into key entity characteristics, likely risk areas, findings, and evidence relevant to the current year's financial statements, such as the audited opening balances.

STANDARDS CHECK

CAS 230

2. Audit documentation that meets the requirements of this CAS and the specific documentation requirements of other relevant CASs provides:
   (a) Evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and
   (b) Evidence that the audit was planned and performed in accordance with CAS/ISAs and applicable legal and regulatory requirements.

Source: *CICA Handbook—Assurance*, 2012.

The following box outlines the impact that destroying audit working papers has on the value of the audit and the reputation of the audit firm. The Andersen document shredding scandal was a key driver for development of more rigorous auditing standards. It shows why documentation is considered important by audit firms and the auditing standard setters.

SHREDDED AUDIT PAPERS. . . . SHREDDED AUDITOR REPUTATION

In 2001, Andersen was the fifth largest auditing firm in the world, employing 85,000 people in 84 countries and reporting revenues of US$9.3 billion. In a crippling blow, in March 2002, the U.S. Justice Department indicted Andersen on criminal charges of obstruction of justice. The indictment alleged that the audit firm had shredded tons of documents sought by investigators who were probing financial problems at Andersen's client, the energy giant Enron Corp. These criminal charges were the first to come out in the Enron case, and they struck a blow that eventually led to the demise of the nearly 90-year-old auditing firm that had long enjoyed a solid reputation for integrity. The events that led to the destruction of Andersen are related below.

Signs of trouble at Enron first arose in the summer of 2001, when Enron vice-president Sherron Watkins warned chairman Kenneth Lay that the company might be overcome by a wave of accounting scandals unless it took quick action to correct a series of questionable transactions that its auditors, Andersen, had helped it to devise. Despite this warning, Enron's stock price collapsed amid questions about its accounting practices, and in December 2001 it declared bankruptcy. Thousands of employees lost their jobs, and current as well as former employees lost their retirement savings as they had been encouraged to invest them in Enron shares. As rumours began to circulate that Andersen should not have given a clean audit opinion on Enron's financial statements, its reputation fell under suspicion and lawsuits against it began to pour in. Andersen's reputation declined further in January 2002, when it announced publicly that it had shredded documents related to Enron's audit.

The indictment against Andersen, issued by a federal grand jury in Houston, alleged a widespread effort to destroy audit documentation related to questionable transactions at Enron. It alleged that shortly after the Securities and Exchange Commission (SEC) informed Andersen, on

17 CAS 230.

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October 19, that it was launching a preliminary investigation of whether Enron had filed misleading financial reports, document shredding on a massive scale began. "The shredder at the Andersen office at the Enron building was used virtually constantly and, to handle the overload, dozens of large trunks filled with Enron documents were sent to Andersen's main Houston office to be shredded," the indictment alleged. Andersen undertook "an unparalleled initiative . . . to shred physical documentation and delete computer files. . . . Tons of paper relating to the Enron audit were promptly shredded as part of the orchestrated document destruction." As the indictment proceeded, prosecutors piled more pressure on Andersen by revealing damaging e-mails between auditors in the middle of the mass destruction of Enron documents, including one that read, "Argh, send more shredding bags."

As stories of the document shredding covered the front pages of newspapers, Andersen began to lose some of its biggest clients, casting doubt on whether the firm would be able to survive the crisis. The jury trial began on May 2, 2002, and on June 15, 2002, a guilty verdict was handed down. Andersen was found guilty of obstruction of justice and was barred from auditing SEC-registered companies after August 31, 2002. By then a large number of Andersen's 2300 public-company clients had already replaced Andersen. As a result of these events, Andersen's ability to continue as an auditing firm was effectively destroyed, and it ceased operations on August 31, 2002.

Accounting researchers found that, in the days following Andersen's January 2002 announcement that it shredded Enron audit documents, the share prices of Andersen's other clients experienced a significant drop, indicating that investors downgraded the quality of the audits performed by Andersen. These findings show the importance of the auditor's reputation to investors. If investors believe the audit is of low quality, they have less assurance that the company's financial statements reflect its real business performance and financial position. They assess a higher likelihood that its income and net book value are overstated and that the auditor has failed to report this.

On May 31, 2005, the Supreme Court overturned the 2002 criminal conviction of Andersen on the grounds that the Houston jury was given overly broad instructions by the federal judge who presided at the trial that found it guilty of obstruction of justice. But, by then, Andersen, its reputation, and its business were long gone.

When asked whether the destruction of a firm with 85,000 employees and thousands of commercial clients was an appropriate price for Andersen to pay, one of the prosecuting attorneys suggested that Andersen had only itself to blame. "It should not come as a surprise that serious charges have serious consequences," the deputy attorney general said.

Sources: S. English, "Auditor overtime 'used for shredding'," *Daily Telegraph,* May 22, 2002, p. 32, © Telegraph Group Limited; C. Mondics and S. M. Hopkins, "Andersen indicted in Enron shredding," *The Record,* March 15, 2002, p. a01, © 2002 North Jersey Media Group Inc.. All rights reserved; K. Bewley, J. Chung, and S. McCracken, "An examination of auditor choice using evidence from Andersen's demise," *International Journal of Auditing,* (2008) 12, pp. 89–110; P. Chaney and K. Philipich, "Shredded reputation: The cost of audit failure," *Journal of Accounting Research,* 40 (4), pp. 1221–1245, © 2002, Blackwell Publishing.

Working papers can be classified into three categories: (1) permanent file papers, (2) audit administrative papers, and (3) audit evidence papers. The last two categories are often called the **current file** because they relate to the planning and performance of the audit of the current period.

current file: the administrative and evidence audit working papers that relate to the audit work for the year being audited

Permanent File Papers

The **permanent file** contains information of continuing interest over many years' audits of the same auditee. This file can be used year after year, whereas each year's current audit evidence papers are filed away after they have served their purpose. Documents of permanent interest and applicability include (1) copies or excerpts of the corporate charter and bylaws or partnership agreements; (2) copies or excerpts of continuing contracts, such as leases, bond indentures, royalty agreements, management bonus contracts, and so on; (3) a history of the company, its products, and its markets; (4) excerpts of minutes of shareholders' and directors' meetings on matters of lasting interest; and (5) continuing schedules of accounts whose balances are carried forward for several years, such as share capital, retained earnings, partnership capital, and the like. Copies of prior-years' financial statements and audit reports may also be included. The permanent file is a ready source of information for new auditors on the engagement who must familiarize themselves with the auditee.

permanent file: audit working papers that are of continuing interest from year to year, including the client company's articles of incorporation, shareholder agreements, major contracts, minutes, etc.

Audit Administrative Papers

Administrative papers contain the documentation of the early planning phases of the audit. They usually include the engagement letter, staff assignment notes, conclusions related to understanding the auditee's business, results of preliminary analytical procedures, initial assessments of audit risks, initial assessments of audit materiality, and other decisions set

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out in the overall audit strategy. Many auditing firms follow the practice of summarizing these data in an engagement planning memorandum.

Audit planning and administration also includes work on the preliminary assessment of control risk and preparation of a written audit plan. The following items are usually among the administrative working papers in each year's current file:

1. Engagement letter
2. Staff assignments
3. Auditee organization chart
4. Memoranda of conferences with management, board of directors, audit committee
5. Overall audit strategy:
   (*a*) Preliminary analytical review notes
   (*b*) Initial risk assessment notes
   (*c*) Initial materiality assessment notes
   (*d*) Audit engagement time budget
6. Internal control questionnaire and control analyses:
   (*a*) Management controls questionnaire
   (*b*) IT controls questionnaire
   (*c*) Internal control system flowcharts
7. Audit plan and specific programs
8. Working trial balance of general ledger accounts
9. Working paper record of preliminary adjusting and reclassifying entries
10. Review notes and unfinished procedures (all cleared by the end of the field work)

Audit Evidence Papers

The current-year audit evidence working papers are typically organized in sections: major accounting processes or cycles and balance sheet accounts. Each section contains a lead sheet that shows the dollar amounts reported in the financial statements, summary of the audit objectives in relation the account's assertions, procedures performed, evidence obtained, and conclusions reached for that section overall. The lead sheet is like an index, or table of contents, that provides references to all the audit working paper pages relating to the audit work on that section (see Exhibit 8–7). These papers communicate the quality of the audit, so they must be clear, concise, complete, neat, well indexed, and informative. Each separate working paper (or multiple pages that go together) must be complete in the sense that it can be removed from the working paper file and considered on its own, with proper cross-reference available to show how the paper fits in with the others. Working papers may be hard copy (handwritten, typed, printed from computer files) or stored electronically. Exhibit 8–8 provides an example working paper: a printout of bank reconciliation from the auditee's accounting system supporting the cash account amount recorded in the company's trial balance. The auditor has used the auditee-prepared report to document audit work results by making hand-written notes on the paper.

The current audit evidence papers must show the auditors' decision problems and conclusions. The papers must record the management assertions that were audited (book values or qualitative disclosures), the evidence gathered about them, and the final decisions. Auditing standards recommend that the working papers show (1) evidence that the work was adequately planned and supervised, (2) a description of audit evidence obtained, (3) evidence of the evaluation and disposition of misstatements, and (4) copies of letters or notes concerning audit matters reported to the auditee. Common sense also dictates that the working papers show that the financial statements conform to GAAP and that the disclosures are adequate. The working papers also should explain how exceptions and

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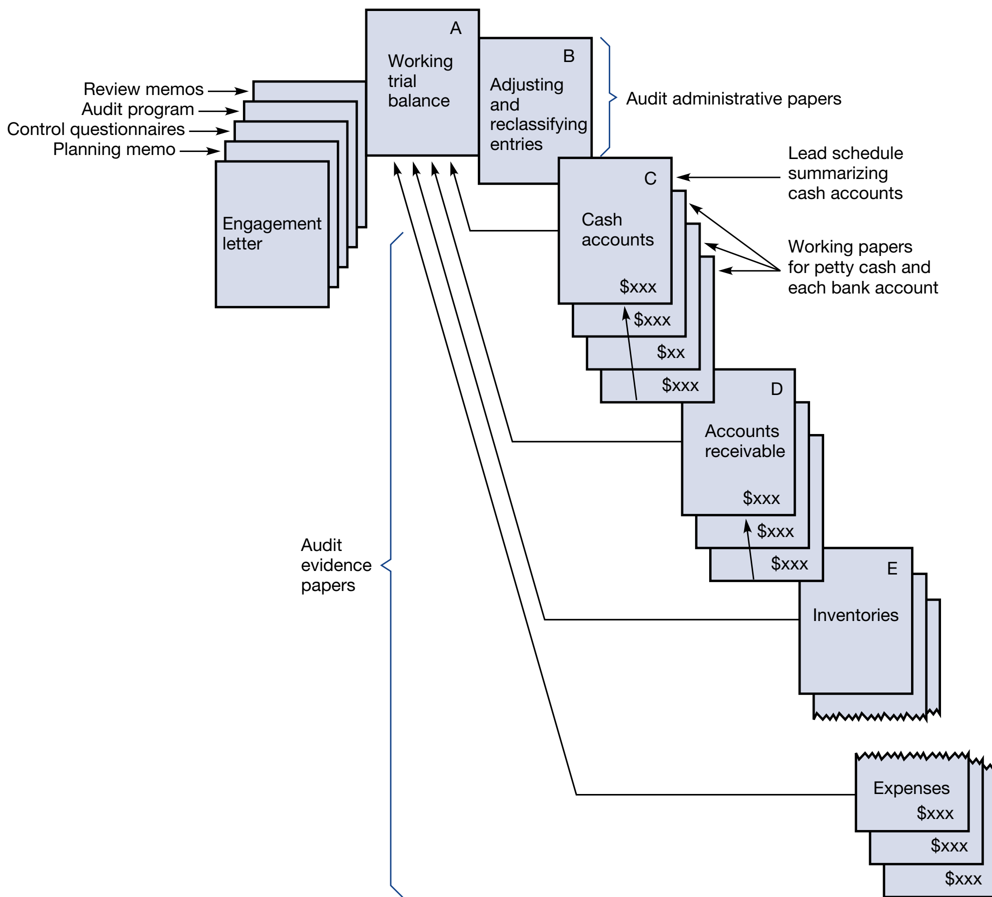
EXHIBIT 8–7 Current Working Paper File



unusual accounting questions were resolved or treated. (Note in Exhibit 8–8 the auditor's confirmation of the disputed account payable liability.) Taken altogether, these features should demonstrate that all the auditing standards were observed.

Working Paper Arrangement and Indexing

Auditing organizations use different methods of arranging and indexing working papers. Usually, the papers are grouped behind the trial balance, ordered according to balance sheet and income statement captions. The current assets usually appear first, followed by fixed assets, other assets, liabilities, equities, revenue, and expense accounts. A typical arrangement is shown above in Exhibit 8–7.

The quality of the finished product depends on the working papers following specific preparation formats. The following points are also shown in the illustrative working paper in Exhibit 8–8.

- *Indexing.* Each working paper is given an index number, like a book page number, so it can be found, removed, and replaced without loss. An index number might consist of a section letter (e.g., C) and a page number within that section (e.g., C-2). Each section could be given to a different audit team without affecting other sections. (An example of an indexing system used in practice is provided in Appendix 11C on Connect.)

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EXHIBIT 8–8 Illustrative Working Paper

Index number — Auditee name — Initials of auditors and dates of work

KINGSTON COMPANY

C-2 BANK RECONCILIATION-NORTH COUNTRY BANK — Prepared 9.D. 1/10/14

General Account — Reviewed JRA 1/10/14

12/31/13

(Prepared by client)

Balance per bank statement				506,100 c
Add:				
Deposit in transit as of 12/31/13				51,240 n
				557,340
Deduct outstanding cheques:				
Date	No.	Payee		
12/10/12	842	Ace Supply Company	500 ∝	
11/31/13	1280	Ace Supply Company	1,800 ✓	
12/15/13	1372	Northwest Lumber Co.	30,760 ✓	
12/28/13	1412	Gibson & Johnson	7,270 ✓̸	
12/30/13	1417	First National payroll	20,000 ✓	
12/30/13	1418	Ace Supply Company	2,820 ✓	
12/30/13	1419	Windy City Utilities	2,030 ✓	
12/30/13	1420	Howard Hardware Supply	8,160 ✓	
				73,340
Balance per book				484,000 f
				(T/B-1)

Tick-mark symbols

Cross-index to trial balance

Legend for tick-mark symbols

Note: Obtained cutoff bank statement 1/9/14 (C-23)

f Footed

c Confirmed by bank standard bank confirmation (C-22)

n Vouched to cutoff bank statement, deposit recorded by bank on 1/3/14. Vouched to duplicate deposit slip validated 1/30/14

✓ Vouched to paid cheque cleared with cutoff bank statement.

✓̸ Vouched to statement from lawyers. Amount agrees

∝ Amount in dispute per controller. Confirmation from supplier claims liability of $5,000. See (K-4) recommended adjustment.

Cross-index to other working papers

Explanations of audit work performed

- *Cross-indexing.* Numbers or memoranda related to other working papers carry the index of other working paper(s) so that the connections can be followed.
- *Heading.* Each working paper is titled with the name of the company, the period under audit date, and a descriptive title of the contents of the working paper. If the paper was created by auditee personnel (rather than the auditor) this is noted in the title.
- *Signatures and initials.* The auditor who performs the work and the supervisor who reviews it must sign the working papers so that personnel can be identified.
- *Dates of audit work.* The dates of performance and review are recorded on the working papers so that reviewers can tell when the work was performed.
- *Tick marks and explanations.* Tick marks are the auditor's shorthand for indicating the work performed. They must always be accompanied by a full explanation of the auditing work.

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STANDARDS CHECK

CAS 230

9. In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:
   (a) The identifying characteristics of the specific items or matters tested; (Ref: Para. A12)
   (b) Who performed the audit work and the date such work was completed; and
   (c) Who reviewed the audit work performed and the date and extent of such review. (Ref: Para. A13)

Source: *CICA Handbook—Assurance,* 2012.

Audit Working Paper Software

Specialized working paper software is common in public practice. Electronic working papers boost productivity by automating many tasks, such as carrying adjustments over to related working paper documents and the financial statements. Good working paper software integrates the audit information and makes it easy to access, review, and change the format, content, or order of the files. Because most organizations' data are already in electronic form, it is logical to integrate this data with electronic working paper files. In addition, the volume of paper required for file documentation is reduced or eliminated, and with laptop computers there is better communication and information sharing among team members, as well as continuous monitoring and review of the work, even from a distance, by a supervisor. The entire audit process can make use of the software's efficiencies, such as standard templates and electronic questionnaires.

Audit working paper software can also facilitate analysis. Links can be established to other databases or even websites so that data or information can be cross-referenced or transferred to the working papers. Thus, audit staff work and various other sources of information can be integrated to support the auditor's opinion.

There are, however, costs associated with computer-generated working papers, including costs of hardware, software, training, document scanning, and continual upgrades with advances in technology. Also, some copies of original source documents such as important contracts may still need to be kept in hard copy form. An example of a working paper software program used in public practice is CaseWare. There are also pitfalls to avoid in going with a paperless audit documentation system, as shown in the following box.

GOING PAPERLESS

Accountants have always feared disaster, such as fires, floods, or even tornadoes, that could destroy their paper working files—the only record of their labour. But they are even more uneasy when their work is stored only in electrons and very susceptible to erasure, corruption, or disappearance.

While most practitioners have gone at least part way toward a paperless documentation system, many have difficulty moving beyond the first tentative steps. Most have the hardware, software, and experience to save the majority of documents in electronic formats, whether through creating forms electronically in the first place (e.g., Excel spreadsheets) or by scanning paper documents. The big challenge is to implement a logical, intuitive, and consistent storage system for all those electronic forms. The forms must be quickly accessed, safely stored, properly archived, and backed up securely on a timely basis.

While something as ubiquitous as Windows Explorer can be used to create logical file directories and sub-directories, the flexibility available in Windows Explorer can create problems when new users do not understand how the file system was set up to work, and how to put new documents into it. It is hard to prevent files from being lost or mis-filed.

So, a key issue in going to paperless audit documentation is to address is how to lay out directories and how and where to store files so they can be easily retrieved. Many small and medium practices using CaseWare can make use of its built-in "document manager" function—this can provide an excellent structure on which to base a simple document management system. Just remember, you do not need to scan everything! If it would not be kept in a paper file then there is no need to clutter up electronic files either; and all this scanning can waste a lot of time. Also, finding tricks to keep file sizes small, such as scanning in black and white or greyscale and avoiding coloured highlighting in Excel files, helps to keep things more manageable.

Source: Adapted from Ray Desjardins, "Going down the paperless road," *CA Magazine,* November 2009, pp. 49–50.

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STANDARDS CHECK

CAS 230

14. The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report. (Ref: Para. A21–A22)

A21. . . . An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.

A23. . . . The retention period for audit engagements ordinarily is no shorter than five years from the date of the auditor's report. . . .

Source: *CICA Handbook—Assurance,* 2012.

REVIEW CHECKPOINTS

8-27 Why do audit firms and auditing standards require auditors to prepare and retain specific documentation of their audit work?

8-28 What information would you expect to find in a permanent audit file and how would auditors use this information?

8-29 What audit administration working papers are included in the current audit evidence working paper files?

8-30 What is considered the most important content of the current audit working papers?

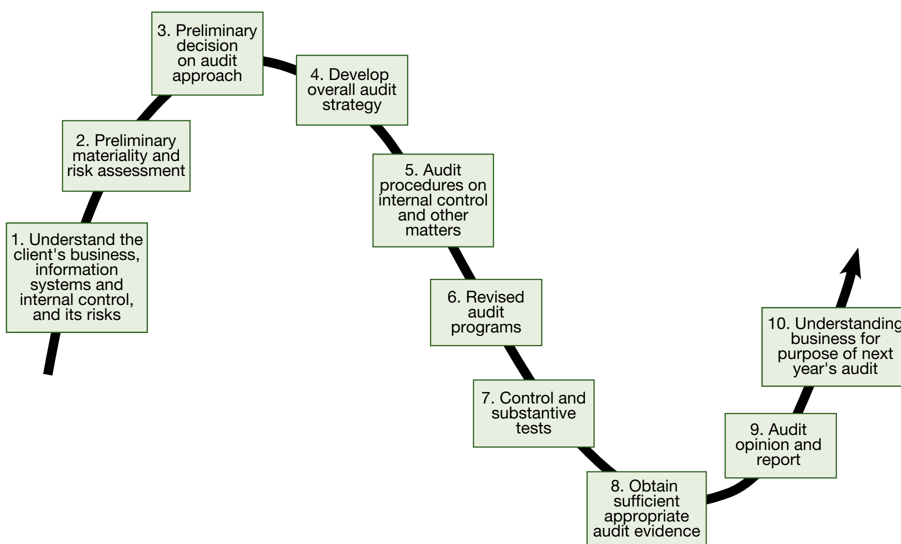
8-31 What is the purpose of indexing and cross-referencing audit working papers?

8-32 What techniques can auditors use to improve the quality of working paper documentation?

8-33 How can software be used to prepare audit working papers?

Audit documentation's key role is to provide a record of the work done, to help in revising the audit plan as the work proceeds, to allow for quality control reviews to be done effectively, and to help with planning the subsequent year's audit work. As the discussion in Part 2 up to now has shown, audit planning is a process of learning, feedback, and continuous improvement, as is depicted in Exhibit 8–9 below.

EXHIBIT 8–9 Audit Planning—A Process of Continuous Improvement



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APPLICATION CASE WITH ANALYSIS

Review of an Audit Plan

DISCUSSION CASE

Toward the end of his first year in public practice, Jack is assigned to the audit team for Foyer Properties Inc. (Foyer). Foyer's main activity is development and leasing of commercial real estate properties, such as shopping malls and office towers. In the past few years, Foyer has developed a niche residential property business: building university residences and nursing homes and leasing them under a head lease with a public sector organization, such as a university or municipal government. The public sector organization handles collection from the individual residents. Foyer is a private company, with the chairman holding 60% of the shares and the president and chief operating officer holding the remaining 40%.

Foyer has been a long-time audit for Jack's firm. The previous audit manager, Hank, just left the firm after ten years to be the chief financial officer (CFO) at a local mining company, and Hilda has taken over from him for the 20X8 audit. Hank had been on the Foyer audit since joining the firm and had managed the audit for the past six years. Looking over the previous audit files, Hilda noted that Hank had not changed the audit approach for years: a substantive approach focusing primarily on verifying existence and valuation of all the major real estate properties and all large transactions, such as the major purchase or sale of a property. Since accounts receivable from the universities and governments were always received by the time the audit was being done, they were verified by vouching subsequent receipts, not by confirmation. Revenues and expenses from the property leasing operations were audited entirely by analytical procedures.

Hilda is confident that the past audits obtained sufficient appropriate evidence to support the audit opinion, which has always been unmodified, but feels that the audit planning should be updated to follow a risk-based approach. This may identify areas where a more effective audit approach could be applied. Since Jack has had experience using risk-based audit plans in several of his other audits this year, Hilda thought it would be a good learning experience for Jack to apply the risk-based approach in Foyer's audit planning.

Hilda has asked Jack to develop a risk-based overall audit strategy and preliminary audit plan for the current-year audit of Foyer. She would then like him to compare this plan with the plan used in previous years to identify and justify any differences.

The first thing Jack does is get out Foyer's prior-year audit files (for its year ended December 31, 20X7) and study the final financial statements and the planning memorandum that Hank had prepared. Jack notices that Hank's planning memo has been copied and carried forward for several years, with any new information tacked on at the end. Extracts from Foyer's prior-year audited financial statements and planning memorandum are provided below. What are the steps Jack will go through to create a risk-based audit plan?

FOYER PROPERTIES INC.CONSOLIDATED BALANCE SHEET AS AT DECEMBER 31, 20X7		
	20X7	20X6
	(in thousands of dollars)	
Assets		
Rental properties (note 4)	$32,180	$36,211
Cash and short term investments	8,296	8,910
Deferred charges (note 7)	2,031	2,052
Other (note 8)	929	528
Construction in progress	857	402
Corporate taxes recoverable	28	—
	$44,321	$48,103
Liabilities		
Mortgages and other loans payable (note 10)	$26,362	$31,247
Accounts payable and accrued liabilities	968	870
Pension obligation (note 11)	768	828
Tenant deposits	297	393
	28,395	33,338

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Shareholders' Equity		
Share capital (note 12)	5,850	5,850
Retained earnings	10,076	8,915
	15,926	14,765
	$44,321	$48,103

STATEMENT OF INCOME AND RETAINED EARNINGS FOR THE YEAR ENDED DECEMBER 31, 20X7

Real estate operations	**20X7**	**20X6**
	(in thousands of dollars)	
Revenue		
Rental income	$ 4,847	$4,600
Property management and other fees	902	1,137
	5,749	5,737
Operating expenses		
Municipal taxes	586	874
Repairs and maintenance	472	411
Utilities	251	356
Property management	201	164
Insurance	44	50
	1,554	1,855
	4,195	3,882
Interest	2,044	1,656
Amortization	999	828
	3,043	2,484
Net income from real estate operations	1,152	1,398
Other income (loss)		
Gain on disposition of real estate assets	1,518	2,806
Interest and other investment income	368	450
	1,886	3,256
General and administrative expenses		
Salaries and benefits	275	290
Office	355	274
Capital taxes	71	99
Professional fees	42	32
	743	695
Net income for the year	2,295	3,959
Dividends paid during the year	(1,134)	(798)
Retained earnings, beginning of the year	8,915	5,754
Retained earnings, end of the year	$10,076	$8,915

Note 4. Rental properties and other capital assets (in thousands of dollars)

	——————20X7——————			20X6
	Cost	Accumulated amortization	Net book value	Net book value
Buildings	$25,738	$2,763	$22,975	$28,028
Land	8,870	–	8,870	7,826
Parking lots and roadways	192	40	151	161
Furniture, fixtures, and equipment	370	187	183	196
	$35,170	$2,990	$32,180	$36,211

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Note 10. Mortgages and other loans payable (in thousands of dollars)

	20X7	20X6
Mortgages and loans secured by rental properties and bearing interest at fixed rates ranging from 5.45% to 7.28%, blended monthly payments	$24,404	$30,524
Loan secured by rental property and bearing interest at prime plus 1.25%, blended monthly payments, due on demand	1,958	723
	$26,362	$31,247

Interest paid on this debt during the year totalled $2,043.

Foyer Properties Inc.

Planning Memorandum

Prepared by: Hank Grouse, Senior Manager

Knowledge of the Auditee Business

Private corporation, provincial incorporation on April 1, 20X0. Two shareholders, one (holds 40%) is the general manager of the business; the other (holds 60%) is chair of the corporation's board. Both have access to monthly financial reports and other information they require. Main reason for audit is to support borrowing for construction financing—the shareholders feel audited financial statements show the company is solid. Main operations are developing and leasing commercial shopping malls and office buildings, focus on high quality properties and tenants (e.g., banks, pharmacies)

Materiality

Materiality $90,000 (10% normal pretax profit)

Risk Analysis

- Audit risk: Can accept the highest level
  Reasons for conclusion: Private company, few shareholders have access to all financial reports, other users are creditors with property-securing loans, company is profitable and in strong financial position.
- Inherent risk: LOW
  Reasons for conclusion: Operations and accounting not complex, previous audit work good, typically find only small (less than $3,000) misstatements that management always corrects, and low volume of high-value transactions not susceptible to error and easily monitored by management.
- Control risk: HIGH—will not rely on controls; will test substantively
  Reasons for conclusion: Controls appear strong, management control attitudes good, senior management monitors financial results closely, president is a major shareholder, clear job descriptions and lines of authority, rigorous human resource policies for hiring and evaluation and compensation, and no fraud indicators noted.
- Detection risk: MODERATELY HIGH
  Reasons for conclusion: Substantive evidence will verify key assertions for all significant financial statement amounts.

Other Planning Points

- Commercial real estate market values tend to be stable
- Environmental liabilities—management is on top of this; no problems to date over 25 purchase deals
- Management policy is to retain adequate cash reserves to have flexibility to pay for unexpected repairs, or to be able to seize good acquisition opportunities that can arise at any time
- Communications between shareholders are open; any shareholder loans or other related-party transactions are agreed and approved by both
- All accounting policies used are acceptable in real estate industry
- Management's key performance measure is cash flow from operations (net revenue from properties less debt service, so risk of manipulation of accruals is minimal—only cash is considered)

Systems Notes

- Control environment is strong; will not rely on systems and application controls; substantive approach will be used.
- An industry standard financial reporting package (REMR) used—provides reliable monthly operating information (actuals vs. budgets)—summary data from REMR manually transferred to G/L.
- Logins used for access; no systems changes required as operation is quite stable.
- REMR system is behind firewall from the office IS network, so Internet interface has minimal security risk.

Significant Financial Statement Accounts, Audit Approach to Verify to Assertions:

R/R/R Key assertions—CEV

- Rent roll (rent revenue journal) is updated regularly, management reviews reports monthly, and rent entries are easily auditable by matching to lease agreements.

P/P/P Key assertions—CEV

- Management closely monitors monthly financial reports and follows up discrepancies.
- Expenditures are largely regular and predictable so variances are easily detected.

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- Two signatures (CFO and Operations Manager) required on all cheques.
- Audit will be by analytical procedures: Detailed comparison to prior years, by property, by month, and comparison to budgets.

Rental Properties—EOV

- Purchase agreements and lease agreement terms will be verified. Property tax bills will be inspected to verify Foyer retains ownership of each property. Loans and collateral agreements will be confirmed; analysis of interest and property taxes will be based on these inputs. Lease agreements and lease receipts will be analyzed in relation to properties leased. Management representations will be obtained to ensure no property sales are unrecorded and all purchases and new leases are recorded.

Additions to Planning Memorandum

Note new information for 20X5 audit:

Company has entered a specialized residential real estate leasing business. Residential properties, such as student residences and nursing homes, are developed to order for public sector organizations, such as universities and municipal governments—risks seem low. Foyer's management has capability to handle this type of operation, so no impact on audit for now.

Note for planning 20X6 audit:

Asset sale transactions can be complex. We were asked to review the agreement terms and management's proposed accounting entry prior to finalizing so that there are no surprises when it comes to reporting sale in year-end financial statements, and determined a $300,000 adjustment was required to management's proposed entry to account for the stepped-up rent payments over the term of the lease, per GAAP.

Notes for planning 20X7 audit:

Hank met with Foyer president to discuss the audit plan. He noted that construction project cost overruns on the public sector residential property have been a problem, as public sector officials get involved and demand various changes to the agreed plans. Foyer has hired a new construction project manager with experience in the public sector so these demands can be handled better. The construction manager reviews and approves all expenditures, and the two cheque-signing officers will not sign unless this approval is received. Construction changes and cost overruns are a potential risk area, since the lease payments are set prior to construction and may not be adequate to recover a higher investment in the property.

Note for planning 20X8 audit:

Hank had lunch with the Foyer president and learned that ten public sector residential properties are now leased, and six more are under construction. The company's strategy is to grow the public sector residential business, as commercial real estate leasing is mature and harder to grow. Most of Foyer's commercial properties can be sold now for good gains, so the new strategy is to begin to divest the commercial buildings when market conditions are optimal and buyers are found.

ANALYSIS

After reviewing all the planning notes, Jack realizes that Hank had obtained a very thorough knowledge of the company and its risks and controls, and he had assessed the risks of material misstatement appropriately. He had also developed a reasonable response to the assessed risks by deciding to use a substantive audit approach.

However, the effectiveness of the audit can be improved by implementing a more strategic analysis of the business risk factors, explicitly linking these to risk of material misstatement at the financial statement level and at the assertion level for the significant classes of transactions, account balances, and disclosures. Jack could reorganize the information from the planning notes and preliminary analysis of Foyer's financial statements to follow the risk-based planning steps and develop more fully the links between the business risks and specific risks of material misstatement and the audit responses that should be performed. The risk assessment must also consider fraud risk more explicitly.

Management's related controls to reduce those risks could be considered, and the remaining risks that the audit plan needs to respond to identified. This analysis would more likely draw the audit team's attention to the potential increase in risk from the company's new strategy in the public sector residential leasing business. The audit team will develop appropriate responses by planning further audit procedures related to this business line. The materiality determination and qualitative factors considered should also be more fully explained and documented.

Jack could document the business risk analysis by type of factor, as follows.

Understanding the Entity and Its Business, Environment, Risks, and Controls

Nature of entity

Private corporation, provincial incorporation on April 1, 20X0. Two shareholders, one (holds 40%) is the general manager of the business, the other (holds 60%) is chair of the corporation's board. Both have access to monthly financial reports and other information they require. Main reason for audit is to support borrowing for construction financing; the shareholders feel audited financial statements show the company is solid. Main operations are developing and leasing commercial shopping malls and office buildings, focus on high-quality properties and tenants (e.g., banks, pharmacies).

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Industry risk factors

No significant risks: local operation, very minimal and noncomplex regulatory environment, and simple valuation measurements.

Legal regulatory risk factors
For land/property purchases need to do due diligence re environmental liabilities. Management is on top of this, no problems to date with over 25 purchase deals closed.

Economic risk factors
Real estate values have stopped increasing in current year but are expected to be stable, not crash, in near term. Fair values exceed carrying values so no impairment expected; no financial instruments or complex financing is used, just standard mortgage loans.

Business relations
No key competitors/suppliers. Key customers are city government and universities involved in residential properties.

Strategy and related processes
Develop and lease profitable buildings.

- Select unique locations for targeted tenants—high-quality businesses, public sector residential.
- Plan construction and monitor project costs closely to keep investment at level where required return can be achieved.
- Structure leases to ensure adequate rate of return on investment and recovery of operating cost and any increases (e.g., energy, property taxes, insurance).
- Implement effective collection procedures to ensure cash flows are on time and as planned.
- Arrange loans from large financial institutions, using specific assets as collateral, to obtain low cost financing.
- Retain adequate cash reserves to have flexibility in paying for unexpected repairs or seizing good acquisition opportunities that can arise at any time.

Internal Control Factors

Control environment

- Management is experienced and successful in industry
- Management works as team
- Clear job descriptions and lines authority

Management's risk assessment process

- Conservative risk takers, focus on rates of return on investment
- Budgeting for new property developments and ongoing operations

Information system, related business processes, financial reporting, and communication

- Use industry standard information system (REMR)
- Accounting policies follow real estate industry guidelines re depreciation assumptions, and so on.
- Cash and straight line revenue recognition for stepped rent leases (per GAAP)

Control activities

- Access controls, regular reporting

Monitoring of controls

- Top management actively involved and monitoring all aspects of the operation

Key Financial Statement Accounts and Underlying Business Processes

Revenue process

- The rent roll is updated regularly, system controls are strong, management reviews key reports
- As long as the entity level controls are adequate, the audit approach can be based on substantive testing alone because the rent transactions can be verified by matching them to lease agreements.

Purchasing process

- Management closely monitors monthly financial reports and follows up discrepancies
- Expenditures are largely regular and predictable so variances are easily detected
- Two signatures required on all cheques

Key performance measure
Cash flow operations show net revenue from properties less debt service (so risk of manipulation of accruals is minimal—only cash is considered)

Systems
Industry standard financial reporting package (REMR) used:

- Provides reliable monthly operating information (actuals vs. budgets)
- Summary data from REMR manually transferred to G/L
- Logins used for access, no systems changes required as operation is quite stable
- REMR system is behind firewall from the office computer network, reduces Internet security risk

Materiality Determination

Users—Shareholders, lenders
Qualitative considerations—Very profitable business, well capitalized, well managed, low transaction volume; we have audited it problem-free for many years, no management or operating changes this year

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Worksheet:

	ANTICIPATED CURRENT YEAR	PRIOR YEAR
Net income before taxes (NIBT)	$2.95m	$2.3m
Total assets	$50m	$44m
Nonrecurring items in income		
– Gain on sale	$2m	$1.5m
NIBT—normal, continuing	$.95m	$0.8m
Typical percentage:		
– NIBT 5–10%, use 10% due to qualitative factors	$95,000	$80,000
Comparison with alternative base, – Total assets 0.5–1%	$250,000	$220,000
Materiality for financial statement as a whole	$95,000	$80,000
Anticipated misstatements based on previous audits		
– Less than $5000, most years misstatements negligible	$5,000	$5,000
Performance materiality	$90,000	$75,000

A matrix such as the one below could be used to organize the planning considerations. The key risk revealed by Jack's review is entered as an example, and the other business risks in Foyer can be analyzed and entered similarly.

Describe business risks with financial reporting implications or fraud risks	**Describe related risks of material misstatement by account and assertion**	**Rate risks as high/ medium/low**	**Describe management control(s) addressing the risk**	**Rate control effectiveness to reduce risk as high/ medium/low**	**Are risks adequately controlled? Yes/No**	**Audit implications: e.g., control testing required, further audit procedures required to address remaining risk**
– Public sector residential projects fix future lease payments prior to construction – Construction cost overruns can occur to meet public sector official's demands – Etc.	– Rental property costs can exceed recoverable values – Fraud risk of kickbacks to public sector officials	Medium	– Project costs approved – Monitoring project cost overruns – Leasing agreements structured to provide required return on investment (ROI)	Medium	Yes	– Observe and enquire as to monitoring effectiveness – Examine project costs, approvals – Analyze lease agreement, verify recovery of investment and operating costs

Overall Audit Strategy—Other Preliminary Conclusions

- Financial Reporting Framework is GAAP (ASPE), an, acceptable, fair presentation framework.
- Preliminary risk assessment at financial statement level: LOW
  - It appears risks of material misstatement are low initially, and management risk assessment is adequate to reduce these. Some further procedures needed to verify conclusions based on management control effectiveness via observation and enquiry of management.
- Preliminary audit strategy to respond to assessed risk at financial statement level:
  - Consider—Business processes involve small number of large transactions for property sales, planned and monitored construction project costs for development process, lease-driven revenue streams, and predictable cost patterns for rental process. Substantive approach is most effective to obtain sufficient appropriate evidence.
- Preliminary risk assessment at assertion level:
  - Main identified risks affect following account/ assertion:
    - Rental property/Valuation (costs incurred and recoverability of investment)
    - Rental revenue/Existence (public-sector leases)

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Preliminary Audit Plan to Respond to Assessed Risks:

(a) *Timing*
Year-end balance audit—not efficient to do interim work

(b) *Nature*
Rental property valuation—detailed analysis of budget and actual costs, any changes in project costs (overruns), and changes in economic factors that can suggest investment not recoverable.
Revenues—detailed analysis based on comparison with lease agreements and verify cash receipts. For new public sector residential business, external confirmation should be obtained of terms and payments from appropriate counterparty, to ensure no fraudulent scheme is occurring.
Expenses—predictable: we have a history for comparison, so analysis of reasonability sufficient; can also indicate any misstatements/fraud in revenues.

(c) *Extent*
Plan to confirm all revenue amounts that are material in total from one counterparty.
Analysis will cover all significant accounts on balance sheet and income statement.

Staffing
Experienced staff should be assigned to perform the bulk of the audit work as the analysis requires careful judgment and preparation. One junior staff member should be assigned to get experience but needs close supervision. A team meeting should be held prior to beginning audit preparations. Daily meetings should be held during field work to cross-reference findings. A final meeting should be held after the files are completed for the partners' review and to clear any outstanding issues, if possible, or ensure they are documented clearly for the partner to follow up.

Summary
Overall, the auditee presents a low risk of misstatement, and the substantive verification of year-end balances of rental property (vouching costs), loan balances and terms (confirmation), and public sector residential lease revenues (confirmation), combined with detailed analytical procedures, will provide sufficient appropriate evidence that material misstatement does not exist in the financial statements.

SUMMARY

This chapter continued the explanation of audit planning started in Chapters 6 and 7 by describing the six general techniques for obtaining audit evidence:

- The main sources of evidence were outlined.
- The underlying theory of evidence and its persuasiveness was explored by discussing the fundamental auditing concept of sufficient appropriate audit evidence along with the reliability of various techniques for gathering it. This explanation of procedures was enriched with additional notes about the ways in which procedures can be misapplied. Analytical procedures were introduced, and their power was illustrated with some empirical research findings based on actual audit results.
- The chapter provided an overview of the audit plan and specific programs for collecting evidence. Programs were categorized as risk assessment programs, internal control programs, and balance audit programs.
- The chapter described some key considerations about audit documentation by looking at planning documentation: the form, content, and purpose of audit working papers.

The chapter finished with an Application Case that provided an opportunity to review a risk-based audit plan for the audit of a real estate business. Now the stage is set for Chapter 9, where we pursue a more detailed examination of the auditor's review, understanding of the auditee's information systems, and evaluation and testing of internal control.

KEY TERMS

analysis
audit plan
balance audit program
current file
extent
internal control program
nature (of audit procedures)
permanent file
planning memorandum
recalculation
reperformance
risk assessment program
scanning
timing

EXERCISES AND PROBLEMS

EP 8-1 Audit Procedures. LO1 Auditors frequently refer to the terms *standards* and *procedures*. Standards deal with measures of the quality of performance. Standards specifically refer to the generally accepted auditing standards expressed in the CASs. Procedures specifically refer to the methods or techniques used

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by auditors in the conduct of the examination. Procedures are also expressed in the CASs.

Required:
List six different types of procedures auditors can use during an audit of financial statements and give an example of each.

EP 8-2 Potential Audit Procedure Failures. LO1 For each of the general audit procedures of (*a*) recalculation, (*b*) physical observations, (*c*) confirmation (accounts receivable, securities, or other assets), (*d*) verbal enquiry, (*e*) inspection of internal documents, and (*f*) scanning, discuss one way the procedure could be misapplied or the auditors could be misled in such a way as to render the work (audit evidence) misleading or irrelevant. Give examples that are different from the examples presented in Chapter 8.

EP 8-3 Confirmation Procedure. LO1, LO2 A PA accumulates various kinds of evidence on which to base the opinion on financial statements. Among this evidence are confirmations from third parties.

Required:
a. What is an audit confirmation?
b. What characteristics of the confirmation process and the recipient are important if a PA is to consider the confirmation evidence competent?

EP 8-4 Audit Procedure Terminology. LO1, LO2

Required:
Identify one or more types of procedures being employed in each situation described below (vouching, tracing, recalculation, observation, and so on):

1. An auditor uses audit software to select vendors' accounts payable with debit balances and compares amounts and computation with cash disbursements and vendor credit memos.
2. An auditor examines property insurance policies and checks insurance expense for the year. The auditor then reviews the expense in light of changes and ending balances in capital asset accounts.
3. An auditor uses audit software to test perpetual inventory records for items that have not been used in production for three months or more. The auditee states that the items are obsolete and have already been written down. The auditor checks journal entries to support the auditee's statements.
4. An auditor tests cash remittance advices to see that allowances and discounts are appropriate and that receipts are posted to the correct customer accounts in the right amounts and reviews the documents supporting unusual discounts and allowances.
5. An auditor watches the auditee take a physical inventory. A letter is also received from a public warehouser stating the amounts of the auditee's inventory stored in the warehouse. The company's cost flow assumption, FIFO (first in, first out), is then tested by the auditor's computer software program.

EP 8-5 General Audit Procedures and Financial Statement Assertions. LO3 The six general audit procedures produce evidence about the principal management assertions in financial statements. However, some procedures are useful for producing evidence about certain assertions, while other procedures are useful for producing evidence about other assertions. The assertion being audited may influence the auditors' choice of procedures.

Required:
Prepare a two-column table with the six general procedures listed on the left. Opposite each one, write the financial statement assertions most usefully audited by using each procedure. Then provide a specific example of an account that would be found in the audit of a real estate company, and expand the general procedures to explain specifically how the evidence would be obtained for this auditee.

EP 8-6 Relative Appropriateness of Evidence. LO3 Generally accepted standards of audit field work require that auditors obtain sufficient appropriate evidential matter to afford a reasonable basis for an opinion regarding the financial statements under examination. In considering what constitutes sufficient appropriate evidential matter, a distinction should be made between underlying accounting data and all corroborating information available to the auditor.

Required:
What presumptions can be made about each of the following:
a. The relative appropriateness of evidence obtained from external and internal sources.
b. The role of internal control with respect to internal evidence produced by an auditee's data processing system.
c. The relative persuasiveness of auditor observation and recalculation evidence compared with the external, external-internal, and internal documentary evidence.

(AICPA adapted)

EP 8-7 Relative Appropriateness of Evidence. LO3

Required:
1. Classify the following evidential items by type (direct knowledge, external, and so on), and rank them in order of appropriateness:
   a. Amounts shown on monthly statements from creditors
   b. Amounts shown on "paid on account" in the accounts payable register
   c. Amount of "discounts lost expense" computed by the auditor from unaudited supporting documents
   d. Amounts shown in letters received directly from creditors
2. Classify the following evidential items by type (direct knowledge, external, and so on), and rank them in order of appropriateness:
   a. Amounts shown on a letter received directly from an independent bond trustee
   b. Amounts obtained from minutes of board of directors' meetings

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c. Auditors' recalculation of bond interest and amortization expense when remaining term and status of bond are audited
d. Amounts shown on cancelled cheques

EP 8-8 Audit Working Papers. LO4, LO5 The preparation of working papers is an integral part of a PA's audit of financial statements. On a recurring engagement, PAs review their audit programs and working papers from their prior audit while planning the current audit to determine usefulness for the current-year work.

Required:

a. (1) What are the purposes or functions of audit working papers? (2) What records may be included in audit working papers?
b. What factors affect the PA's judgment of the type and content of the working papers for a particular engagement?
c. To comply with generally accepted auditing standards, a PA includes certain evidence in his or her working papers; for example, "evidence that the audit was planned and work of assistants was supervised and reviewed." What other evidence should a PA include in audit working papers to comply with generally accepted auditing standards?
d. How can a PA make the most effective use of the preceding year's audit programs in a recurring audit?

(AICPA adapted)

EP 8-9 Audit procedure for error detection. LO5 You are performing the audit of the JZ Limited (JZ) financial statements for its year ended September 30, 20X2. JZ is a private company that provides computer network repair services to businesses in the Greater Toronto Area (GTA). JZ's audited financial statements are used mainly by its bank to support an ongoing operating loan arrangement. JZ has four shareholders who are all actively involved in the business. JZ's accounting policy is to recognize revenue when each repair job is completed. All sales are on account. At their September 30, 20X2, year-end, JZ had completed a large job, but during your audit you have discovered that the company's accountant did not record this sales revenue until October 10, 20X2, when the company issued the customer an invoice for $145,000.

Before correcting this error, JZ's draft financial statements show sales revenues of $3,200,000 and accounts receivable, net of allowance for bad debts, of $450,000.

Required:

a. Explain how the accounts in the JZ financial statements will be affected by this error.
b. Explain the assertion that has been violated by this error.
c. Give one example of an audit procedure that would have discovered this error.
d. What is the impact of this error on JZ's accounts receivable turnover? (*Note:* Accounts receivable turnover = Credit sales for the year/ Net accounts receivable at year end)
e. Would you consider this error to be material? Justify your response.

DISCUSSION CASES

DC 8-1 Financial Assertions and Audit Procedures. LO2 You were engaged to examine the financial statements of Kingston Company for the year ended December 31.

Assume that on November 1, Kingston borrowed $500,000 from North Country Bank to finance plant expansion. The long-term note agreement provided for the annual payment of principal and interest over five years. The existing plant was pledged as security for the loan.

Because of the unexpected difficulties in acquiring the building site, the plant expansion did not begin on time. To make use of the borrowed funds, management decided to invest in stocks and bonds, and on November 16 the $500,000 was invested in securities.

Required:

Describe a complete audit program for collecting relevant evidence for the audit of investments in securities at December 31.

Approach:

Develop specific assertions related to investments in securities at December 31 based on the five principle assertions.

DC 8-2 Financial Assertions and Audit Procedures. LO3, LO4 You were engaged to audit the financial statements of Karachi Company for the year ended December 31, 20X1.

On June 1, 20X1, Karachi initiated a product warranty program to help it stay competitive with other companies in its industry. The warranty covers parts, labour, and shipping to repair any defect within one year of purchase.

During 20X1, Karachi paid $50,000 in warranty costs on product sales of $4,000,000 (approximately 80,000 units). Based on this, management estimates its warranty liability at December 31 is $80,000.

Required:

Describe a complete audit program for collecting relevant evidence for the audit of the estimated warranty liability.

Approach:

Develop specific assertions related to warranty liability based on the five principle assertions.

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DC 8-3 Appropriateness of Evidence and Related Parties. LO3, LO5 Johnson & Company, PAs, audited the Guaranteed Trust Company. M. Johnson had the assignment of evaluating the collectability of real estate loans. Johnson was working on two particular loans: (1) a $4 million loan secured by the Smith Street Apartments and (2) a $5.5 million construction loan on the Baker Street Apartments now being built. The appraisals performed by the Guaranteed Appraisal Partners Inc., showed values in excess of the loan amounts. Upon enquiry, Mr. Bumpus, the trust company vice-president for loan acquisition, stated, "I know the Smith Street loan is good because I myself own 40% of the partnership that owns the property and is obligated on the loan."

Johnson then wrote in the working papers: (1) the Smith Street loan appears collectible; Mr. Bumpus personally attested to knowledge of the collectability as a major owner in the partnership obligated on the loan, (2) the Baker Street loan is assumed to be collectible because it is new and construction is still in progress, and (3) the appraised values all exceed the loan amounts.

Required:

a. Do you perceive any problems with related-party involvement in the evidence used by M. Johnson? Explain.

b. Do you perceive any problems with M. Johnson's reasoning or the appropriateness of evidence used in that reasoning?

DC 8-4 Audit Plan with Weaknesses in Revenue Controls, Not-for-Profit Auditee. LO1, LO4 Kindness Home (KH) is a not-for-profit organization that operates a nursing home in a town near a major city. You are auditing the revenue and receivables at KH. The nursing home has a reputation for delivering excellent patient services, but its accounting department is understaffed and does not have time for internal verification or other accuracy checks. Your assessment of controls over cash receipts indicates that there are effective management supervision and monitoring procedures in place, and you have found no indication of fraud risk, but past audits have found misstatements in recording the patient invoices and accounts receivable. In confirming the accounts receivable from patients in past audits, you have had a very low response rate. Furthermore, those patients who did respond did not appear to know what information they were being asked to provide or what their correct outstanding balance actually was. You have had the same experience in confirming receivables at other nursing homes. The nursing home has a large bank loan payable, which is up for renewal two months after year-end. The bank's loan officer has told management the bank's head office may not approve a renewal. The bank is concerned about its exposure to not-for-profit nursing homes because many new government-funded nursing homes are expected to open over the new few years. These new long-term care facilities will be more modern and will be located closer to many large hospitals than KH.

Required:

a. Identify the business risks in KH.

b. Assess the risk of material misstatement at the overall financial statement level. Identify the inherent and control risk factors in the organization to support your assessment.

c. In the audit of the revenues, explain the overall audit approach you would use to obtain sufficient appropriate evidence in this situation. Give clear reasons for the mix of control and substantive work you would plan to do. Describe the substantive tests you would perform to audit the revenue transactions in this organization. Be specific and show how the tests tie in to the relevant assertions.

DC 8-5 Working Paper Review. LO5 The schedule in Exhibit DC8–5 was prepared by the controller of World Manufacturing Inc. for use by the independent auditors during their examination of World's financial statements. All procedures performed by the audit assistant were noted in the bottom "Legend" section, and it was initialled properly, dated and indexed, and then submitted to a senior member of the audit staff for review. Internal control was reviewed and is considered to be satisfactory.

Required:

a. What information essential to the audit of marketable securities is missing from the schedule?

b. What essential audit procedures were not noted as having been performed by the audit assistant?

Approach:

Write specific assertions based on the five general assertions, then look to the working paper for documentation of evidence related to each one.

(AICPA adapted)

DC 8-6 Comprehensive Audit Planning Case. LO1, LO2, LO4 You have been assigned to the audit of the financial statements of Equality Coffee Roasters Limited (ECR) for its year ending December 31, 20X2. The company started five years ago and is in the business of obtaining coffee beans from around the world under a fair trade policy, roasting the beans locally and selling them to coffee shops in Ontario. Most of their sales are in the urban centres of the province. ECR's business involves obtaining raw coffee beans from coffee producing countries around the world. ECR business model is to only purchase coffee from certified fair trading plantations where the agricultural workers receive a fair wage and share of profits. Investors in ECR's shares are primarily ethical investors and mutual funds that concentrate on investing in companies that have high corporate social responsibility ratings.

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EXHIBIT DC8–5 Marketable Securities (World Manufacturing Inc., year ended December 31, 20X2)

DESCRIPTION OF SECURITY			SERIAL NO.	FACE VALUE OF BONDS	GENERAL LEDGER 1/1	PURCHASED IN 20X2	SOLD IN 20X2	COST	GENERAL LEDGER 12/31	12/31 MARKET	*Dividend and Interest* PAY DATE(S)	AMT. RECEIVED	ACCRUALS 12/31
CORP. BONDS	%	YR. DUE											
											1/15	300**b,d**	
A	6	09	21-7	10,000	9,400**a**				9,400	9,100	7/15	300**b,d**	275
D	4	03	73-0	30,000	27,500**a**				27,500	26,220	12/1	1,200**b,d**	100
G	9	06	16-4	5,000	4,000**a**				4,000	5,080	8/1	450**b,d**	188
R**c**	5	03	08/2	70,000	66,000**a**		57,000**b**	66,000					
S**c**	10	07	07-4	100,000		100,000**e**			100,000	101,250	7/1	5,000**b,d**	5,000
					106,900	100,000	57,000	66,000	140,900	141,650		7,250	5,563
					a,f	**f**	**f**	**f**	**f,g**	**f**		**f**	**f**
Stocks													
											3/1	750**b,d**	
P 1,000 shs			1,044		75,00**a**				7,500	7,600	6/1	750**b,d**	
Common											9/1	750**b,d**	
											12/1	750**b,d**	250
											3/1	750**b,d**	
U 50 shs			8,530		9,700**a**				9,700	9,800	2/1	800**b,d**	
Common											8/1	800**b,d**	667
					17,200				17,200	17,400		4,600	917
					a,f				**f,g**	**f**		**f**	**f**

Legends and comments relative to above:
a = Beginning balances agreed to 20X1 working papers
b = Traced to cash receipts
c = Minutes examined (purchase and sales approved by the board of directors)
d = Agreed to general ledger entry to income account
e = Confirmed by tracing to broker's advice
f = Totals footed
g = Agreed to general ledger

In the preliminary audit planning done to date, your audit manager has determined that inventory is the account with the highest risk of material misstatement. Last year, the audit team uncovered an error in the ending inventory balance in the amount of $65,000 overstatement. You have been assigned to continue the ECR audit planning work by finalizing and documenting various risk assessment and planning decisions so the audit team can move on to developing the detailed audit plans.

It is now January 20X3, and you are at the ECR offices to begin your audit work. In discussion with the company's management, you have learned that ECR currently has about 10% of the coffee bean market in Ontario. Its coffee is considered to be a premium product because of its ethical sources but also because it purchases only the highest quality of Arabica beans and uses a special just-in-time roasting and delivery business process that puts the very best-quality product into the stores at the peak of its flavour. About 75% of its sales are to independent neighbourhood coffee shops in urban areas. ECR also sells to one major coffee shop chain, and supplies an up-market grocery store chain. Fair trade coffees can sell for 20–25% more than coffee from other sources and have enjoyed increasing popularity over the past few years.

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Exhibit DC8-6 shows is the December 31, 20X2, adjusted trial balance listing that you have obtained from ECR management.

EXHIBIT DC8–6 **Equality Coffee Roasters Limited Trial Balance as of December 31, 20X2**

	DEBITS	CREDITS
Cash	248,726	
Accounts receivable	946,241	
Allowance for bad debts		61,444
Inventory, finished goods	4,670,992	
Inventory, work-in-progress	606,086	
Inventory, raw materials	1,668,580	
Patents, at cost	84,547	
Provision for inventory obsolescence		98,311
Property, plant, and equipment	23,842,581	
Accumulated amortization, PPE		9,585,303
Accounts payable		1,961,300
Income taxes payable		46,206
Warranty provision		73,733
Long-term bonds payable, due 20X4		4,915,540
Share capital, common shares		245,777
Retained earnings, beginning of year		11,838,430
Revenue		21,658,361
Cost of goods sold	11,469,184	
General and administration expenses	3,687,884	
Other expenses	2,209,535	
Management bonuses	500,000	
Income tax expense	550,049	
Totals	50,484,406	50,484,405

Required:

Continue the audit planning for ECR by answering the following questions:

a. List and explain three factors your audit firm would have to consider in order to have decided to accept the ECR audit engagement for the current year.

b. What materiality levels would you use for planning this audit? Show your calculations and justify your decision.

c. What audit risk level would you be willing to accept for this engagement? Describe your choice in terms of one of these levels: low, lower, or lowest. Explain the factors that support your decision.

d. Describe three business risk factors that could increase the risk of material misstatement in the ECR financial statements. Explain which account(s) each of the business risk factors could affect and the type of misstatement(s) that it might cause.

e. Based on the business risk analysis for ECR, your audit manager believes the ECR inventory account balance has the highest risk of material misstatement. Your manager has asked you to assess the inherent risk of misstatement at the assertion level for the inventory. Use the levels high, medium, or low to describe your assessment and explain the factors that support your assessment.

f. Describe one audit procedure you would perform that would provide relevant evidence regarding one or more of the inventory assertions. Explain what type of evidence the procedure would provide. Discuss how reliable this audit evidence is.

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CHAPTER 9

Control Assessment and Testing

Chapter 9 expands on the auditor's internal control work by describing the activities of internal control evaluation and highlighting the role of control risk assessment and testing in planning the audit.

EcoPak Inc.

Donna and Caleb go to EcoPak to begin the systems part of their work at the company. It is early November and EcoPak has a December 31 year-end. They learn from Nima that because the customers require a fairly predictable supply of their food containers, EcoPak is able to schedule production very close to delivery dates and keep its own inventory to minimal levels. To operate this way, all EcoPak's systems are highly integrated and linked electronically to its customers' systems. Next, they interview the accounts receivable manager and quickly learn that the sales system description notes they have from last year need to be updated. The system notes explain the flow of "documents" to process a customer order, record a sale, and set up the related receivable, but they realize that this refers to electronic documents processed within EcoPak's computer system. Since a large volume of sales transactions occurs, and they are all processed automatically, the only evidence available to verify that all the sales recorded are real, authorized, accurately calculated, and posted is electronic. Tariq has assigned one of Meyer & Gustav (M&G)'s information technology (IT) audit experts, Shree, to the EcoPak audit team, and Donna contacts her to let her know she will need to design some IT-based audit procedures to get the evidence they need to audit the sales transactions.

Donna and Caleb also learn how the volume discounts are processed at EcoPak. The system automatically invoices all sales at the full contract prices, and one of the accounting clerks has the job of doing a monthly review of each customer's sales for the year to date, to identify when each

LEARNING OBJECTIVES

After completing this chapter, you will be able to do the following:

LO1 Distinguish between management and auditor's responsibilities regarding an auditee organization's internal controls.

LO2 Explain why the auditor evaluates an auditee's internal controls.

LO3 Define seven internal control objectives, relating them to the assertions in management's financial statements.

LO4 Describe general and application control activities found in an accounting information system.

LO5 Document an accounting system to identify key controls and weaknesses in order to assess control risk.

LO6 Write key control tests for an audit program.

LO7 Outline the auditor's responsibility when internal control evaluation work detects or indicates a significant control deficiency or a high risk of fraudulent misstatement.

CHAPTER APPENDICES

Appendix 9A: Internal Control Assessment Aids for Audit Planning

Appendix 9B: Understanding Information Systems and Technology for Risk and Control Assessment *(online)*

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volume-discount level is reached. The clerk manually processes a volume-discount credit note to the customer for the amount of volume discount earned. Since the discount rates are sometimes renegotiated during the year, or special arrangements are made, this part of the process is always a manual adjustment and can get somewhat complex. The volume credit notes are all approved by the accounts receivable manager, and a monthly report is also sent to Nima who monitors the reasonability of the amounts each customer is receiving.

Donna decides they should try to test controls over this process to lessen the extent of volume credit note transactions that need to be tested substantively. She designs a dual-purpose test that not only tests whether the controls they have identified are being effectively applied, but it also traces the credit note entry through the accounting system to the general ledger. She also asks Caleb to give some thought to how an analytical procedure could be used to assess whether the year-end sales total is reasonable.

Caleb really likes this kind of mental challenge, and a bit later, he tells Donna about an idea he has: "I think if I review all the customer contracts to get the volume-discount levels and percentages, and then use the reported sales totals by customers from their monthly management sales reports, I should be able to come up with an amount pretty close to what we would expect the total sales less volume credit notes to be for the year. Now, it is possible that the sales force made a lot of special deals that might throw the relationships off, so I will ask the sales manager about that, and then see whether what she says makes sense with what my analysis shows. How does that sound to you, Donna?"

"Brilliant, Caleb. I think that will be pretty strong evidence, even though it is analytical, because it uses a lot of corroborating evidence from other sources. It uses the monthly management sales reports that we will have assessed for reliability through enquiry, analysis, and Shree's systems testing, as well as enquiry evidence independently obtained from the sales manager, plus our inspection of the sales contract terms. Very creative. I think you are going to do well in this job!"

INTERNAL CONTROL ASSESSMENT FOR PLANNING THE AUDIT

Chapters 5 to 8 discussed the need to understand internal control before making a preliminary assessment of the risk of material misstatement and designing the overall audit strategy and audit plan. In Chapter 9, these planning activities, concepts, and tools are used to identify and evaluate key controls that can detect or prevent material misstatements. Management assertions and their related audit objectives are applied to identify specific control risks in the auditee's information systems and processes, and to indicate the objectives of the auditee's control procedures. These control objectives are then used to assess the strengths and weaknesses in the auditee's internal control systems. The control strengths and weaknesses guide the auditor's plans on whether to test control procedures.

Internal control evaluation and control risk assessment are essential components of every financial statement audit and must be considered in planning the audit work. Generally accepted auditing standards emphasize internal control and the controls relevant to the audit.[1] The standards require the auditor to understand the auditee's controls related to significant risks, and to assess the risk of material misstatement. When controls must operate effectively for the auditor to lower the assessed risk of material misstatement to an acceptable level, the auditor is required to test the effectiveness of those controls.

STANDARDS CHECK

CAS 315

12. The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. (Ref: Para. A42–A65)

Source: *CICA Handbook—Assurance*, 2012.

1 CAS 315.

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MANAGEMENT VERSUS AUDITOR RESPONSIBILITY FOR CONTROL

LO1 Distinguish between management and auditor's responsibilities regarding and auditee organization's internal controls.

A company's management deals with rapidly shifting economic and competitive conditions and changes in customer demand, and it must respond to these changes to ensure survival and growth. Internal controls are put in place to keep the company on course toward achieving its goals, and to help anticipate changes that can affect their plans. In this dynamic and risky environment, internal controls help management improve operating efficiency, minimize risks of asset loss, enhance the reliability of financial statements, and monitor compliance with laws and regulations. This broad concept of internal control is exemplified by the definition set out by the Committee of Sponsoring Organizations (COSO) in the following box.

COSO INTERNAL CONTROL DEFINITION

Internal control is broadly defined as a process—put into effect by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations

The first category addresses an entity's basic business objectives, including performance and profitability goals, and safeguarding of resources. The second relates to the preparation of reliable published financial statements, including interim and condensed financial statements and selected financial data derived from such statements, such as earnings releases reported publicly. The third deals with complying with those laws and regulations to which the entity is subject. These distinct but overlapping categories address different needs and allow a directed focus to meet the separate needs.

Internal control systems operate at different levels of effectiveness. Internal control can be judged effective in each of the three categories, respectively, if the board of directors and management have reasonable assurance that they understand the extent to which the entity's operations objectives are being achieved, published financial statements are being prepared reliably, and applicable laws and regulations are being complied with.

While internal control is a process, its effectiveness is a state or condition of the process at one or more points in time. In small and mid-sized companies, controls may be less formal and less structured than in large companies, yet a small company can still have effective internal control.

Source: "COSO Definition of Internal Control," Executive Summary of the COSO Internal Control Integrated Framework, Committee of Sponsoring Organizations of the Treadway Commission, 1992, p. 3. © 1992 by Committee of Sponsoring Organizations of the Treadway Commission (COSO). Reprinted with permission.

Management balances the cost of controls with the benefit of risk reduction. At some point, the costs will exceed the benefits because it is not possible to reduce risks to zero. Managers need to decide what level of risk is acceptable. If they understate the risks through ignorance, poor analysis, or an attempt to cut costs, it becomes a source of control risk.

Controls could be made nearly perfect, but at great expense. A fence could be erected, locks installed, lighting used at night, television monitors put in place, and guards hired. Each successive safeguard costs money, as does extensive supervision of clerical personnel in an office. At some point, the cost of protecting the inventory from theft or of catching every clerical error exceeds the benefit of the control. Hence, control systems generally do not provide absolute assurance that the objectives of internal control are satisfied. Reasonable assurance is enough, recognizing that the cost of an entity's internal controls should not exceed the expected benefits.

Business managers can estimate the expected benefits of controls and weigh them against the costs. They make their own judgments about how much control is necessary and how much business risk they are willing to accept. However, auditors should be aware that the "cost-benefit" justification might be used loosely by management to boost profits by tolerating control deficiencies; this can greatly increase control risk.

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REVIEW CHECKPOINTS

9-1 List the responsibilities of management regarding their organization's internal control.

9-2 Why does management have to trade off between costs and benefits of internal controls?

9-3 How does management's cost–benefit trade-off decision affect control risk?

9-4 Why do internal controls provide reasonable but not absolute assurance that control objectives are met?

9-5 How can management's cost–benefit judgments lead to internal control deficiencies?

External auditors are not responsible for designing effective internal control for auditees. They are responsible for evaluating existing internal controls and assessing the risk of a material misstatement related to them. They use their assessment to determine the audit work required and develop appropriate audit programs to support their opinion. Public accountants may help design internal control systems as consulting engagements for non-audit clients. Such design work must be separate and apart from an audit engagement because it could impair the public accountant's objectivity in assessing those controls in an audit. This is a threat to auditor independence.

Given the realities of reasonable assurance, auditors must carefully determine whether a system contains any internal control weakness. The auditor's primary purpose for this evaluation of internal control is to guide the design of the final audit plan. For this reason, the auditor's understanding of the auditee's internal control and the control risk assessment must be documented.

External auditors' documentation of control weaknesses can help management carry out its responsibility for maintaining effective internal control. However, external auditors' observations and recommendations are usually limited to external financial reporting matters. Their basis for knowing about control weaknesses comes from familiarity with the types of errors, frauds, and misstatements that can occur in an account balance or class of transactions. Clearly, hundreds of innocent errors and not-so-innocent fraud schemes are possible. Rather than discuss hundreds of possible errors and frauds, we show in Exhibit 9–1 seven general categories, along with some examples. Management's responsibility is to control against these types of problems. The external auditors' task of control risk assessment involves finding out what the company does to prevent, detect, and correct these potential errors and fraud. You will encounter the flip side of these when you study control objectives later in this chapter.

EXHIBIT 9–1 General Categories and Examples of Misstatements

CATEGORY	EXAMPLE
1. Invalid transactions are recorded.	Fictitious sales are recorded and charged to nonexistent customers.
2. Valid transactions are omitted from the accounts.	Shipments to customers never get recorded.
3. Unauthorized transactions are executed and recorded.	A customer's order is not approved for credit, yet the goods are shipped, billed, and charged to the customer without requiring payment in advance.
4. Transaction amounts are inaccurate.	A customer is billed and the sale is recorded in the wrong amount because the quantity shipped and the quantity billed are not the same, and the unit price is for a different product.
5. Transactions are classified in the wrong accounts.	Sales to a subsidiary company are recorded as sales to outsiders instead of as intercompany sales, or the amount is charged to the wrong customer account receivable record.
6. Transaction accounting is incomplete.	Sales are posted in total to the accounts receivable control account, but some are not posted to individual customer account records.
7. Transactions are recorded in the wrong period.	Shipments made in January are backdated and recorded as sales and charges to customers in December (previous year); shipments in December are recorded as sales and charges to customers in January (next year).

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REVIEW CHECKPOINTS

9-6 What are auditors' responsibilities in relation to an auditee's internal controls?

9-7 Why is being involved in designing internal controls considered a risk to auditor independence?

9-8 How do external auditors help managers meet their responsibilities for internal control?

9-9 Define control risk and list seven general categories of misstatements that controls are intended to prevent, detect, and correct.

REASONS FOR CONTROL EVALUATION

LO2 Explain why the auditor evaluates an auditee's internal controls.

The primary reason for evaluating a company's internal control and assessing control risk is to have a basis for planning the audit and determining the nature, timing, and extent of audit procedures in the detailed audit plan. The auditor is concerned with the impact that controls have on safeguarding the company's assets and the accuracy of the accounting records (accounting controls), financial reporting, and disclosures. From this, the auditor prepares a preliminary audit program and thinks about the work that needs to be done, considering even the extreme possibility that the organization may not be auditable. This preliminary program might be last year's audit program or a template program that will need to be modified on the basis of auditee-specific preliminary analytical review findings, materiality, and risk assessments. Exhibit 9–2 outlines the process.

As introduced in Chapter 6, control risk is the risk that internal control will fail to prevent or detect a material financial statement misstatement. In the business risk approach, the auditor's main goal is to assess the risk of the financial statements' being misstated, and assessing both inherent and control risk is a key step in performing this assessment. The standards do not give a specific definition of control risk, and they allow for inherent and control risk assessments to be combined, since they are closely related. For example, consider an item with high inherent risk, such as an inventory of Rolex watches in a jewellery business. The inherent risk is high because these items are easy to pick up and conceal, have a high dollar value, and are easy to sell illegally. The auditor would expect management to have strong controls in place against these risks; otherwise, the company could not survive. So, the auditor will expect to observe effective and continuous controls over the Rolex inventory in the management's risk assessment process. If this is not found, further procedures would need to be planned to address the risk that the inventory is materially misstated.

Control risk is a characteristic of the auditee's internal control, and the auditors' task is to assess it; that is, to assign an evaluation to it. Auditors may document their internal control risk assessment decisions with descriptions (e.g., high, moderate, low), and some auditors assign probability numbers to them (e.g., 1.0, 0.50, 0.30).

The role of internal control evaluation is one of the more difficult topics in an audit course. Perhaps the easiest way to understand this role is to imagine two extreme audit situations: the "clean" audit and the "dirty" audit. In a **clean audit**, the accounting records are easy to verify and accurate. In a "dirty audit," however, the accounting records may be incomplete, riddled with misstatements, and harder to verify. Most people find it intuitive that a clean audit should require less work than a dirty audit, as the controls are likely to be good at meeting their objective of lowering the risk of material misstatement. Conversely, a dirty audit is associated with poor or nonexistent controls. So, auditors evaluate internal controls because these are a good indicator of the accuracy of the accounting records and, therefore, reduce the amount of work needed to verify their accuracy more directly. Thus, evaluating internal controls creates efficiencies in clean audits and can provide assurance that the risk of material misstatement is low, so less substantive audit work is required.

clean audit: an audit of a client where the accounting records are accurate and easy to verify and there are good controls

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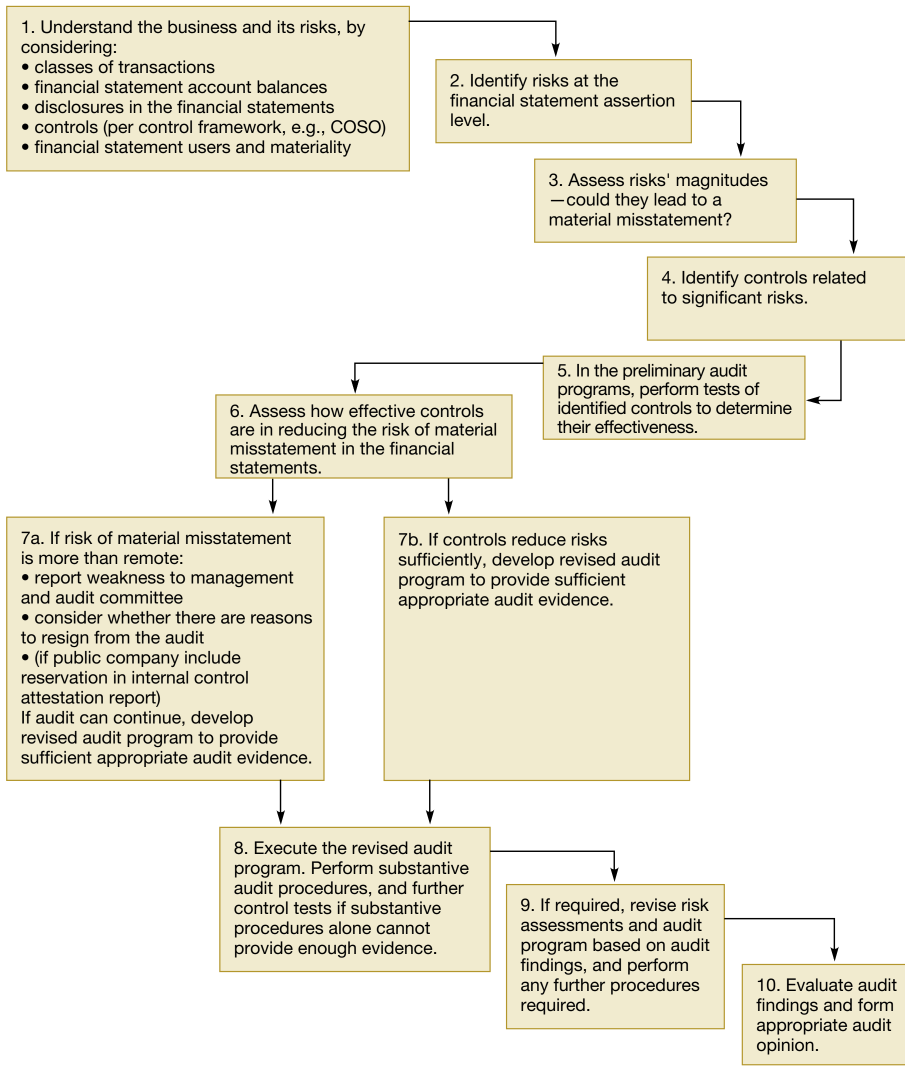
EXHIBIT 9–2 Role of Internal Control in Assessing Risk of Material Misstatement



Auditors rely on controls for more than just efficiencies. There may be risks of misstatements that substantive procedures alone cannot remove. For example, a completeness assertion is virtually impossible to verify without some evaluation of control effectiveness, as that gives auditors assurance on whether items that they might not know about, such as accrued liabilities, get recorded. It is possible that controls are so bad, leading to such a dirty audit situation, that an organization is not auditable. The box on the next page describes a situation where the control risks are so great that the auditor cannot develop compensating audit procedures to reduce the risk of material misstatement to an acceptable level. This extreme case is a fairly rare occurrence. In many cases, if controls are weak, more substantive procedures can be performed to provide sufficient evidence about whether the financial statements contain a material error.

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UNDERSTANDING THE AUDITABILITY OF THE ACCOUNTS: BAD BOOKS BLOCK A MUNICIPAL GOVERNMENT AUDIT

Officials of a municipal government kept such poor financial records for four nonprofit corporations they controlled that the public accountant appointed to audit the corporations reported to the municipal council that the audits could not be done. The four corporations were conduits for more than $630 million in low-interest financing provided by the municipal government to local businesses. A public inquiry was called to investigate and report on the situation. The public accountant declared to the inquiry that the four corporations' records were beyond horrid—in fact, he found there were virtually no records at all.

The inquiry found that (1) no records were kept of purchases and redemptions of certificates of deposit worth hundreds of thousands of dollars, (2) there might be certificates of deposit that the municipal officials did not know existed, (3) bank statements were not kept, and (4) chequing accounts were not reconciled.

The former treasurer of the corporations reported to the inquiry that the corporations used a very simple bookkeeping system; money went in and went out. The system was not sophisticated because, in the former treasurer's view, it was not needed. The public accountant, and the taxpayers who provided the funds, would see it differently.

REVIEW CHECKPOINTS

9-10 Why does the auditor evaluate the auditee's internal controls?

9-11 Why does an inventory of Rolex watches have a high inherent risk, and why does the auditor expect management to have strong controls over this inventory?

9-12 Describe the two extreme cases of control risk assessment that an auditor could encounter in practice.

9-13 What is the impact on audit work of a "clean" audit as compared with a "dirty" audit?

9-14 Why can it be efficient for the auditor to rely on internal controls?

9-15 If internal controls are weak, in what situations could an audit still be done, and in what situations would it not be possible to do an audit?

Control Evaluation, Further Audit Procedures, and Reasonable Assurance

As you study auditors' control tests and their relation to substantive tests of account balances, it may be helpful for you to think about the overall purposes of all audit procedures. The purpose of all audit work is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, in order to be able to express an opinion on whether the financial statements are fairly presented, in all material respects, in accordance with generally accepted accounting principles (GAAP). In turn, the purpose of audit procedures is to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement by designing and implementing appropriate procedures in response to those risks. The most effective approach integrates all aspects of the auditee's business and systems into the overall design of the audit. The choice of control reliance and substantive evidence should maximize efficiency and minimize auditing costs.

For study purposes, we tend to discuss control tests and substantive test procedures as if these are easily distinguishable. The six general audit techniques described in Chapter 8 can be used in both tests of controls and in substantive procedures. What distinguishes a control test from a substantive procedure is the auditor's purpose in doing the test. With a control test, the auditor wants to obtain evidence about the operating effectiveness of control procedures to provide indirect evidence about the risk of material misstatement of

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monetary amounts in the financial statements. For substantive procedures, the auditor's wants to obtain direct evidence about monetary misstatements.

As discussed earlier, a single procedure may produce both control and substantive evidence that serves both purposes: dual-purpose tests. For example, a selection of recorded sales entries could be used to both vouch sales to supporting shipping documents and calculate the correct dollar amount of sales. The first part of the test provides information about control compliance, while the second is dollar-value information that may help measure the amount of misstatement in the general ledger balance of sales. The confirmation of accounts receivable procedure is another example. Its purpose is mainly substantive, but if confirmation replies indicate significant or systematic errors, that evidence is relevant to control evaluation as well as to measuring the dollar value of misstatements.

The auditor's goal at the planning stage is to select the most cost-effective set of evidence gathering procedures to provide reasonable assurance to support the audit opinion. Since dual-purpose tests provide both compliance and substantive evidence, they can lower the cost of obtaining audit evidence. This allows the auditor to select an audit approach combining control reliance and substantive evidence as the basis for a cost-effective overall audit plan, and one that provides sufficient appropriate evidence from both control and substantive testing.

As explained in Chapters 5 and 6, the auditor begins the preliminary risk evaluation by understanding the organization's overall control environment, management's risk assessment process, the business processes along with related information systems and communication, and the monitoring procedures in place. Exhibit 6–17 (see p. 223) shows a sample framework for this.[2] The auditor identifies any significant risks related to financial reporting, and then considers whether effective controls are in place to address them. The auditor evaluates the auditee's control activities—the specific procedures it uses to control processes, applications, and transactions.

The auditor's understanding of the accounting information systems is key to evaluating control over financial reporting and planning further audit procedures. Important information systems functions include processes, records, and controls that can be directly related to the assertions and audit objectives that guide the auditor in planning audit evidence-gathering procedures. The table below highlights key aspects of the descriptions of information systems functions and links these to the related assertions in the financial statements.

DESCRIPTIONS OF INFORMATION SYSTEM FUNCTIONS RELATED TO FINANCIAL REPORTING	RELATION TO PRINCIPAL FINANCIAL STATEMENT ASSERTIONS
Identify and record all valid and authorized transactions	Existence *(valid)* Completeness *(all)* Ownership *(authorized)*
Describe the transactions on a timely basis and in sufficient detail to permit their proper classification for financial reporting	Presentation *(proper classification)*
Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements	Valuation *(proper monetary value)*
Determine the period in which transactions occurred to permit recording in the proper accounting period	Existence *(proper accounting period)* Completeness *(proper accounting period)*
Present properly the transactions and related disclosures in the financial statements	Presentation *(present properly; related disclosures)*

A properly functioning information system will the reduce the risk of misstatement at the financial statement assertion level. Identifying and recording all valid transactions,

2 The auditor may choose another accepted framework to guide this evaluation. Appendix 6B on Connect outlines control frameworks organizations and auditors can select to use in practice.

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and ensuring that they are recorded in the proper accounting period, satisfies the existence and completeness assertions. Procedures ensuring that recorded transactions are authorized as proper rights or obligations achieves the ownership assertion. The valuation assertion is addressed when the dollar values of transactions are measured and calculated appropriately and in accordance with GAAP. When transactions are recorded in enough detail to properly classify and present them in the financial reports, and to support related disclosures, the presentation assertion is accomplished.

Note that even if auditors assess a low control risk by performing control testing on the information system, the potential for management override of controls means it is still necessary to perform substantive procedures to evaluate the integrity and accuracy of the financial statement closing process. This is because material misstatements can arise from errors or fraud during this final stage of financial statement preparation. These substantive procedures include reconciling the final financial statements with the general ledger and supporting accounting records. They also include examining the purpose and appropriateness of any material journal entries or other adjustments made that cause the final financial statement amounts to differ significantly from those in the general ledger produced from the information system that was subject to control testing.

Rapid technological change increases both an auditee's business risk and the risk that auditors will not detect critical business risks and/or control weaknesses. If an information system is fully manual, the transaction processing would be supported by a trail of paper documents: approvals, invoices, and other records of accountability, such as perpetual inventory records. Many aspects of IT-based systems are designed along similar lines, so similar "documents" may exist. However, in many cases these documents are available only in electronic form. Further, the basic records (ledgers and journals) of an IT-based accounting system are electronic data files that cannot be read or changed without a computer and may be deleted so that there is no paper trail for tracing transactions. When these or other complex aspects of IT-based systems are present, such as remote access by many users, use of customized software, dependency on a continuously operating website, risk is increased. In these cases, the auditor will likely need to include an IT expert on the audit team. Appendix 9B on Connect gives more detail on the risks and controls found in IT-based systems for students who are interested in a detailed understanding of accounting information systems from an auditor's perspective.

REVIEW CHECKPOINTS

9-16 Explain how using dual-purpose tests can lower audit costs.

9-17 What does it mean if an overall audit plan is said to be cost effective? How do auditors develop a cost-effective overall audit plan?

9-18 If the auditee's revenue transactions for the year are material but the auditor assesses the risk of material misstatement to be low, why do the audit standards require the auditor to design and perform substantive procedures for these transactions regardless of the low risk assessment?

9-19 What procedures are auditors required to perform related to the financial statement closing process? Why are these procedures required? What can they find? If the auditor assessed the risk of material misstatement to be low, why would these procedures still be required?

How Control Risk Assessment Affects the Audit Plan

Examining the business processes and related accounting processes allows the auditor to design audit procedures to test controls and financial statement transactions and balances. Tests of controls are performed if it is a less costly way to obtain audit evidence or if effective control is necessary to get sufficient appropriate audit evidence about one or more assertions. Auditors might try to design dual-purpose tests—tests of controls that also

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provide substantive evidence. For example, a test verifying the control that all payments have been properly authorized could also trace each payment amount to the cash records and the general ledger for substantive evidence of correct recording.

The auditor's control risk assessment will affect the procedures included in the detailed audit programs of the audit plan. As explained in Chapter 8, an audit program is a list of specific audit procedures designed to produce evidence about the assertions in financial statements. Each procedure's description should indicate its nature, timing, and extent, as well as a direct association with one or more financial statement assertions. The nature of procedures refers to which of the six general techniques the procedure will involve, the timing specifies when they will be performed, and the extent refers to the amount of evidence to be obtained, such as the sample size.

Exhibit 9–3 lists five procedures for auditing two of the accounts receivable assertions as part of the account balance audit program. The existence and completeness subheadings and columns in the exhibit indicate connections to financial statement assertions and to the nature, timing, and extent of the procedures. Some decisions about the timing and extent of work shown in this exhibit suggest the auditor has assessed control risk to be low:

- Confirmation of a sample of customer accounts receivable before year-end, instead of confirmation of all accounts as of December 31
- Vouching the last 5 days' recorded sales to bills of lading for cutoff evidence, instead of vouching the last 15 days' sales
- Tracing the last 5 days' shipments to recorded sales invoices for cutoff evidence, instead of tracing the last 15 days' shipments

EXHIBIT 9–3 Account Receivable Balance Audit Program (Partial Illustration)

ASSERTIONS/PROCEDURES	NATURE	TIMING	EXTENT
Existence/Cutoff: Accounts receivable are authentic obligations owed to the company and represent sales made before December 31.			
1. Obtain a trial balance of customers' accounts. Select 75 for positive confirmation.	Confirmation	November 1 (interim date)	Limited sample
2. Obtain a year-end trial balance of customer accounts. Compare to the November 1 trial balance and investigate significant changes by vouching large increases to sales invoices and bills of lading.	Analytical procedures Document vouching	December 31 (year-end)	All customer Accounts
3. Select all the sales invoices recorded in the last five days of the year, and vouch to bills of lading for December shipping date.	Document vouching	December 31 (year-end)	Last five days' Sales
Completeness/Cutoff: Accounts receivable include all amounts owed to the company at December 31.			
4. Send positive confirmations to customers with zero balances.	Confirmation	December 31 (year-end)	All zero balance Accounts
5. Select all the bills of lading dated in the last five days of the year, and trace to sales invoices recorded in December.	Document tracing	December 31 (year-end)	Last five days' Shipments

You should assume the auditors found the controls to be strong and, thus, think the preceding program is efficient. If they found control weaknesses, the risk of material misstatement is increased and a different program would be more appropriate, but it would probably take more time and cost more, too. For example, it might require the auditor to do the following:

- Confirm the customer accounts as of year-end, December 31, rather than an earlier date
- Confirm a larger sample of customer accounts
- Select all the sales invoices recorded in the last 15 days for vouching to December shipping documents
- Select all shipping documents dated in the last 15 days for tracing to December sales invoices

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Note that, in this higher risk situation, more substantive evidence is needed to provide reasonable assurance about whether or not there is a material financial statement misstatement.

The preliminary audit program in Exhibit 9–3, therefore, depends on the auditor having assessed a low control risk related to the company's internal control structure. The task is to assess the inherent and internal control risks that there is a material misstatement (error or fraud) in the accounts receivable total. If the risks are too high, procedures are changed to provide for greater extent (larger samples) and closer timing (confirmation moved to December 31). Likewise, if the risk is not high, less work needs to be done (e.g., the confirmation of zero-balance receivables might be omitted). In general, a good system of internal control should result in less audit work than a bad system of internal control. Thus, audit efficiencies come from good internal controls: less testing and spreading the audit work out over more convenient times.

REVIEW CHECKPOINTS

9-20 How does the auditor's control risk assessment affect the preliminary audit program?

9-21 What audit planning activities are performed to lead up to the control risk evaluation?

9-22 Give two reasons why controls would be tested.

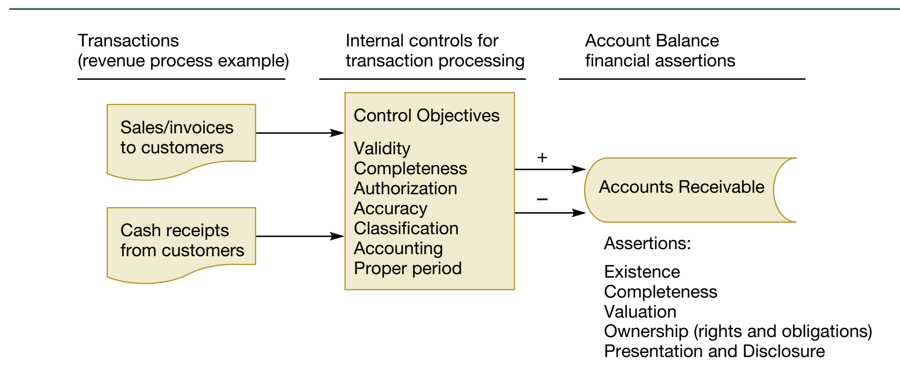
9-23 In what situation(s) would controls not be tested?

CONTROL OBJECTIVES AND PROCEDURES

LO3 Define seven internal control objectives, relating them to the assertions in management's financial statements.

The objective of control procedures is to process transactions correctly. Correctly processed transactions produce accurate account balances, which, in turn, help produce reliable assertions in the financial statements, as shown in Exhibit 9–4. The exhibit gives an example of two revenue transaction streams, sales invoicing and cash receipts, and links these to the control objectives. These control objectives then link to the impact of the transaction streams on increasing (sales) and decreasing (cash receipts) the accounts receivable account balance. If the control objectives over the transaction streams are met, this should ensure that the assertions in the final account balance are true.

EXHIBIT 9–4 Control Objectives and Financial Statement Assertions—Revenue Transactions



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Control Objectives

Note that each control objective is the flip side of one of the seven misstatement risks shown in Exhibit 9–1. The seven objectives are listed in Exhibit 9–5, with a general statement of each objective along with a specific example for the revenue transaction process. The explanations that follow this exhibit tell you more about these objectives and give examples of auditee procedures designed to accomplish them.

EXHIBIT 9–5 Internal Control Objectives

OBJECTIVE	GENERAL STATEMENT	MAIN RELATED FINANCIAL STATEMENT ASSERTIONS	SPECIFIC EXAMPLE (REVENUE PROCESS)
Validity	Recorded transactions are valid and documented.	Existence Ownership	Recorded sales are supported by invoices, shipping documents, and customer orders.
Completeness	All valid transactions are recorded, and none are omitted.	Completeness Ownership	All shipping documents are prenumbered and matched with sales invoices daily.
Authorization	Transactions are authorized according to company policy.	Existence Valuation Ownership	Credit sales over $1000 are given prior approval by the credit manager.
Accuracy	Transaction dollar amounts are properly calculated.	Valuation	Sales invoices contain correct quantities and are mathematically correct.
Classification	Transactions are properly classified in the accounts.	Valuation Presentation/ Disclosure	Sales to subsidiaries and affiliates are classified as intercompany transactions.
Accounting	Transaction accounting is complete.	Valuation Presentation/ Disclosure	All sales on credit are charged to customers' individual accounts.
Proper period	Transactions are recorded in the proper period.	Existence Completeness Ownership Presentation/ Disclosure	Sales of the current period are charged to customers in the current period, and sales of the next period are charged in the next period.

validity: ensuring that the recorded transactions are ones that should be recorded; that is, that they exist

Validity is ensuring that recorded transactions are ones that should be recorded; that is, they really exist. The auditee's procedure might require matching shipping documents with sales invoices before a sale is recorded. This procedure prevents the recording of undocumented (possibly fictitious) sales.

completeness: ensuring that valid transactions are not missing from the accounting records

Completeness is ensuring that valid transactions are not missing from the accounting records. If sales are represented by shipments, then every shipment should be matched with a sales invoice. Transaction documents (e.g., shipping documents) are often prenumbered, and accounting for their numerical sequence is a control procedure designed to achieve the completeness objective.

authorization: ensuring that transactions are approved before they are recorded

Authorization is ensuring that transactions are approved before they are recorded; that is, they are "owned" by the company. Management establishes criteria for recognizing transactions in the accounting system and for supervisory approval of them, much as credit sales must be preapproved. A control system should stop any unauthorized transactions from entering the accounting records.

The nature of authorization for transactions may vary. For example, authorization is not usually needed to record a cash receipt from a regular customer as companies are happy to accept payments, but a sales manager may need to approve giving a discount after the end of the discount period. Unauthorized transactions of any kind are a source of risk that the auditor needs to understand. For example, unauthorized cash receipts may be part of a fraud cover-up or an illegal money laundering scheme.

Authorization for routine transactions may be delegated to a fairly low level of management. For example, (1) all shipments with a value of more than $1000 require credit approval,

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(2) all sales are recorded in the accounting department upon receipt of a copy of a shipping document, and (3) the receptionist's listing of payments received on account when the mail is opened may be sufficient authorization for cash receipts. Some authorizations have to come from a high level of the company's governance structure, such as the board of directors. For example, significant nonroutine transactions, such as sales of major assets and acquisition of another business, or signing the company name to a loan agreement, usually will be authorized specifically by the board of directors, with the authorization included in the minutes of that board meeting.

Accuracy is ensuring that dollar amounts are calculated correctly. A manual or computer check that the quantity invoiced equals the quantity shipped and the correct list price is used, with a correctly calculated total, is a control procedure for accuracy.

Classification is ensuring that transactions are recorded in the right accounts, charged or credited to the right customers (including classification of sales to subsidiaries and affiliates, as mentioned in Exhibit 9–5), entered in the correct segment product line or inventory description, and so forth. Classification errors between balance sheet and income statement accounts present the greatest risk of misstatement because they will change the net income. For example, before its bankruptcy WorldCom misstated its income by misclassifying operating expenses as assets, thereby concealing its poor financial performance from financial statement users.

Accounting is a general category concerned with ensuring that the accounting process for a transaction is performed completely and in conformity with GAAP. For example, a clerk can balance the total of individual receivables with the control account to determine if all entries to the control account have also been entered in individual customers' accounts. Bank reconciliation could be done by a person who is independent of cash recording. Balancing and reconciliation procedures like these can meet more than one control objective. Control over accounting, in general, is a useful category if you cannot identify a control problem in one of the other categories.

Proper period refers to ensuring that transactions are accounted for in the period they occurred in. This control objective relates to cutoff—part of the existence and completeness assertions. The auditee's accountants must be alert to the dates of transactions in relation to month-, quarter-, and year-end. Proper period accounting (cutoff) is a pervasive problem. It is mentioned in relation to all kinds of transactions—sales, purchases, inventories, expense accruals, income accruals, and others. The risk of errors in cutoff is high because they are complex and nonroutine events, but they can also be used to manipulate income, for example, by using accruals to record sales too early or expenses too late.

Control Objectives and Assertions

The control objectives are closely connected to the assertions in management's financial statements. For example, the accuracy control objective relates to the existence, completeness, and valuation assertions, as mechanical errors will result in overstated, understated, or incorrectly measured balances. However, recognizing that the control objective is to assess accuracy is more helpful in designing appropriate tests, such as tests for errors of billing at too low or too high a price, or for a smaller or larger quantity than shipped, or for using price lists in U.S. dollars when the financial statement information should be in Canadian dollars.

The grid in Exhibit 9–6 shows how the control objectives are related to the assertions, the Xs showing the primary relevance. To interpret Exhibit 9–6, link the achievement of control objectives with the probability that an assertion may be materially misstated. For example, a strong control over the validity of recorded sales and cash receipts transactions, an effective system of credit authorization, and a system ensuring that transactions are recorded in the proper period, allows control risk related to the existence/occurrence assertions for accounts receivable and sales balances to be assessed as low.

However, an auditor may find that some, but not all, of the control objectives for a particular account balance (i.e., set of assertions) are achieved. For example, the above situation may coexist with failure to achieve control over the completeness of recording sales

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EXHIBIT 9–6 How Control Objectives Relate to Financial Statement Assertions

CONTROL OBJECTIVE	FINANCIAL STATEMENT ASSERTIONS: EXISTENCE	COMPLETENESS	VALUATION	OWNERSHIP	PRESENTATION AND DISCLOSURE
Validity	X			X	
Completeness		X		X	
Authorization	X		X	X	
Accuracy			X		
Classification			X		X
Accounting			X		X
Proper Period	X	X		X	X

transactions and accounts receivable amounts. In this case, the preliminary audit program may be changed to require more work related to the completeness of accounts receivable (the assertion which had high control risk) and be unchanged for the work on the existence of accounts receivable (which had low control risk).

The final evaluation of a company's internal control is the assessment of the control risk (CR) related to each assertion. (The audit risk model $AR = IR \times CR \times DR$ was explained in Chapter 6.) In this assessment, an auditor expresses the effectiveness of the control system for preventing, detecting, and correcting specific errors and irregularities in management's financial statement assertions.

REVIEW CHECKPOINTS

9-24 Why do control procedures affect management's financial statement assertions?

9-25 List the control objectives and the misstatement risk that each one relates to.

9-26 Why can some authorization procedures be performed by low-level managers? What kinds of authorizations need to come from the board of directors?

9-27 What are the risks related to cutoff procedures?

9-28 Match the seven control objectives to the five principal assertions.

9-29 Can control risk be high for one assertion and low for another assertion for the same account balance? Explain.

9-30 How does the auditor's control risk assessment relate to audit risk?

PHASES OF A CONTROL EVALUATION

LO4 Describe general and application control activities found in accounting information systems.

As discussed in Chapters 5 to 8, the auditee's controls need to be understood to assess the risk of material misstatement, develop the overall audit strategy, and make preliminary planning decisions to use a combined or substantive audit approach. As the audit work proceeds, new knowledge allows the audit team to continuously refine and improve the planned audit work, but in many audits the detailed internal control work will follow the initial plan. We now will look at the detailed audit work done to assess and test internal control, noting that the findings of this work may result in some revisions to the original strategy and plan.

This section describes the three phases of control evaluation:

Phase 1 Understanding control (expanding on the discussion in Chapter 6)

Phase 2 Assessing control risk by identifying control strengths and weaknesses in the accounting information system

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Phase 3 Testing controls (The main coverage of this topic is in this chapter, and Chapter 10 covers sampling aspects. Testing controls also will be integrated with the planned substantive audit procedures included in audit programs that will be covered in detail in Part 3.)

Audits aim to be efficient. This means doing high-quality work to obtain sufficient appropriate evidence with minimum time and cost expenditure. The time allocation between control evaluation and "substantive audit work" (e.g., the procedures in Exhibit 9–3) is a cost-benefit tradeoff. Generally, the more auditors know about good controls, the less substantive year-end work they need to do. They might not need to evaluate or test the entire internal control structure for this, but they need to understand it well enough to assess if there are any significant risks of material misstatement that the audit work needs to address.

If there are significant risks and certain controls are essential to preventing or detecting these risks, those would be considered by the auditor to be **key controls**. They are evaluated by testing their effectiveness during the audit period in preventing material misstatement in the financial statements. Auditors may choose to only obtain a minimum understanding on non-key controls and instead rely primarily on substantive audit work on the financial statement balance or transactions. If the risk of misstatement in a particular financial statement account is very low, they may perform very little substantive work. Some examples of transaction processing risks and the importance of controls in the audit are provided in the box below.

key controls: important control procedures; auditors should identify and audit only these controls

KEY AND NON-KEY CONTROLS

Examples	Control importance: Is it a key or non-key control?
The business processes a high volume of cash sales transactions through retail stores (e.g., Canadian Tire). There is a significant risk that not all sales will be recorded.	**Key:** Controls over sales completeness will be considered key controls because a material misstatement could occur and there is no other reliable substantive procedure that auditors can use to verify that all sales have been recorded. If these were absent, it would present a material risk of misstatement.
The inventory controller performs a monthly variance analysis to ensure production costs are staying within budget. There is a risk that avoidable cost overruns will occur if timely action is not taken when variances from budget occur.	**Non-key:** Because the auditor plans to obtain evidence at year-end by extensive inventory valuation testing, controls over monthly production costs would be considered non-key.
The company's petty cash fund of $200 is kept in a locked box by the receptionist, who must present valid signed receipts for all expenditures to the controller when the fund runs low. The controller authorizes the payables manager to issue a cheque to "cash" to replenish the fund back up to $200. There is a risk that petty cash funds will be misappropriated.	**Non-key:** The controls here—reconciliation, supervision, and segregation—are non-key because the auditor plans to scrutinize the petty cash expenditure records for the whole year and expects the total value of these transactions to be immaterial. Thus, there is no need to evaluate these controls. If a material amount of expenditures is found to have been processed through petty cash, this may suggest a fraud and this possibility will need to be investigated substantively. In either case, these controls will not be relevant to the audit work planned.
The company uses an Internet-based sales order system. Customers enter order details online and pay online by entering their credit card information. The order entry system automatically checks that order details are correct and the goods are in stock, calculates the price, and verifies the validity of the credit card payment online with the credit card company. After these control routines are run, a shipping order is automatically created which simultaneously creates entries in the accounting system to recognize the revenue and costs of sales.	**Key:** Since the automated controls are necessary to ensure the sale information recorded is valid and accurate and that the customer's payment is valid, these automated controls are considered key. The accounting entries are made automatically once the controls have been performed, so there is no paper trail or other documented evidence of performance of the control procedures. The auditor will need to test these automated controls for assurance that all sales are valid and accurately recorded, and that the credit payments have been authorized through online verification with the credit card company.

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Auditors must make a trade-off between costs of evaluating internal control and costs of substantive audit tests. A decision to obtain a high level of assurance from controls will cause the costs of control evaluation and testing to be high but should be offset by lower costs for substantive testing as less substantive evidence is required. On the other hand, obtaining a low level of assurance from testing controls may mean that substantive testing costs will be higher. An efficient audit program looks for the combination of control evaluation and substantive work that provides an acceptable level of assurance at the lowest total cost.

The three phases of control evaluation work are described as if they are distinct programs completed before any substantive audit work begins. In practice, work on the phases overlaps. The understanding phase and the control risk assessment phase are each made distinct to help you to comprehend the purpose of this part of the audit work. However, in practice, most auditors do the two together, since the purpose of understanding the controls is to assess control risk. Understanding and assessment can both involve control testing. For example, auditors learn more about the existence and operating effectiveness of controls when they actually start testing them. The control evaluation phase can also overlap substantive work. For example, account balance audit work may be done at an interim date (before the company's fiscal year-end) while some of the control evaluation work is being done. However, the three phases described here are a simple way to explain the analytical thinking that auditors follow to decide on the best approach for collecting sufficient appropriate audit evidence to support their opinion.

REVIEW CHECKPOINTS

9-31 Why is there a cost-benefit trade-off involved in evaluating internal controls for planning the audit?

9-32 What is a key control? Give a specific example.

9-33 What is a non-key control? Give a specific example.

9-34 Why do key controls always need to be evaluated in an audit?

Phase 1: Understanding the Internal Control

Nature and Timing of Phase 1 Work

Understanding controls is a key part of understanding the business and risk of misstatement introduced in Chapters 5 and 6. Done early in the engagement, this work acquaints auditors with the overall control environment and the flow of transactions through the accounting system. We now will apply this understanding to identify significant risks at the assertion level in account balances, transaction streams, and disclosures. These risks will correspond to the key control activities that should be in place to minimize them, as described in the following section.

Control Activities: General Controls and Application Control Procedures

The internal control framework presented earlier showed that management implements control activities to achieve the organization's control objectives. Control activities are classified as either general or application controls. General controls are those that have an overall impact on accounting processes. Applications controls address the control objectives relating to input, processing, and output of data in each accounting process. All detail control procedures are directed, one way or another, toward preventing or detecting and correcting errors, irregularities, frauds, and misstatements. Exhibit 9–7 provides an overview of control activities, which are further explained below.

General Controls

Organizational features like capable personnel, segregation of responsibilities, controlled access, and periodic comparison are general controls. Similar to environmental controls, general

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controls are primarily preventive in nature and pervasively impact the various accounting cycles. For these reasons, auditors tend to focus on environmental and general controls in the preliminary evaluation of internal controls. Some of the general controls are discussed below.

EXHIBIT 9–7 Overview of Control Activities

	APPLICATION CONTROLS		
GENERAL CONTROLS	APPLICATIONS	SYSTEM FUNCTIONS TO BE CONTROLLED	CONTROL OBJECTIVES
• Capable personnel • Performance reviews • Segregation of responsibilities • Supervision • Controlled access • Periodic comparison • IT controls	Revenues/Receivables/Receipts Purchases/Payables/Payments Production and Payroll Investment and Finance Other applications	Transaction input Transaction processing Transactions, balances, and disclosure output	Specific procedures to ensure: • Validity • Completeness • Authorization • Accuracy • Classification • Accounting • Proper period

Capable Personnel The people who make the system work are the most important aspect of control. Personnel problems might result in internal control problems. High turnover in accounting jobs means that inexperienced people are doing the accounting and control tasks, and they generally make more mistakes than experienced people. New accounting officers and managers (e.g., financial vice-president, controller, chief accountant, plant accountant, or data processing manager) are not familiar with company accounting and may make technical and judgmental errors. Accounting officers and employees may be fired because they refuse to go along with improper accounting procedures desired by a higher level of management. In general, accounting personnel changes may be a warning signal.

Performance Reviews Management reviews of how reported performance compares with expectations are an effective general control. Comparing reported performance with budgets and prior years is an important part of management's risk assessment process. Management should follow up on any discrepancies and, if errors or other irregularities are uncovered, take appropriate action to implement corrections and solutions. Performance review procedures can be reperformed by auditors as part of their analytical procedures to reveal significant control weaknesses, risks, or actual errors and fraud.

Segregation of Responsibilities An important characteristic of reliable internal control is the appropriate segregation of functional responsibilities. Sometimes called *division of duties*, proper segregation of responsibilities is necessary for making detailed clerical control procedures effective. Examples of duties that should be done by separate individuals include reports, review and approval of reconciliations, and approval and control of documents. These are four kinds of functional responsibilities that should each be performed by different departments, or at least by different people on the company's accounting staff:

1. *Authorization to execute transactions.* This duty belongs to people who have authority and responsibility for initiating the recordkeeping for transactions. Authorization may be general, referring to a class of transactions (e.g., all purchases), or it may be specific (e.g., sale of a major asset).
2. *Recording of transactions.* This is the accounting and recordkeeping function (bookkeeping) that in most organizations is performed by a computerized process.
3. *Custody of assets involved in the transactions.* This is the actual physical possession or effective physical control of property.

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4. *Periodic reconciliation of existing assets to recorded amounts.* This duty refers to making comparisons at regular intervals and taking appropriate action with respect to any differences.

Responsibilities are incompatible when they place a single person in a position to create and conceal errors or fraud. No one person should control two or more functional responsibilities. The first and fourth responsibilities are management functions, the second is an accounting function, and the third is a custodial (physical access) function. If different departments or persons deal with the different transactions, two benefits are obtained: (1) Fraud would require collusion of two or more people, and most people hesitate to ask for help when conducting wrongful acts, and (2) innocent errors are more likely to be found and flagged for correction. The saying that two heads are better than one is as true as its flip side; the more people assigned to control duties, the better the controls are. The costs, however, would be higher as well. Any control system will reflect a cost-benefit compromise.

Separation of the duties is also an important IT control. Work performed by analysts, programmers, and operators should be segregated. Anyone who designs a processing system should not do the technical programming work, and anyone who performs either of these tasks should not be the computer operator when "live" data are being processed. People performing each function should not have access to each other's work, and only the computer operators should have access to the equipment. Lack of separation of duties along these lines should be considered a serious weakness in general control. A lack of segregation here could be compensated for by having a separate information control group, or monitoring by the user departments. The following box gives an example of what can happen when incompatible IT functions are performed by the same individual.

PROGRAMMER AND OPERATOR COMBINED

A programmer employed by a large U.S. savings and loan association wrote a special subroutine that could be activated by a command from the computer console. The computation of interest on deposits and certificates was programmed to truncate calculations at the third decimal place. The special subroutine instructed the program to accumulate the truncated mills, and, when processing was complete, to credit the amount to the programmer-operator's savings account. Whenever this person was on duty for the interest calculation run, she could "make" several hundred dollars! She had to be on duty to manipulate the control figures "properly" so that the error of overpaying interest on her account would not be detected by the control group. She was a programmer with computer operation duties.

Supervision Supervision is an important element of control. Management's supervision of the work of clerks and computers carrying out the accounting and control procedures is important. A supervisor could, for example, oversee the credit manager's performance or could periodically compare the sum of customers' balances with the accounts receivable control account total. Supervisors or department heads can correct errors found by the clerical staff and make or approve accounting decisions. Supervision is an important means used by management for monitoring and maintaining a system of internal control.

Controlled Access Access to assets, important records, documents, and blank forms should be limited to authorized personnel. Inventory and securities should not be available to people who have no need to handle them. Likewise, access to cost records and accounts receivable records should be denied to people who do not have a recordkeeping responsibility for them. Access to blank forms is the equivalent of access to, or custody of, an important asset. For example, someone who has access to blank cheques has a measure of actual custody of and access to cash. Blank sales invoices and shipping orders are very important for accounting and control, and their availability should be restricted to those involved in accounting for sales.

In IT-based systems, controlled access is achieved through locating hardware, software, and data in secured facilities, and through use of user identity codes and passwords to

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restrict online access for networks, programs, and data to authorized personnel. Determining who should have access to which IT functions should be done on the basis of keeping incompatible functions separate.

A physical control's relevance to financial statement reliability and the audit depends on the auditee's accounting system. For example, if management uses periodic physical counts to detect any inventory losses and records all these losses in the financial statements, the physical controls would not be highly relevant to the audit. However, if management relies on perpetual inventory records for financial reporting purposes and inventory is physically counted at a date other than year-end, then the physical security controls would be relevant to the audit. In this case, the auditor needs assurance that controls operated effectively throughout the period between the physical count and the financial statement date to have sufficient appropriate audit evidence about the reported ending inventory balance.

Periodic Comparison Management has responsibility for the recorded accountability of assets and liabilities. The recorded amounts should be periodically compared with independent evidence of existence and valuation. This is done by periodic counting of cash, securities, and inventory and then comparing the results with control totals in the accounting records. Internal auditors and others on an accounting staff could do this on a regular basis, but the same people should not also have responsibility for authorization of related transactions, accounting or recordkeeping, or custodial responsibility for the assets.

Periodic comparisons include counts of cash on hand, reconciliation of bank statements, counts of securities, confirmation of accounts receivable balances, reconciling customer account balances to the general ledger accounts receivable control balance, reconciling accounts payable to supplier statements, and other comparisons to determine if accounting records—the recorded accountability—represent real assets and liabilities. Frequent comparisons give management more opportunities to detect errors in the records than infrequent ones do, and these can also motivate employees to work more accurately. As is the case for all control procedures, frequency of comparisons is governed by the costs and benefits. Very frequent comparisons are worthwhile for assets especially susceptible to loss or error, or ones that are highly valuable. In other words, if the inherent risk is high, the controls should be strengthened to compensate and lower the control risk.

Follow-up to correct differences found by periodic comparisons is also important. This lowers the risk that material misstatements will remain in the accounts. Accounting data error-checking techniques can be categorized as (1) input controls, (2) processing controls, and (3) output controls. The weakest point in computer systems is input—the point at which transaction data are transformed from hard-copy source documents or online order keying into machine-readable form. When undetected errors are entered originally, they may not be detected during processing, and, if detected, they can be costly to correct. For this reason, preventive controls at input are the most cost effective. Processing controls are error-condition check routines written into the computer program. Output control refers primarily to control over the distribution of reports, but it includes feedback on errors and comparison of input totals to output totals. Error-checking techniques are closely related to application controls, but, because errors compound if they are not corrected quickly and appropriately, they have a pervasive impact on the accounting system's integrity. The auditor should consider the overall effectiveness of error-correction procedures as a key part of the general IT control activities.

IT Controls General IT controls are policies and procedures that relate to IT-based systems and support the effective functioning of IT application controls by helping to ensure the continued proper operation of information systems. These controls apply to mainframe, server, and end-user environments. General IT controls over computer operations commonly include the following:

- Operating system and application software acquisition, change, and maintenance
- Access security, authorization for access to systems, programs, and data files
- System and application development and maintenance
- Routine data and system backup procedures

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- Disaster recovery plans to restore systems and data, or to provide backup processing capability
- Physical security of assets, including adequate safeguards such as secured facilities over access to assets and records with appropriate environmental controls

REVIEW CHECKPOINTS

9-35 What risks are addressed by controlled access?

9-36 Give some examples of periodic comparisons a company can perform. How do they control the accuracy of its financial records?

9-37 List some commonly used general controls related to IT.

9-38 Which duties should be segregated within the information system? Why?

Applications Control Activities

Applications control activities are specific procedures used in each accounting process to meet the relevant control objectives. Auditors evaluate the activities in terms of how they address financial reporting risk at the assertion level. The audit approach starts with documenting the accounting processes and information systems, and then it identifies the application controls within each system. Methods of documenting accounting systems and controls are discussed next.

DOCUMENTATION OF AN ACCOUNTING INFORMATION SYSTEM

LO5 Document an accounting system to identify key controls and weaknesses in order to assess control risk.

Auditors' understanding of the internal controls in the accounting system comes through several sources of information: (1) last year's audit experience with the company, (2) auditee personnel responses to enquiries, (3) documents and records inspection, (4) walk-through observation of the activities and operations of a single transaction. Such walk-through procedures have traditionally been used to verify the accuracy of the auditor's narrative or flow chart description of the system.

Working paper documentation should include records showing the audit team's understanding of the internal controls. It can be summarized in the form of questionnaires, narratives, and flow charts. The decision on how much reliance to place on controls and how much to place on substantive work must also be documented in the audit file, explaining underlying reasons, for instance, to increase effectiveness and efficiency. This is helpful for reference in next year's audit.

Internal Control Questionnaire and Narrative

internal control questionnaire: checklist to gather evidence about the control environment

The most efficient means of gathering evidence about internal control is to conduct formal interviews with knowledgeable managers using a checklist guide such as the example of an **internal control questionnaire** shown in Exhibit 9–8. This questionnaire is organized under headings identifying the questions related to the environment and general controls and those related to each of the seven control objectives. In creating a questionnaire, using these seven categories helps to ensure it will cover all the assertions.

Internal control questionnaires are designed to help the audit team obtain evidence about the control environment as well as about the general and application control activities that can reduce risks of error and fraud. Answers to the questions, however, should not be taken as final and definitive evidence about how well control actually functions. Evidence obtained through the interview-questionnaire process is hearsay, as its source is an individual who, while knowledgeable, may not be the person who actually performs the control work. These individuals may give answers reflecting what they believe the system should be rather than what it really is, may be unaware of informal ways that have been changed, or may be innocently ignorant of the system details. Nevertheless, interviews and questionnaires are useful as a starting point. If a manager admits to a weak control, it is important to document and follow up in subsequent audit work.

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EXHIBIT 9–8 Example of an Internal Control Questionnaire—Revenue Transaction Processing

Auditee ______________________ Audit Date ______________________

Auditee Personnel Interviewed ______________________

____

____

Auditor ______________________ Date Completed ______________________

Reviewed by ______________________ Date Reviewed ______________________

Question	Answer			
	NA	Yes	No	Remarks
Environment and General Controls Related to Sales Transaction Processing				
1. Is the credit department independent of the marketing department?				
2. Are sales accounting staff properly trained in and subject to supervisory reviews? Are they independent of marketing and credit departments?				
3. Are nonroutine sales of the following types controlled by the same procedures described below? Sales to employees, COD (cash on delivery) sales, disposals of property, cash sales, and scrap sales.				
4. Are policies in place to ensure effective IT management and IT staff supervision?				
5. Are IT systems general controls in place to ensure:				
– accurate data and processing of sales transactions?				
– authorized access to data and application software?				
Application Control Assessments:				
Validity Objective				
6. Are procedures in place to:				
– prevent fictitious sales being recorded in accounts?				
– ensure approved revenue recognition policies are followed?				
7. Is access to sales invoice blanks, or online order entry restricted to authorized personnel?				
8. Are prenumbered bills of lading or other shipping documents prepared or completed in the shipping department?				
Completeness Objective				
9. Are procedures in place to ensure:				
– all goods shipped/services performed are invoiced?				
– no fictitious sales credits are recorded?				
10. Are sales invoice blanks or online orders numbered sequentially?				
11. Is the sequence checked for missing invoices by appropriate personnel?				
12. Is the shipping document numerical sequence checked for missing bills of lading numbers by appropriate personnel?				
Authorization Objective				
13. Are all credit sales approved by the credit department prior to shipment?				
14. Are sales prices and terms based on approved standards?				
15. Are returned sales credits and other credits supported by documentation as to receipt, condition, and quantity and approved by a responsible officer?				
Accuracy Objective				
16. Are shipped quantities compared with invoice quantities by appropriate personnel?				
17. Are sales invoices checked for error in quantities, prices, extensions and footing, and freight allowances, as well as checked with customer's orders?				
18. Is there an overall check on arithmetic accuracy of period sales data by a statistical or product-line analysis?				

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EXHIBIT 9–8 Continued

19. Are periodic sales data reported directly to general ledger accounting independent of accounts receivable accounting?				
Classification Objective				
20. Does the accounting manual contain instructions for classifying revenues according to the company's revenue recognition policies?				
21. Are accounting supervisors aware of related parties, and are related-party transactions flagged in the accounting system?				
Accounting Objective				
22. Are summary journal entries approved before posting?				
Proper Period Objective				
23. Does the accounting manual contain instructions to date sales invoices on the shipment date?				
24. Do accounting staff understand proper period end cutoff procedures for sales and cash receipts?				
25. Does the information system correctly age receivables to provide information about doubtful accounts?				

A strength of questionnaires is that they minimize the risk that an important point will be forgotten. Questions are usually worded so that a "no" answer points out some weakness or control deficiency, thus making analysis easier. These enquiry procedures can be tailored to a particular company by writing descriptions of each important control subsystem. It would simply describe all the environmental elements, the accounting system, and the control procedures. The narrative description may be efficient in audits of small businesses or simple systems within larger organizations.

REVIEW CHECKPOINTS

9-39 What does the auditor need to understand about the auditee's control environment?

9-40 What does the auditor need to understand about the flow of transactions in the auditee's information systems?

9-41 What sources of information can auditors use to gain knowledge about the auditee's internal controls?

9-42 What internal control documentation needs to be included in the audit files?

9-43 Why is audit file documentation required for the auditor's decision on whether to rely on controls in the audit planning?

9-44 What is an audit internal control questionnaire?

9-45 What is an internal control system narrative, and what is it used for in an audit?

Accounting and Control System Flow Charts

Flow charts are one technique used by auditors to document their understanding of accounting and control systems. Many control-conscious companies have their own flow charts, usually prepared by internal auditors, that external auditors can use instead of constructing their own. The advantages of flow charts can be summarized by an old adage, "A picture is worth a thousand words." They enhance auditors' evaluations and are easy to update—simply add or delete symbols and lines.

Flow chart construction takes time, because an auditor must learn about the operating of personnel involved in the system and gather samples of relevant documents. Thus, the information for the flow chart, like the narrative description, involves a lot of legwork and observation. When the flow chart is complete, however, the result is an easily evaluated, informative description of the system. Flow charting software that saves time and produces more readable output is available.

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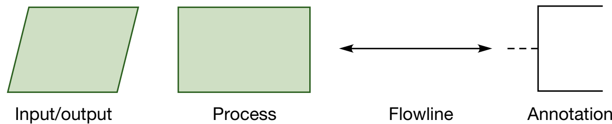
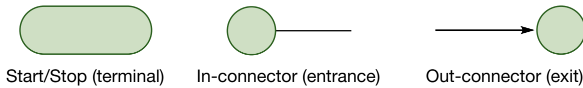
Exhibit 9–9 contains a few simple flow chart symbols. An audit supervisor should be able to understand the chart without consulting a lengthy index of symbols. It should be legible and drawn with a template and ruler or with computer software. The starting point in the system should, if possible, be placed at the upper left-hand corner, with the flow of procedures and documents moving from left to right and from top to bottom, as much as is possible. Narrative explanations should be written on the chart as annotations, or be part of a readily available reference key.

EXHIBIT 9–9 Standard Flow chart Symbols

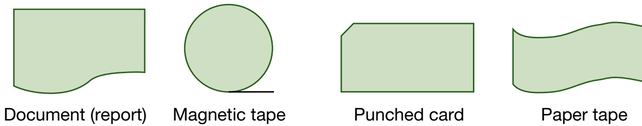
Basic



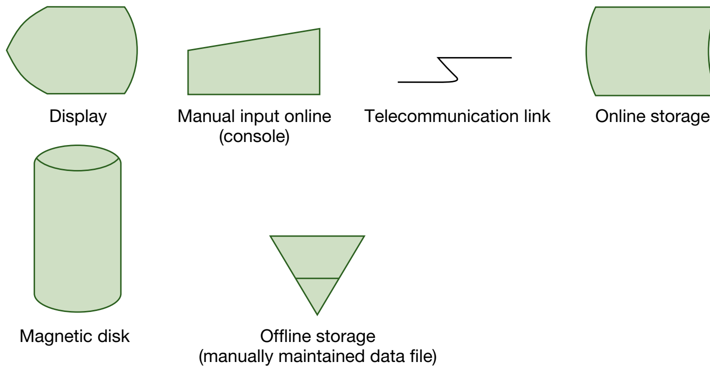
Additional



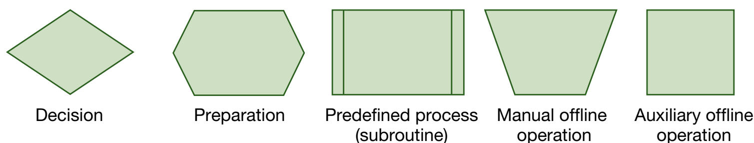
Specialized for Media



Specialized for Equipment



Specialized for Processing



The flow chart should communicate all relevant information and evidence about segregation of responsibilities, authorization, and accounting and control procedures in an understandable, visual form. Exhibit 9–10 shows a partial flow chart representation of the

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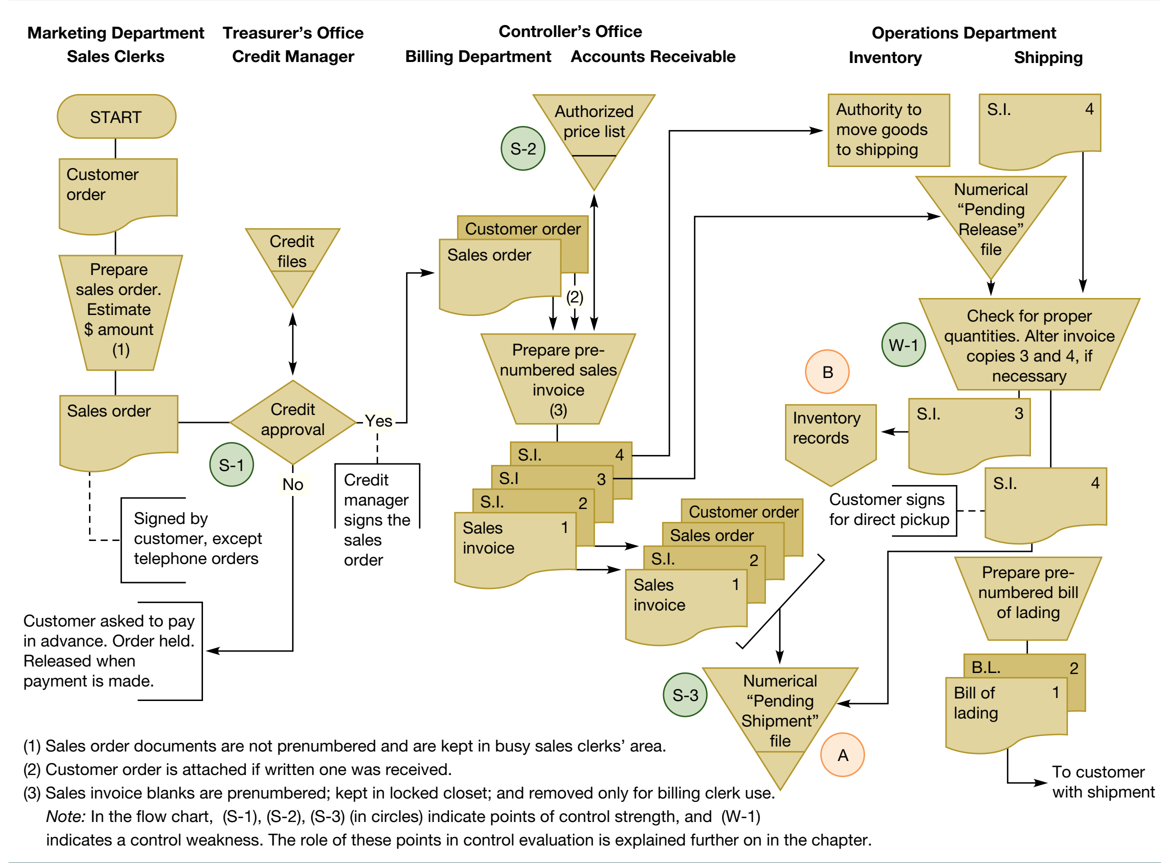
beginning stages of a sales and delivery processing system. The out-connectors shown by the circled A and B indicate continuation on other flow charts. Ultimately, the flow chart ends by showing entries in accounting journals and inventory ledgers.

In Exhibit 9–10, you can see some characteristics of both flow chart construction and this accounting system.[3] Minimizing the number of flow lines that cross each other is helpful for following the chart. Reading down each department's column shows that initiation authority for transactions (both credit approval and sales invoice preparation) and custody of assets are separated. All documents have an intermediate or final resting place in a file (some of these files are in the flow charts connected to A and B), thus giving auditors information about where to find audit evidence later.

Technology such as workflow charting software tools allows businesses to describe their processes, integrate various processes, automate routine management activities, and integrate information systems. Securities market regulations (such as CSA 52-109 in Canada, and SOX in the United States) require public companies to document their controls, and tools like these help businesses comply.

Regardless of the method used to develop the flow chart, its accuracy can be verified by performing a walk-through test of the documents and procedures to see if they are processed as described in the flow chart. An understanding of the flow of transactions through the accounting system supports the design of substantive audit procedures, and it begins with referring to

EXHIBIT 9–10 Example of a Flow chart for the Revenue Process: Credit Approval and Revenue Processing, Shipment and Delivery



(1) Sales order documents are not prenumbered and are kept in busy sales clerks' area.
(2) Customer order is attached if written one was received.
(3) Sales invoice blanks are prenumbered; kept in locked closet; and removed only for billing clerk use.
Note: In the flow chart, (S-1), (S-2), (S-3) (in circles) indicate points of control strength, and (W-1) indicates a control weakness. The role of these points in control evaluation is explained further on in the chapter.

3 Accounting firms have various methods for constructing flow charts. The illustrations in this book take the approach of describing an accounting subsystem completely. Some accounting firms use more efficient methods of charting only the documents, information flows, and controls considered important for the audit.

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the auditee's description of the accounting processes. Descriptions could include user's manuals and instructions, file descriptions, system flow charts, and narrative descriptions.

The audit team may find that there already is documentation related to the flow of transactions which may be adequate for understanding the accounting system. Early in the audit planning, the internal auditors and other auditee personnel should be consulted to determine whether they have documentation that can be useful.

INTERNAL CONTROL EVALUATION AND PLANNED AUDIT APPROACH

A brief overview of how internal controls affect the audit approach to be used in the detailed audit programs for each significant transaction stream and account balance concludes this section.

STANDARDS CHECK

CAS 315

14. The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:
    (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behaviour; and
    (b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment. (Ref: Para. A69-A78)

Source: *CICA Handbook—Assurance,* 2012.

1. All audit engagements involve some evaluation of internal controls, even if only on environmental controls affecting all processes (e.g., reconciliation of general ledger to subsidiary ledgers). Under GAAS, auditors are required to understand internal controls in order to assess the risk of material misstatement for all audits.[4]
2. Internal control is documented through narratives, questionnaires, and flow charts. These are corroborated with walk-through procedures which include tracing of a representative transaction.
3. In reaching a preliminary evaluation of internal control, the auditor must consider:
   (*a*) Misstatements that may arise.
   (*b*) Controls that exist to prevent or detect those misstatements.
   Professional judgment is applied to knowledge gained in point (*b*).
4. The review, preliminary evaluation, and documentation must be applied to specific internal controls within an individual accounting process. The specific controls activities, not the system as a whole, are assessed. Only the specific controls which auditors intend to obtain audit assurance from need to be tested.
5. If the auditor wishes to use internal controls as a component of audit evidence, tests of control need to be planned and executed. The decision to test the controls is a function of:
   (*a*) Evaluation of the design of the system.
   (*b*) Cost-benefit trade-offs of control testing, assuming the design is adequate.

In summary, if the auditor is unable to rely, or chooses not to rely, on internal control effectiveness, the **substantive audit approach** is being used. If, on a preliminary basis, the auditor does decide to test internal controls, and the tests confirm that the controls are operating effectively, then the auditor may reduce the extent of substantive audit procedures. Finally, in the case where the auditor cannot obtain sufficient appropriate audit evidence on the basis of substantive tests alone, testing controls and finding them effective increases the evidence sufficiency to an acceptable level to support the audit opinion. These last two approaches are referred to as the **combined audit approach**.[5]

substantive audit approach: an approach to performing an audit that involves obtaining assurance only from substantive procedures, with no reliance on internal control effectiveness

combined audit approach: an approach to performing an audit that involves obtaining assurance from reliance on internal controls based on testing their effectiveness, combined with assurance from substantive procedures

4 CASs 200 and 315.

5 CAS 330.

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STANDARDS CHECK

CAS 200

A39. Control risk is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. The CASs provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures to be performed.

Source: *CICA Handbook—Assurance,* 2012.

STANDARDS CHECK

CAS 330

A2. The assessment of the risks of material misstatement at the financial statement level, and thereby the auditor's overall responses, is affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at the period end. Deficiencies in the control environment, however, have the opposite effect; for example, the auditor may respond to an ineffective control environment by:

- Conducting more audit procedures as of the period end rather than at an interim date.
- Obtaining more extensive audit evidence from substantive procedures.
- Increasing the number of locations to be included in the audit scope.

A3. Such considerations, therefore, have a significant bearing on the auditor's general approach, for example, an emphasis on substantive procedures (substantive approach), or an approach that uses tests of controls as well as substantive procedures (combined approach).

Source: *CICA Handbook—Assurance,* 2012.

REVIEW CHECKPOINTS

9-46 What is the purpose of an internal control systems flow chart? How does it differ from a narrative?

9-47 Why do many organizations have documentation of their internal control system?

9-48 What is a walk-through, and why is this procedure used in an audit?

9-49 What role can internal auditors play in internal control system documentation?

9-50 What is a substantive audit approach, and how does it differ from a combined audit approach?

Phase 2: Assessing the Control Risk

After phase 1—obtaining an understanding of the internal control and making a preliminary decision on an audit approach—the audit team assesses the control risk at the assertion level. Control risk assessment involves the following:

- Identifying specific control objectives based on the risks of misstatements that may be present in significant accounting applications
- Identifying the points in the flow of transactions where specific types of misstatements could occur
- Identifying specific control procedures designed to prevent or detect misstatements

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- Identifying the control procedures that must function to prevent or detect misstatements
- Evaluating the design of control procedures to determine whether it suggests the auditee has strong control procedures in place and whether it may be cost effective to test these controls as part of the audit.

A useful assessment technique is to analyze control strengths and weaknesses. **Control strengths** are specific features of effective control procedures that would prevent, detect, or correct material misstatements. **Control weaknesses** are a lack of controls in particular areas that would allow material errors to get by undetected. The auditors' findings and preliminary conclusions on control strengths and weaknesses should be written up for the working paper files in a document called a **bridge working paper**—so called because it connects (bridges) the control evaluation to subsequent audit procedures. The major strengths and weaknesses apparent in the flow chart of Exhibit 9–10 are summarized in the bridge working paper in Exhibit 9–11. On the flow chart, the strengths are indicated by S-, and the weakness by W-. In Exhibit 9–11, the "audit program" column contains procedures for auditing the control strengths and suggestions about substantive account balance audit procedures related to the weaknesses (the last column in the exhibit). Auditors do not need to test control weaknesses just to prove they are weak places, as this would be inefficient. However, auditors do always need to take control weaknesses into account when assessing the risk of material misstatements in the financial statements.

control strengths: specific features of effective controls that would prevent, detect, or correct material misstatements

control weaknesses: the lack of controls in particular areas that would allow material errors to get by undetected

bridge working papers: audit documentation that connects (bridges) the control evaluation to subsequent audit procedures by summarizing the major control strengths and weaknesses, listing test of controls procedures for auditing the control strengths, and suggesting substantive audit procedures related to the weaknesses

EXHIBIT 9–11 Bridge Working Paper

Prepared by ______________ Date: ______________ File Index: ______________

Reviewed by ______________ Date: ______________

EcoPak Inc.
Credit Approval, Sales Processing, Shipment and Delivery Control
December 31, 20X1

	Strength/Weakness*	Audit Implication	Audit Program
S-1	Credit approval is done on sales order.	Credit authorization reduces risk of bad debt loss and helps check on validity of customer identification.	Select a sample of recorded sales invoices, and look for credit manager signature on attached sales order.
S-2	Unit prices are taken from an authorized list.	Prices are in accordance with company policy, minimizing customer disputes.	Using the S-1 sample of sales invoices, vouch prices used thereon to the price lists.
S-3	Sales are not recorded until goods are shipped.	Cutoff will be proper and sales will not be recorded too early.	Using the S-1 sample of sales invoices, compare the recording date with the shipment date on attached bill of lading or copy 4. (Also, scan the "pending shipment" file for old invoices that might represent unrecorded shipments.)
W-1	Shipping personnel have transaction alteration (initiation) authority to change the quantities on invoices, as well as custody of the goods.	Dishonest shipping personnel can alone let accomplices receive large quantities and alter the invoice to charge them for small quantities. If this happened, sales and accounts receivable would be understated, and inventory could be overstated.	The physical count of inventory will need to be observed carefully (extensive work) to detect material overstatement.

*S = strength; W = weakness

At this stage in the control risk assessment, the control risk related to the inventory balance's existence might be set very high (e.g., 0.8 or 0.9 in probability terms). The three control strengths, however, relate to good control over sales validity and accounts receivable accuracy. The auditors probably will want to rely on these controls to reduce audit work on the accounts receivable balance. Tests of these control procedures would need to be performed to obtain evidence about whether the apparent strengths actually are performed well. The "audit program" segment of Exhibit 9–11 for each of the strengths, describes specific control tests of the relevant control procedure. Testing controls (phase 3) consists of tests designed to produce evidence of how well the controls worked in practice. If they

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pass the auditor's criteria (the required degree of compliance), control risk can be assessed low, but, if they fail the test, a high control risk is assessed and the audit plan must be revised to take the control weakness into account. Control tests only provide indirect evidence of the monetary accuracy of financial statement balances because not all monetary misstatements are caused by control weaknesses. Substantive testing provides more direct evidence about monetary accuracy.

REVIEW CHECKPOINTS

9-51 What steps are involved in a control risk assessment?

9-52 What is a control strength? What is a control weakness? How do control strengths relate to control testing?

9-53 What is the purpose of a bridge working paper, and what information does it contain?

9-54 Why is it not necessary to test control weaknesses? What action does the auditor need to take when control evaluation work indicates a control weakness?

9-55 What are the implications for the audit program if tests of key controls indicate they are operating effectively for the whole period being audited? What are the implications if a key control is tested and a high degree of noncompliance is found?

This section on control risk assessment concludes with a special note on assessing risks in complex IT and e-commerce environments as well as considerations of manual and IT controls in information systems.

Special Note: Assessing the Control Risk in Complex IT and E-Commerce Environments

Business Internet and IT use have a big impact on control risk. There are many business strategies that incorporate the Internet, and most businesses make use of the Internet for basic administrative processes like e-mail communication. (This is further discussed in Appendix 6D on Connect.)

Auditors are mainly concerned with the security of IT processing, especially as it affects the accuracy and reliability of the accounting function. In a business with complex IT use and e-commerce activities, it is challenging to maintain the integrity of control systems and to ensure access to relevant records for management and audit purposes in a rapidly changing environment. In some circumstances (e.g., when e-commerce systems are highly automated, when transaction volumes are high, or when electronic evidence comprising the audit trail is not retained), the auditor may determine that controls are critical to reducing financial reporting risks as it may not be possible to reduce audit risk to an acceptably low level using only substantive procedures. It will be necessary to assess and test effectiveness of key controls to determine their adequacy in ensuring that the requirements relevant to the financial statement assertions are met. Controls are also required related to information's authorization, authenticity, confidentiality, integrity, nonrepudiation, and availability, as further explained below.

When the auditee engages in e-commerce, the following aspects of internal control are particularly relevant:

- Security
- Transaction integrity
- Process alignment

These aspects are explained in the following paragraphs.

Security External parties' ability to access the auditee's information system using the Internet creates security risks. The security infrastructure and related controls include an information security policy, an information security risk assessment process, and security procedures, which incorporate both physical measures and logical or other technical

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safeguards such as user identities, passwords, firewalls, and encryption, including both authorization and safeguarding of decryption keys. The control environment ensures systems are updated so that risk posed by new technologies is addressed. Security concerns and controls can be broken down into the components shown in the following box.

SEVEN CORNERSTONES OF BASIC SECURITY

Security Concerns	Examples of Controls
1. Network security	1. Network segmentation, intrusion detection software, all network devices at current patch level
2. Database security	2. Control administrator access accounts, update access restrictions
3. Operating system security	3. Upgrade Windows operating system to eliminate vulnerabilities, penetration audits
4. External security	4. Firewalls for modem and wireless access; monitor trading partner access accounts
5. Application security	5. Rule of least access for users, review transaction routing, application triggers for unusual items, purge old users
6. Physical security	6. Annual physical security audit, surprise intrusion tests
7. Business continuance and disaster preparedness security	7. Server, applications, firewall and Internet service provider (ISP) redundancy, business continuance plan stored off-site at key employees' homes

Source: Adapted from Gordon E. Smith, "Information security: Is your auditing up to the task?" *The Journal of Corporate Accounting and Finance*, 15 (4),May/June 2004, p. 13.

In addition to internal risks, information security breaches in e-commerce applications can lead to unauthorized access to private information, customer credit card numbers and social insurance numbers, for example. Privacy laws require all businesses to have control over privacy of information in place, and weaknesses can result in legal action against a company, as well as action by private individuals whose information was improperly given out. A weakness in privacy controls could thus mean that a material misstatement of the financial statements exists in the form of an undisclosed contingent liability. Rapid and radical technological changes are risk factors that can expose the organization to control risks, such as unauthorized access to their proprietary or confidential information.

The auditor needs to consider whether the entity has implemented general IT and application controls that respond adequately to the risks arising from IT. Auditors consider these controls effective if they maintain the integrity of information and the security of the data processed.[6] This is another reason for audit teams to include up-to-date IT experts.

REVIEW CHECKPOINTS

9-56 What challenges arise for management and the auditor when an auditee uses complex IT and/or is involved in e-commerce?

9-57 Why are an auditee's privacy controls relevant to the audit?

Transaction Integrity Risks related to the recording and processing of e-commerce transactions include the completeness, accuracy, timeliness, and authorization of information in the entity's financial records. Control activities relating to transaction integrity in an e-commerce environment are often designed to do the following:

(*a*) Validate input

(*b*) Prevent duplication or omission of transactions

6 CAS 315.

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(*c*) Ensure the terms of trade have been agreed before an order is processed; usually payment is obtained when an order is placed

(*d*) Distinguish between customer browsing and orders placed, ensure a party to a transaction cannot later deny having agreed to specified terms (nonrepudiation), and ensure transactions are with approved parties, when appropriate

(*e*) Prevent incomplete processing by rejecting the order if all steps are not completed and recorded (e.g., for a B2C [business-to-consumer] transaction: order accepted, payment received, goods delivered, and accounting system updated)

(*f*) Ensure the proper distribution of transaction details across multiple systems in a network (e.g., when data are collected centrally and communicated to various resource managers to execute the transaction)

(*g*) Ensure records are properly retained, backed up, and secured

Weaknesses in IT and e-commerce controls can increase the company's vulnerability to fraudulent activities by employees as well as by outside customers, suppliers or strangers, as described in the following box.

FRAUD RISKS IN E-COMMERCE

Possible fraudulent activities include the following:

- Unauthorized movement of money, such as payments to fictitious suppliers located in jurisdictions where recovery of money will be difficult
- Misrepresentations of company tenders
- Corruption of electronic ordering or invoicing systems
- Duplication of payments
- Denying an order was placed
- Denying an order was received
- Denying receipt of goods
- Denying that payment was received
- Falsely declaring that a payment was made

Source: Adapted from Jagdish Pathak, "A conceptual risk framework for internal auditing in e-commerce," *Managerial Auditing Journal*, 19 (4), 2004, p. 560.

Process Alignment. Process alignment refers the integration of IT systems so that they operate as one system. Transactions generated on the business website should be processed properly by the entity's various internal systems, such as the accounting, customer relationship management, and inventory management systems (often known as "back office" systems). Many websites are not automatically integrated with internal systems, increasing the risk of inconsistent recording and other errors.

Identifying specific control objectives is the same in both manual and IT-based data processing procedures. However, the points in the flow of transactions where misstatements could occur may be different, as is seen in Exhibit 9–12, which gives a flow chart of a basic IT-based accounting system indicating the points in the process where misstatements could occur.

The points in the system where misstatements might occur are:

Input

1. Activities related to source data preparation are performed, causing the flow of transactions to include authorization and initial execution.
2. Manual procedures are applied to source data, such as a manual summarization of accounting data (preparation of batch totals).
3. Source data are converted into computer-readable form.
4. Input files are identified for use in processing.

Processing

5. Information is transferred from one computer program to another.
6. Computer-readable files are used to supply additional information relating to individual transactions (e.g., customer credit reports).
7. Transactions are initiated by the computer.

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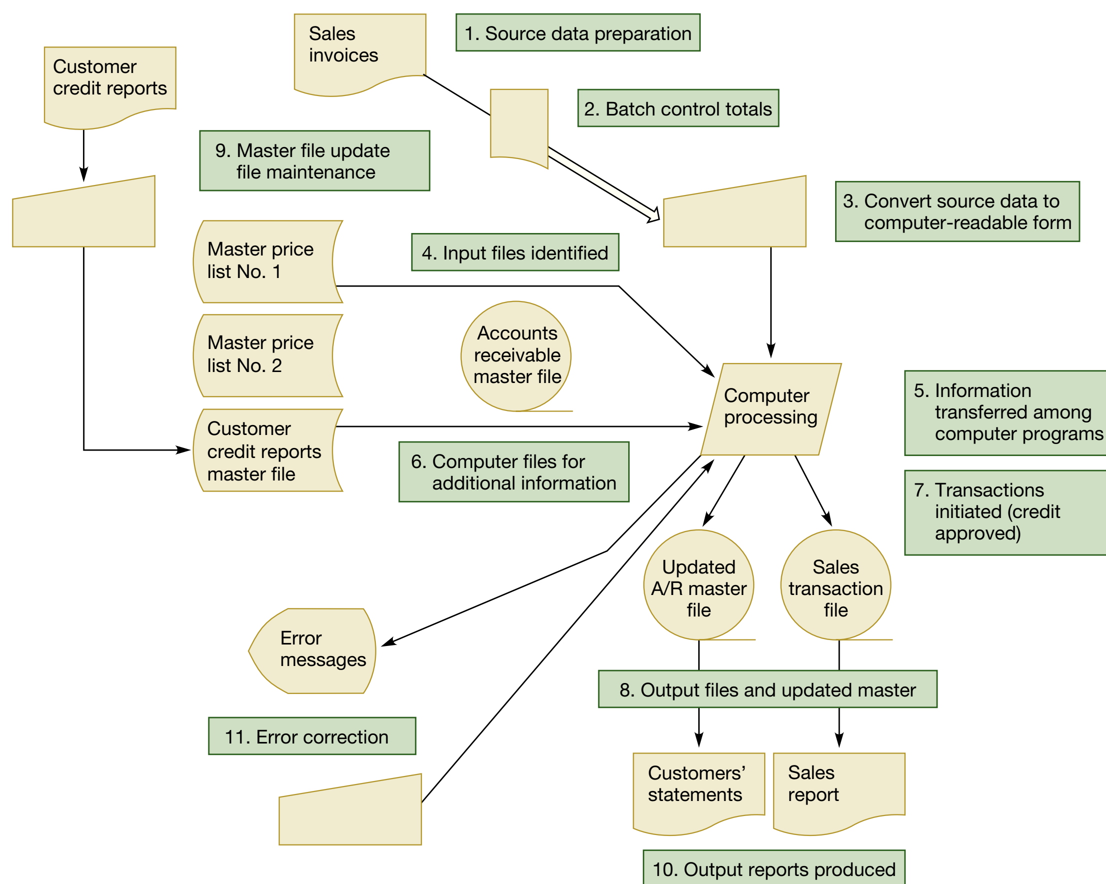
Output

8. Output files are created or master files are updated.
9. Master files are changed (records added, deleted, or modified) outside the normal flow of transactions within each cycle through file maintenance procedures.
10. Output reports or files are produced.
11. Errors identified by control procedures are corrected.

EXHIBIT 9–12 It Accounting: Points of Vulnerability to Misstatement Errors



Once the audit team has identified the risks, specific control objectives can be related to such points. For example, invoicing customers with incorrect prices if the wrong price-list file has been used would lead to a misstatement. The control objective for this type of misstatement is: "Appropriate price information should be used during the invoicing process." The controls associated with prevention, detection, and correction of misstatements can be grouped into three broad categories: input, processing, and output controls. Input controls are associated with preventing misstatements related to the points numbered 1 through 4 above. Processing controls are primarily designed to detect misstatements related to points 5 through 8. Output controls are designed to correct misstatements related to points 9 through 11.

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Control procedures should be related to specific control objectives. For example, for the objective of using appropriate price information, one control procedure might be: "The invoicing program should use the most up-to-date price-list file and the price-list file date should appear on the invoicing summary management report. The accounts receivable manager should review the invoicing summary report and verify that the correct price list has been used to calculate the invoice amounts prior to issuing and sending the invoices to customers."

Manual control procedures may differ from IT controls that are designed to accomplish the same control objectives. For example, in a manual procedure, credit approval usually is indicated by an authorized person putting their signature on a source document, such as a customer's order or invoice. In an IT-based system, however, approval can be accomplished by the authorized person using an approved password that releases a credit sale transaction by assigning a special code to it. Even though the objectives are the same because the methods used to achieve the objectives and the visible evidence differ, different audit approaches may be required as well. The following section will describe manual and IT control components in detail and discuss the benefits and risk of each type of control.

Manual and IT Controls over Information Processing Most entities use IT systems for financial reporting and operational purposes, but even so, there will also be manual elements to the systems. The system of internal control is also likely to contain manual and automated procedures, the characteristics of which will affect the auditor's risk assessment and design of further audit procedures. The methods used to process accounting transactions will affect a company's organizational structure and influence the procedures and techniques used to accomplish the objectives of internal control.

Manual system controls include approvals, management reviews of reports and activities, reconciliations, and follow-up of reconciling items. Controls in IT-based systems will typically be a combination of automated controls (e.g., controls embedded in computer programs) and manual controls, which may either use information produced by IT or be independent in IT. In order to understand internal control, the auditor has to understand the risks of IT or manual systems and whether management has responded adequately by establishing effective controls. Some of the risks and benefits of manual versus IT procedures in internal control are noted in the following box.

MANUAL VERSUS IT CONTROLS: RISKS AND BENEFITS

IT Control Benefits

IT can enhance internal control effectiveness and efficiency by the following:

- Consistently processing large volumes of transactions or data by applying predefined business rules and performing complex calculations
- Enhancing the timeliness, availability, and accuracy of information
- Facilitating the further information analysis
- Enhancing the entity's performance monitoring
- Reducing the risk of controls being overridden
- Allowing effective segregation of duties by implementing security controls in applications, databases, and operating systems

IT Control Risks

IT also can create specific internal control risks, including the following:

- Reliance on inaccurate systems, programs, or data
- Unauthorized data access allowing data destruction, improper changes, recording unauthorized, inaccurate, or nonexistent transactions, particularly when multiple users access a common database
- IT personnel gaining inappropriate or unnecessary access privileges that undermine segregation of duties, or allow unauthorized changes to master file data, systems, or programs
- Failure to make necessary updates to systems or programs
- Inappropriate manual intervention
- Potential loss of data or inability to access data as required

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Manual Control Benefits	**Manual Control Risks**
Manual systems can be beneficial when judgment and discretion are required, such as for the following circumstances: • Large, unusual, or nonrecurring transactions • Circumstances where errors are difficult to define, anticipate, or predict • Changing circumstances that require a control response outside the scope of an existing automated control • Monitoring the effectiveness of automated controls	Manual controls tend to raise the following risks: • Human error is always possible, so mistakes can occur and consistent application cannot be assumed • Relatively easy to bypass, ignore, or override • Less effective for high volume or recurring transactions, or other situations where typical errors can be anticipated, prevented, or detected by control parameters that can be automated **Source:** Adapted from CAS 315.

Regardless of whether it is manual or automated, every accounting system must contain procedures ensuring proper recording of transactions, prevention or detection of errors and fraud, and monitoring of control effectiveness. It is management's responsibility to establish and maintain internal controls, and the information system policies and procedures are part of this. The audit team's responsibility is to make an assessment of the control risk in the system. Management can meet its responsibility and assist auditors by (1) ensuring that documentation of the system is complete and up to date, (2) maintaining a system of transaction processing that includes an audit trail, and (3) making IT resources and knowledgeable personnel available to the auditors. Appendix 9B on Connect provides a detailed description of the characteristics of IT-based information systems, and of the auditors' risk and control assessment, for students who are interested in applying the concepts and techniques from their management information systems courses.

REVIEW CHECKPOINTS

9-58 What are the main purposes of control procedures in an information system?

9-59 Explain the difference between manual controls and IT controls. Give an example of each.

9-60 In which situations are manual controls preferable, and in which are IT controls preferable?

9-61 What risks and controls relate to recording and processing e-commerce transactions?

9-62 List some fraud risks that may exist in e-commerce activities.

9-63 What risk arises if IT systems are not properly aligned to each other?

9-64 Identify the three main components in the flow of transactions.

9-65 Categorize the eleven points of vulnerability to misstatement errors related to manual input, computer processing, and error correction activities in a computerized information system.

Summary of Phases 1 and 2

According to GAAS, the auditor is required to assess control risk for the different classes of transactions and account balances at the assertion level. The information gathered about the auditee's control environment, the accounting information systems, and the control procedures should enable the auditor to reach one of the following conclusions about control risk and the most effective audit approach to use.

- *Control risk may be assessed low, and it seems efficient to test controls.* The auditor believes the control procedures designed to prevent or detect misstatements can be audited for compliance in a cost-effective manner, reducing the amount of substantive evidence needed for reasonable assurance. Alternatively, when certain control

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procedures are essential for reducing risk of material misstatement, and substantive procedures alone won't provide sufficient appropriate evidence about the assertion(s), controls must be tested to support the audit opinion. In this case, the auditor plans an audit approach that combines control testing and substantive evidence gathering.

or

- *Control risk may be assessed low, but audit inefficiencies would occur if controls were tested.* Control policies and procedures appear to be good, but testing controls is not cost effective because substantive procedures can provide sufficient appropriate evidence and are more efficient than a combined approach. In this case the auditors would concentrate attention on the substantive audit procedures.

or

- *Control risk may be assessed high.* Control policies and procedures do not appear to be sufficient to prevent or detect material misstatements. In this case, the auditors will concentrate on substantive audit procedures. The auditor also has additional responsibilities to report the control weaknesses to management and those charged with governance. If the effective operation of controls is essential to reduce the risk of material misstatement, and substantive procedures alone will not provide sufficient appropriate evidence about the assertion(s), a scope limitation exists that may prevent the auditor from obtaining reasonable assurance that no material misstatement has occurred.

The control risk conclusion determines the approach that will be followed in planning the audit. The first conclusion above will result in the auditor's choosing a combined audit approach using both control and substantive testing, and the second and third conclusions will result in choosing an approach based on obtaining substantive evidence. Since the auditor is required to make the control assessment at the assertion level, it may be possible to identify specific control procedures that provide a low risk assessment with regard to some but not all assertions, leading the auditor to use a combination of tests of controls and substantive auditing. Other audit objectives may be achieved through substantive procedures alone. The box below summarizes the possible control risk assessment outcomes and the considerations regarding audit approach.

CONTROL RISK ASSESSMENT	COST BENEFIT AND SCOPE CONSIDERATIONS	AUDITOR'S DECISION ON AUDIT APPROACH
Low or moderate (controls effective)	Control reliance reduces required substantive procedures in excess of cost of control testing	Combined Audit Approach – Test controls – Reduce planned substantive procedures
Low or moderate (controls effective)	Substantive procedures can provide sufficient appropriate evidence at a lower cost than control tests	Substantive Audit Approach – Do not test controls – Plan substantive procedures to provide high assurance
Low or moderate (controls effective)	Substantive procedures alone cannot provide sufficient assurance	Combined Audit Approach – Test controls – Plan substantive procedures to provide high assurance
High	Substantive procedures alone can provide sufficient assurance	Substantive Audit Approach – Do not test controls – Plan substantive procedures to provide high assurance
High	Substantive procedures alone *cannot* provide sufficient assurance	It is unlikely that sufficient evidence can be obtained in this situation Scope limitation—Modified audit opinion (qualified or disclaimer of opinion) may be required

To summarize the auditor's control assessment up to this point, phases 1 and 2 can be described as dealing with the evaluation of whether the controls are designed to operate effectively. Now we move on to phase 3 where we test the actual operation of the controls.

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REVIEW CHECKPOINTS

9-66 Why are the control objectives the same regardless of whether manual or IT controls procedures are used?

9-67 Why might manual control procedures differ from IT control procedures, even if both are directed at the same control objective?

9-68 Describe one manual and one IT control procedure designed to prevent a credit sale being processed without proper authorization by the credit manager.

9-69 What three conclusions about control risk can be reached based on internal control evaluation? What are the implications of each on the audit approach selected?

CONTROL TESTING

LO6 Write key control tests for an audit program.

By the third phase of an internal control evaluation, auditors will have assessed individual controls. To reach a conclusion on control risk, auditors must determine (a) what degree of compliance with the control policies and procedures is required, and then (b) what degree of control compliance is actually present. The degree of compliance required is the criterion that control performance is assessed against. Knowing that compliance cannot be perfect, auditors might decide, for example, that using shipping documents to validate sales invoice recordings 96% of the time is sufficient to assess a low control risk for the audit of accounts receivable (controls relating to the existence assertion in receivables and sales). Auditors perform control tests to determine how well the company's control procedures actually worked during the period under audit.

A control test has two parts. Part one is identifying the data population from which to select a sample of items for audit. Part two is describing the action that was taken to produce relevant evidence. Basically, the action determines whether the selected items both correspond to a standard (e.g., mathematical accuracy) and agree with information in another data population. The control tests in the audit program in Exhibit 9–11 show this two-part design.

REVIEW CHECKPOINTS

9-70 What do the terms "required degree of control compliance" and "actual degree of control compliance" mean?

9-71 How does the degree of control reliance relate to the auditor's control risk assessment?

9-72 What is a control test? Why do auditors perform control tests? What audit evidence is produced by control tests?

9-73 What two parts are important in writing out a control test for an audit program?

One other important aspect of these audit procedures is known as the **direction of the test**. The procedures described in Exhibit 9–11 provide evidence about control over the validity of sales transactions. However, they do not provide evidence about control over completeness of recording all shipments. Another data population, the shipping documents, can be sampled to provide evidence about completeness. The direction of the test idea is illustrated in Exhibit 9–13. For example, if the completeness control is found to be strong, the auditors could omit the year-end procedure of confirming customers' zero-balance accounts receivable to search for unrecorded assets (understatements).

direction of the test: description of the nature of an audit test procedure in terms of whether it involves vouching from the accounting records back to source documents ("grave to cradle") or tracing from the source documents up to the accounting records ("cradle to grave")

Linking back to the discussion in Chapter 6, recall that auditors identify accounting processes, in which the accounts and transactions tend to move together in a cycle, for the purpose of designing audit programs. Taking the revenue/receivables/receipts process as an example, there are two classes of transactions that change the accounts receivable balance: the credit sales transactions and the cash collection transactions. If there is an invalid

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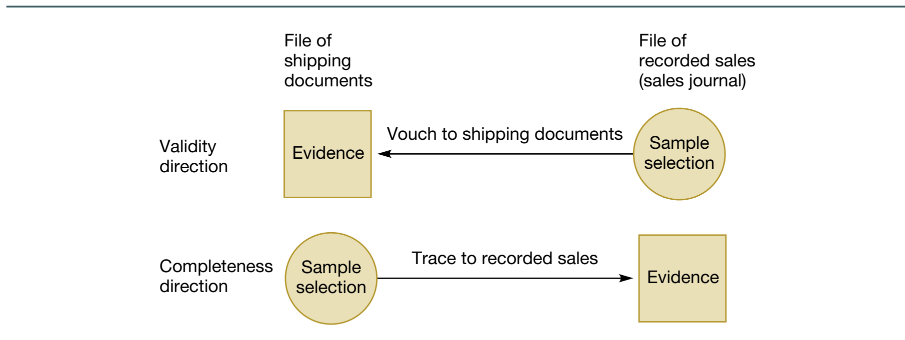
(non-existent) credit sale recorded, both the revenue transaction total and the accounts receivable balance will be overstated (an existence/occurrence assertion misstatement). These misstatements go in the same direction. So, if controls are strong over validity of recording sales, this means controls lower the risk of misstatement in the existence assertion and the auditor can consider getting less substantive evidence regarding that assertion for the accounts receivable balance. On the other hand, if an invalid (non-existent) cash collection transaction is recorded, it would result in the accounts receivable balance being understated (a completeness assertion misstatement). These misstatements go in opposite directions. So, if controls over validity of cash collections are found to be strong, there is less risk of a completeness error and less need for substantive evidence in relation to the risk. Conversely, if control weaknesses are found in transactions classes, this will increase the substantive evidence that must be collected for the related assertions in the balance audit program.

If control tests involve recalculation/reperformance, auditors redo the arithmetic calculations and comparisons that employees were supposed to have performed. This control could be tested by inspection alone—looking to see if the documents were marked with an initial, signature, or stamp indicating they had been checked. Recalculation/reperfomance provides more reliable, first-hand evidence that the control operates effectively. Merely inspecting the control only provides evidence that it exists, not that it operates effectively. Performing both procedures with dual-purpose tests is very cost effective. Much of the cost of control testing is in designing the procedures and selecting the sample to inspect. The marginal cost of extending the work to reperform the calculation or comparison can often be worthwhile. The additional evidence is also substantive in nature, since it would actually detect any material misstatement—hence, the term dual purpose; that is, providing evidence of both control effectiveness and whether any monetary errors have occurred.

EXHIBIT 9–13 Direction of Control Testing



REVIEW CHECKPOINTS

9-74 How does the direction of a control test relate to control objectives?

9-75 What is the difference between inspection and reperformance in control testing?

9-76 What is a dual-purpose test?

Control tests that depend on documentary evidence, such as signatures, initials, checklists, reconciliation working papers, and the like, provide better evidence than procedures that leave no documentary traces. Some control elements, such as segregation of

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employees' duties, may produce no documents. Since reperformance of these control operations cannot be done, a less reliable procedure, observation, must be used: An auditor performs unobtrusive eyewitness observation of employees at their jobs performing control operations.

Control tests should be applied to samples of transactions and control procedures executed throughout the whole period being audited. This is required because the auditor's conclusions about whether controls operated effectively must apply to the whole period covered by the financial statements under audit.

The box below gives an example of a control test that could be included in the internal control program for the sales revenue process. It consists of procedures designed to produce evidence about the effectiveness of an auditee's internal control performance, and now you are ready to obtain the evidence. The control tests listed in the box determine how well the control procedures were followed on the transactions affecting accounts receivable. After each action, the parenthetical note tells you the control objective being tested. This program describes the *nature* of the control testing procedures. Each is a specific application of one of the general control testing techniques.

EXAMPLE OF A CONTROL TEST IN AN INTERNAL CONTROL AUDIT PROGRAM

1. Select a sample of recorded sales invoices and perform the following:
   a. Determine whether a shipping document is attached (evidence of validity).
   b. Determine whether credit was approved (evidence of authorization).
   c. Determine whether product prices on the invoice agree with the approved price list (evidence of authorization and accuracy).
   d. Compare the quantity billed with the quantity shipped (evidence of accuracy).
   e. Recalculate the invoice arithmetic (evidence of accuracy).
   f. Compare the shipment date with the invoice record date (evidence of proper period).
   g. Trace the invoice to posting in the general ledger control account and in the correct customer's account (evidence of accounting).
   h. Note the type of product shipped, and determine proper classification in the right product-line revenue account (evidence of classification).

2. Select a sample of shipping orders and perform the following:
   a. Trace them to recorded sales invoices (evidence of completeness).
   b. The procedures in #1*b*, *c*, *d*, *e*, *f*, and *h* also could be performed on the sales invoices produced by this sample. However, the work need not be duplicated.

3. Select a sample of recorded cash receipts and perform the following:
   a. Trace them to deposits in the bank statement (evidence of validity).
   b. Vouch discounts taken by customers to proper approval or policy (evidence of authorization).
   c. Recalculate the cash summarized for a daily report or posting (evidence of accuracy).
   d. Trace the deposit to the right cash account (evidence of classification).
   e. Compare the date of receipt to the recording date (evidence of proper period).
   f. Trace the receipts to postings in the correct customers' accounts (evidence of accounting).

4. Select a sample of daily cash reports or another source of original cash records and perform the following:
   a. Trace to the cash receipts journal (evidence of completeness).
   b. The procedures in #3*b*, *c*, *d*, *e*, and *f* also could be performed on this cash receipts sample. However, the work need not be duplicated.

5. Scan the accounts receivable for postings from sources other than the sales and cash receipts journals (e.g., general journal adjusting entries, credit memos). Vouch a sample of such entries to supporting documents (evidence of validity, authorization, accuracy, and classification).

REVIEW CHECKPOINTS

9-77 How are control procedures with no documentary evidence tested?

9-78 Why would controls be tested for the whole period being audited?

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Audit Procedures Planned to Respond to Assessed Risks of Material Misstatement

The auditor's control evaluation work links directly to performing further audit procedures. To show this link, the audit standards that result in the auditor's obtaining reasonable assurance on fair presentation of the financial statements are summarized in the box below.

AUDIT PROCEDURES RESPONSIVE TO THE ASSESSED RISKS OF MATERIAL MISSTATEMENT AT THE ASSERTION LEVEL

Overview

The purpose of the auditor's inherent and control risk assessment is to allow the auditor to design and perform appropriate audit procedures that reflect the risks of material misstatement at the assertion level for each class of transaction, account balance, and disclosure.

When the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures, the auditor must obtain audit evidence to determine whether the controls are operating effectively. Control testing would also be required in situations when substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

Control Testing

When the auditor plans to rely on controls over a risk the auditor has determined to be a significant risk, the auditor shall test those controls in the current period.

In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control.

The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls.

If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit. The auditor shall obtain this evidence by performing inquiry combined with observation or inspection, to confirm the understanding of those specific controls. In addition:

a. If there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor shall test the controls in the current audit.
b. If there have not been such changes, the auditor shall test the controls at least once in every third audit, and shall test some controls in each audit to avoid the possibility of testing all the controls on which the auditor intends to rely in a single audit period with no testing of controls in the subsequent two audit periods.

Evaluating the Operating Effectiveness of Controls

When evaluating the operating effectiveness of relevant controls, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective.

When deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether:

a. The tests of controls that have been performed provide an appropriate basis for reliance on the controls;
b. Additional tests of controls are necessary; or
c. The potential risks of misstatement need to be addressed using substantive procedures.

Material Control Weaknesses

The auditor shall evaluate whether, on the basis of the audit work performed, the auditor has identified a material weakness in the operating effectiveness of controls.

The auditor shall communicate material weaknesses in internal control identified during the audit on a timely basis to management at an appropriate level of responsibility and, as required by CAS 260, "Communication with Those Charged with Governance," unless all of those charged with governance are involved in managing the entity.

Substantive Procedures

Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.

The auditor's substantive procedures shall include the following audit procedures related to the financial statement closing process:

a. Agreeing or reconciling the financial statements with the underlying accounting records, and
b. Examining material journal entries and other adjustments made during the course of preparing the financial statements.

Source: Adapted from CAS 330.

Exhibit 9–14 summarizes the auditor's decision process related to internal control in a decision-tree format.

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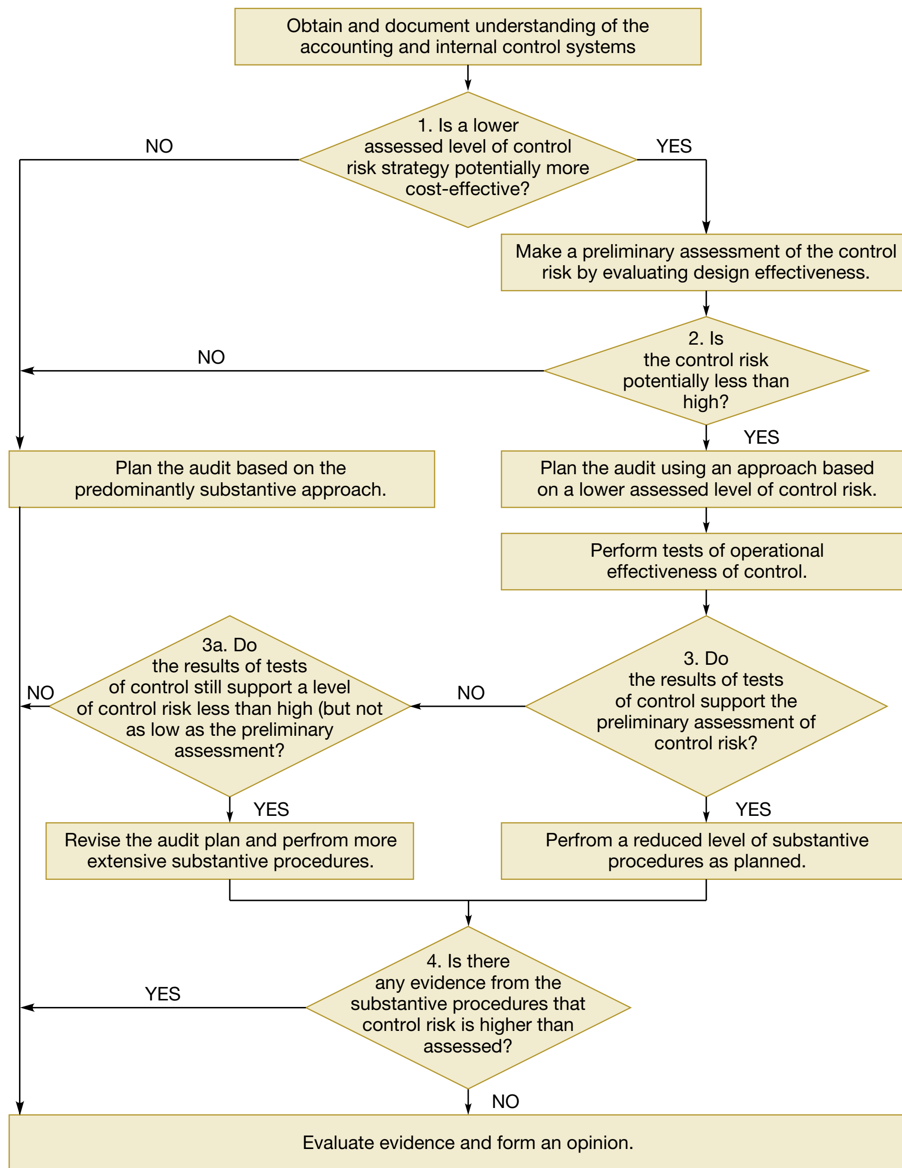
EXHIBIT 9–14 Internal Control Decision Tree



Source: G. Cosserat, "Audit strategy," February 01, 1999, at www.accaglobal.com (Available at http://www2.accaglobal.com/archive/sa_oldarticles/49870).

AUDITOR'S RESPONSIBILITY TO REPORT INTERNAL CONTROL DEFICIENCIES AND FRAUD RISKS

LO7 Outline the auditor's responsibility when internal control evaluation work detects or indicates a significant control weakness or high risk of fraudulent misstatement.

After the auditor has evaluated and tested internal controls, he or she is in a strong position to assess the likelihood of material misstatements. This is a good point to review auditor responsibilities for detecting and communicating misstatements.

Financial misstatements can arise from either error or fraud. A **financial error** is defined as an unintentional misstatement, whereas fraud is intentional. Intent is not

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financial error: an unintentional misstatement of the financial statements; in contrast, fraud (or fraudulent financial reporting), is defined as intentional misstatement

something that the auditor can observe, so it is often difficult to determine, particularly in the case of accounting estimates or the choice and application of accounting principles. Unreasonable accounting estimates may be unintentional or may have been deliberately manipulated to misstate the financial statements. Although an audit cannot determine intent, the auditor still has a responsibility to plan and perform the audit to obtain reasonable assurance that there is no material misstatement, whether intentional or not.[7]

STANDARDS CHECK

CAS 240

35. If the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence. (Ref: Para. A51)
36. If the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is or may be the result of fraud and that management (in particular, senior management) is involved, the auditor shall re-evaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks. The auditor shall also consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained. (Ref: Para. A52)

Source: *CICA Handbook—Assurance,* 2012.

The auditor is responsible for reporting all identified deficiencies in internal control, other than obviously trivial ones, to an appropriate level of management as soon as possible. The appropriate level of management is usually the one at least one level above those responsible for the deficient controls. If the auditor finds that there is an alternative, effective control that achieves the same purpose as the missing one, then there might not be a deficiency or a need to communicate it.

significant control deficiency: when the auditor believes that an identified control deficiency or combination of deficiencies exposes the entity to a serious risk of material misstatement

If the auditor believes an identified control deficiency or combination of deficiencies exposes the entity to a serious risk of material misstatement, it is considered to be a **significant control deficiency**. The auditor has a responsibility to report all significant deficiencies in writing to those charged with governance (audit committee or equivalent). Examples of such deficiencies are a control environment weakness indicating a lack of management competence or integrity, a lack of effective controls over critical accounting processes, a weakness allowing a material misstatement or fraud, or one that increases the entity's susceptibility to fraud. The auditor is required to communicate material weaknesses or other important issues, such as discovery of a fraud or material misstatement, to management and those charged with governance, at various stages of the audit.[8] These communications are two-way: The auditor provides entity officials with information they

STANDARDS CHECK

CAS 265

9. The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. (Ref: Para. A12–A18, A27)
10. The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis: (Ref: Para. A19, A27)
    (a) In writing, significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances; and (Ref: Para. A14, A20–A21)
    (b) Other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management'sattention. (Ref: Para. A22–A26)

Source: *CICA Handbook—Assurance,* 2012.

7 CAS 240, paragraph 2.

8 CAS 260, paragraph 9; 265, paragraphs 9–10.

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need to discharge their responsibilities, and the entity officials provide the auditor with any information they have that is relevant to the audit.

While the auditor's communication to management can be oral rather than written when the control deficiencies are not significant, serious control weaknesses uncovered during the normal performance of the audit are usually communicated in writing to management in a **management letter** (also called a *management control letter*). A copy of the written communication, or a memorandum summarizing the discussion if reported orally, should be placed in the working papers.

management letter: written communication to management of control deficiencies uncovered by the auditor; also called a *management control letter*

Whenever written communication is made, there is potential for misinterpretation, so it is important for the auditor to include a very clear description of the deficiencies identified, their potential effects, and the reasons for the communication. He should also explain that the audit's objective was to express an opinion on the financial statements as a whole, therefore, other deficiencies may exist and other controls not mentioned may not be effective.

Audit requirements for listed public companies in the United States include management reports on internal control effectiveness. This may lead to more audit reporting related to internal control in Canada, although at the time of writing those were not in place. The Canadian Institute of Chartered Accountants (CICA) has issued a practice standard (*CICA Assurance Handbook,* OCS 5925) based on U.S. Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 5 for integrated audits of financial statements and internal control effectiveness, but these audits are voluntary in Canada at this time.

REVIEW CHECKPOINTS

9-79 What are the auditor's reporting responsibilities for internal control deficiencies?

9-80 What is the auditor's responsibility for detecting and communicating misstatements?

9-81 What findings are auditors required to communicate to management? to the audit committee or board of directors?

Under financial institution regulations, Canadian auditors have a "well-being" reporting requirement that includes reporting on significant internal control weaknesses, as described in *CICA Assurance and Related Services Guideline AuG–17*. The matters that need to be reported are shown in the following box.

EXAMPLES OF REPORTABLE CONDITIONS IN FEDERAL INSTITUTIONS LEGISLATION

- Significant weaknesses in internal control, or transactions or events that create risks potentially jeopardizing the institution's ability to continue as a going concern
- Going-concern uncertainties that require disclosure or change in accounting basis
- Reservations in the auditor's opinion
- Indicators of lack of good faith by management
- Contraventions of legislated capital requirements

Source: *CICA Assurance and Related Services Guideline AuG–17*, "Transactions or Conditions Reportable Under the 'Well-Being Reporting Requirement' in Federal Institutions Legislation."

These communication responsibilities highlight the need for the audit to be performed with professional skepticism, which means the auditor should:

1. Be aware of factors that increase the risk of misstatement and take these into account in performing the audit, and
2. Take appropriate action if there is evidence that contradicts the assumption of management integrity.

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Note that many risk factors relate to poor internal controls. If there are enough red flags present, the auditor will assess a higher inherent risk, and, if control risk is also high, these higher assessments will cause the auditor to:

- Obtain more reliable evidence;
- Expand the extent of audit procedures performed;
- Apply audit procedures closer to, or as of, the balance sheet date; and
- Require more extensive supervision of assistants and/or assigning assistants with more experience and training.

In essence, if the auditor suspects that the financial statements are misstated, she or he should perform procedures to confirm or dispel that suspicion.

To summarize, the auditor should inform the appropriate level of management whenever there is evidence of a non-trivial misstatement and weaknesses in internal control that could allow a material misstatement to occur. The audit committee or board of directors should be informed of all significant misstatements and any that appear to be intentional and fraud related. Generally, an auditor is less likely to detect those arising from fraud as there is deliberate concealment involved. (Procedures for fraud detection are discussed in more detail in Chapter 7 and in various examples.)

The auditor should consider obtaining legal advice if he or she has doubts about communicating misstatements to third parties, particularly if the auditor resigned, was removed, or was unable to report on the financial statements.

REVIEW CHECKPOINTS

9-82 How does professional skepticism help financial statement auditors meet their responsibilities to communicate internal control deficiencies?

9-83 How does control risk relate to the risk of material misstatement?

9-84 What action should an auditor take if he suspects the financial statements are materially misstated?

APPLICATION CASE WITH ANALYSIS

Information Systems and Controls in a Small Business

DISCUSSION CASE

After only a year as an audit manager in a mid-sized public accounting firm, Hilda has brought in her first new audit client, Ming Auto Perfection Inc. (Ming). The firm's audit partners are happy that Hilda has shown such initiative so early in her career. Also, the firm recently lost some larger audits clients to the Big Four firms after mergers or buyouts, so the partners now believe their best opportunity for growing their auditing practice is in the small and medium enterprise (SME) sector.

Chi Ming started his business 12 years ago as a car wash in a busy part of the city. A few years later, he married Jin and she joined in the business, with Chi keeping 51% of the shares and Jin receiving 49%. Thanks to Jin's outstanding marketing skills and Chi's strength in operating management, Ming soon expanded from individual car washes to operating a full car cleaning and detailing service for several taxi companies and other businesses in the city. Recently, Ming expanded further, designing and applying advertising material to the sides of taxis and buses. The company has grown successfully and now has six full-time employees and several part-timers.

Recently, Jin decided to move away to care for her aging relatives. She will no longer be activley involved in running the business but will retain her 49% interest. Chi and Jin decided that an independent audit of the company's financial statements would be valuable to them both since it would provide Jin with more comfort about the fairness of the reported profits, even though she will be living in another country. Hilda knows the Mings personally because their sons played in the same hockey league. The Mings have an excellent reputation in the business community, so

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it was an easy decision for the firm to accept Ming as a new auditee.

However, since the firm is fairly new to small and medium-sized entities (SME) auditing, and the partners want to develop this area of practice, they have asked Hilda to use the Ming audit as a basis for developing a robust audit methodology that addresses special concerns in audits of smaller enterprises. Hilda has always been impressed by Jack's grasp of audit theory and his ability to apply it practically, and she thinks it would be both an excellent learning experience for him to draft up the small-business considerations that the firm can use as a general practice guidance and a great opportunity for him to impress the partners right before bonus and promotion time.

Jack meets with Chi to learn about Ming's operations and information systems, and a few key differences from larger organization become apparent. Chi is actively involved, understands all the systems, and can do anyone else's job. Most employees do a number of different accounting tasks, sometimes ones that are incompatible from a control perspective. Most of the accounting information is captured and processed by manual processes and ad hoc computer programs like Excel, Word, and Access. An off-the-shelf accounting package called QuickBooks is used to generate the general ledger and draft financial statements. The office PCs are networked, but there are no user access restrictions; however, they are all in plain sight.

Jack's observations raise a number of questions about the differences between Ming and the larger companies Jack has audited. A good way to begin the SME guidance document for the practice is to consider some key questions Jack will try to answer in this case.

ANALYSIS

Some key questions and related considerations are as follows.

What aspects of good internal control differ between large organizations and small ones?

A company must be large and employ several people (about 10 or more) to have a theoretically appropriate segregation of functional responsibilities and the accompanying high degree of specialization of work. Supervision requires people. There is extensive necessary paperwork and computer control necessary in most large systems. Large organization control theory and practice suggests that people performing in accounting and control roles do not engage in frequent personal interaction across functional responsibility boundaries.

What are the two main features of internal control in a small business?

The small number of people engaged in the accounting and control systems make segregation of functional responsibilities very difficult. Also, the owner-manager is actively involved in the operation of the accounting and control system, making the owner-manager's competence and integrity important considerations for the auditor.

How does the cost of implementing controls affect large businesses differently than small ones?

The theoretical dimensions of good control tend to fit large, not small, businesses. A large company employs enough people to have appropriate segregation of functional responsibilities along with its high degree of specialization of work. There are also enough people to provide supervision and to prepare the paperwork and perform other controls, such as reviews and reconciliations. The computer control necessary in most large systems is extensive and also requires staff to design and implement them. The theory of large organization control also suggests that people performing accounting and control roles do not engage in frequent personal interaction across functional responsibility boundaries, as they usually do in a small business. Small businesses' costs will be affected as they are unlikely to enjoy economies of scale in implementing controls, whereas large business will likely be able to justify the cost of the suggested ideal control policies, procedures, and staffing.

The theory of internal control applies to both large and small businesses as long as the underlying behavioural assumptions are met. However, the fact that small businesses employ only a few people usually means that the required separation of duties is not met, and the entire general theory is less applicable for practical reasons; strict separation of duties, tight authority structure, extensive system of rules and files, and impersonality are harder to satisfy when there are only a few employees operating in an informal manner. The costs of controls are more easily absorbed in a large business, and the benefits of elaborate control structures are also likely to be greater in a large business. In a small business, communications and observation, particularly by the owner-manager, can be highly effective control components.

What impact do the owner-manager role and the lack of complexity have on the internal control requirements of a small business?

Internal control questionnaires designed specifically for small businesses contain more items related to the owner-manager and other key personnel than do large-business questionnaires.

What control risks are related to rapid growth in a small business?

As a small business grows, the transition to more formalized internal control tends to lag behind. For example, the owner-manager may become overburdened with control duties and tacitly delegate these to others but fail to monitor these duties adequately. The need to hire a controller may not be apparent in time to prevent serious and costly breakdowns in the internal controls over financial reporting. The intermediate-sized stage represents a turning point where both owner-manager and auditor need to be very careful. At this point, such measures as limited specialization and surety bonding of employees may help make the transition.

What cost-effectiveness considerations tend to be important in planning small business audits?

Most auditors rely primarily on substantive evidence with small business audits. The minimum documentation

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required in a small business audit is an internal control memorandum with a narrative description of the control system and the results of internal control evaluation. The description should include weaknesses, implications, and recommendations. Generalized audit software applications can be a major advantage, allowing the auditor to obtain a higher degree of audit assurance, at little additional cost.

Auditors can also use trial balance and financial statement software, preparation of audit programs, planning and administration tools, to increase efficiency.

Which important duties are generally not segregated in small business computer systems?

Accounting functions—people in user departments may initiate and authorize source documents, enter data, operate the computer, and distribute output reports.

Computer functions—functions of programming and operating the computer might not be separated; programs and data are often resident on disk at all times and accessible by any operator.

What control techniques can a company use to achieve control over the operation of a PC-based accounting system?

Restricting access to input devices
Standard screens and computer prompting
Online editing and sight verification

What control techniques can a company use to achieve control over the computer processing of accounting data in a PC system?

Transaction logs
Control totals
Balancing input to output
Audit trail

What are the major characteristics and control problems in PC installations?

Characteristics:

Staff and location of the computer—operated by small staff located within the user department and without physical security
Programs—supplied by computer manufacturers or software houses
Processing mode—interactive data entry by users with most of the master files accessible for inquiry and direct update

Control Problems:

Lack of segregation of duties
Lack of controls on the operating system and application programs
Unlimited access to data files and programs
No record of usage
No backup of essential files
No audit trail of processing
No authorization or record of program changes

SUMMARY

This chapter explained the theory and practice of auditors' involvement with an auditee's internal control.

- The distinction between management's and the auditor's responsibilities with respect to internal control was explained. Elements of the accounting system were described in conjunction with control procedures management has designed and implemented to prevent, detect, and correct misstatements that occur in transactions. These misstatements were systematized in a set of seven categories of misstatements that can occur.
- The reasons auditors assess the control risk were discussed. The control understanding and risk assessment allow the auditor to plan a cost-effective audit, including a decision on whether to use a substantive approach or combined approach. It presented the cost-benefit and reasonable assurance considerations that affect the auditor's choice of audit approach with respect to relying on controls and the extent to which substantive work will be used in forming the audit opinion. It was shown that understanding the auditee's business and information systems is relevant to control understanding.
- A reverse expression of the seven categories of potential misstatements yielded the seven control objectives an organization wishes to achieve. These control objectives were related to management's assertions found in financial statements.
- Control activities were organized under the headings of general controls and application controls. The main types of general controls were explained. The control techniques management implements for addressing the control objectives as they relate to input, processing, and output of data in each accounting process were discussed. The explanations of these integrated IT-based accounting systems with control consideration.

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- Documentation of an accounting information system and its application control activities includes control questionnaires, flow charts, and narratives. Questionnaires and flow charts were demonstrated. This then led to the test of controls decisions and the cost-reduction reasons for doing work to obtain a low control risk assessment. The assessed control risk was connected to the control risk component in the audit risk model (covered in Chapter 6). Control evidence was linked to audit programs by presenting a bridge working paper. The chapter also reviewed and compared considerations for auditing IT-based and manual information systems and controls.
- The design of control test procedures for an internal control program was presented. The relation between the direction of testing classes of transactions and the control objectives the test results are relevant to were discussed. The link between the control test findings, control risk assessment, and the impact on risk of material misstatement in the assertions of the related account balance were discussed in terms of the impact on the need to do further substantive procedures. The chapter also provides a summary of key auditing standards requirements related to control risk assessment, control testing, and their relation to substantive procedures. The discussion of control risk assessment provided some basis for the theory and practice of audit sampling, which is covered next, in Chapter 10.
- The chapter discussed the auditor's responsibilities for communicating with management and those charged with governance when control work reveals a significant control deficiency, a fraudulent misstatement, or a high risk of one occurring.

To be able to summarize the role of information systems and control in (a) capturing relevant information from the organization's business environment and activities and (b) processing it into the financial statements and disclosures that contain management assertions about the organization's performance and financial position, it may be helpful to review the big picture overview of the financial reporting process presented in Exhibit 6–19 in Chapter 6.

This chapter concluded with the Application Case given above showing how control theory and evaluations apply to small businesses.

KEY TERMS

authorization
bridge working papers
clean audit
combined audit approach
completeness
control strengths
control weaknesses
direction of the test
financial error
internal control questionnaire
key controls
management letter
significant control deficiency
substantive audit approach
validity

EXERCISES AND PROBLEMS

EP 9-1 **Internal Control Understanding and Assessment.** LO1, LO3, LO4, LO5 Assume that when conducting procedures to obtain an understanding of the control structure in the Denton Seed Company, you checked "No" to the following internal control questionnaire items (selected from those illustrated in the chapter):

- Does access to online files require specific passwords to be entered to identify and validate the terminal user?
- Are control totals established by the user prior to submitting data for processing? (Order entry application subsystem)
- Are input control totals reconciled to output control totals? (Order entry application subsystem)

Required:

a. Describe the misstatements due to error or fraud that could occur because of the weaknesses indicated by the lack of controls.

b. Explain the impact these control weaknesses would have on the audit approach selected and on the design of the audit programs.

EP 9-2 **Approach for Internal Control Assessment.** LO2, LO3 One of the things you can do in a logical approach to the assessment of internal control is imagine what

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types of errors could occur with regard to each significant class of transactions. Assume a company has the significant classes of transactions listed below.

Required:

For each one, identify one or more errors that could occur and name the accounts that would be affected if proper controls were not specified or followed satisfactorily.

1. Credit sales transactions
2. Raw materials purchase transactions
3. Payroll transactions
4. Equipment acquisition transactions
5. Cash receipts transactions
6. Leasing transactions
7. Dividend transactions
8. Investment transactions (short term)

EP 9-3 Key Control, Control Test Evaluation. LO3, LO4, LO5, LO6 The auditor learns that the auditee has a control procedure in place that addresses the validity of sales and existence of accounts receivable. When a truck driver picks up goods from the warehouse, the warehouse employee has the driver sign a "shipper's receipt" showing the quantities and item numbers shipped, and the customer information. The shipper's receipts are filed in date order in the warehouse office. A copy of the signed shipper's receipt is sent to the accounting office where it is used to record the reduction in inventory and issue a sales invoice. The invoice number is noted on the shipper's receipt and it is filed by invoice number in the accounting area. Since the auditee has a large number of customers, the auditor decides this is a key control that will be tested.

Required:

a. Why would the auditor decide this is a key control?

b. What will the auditor achieve by testing this control?

c. Design a control test the auditor could perform for this control procedure. Describe the two parts of the test in detail.

d. Assume the auditor performs a control test and finds the control procedure operated properly 95% of the time. How does this evidence affect the auditor's control risk assessment? What if the control operated 60% of the time? 99% of the time?

EP 9-4 Online Sales, Audit Procedures. LO3, LO4, LO5, LO6 Online retailers, such as Amazon.com or Grocerygateway.com, make use of online customer order forms to allow customers to input all the required sale, delivery, and payment data.

Required:

a. Identify control procedures that can be used in an online sales order system and the risk(s) each addresses.

b. How would the revenue control objectives be audited in an online retail sales business?

EP 9-5 Auditee's Control Procedures and Audit Programs. LO3, LO4, LO5, LO6 To test an organization's internal control procedures, auditors design a test of controls audit program. This audit program is a list of control tests to be performed, and each is directly related to an important auditee control procedure. Auditors perform the tests to obtain evidence about the operating effectiveness of the auditee's control procedures.

Required:

The controls listed below relate to a system for processing sales transactions. Each numbered item indicates an error or irregularity that could occur, and specifies a control procedure that could prevent or detect it. Identify the control objective satisfied by the auditee's control procedure. Write the test of controls audit program by specifying an effective control test to produce evidence about the auditee's performance of the control procedure. [Hint: A control test is a two-part statement consisting of (1) identification of a data population from which a sample can be drawn and (2) expression of an action to take.]

1. The company wants to avoid selling goods on credit to bad credit risks. Poor credit control could create problems with estimating the allowance for bad debts and a potential error by overstating the realizable value of accounts receivable. Therefore, the control procedure is as follows. Each customer order is to be reviewed and approved for 30-day credit by the credit department supervisor. The supervisor then notes the decision on the customer order, which eventually is attached to copy 2 of the sales invoice and filed by date in the accounts receivable department. The company used sales invoices numbered 20,001 through 30,000 during the period under review.
2. The company considers sales transactions complete when shipment is made. The control procedures are as follows: Shipping department personnel prepare prenumbered shipping documents in duplicate (sending one copy to the customer and filing the other copy in numerical order in the shipping department file). The shipping clerk marks up copy 3 of the invoice, indicating the quantity shipped, the date, and the shipping document number, and sends it to the billing department where it is taken as authorization to complete the sales recording. Copy 3 is then filed in a daily batch in the billing department file. These procedures are designed to prevent the recording of sales (i) for which no shipment is made or (ii) before the date of shipment.
3. The company wants to control unit pricing and mathematical errors that could result in overcharging or undercharging customers, thus producing the errors of overstatement or understatement of sales revenue and accounts receivable. The accounting procedures are as follows: Billing clerks use a catalogue list price to price the shipment on invoice copies 1, 2, and 3. They compute the dollar amount of the invoice. Copy 1 is sent to the customer. Copy 2 is used to record the sale and later is filed in the accounts receivable department by date. Copy 3 is filed in the billing department by date.
4. The company needs to classify sales to subsidiaries apart from other sales so that the consolidated financial statement eliminations will be accurate. That is, the company wants to avoid the error of understating the

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elimination of intercompany profit and, therefore, overstating net income and inventory. The control procedure is as follows: A billing supervisor reviews each invoice copy 2 to see whether the billing clerk imprinted sales to the company's four subsidiaries with a big red "9" (the code for intercompany sales). The supervisor does not initial or sign the invoices.

EP 9-6 Control Objectives, Procedures, Assertions, and Tests. LO3, LO4, LO5, LO6 Exhibit EP9–6 contains an arrangement of examples of transaction errors (lettered *a*–*g*) and a set of auditee control procedures and devices (numbered 1–15). You should photocopy Exhibit EP9–6 to use for completing the requirements of this question.

EXHIBIT EP9–6

a. Sales recorded, goods not shipped
b. Goods shipped, sales not recorded
c. Goods shipped to a bad credit risk customer
d. Sales billed at the wrong price or wrong quantity
e. Product line A sales recorded as Product line B
f. Failure to post charges to customers for sales
g. January sales recorded in December

Control Procedures	g	f	e	d	c	b	a
1. Sales order approved for credit							
2. Prenumbered shipping doc prepared, sequence checked							
3. Shipping document quantity compared to sales invoice							
4. Prenumbered sales invoices, sequence checked							
5. Sales invoice checked to sales order							
6. Invoiced prices compared to approved price list							
7. General ledger code checked for sales product lines							
8. Sales dollar batch totals compared to sales journal							
9. Periodic sales total compared to same period accounts receivable postings							
10. Accountants have instructions to date sales on the date of shipment							
11. Sales entry date compared to shipping document date							
12. Accounts receivable subsidiary totalled and reconciled to accounts receivable control account							
13. Intercompany accounts reconciled with subsidiary company records							
14. Credit files updated for customer payment history							
15. Overdue customer accounts investigated for collection							

Required:

a. Opposite the examples of transaction errors lettered *a*–*g* in Exhibit EP9–6, write the name of the control objective organizations wish to achieve to prevent, detect, or correct the error.

b. Opposite each numbered control procedure, place an X in the column that identifies the error(s) the procedure is likely to control by prevention, detection, or correction.

c. For each error/control objective, identify the financial statement assertion most benefitted by the control.

d. For each company control procedure numbered 1–15 in Exhibit EP9–6, write an auditor's control test that could produce evidence on the question of whether the company's control procedure has been installed and is operating effectively.

EP 9-7 Controls and Control Weaknesses in Purchasing System. LO3, LO4, LO5, LO6, LO7

Part A

The following are internal control procedures found in the purchases and payment process of your auditee, Integrated Measurement Systems Inc.

Required:

For each control procedure:

a. Explain the type of control that is being applied.

b. Identify the control objective(s) that the control procedure meets.

c. Describe in detail one test of controls the auditor could perform to test the effectiveness of the control.

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Control 1
Purchase requests from operating departments are authorized by the appropriate person in the requesting department.

Control 2
The purchasing clerk verifies that there is a signature on the purchase request (PR) and then issues a pre-numbered purchase order (PO) for the items required. The purchasing clerk retains copies of the PR and the PO and files them by PO number.

Control 3
The purchasing manager reviews the PO to see whether the purchase request is authorized, and, if so, approves it and forwards it to the buyer.

Control 4
The Buyer must select a vendor from a pre-approved list for all POs over $5000. For POs under $5000 the Buyer can select any vendor.

Control 5
The Receiver who accepts the goods into the warehouse verifies that the quantity received matches the bill of lading (BL), and signs on behalf of Integrated Measurement Systems for receipt of the goods listed on the BL. If there is a discrepancy in the quantity received, the receiver does not sign the BL; the BL is sent to the Buyer to resolve the problem with the vendor.

Control 6
The purchasing clerk matches the signed BL with the filed copies of the PO and PR.

Part B

The following are internal control weaknesses found in the purchases and payment process of your auditee, Integrated Measurement Systems.

Required:
For each control weakness:

d. Describe the control risk that exists because of the weakness—what could go wrong?
e. Explain whether a monetary financial statement misstatement could result because of the weakness, and, if so, what it would be.
f. Describe in detail the impact the weakness will have on your other audit procedures.

Control Weakness 1
The purchasing clerk does not verify that the PRs are authorized by an appropriate person in the operating department, but only checks that there is a signature on the document.

Control Weakness 2
Access to the warehouse is not controlled and anyone can enter and leave anytime.

Control Weakness 3
The receiver does not match the BL to an authorized PO.

EP 9-8 **Explain Computer Control Procedures.** LO2 and LO4 At a meeting of the corporate audit committee attended by the general manager of the products division and you, representing the internal audit department, the following dialogue took place:

Jiang (committee chair): Mr. Marks has suggested that the internal audit department conduct an audit of the computer activities of the products division.
Smith (general manager): I don't know much about the technicalities of computers, but the division has some of the best computer people in the company.
Jiang: Do you know whether the internal controls protecting the system are satisfactory?
Smith: I suppose they are. No one has complained. What's so important about controls anyway, as long as the system works?

Jiang turns to you and asks you to explain IT control policies and procedures.

Required:
Address your response to the following points:

a. State the principal objective of achieving control over (i) input, (ii) processing, and (iii) output.
b. Give at least three methods of achieving control over (i) source data, (ii) processing, and (iii) output.

EP 9-9 **Testing Computer Processing.** LO3 and LO4 An experienced auditor remarked that it is only necessary to check the additions and extensions on one invoice generated by an IT-based system, because if the computer program does one invoice correctly it will do them all correctly, so there is no point in testing a statistical sample of invoices.

Required:

a. Comment on whether or not you agree with this statement. Give your reasons.
b. Assume that a company had effective controls over program changes in prior years, but during the current year a new programmer was hired who was not qualified for the job and did not document changes to the programs that were made during the year. Would this fact have an impact on your response for (*a*)?

EP 9-10 **Controls Tests and Errors/Irregularities.** LO4 The four questions below are taken from an internal control questionnaire. For each question, state (i) one control test you could use to find out whether the control technique was really used, and (ii) what error could occur if the question were answered "no," or if you found the control was not effective.

1. Are blank (sales) invoices available only to authorized personnel?
2. Are (sales) invoices checked for the accuracy of quantities billed? prices used? mathematical calculations?
3. Are the duties of the accounts receivable bookkeeper separate from any cash functions?
4. Are customer accounts regularly balanced with the control account?

EP 9-11 **Control Risk Assessment, Online Input.** LO4 The Canada Revenue Agency has introduced "e-filing." Registered tax professionals can submit taxpayers'

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annual income tax returns online over the Internet. The taxpayer's annual return information is automatically entered into the tax department's computer system. No paper forms or receipts need to be submitted, but the taxpayer must retain them because tax department auditors might ask to see them in the future. The tax return and any refund due are processed much more quickly than when paper forms are mailed in. A refund can be electronically deposited to the taxpayer's bank account, sometimes within one week.

Required:
Comment on the control strengths and weaknesses of the e-file system. In the case of weaknesses, provide recommendations on how they can be compensated for.

EP 9-12 IT Risks and Controls. LO4 The strengths of the IT general controls collectively provide an appropriate foundation for maintaining the integrity of information, the security of data, and the efficient operation of application controls. Weaknesses in IT general controls increase the risk of material misstatement at the financial statement level and undermine the effectiveness of specific IT application controls.

Required:
For each of the following four IT control risks, describe one control that an organization could have in place to reduce the risk of material misstatement, and explain specifically how the risk is reduced.

a. No policies/procedures exist to ensure effective IT management or IT staff supervision.
b. No alignment exists between business objectives, risks, and IT plans.
c. Reliance is placed on systems/programs that are inaccurately processing data or processing inaccurate data.
d. Unauthorized access to data makes it possible for destruction of data, improper changes, unauthorized or non-existent transactions, or inaccurate recording of transactions.

DISCUSSION CASES

DC 9-1 Backup Procedures, Availability of Data for Audit tests. LO1, LO2, LO3, LO4, LO5, LO6 Whistler Corp. is a new audit engagement for your firm. Whistler backs up all its sales transaction detailed data for each month on a portable hand-held disk drive. The drive is retained offsite for three months and then reused. This system is used because the company only has four drives, which cost over $100 each, and offsite storage charges are on a per-drive basis. The Whistler information system manager considers this to be a cost-effective backup procedure. Following the request of their former auditors, Whistler retains backup drives for December (the year-end) and the following January until the financial statement audit is completed. The audit is usually completed by the end of April.

Required:

a. Discuss the impact of this backup procedure on Whistler's control risk. Suggest alternate feasible approaches Whistler's management could use to improve internal control and explain fully how your recommendations improve control and reduce risk. How would you communicate such recommendations to management?
b. Discuss the impact Whistler's backup procedure has on your audit approach. Consider any limitations it may impose on audit tests or analytical procedures, or the possibility of your firm's using a combined audit approach. Suggest alternative feasible approaches that may improve your audit scope.

DC 9-2 Control Risk Assessment and Testing-Costs and Benefits. LO1, LO2, LO3, LO4, LO5, LO6 The following are narrative descriptions of sales systems and controls for these two different businesses.

Avocet Inc.
Avocet is a franchise fast food restaurant business. When customers order food, the counter person presses the appropriate buttons on the cash register. There is a button for each menu item. The point of sale (POS) system retrieves the current item prices from the price files, extends for quantities ordered, and displays the sale total on the cash register screen. A sales entry is also generated in the daily sales register. The customer's payment is then entered and their food order is displayed on a screen in the food preparation area. The POS system generates a cash receipt entry for the cash register and also in the daily cash receipts register. Food preparation staff put together the order and place it in the pick-up area behind the front counter. When the food order is filled, the staff clears the order from the system; this generates an entry in the inventory system to remove the food and packaging items sold from the perpetual inventory listing.

A restaurant manager is on duty at all times. The manager circulates between the counter and food services areas, observing that cash received is placed in the register and spot-checking that food orders match with cash sales. If a customer receives an incorrect order, the manager can void the sale entry using a special key in the cash register and a secret password for the POS entries. A corrected order is then input by the usual method, if required. At the close of each day's business, the cash in the register is totalled and agreed to the cash, debit card, and credit card slips collected in the register during the day. Differences of less than $10 are recorded in an account named "Cash over/under." Larger discrepancies will be

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investigated by scrutinizing the day's entries and interviewing all counter people using the register. The sales and cash information from the POS is then uploaded over a phone line to the franchise company head office, where it is consolidated with the reports from all the restaurants in the system. On a weekly basis, the food and packaging inventory on hand in the restaurant is counted and reconciled to the inventory system. The inventory usage is also compared with the sales records for reasonability.

Bobolink Limited
Bobolink is a new-car dealership. Once a customer has decided to buy a car, the car salesperson fills out a purchase agreement form, including the description of the car, the serial number, and the name and address of the purchaser. The agreed sale price is entered, along with any extras, such as options or extended warranties, any allowance for a used car traded in, additional dealer preparation fees, licensing fees, and various taxes. A second form is used outlining the car purchase financing. The financing can be cash, a bank loan prearranged by the customer, or a lease arranged by Bobolink's financing company. Both forms are reviewed by the customer, and if they are satisfactory, the customer signs. The salesperson then takes the signed forms to the dealership's general manager for review and approval. If payment is by cash, the cash is given to the general manager at this point. Any discrepancies in the payment or paperwork are corrected and must be agreed to by the customer. Once the sales documents are completed, the ownership papers and keys are handed over to the customer, who drives away with the car. The sales documents are faxed to the car manufacturer's sales head office for inventory and warranty purposes, and to the bank or leasing company, if applicable. The sales information is entered by the Bobolink bookkeeper to the financial system and the inventory system. The bookkeeper follows up on collection of the funds from the bank or leasing company, which usually takes two to three days. The sales information is also set up in the dealership management system for purposes of sales incentives and commissions, future service work, and sales follow-up.

Required:

a. Compare and contrast the control risks in these two businesses.
b. Identify input, processing, and output control procedures that exist in each business, including the control objective for each.
c. Comment on whether each business control system relies on prevention of errors, early detection of errors, or later detection and correction. Do you think the control method designed by management in each business is the most effective and efficient system for its particular control risks? Can you recommend any more cost-effective control techniques?
d. Identify control strengths and weaknesses in the two sales systems in relation to the seven control objectives described in the chapter.
e. Assume you are required to test controls in both these audits. Write controls tests that address all the control objectives. Also, indicate which financial statement assertion(s) each control test addresses.
f. Assume that it is your responsibility to decide whether to rely on controls in these two audits. Evaluate the cost-benefit tradeoff of testing controls in both businesses and recommend an audit approach for each, giving your reasons.

DC 9-3 Costs and Benefits of Control. LO1, LO2, LO3, LO5 The following questions and cases deal with the subject of cost-benefit analysis of internal control. Some important concepts in cost-benefit analysis are as follows:

1. Measurable benefit. Benefits or cost savings may be measured directly or may be based on estimates of expected value. An expected loss is an estimate of the amount of a probable loss multiplied by the frequency or probability of the loss-causing event. A measurable benefit can arise from the reduction of an expected loss.
2. Qualitative benefit. Some gains or cost savings may not be measurable, such as company public image, reputation for regulatory compliance, customer satisfaction, and employee morale.
3. Measurable costs. Controls may have direct costs such as wages and equipment expenses.
4. Qualitative cost factors. Some costs may be indirect, such as lower employee morale created by over-controlled work restrictions.
5. Marginal analysis. Each successive control feature may have marginal cost and benefit effects on the control problem.

Case A
Porterhouse Company has numerous bank accounts. Why might management hesitate to spend $20,000 (half of a clerical salary) to assign someone the responsibility of reconciling each account every month for the purpose of catching the banks' accounting errors? Do other good reasons exist to justify spending $20,000 each year to reconcile bank accounts monthly?

Case B
Harper Hoe Company keeps a large inventory of hardware products in a warehouse. Last year, $500,000 was lost to thieves who broke in through windows and doors. Josh Harper figures that installing steel doors with special locks and burglar bars on the windows at a cost of $25,000 would eliminate 90% of the loss. Hiring armed guards to patrol the building 16 hours a day at a current annual cost of $75,000 would eliminate all the loss, according to officials of the Holmes Security Agency. Should Josh arrange for one, both, or neither of the control measures?

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Case C

The Merry Mound Cafeteria formerly collected from each customer as he or she reached the end of the food line. A cashier, seated at a cash register, rang up the amount (displayed on a digital screen) and collected money. Management changed the system, and now a clerk at the end of the line operates a calculator/printer machine and gives each customer a paper tape. The machine accumulates a running total internally. The customer presents the tape at the cash register on the way out and pays.

The cafeteria manager justified the direct cost of $30,000 annually for the additional salary and $500 for the new machine by pointing out that he could serve four more people each weekday (Monday through Friday) and 10 more people on Saturday and Sunday. The food line now moves faster and customers are more satisfied. (The average meal tab is $12, and total costs of food and service are considered fixed.) "Besides," he said, "my internal control is better." Evaluate the manager's assertions.

Case D

Assume, in the Merry Mound situation cited above, that the better control of separating cash custody from the end-of-food-line recording function was not cost beneficial, even after taking all measurable benefits into consideration. As an auditor, you believe the cash collection system deficiency is a significant deficiency in internal control, and you have written it as such in your letter concerning reportable conditions, which you delivered to Merry Mound's central administration. The local manager insists on inserting his own opinion on the cost-benefit analysis in the preface to the document that contains your report. Should you, in your report, express any opinion or evaluation on the manager's statement?

DC 9-4 Controls, Fraud Risk. LO1, LO2, LO7 The SB Construction Company has two divisions. The president, Su, manages the roofing division. Su has delegated authority and responsibility for management of the modular manufacturing division to Jon Gee. The company has a competent accounting staff and a full-time internal auditor. Unlike Su, however, Gee and his secretary handle all the bids for manufacturing jobs, purchase all the materials without competitive bids, control the physical inventory of materials, contract for shipping, supervise the construction work, bill the customers, approve all bid changes, and collect the payment from customers. With Su's tacit approval, Gee has asked the internal auditor not to interfere with his busy schedule.

Required:

a. Discuss the internal control in this fact situation and identify fraud risks that could arise.

b. Assume you are the independent external auditor of SB. Explain your responsibilities to report on this situation to SB's management and board of directors.

DC 9-5 Cash Receipts Control. LO3, LO4, LO5 Sally's Craft Corner was opened in 2003 by Sally Moore, a fashion designer employed by Bundy's Department Store. Sally is employed full-time at Bundy's and travels frequently to shows and marts in Vancouver, Montreal, and Toronto. She enjoys crafts, wanted a business of her own, and saw an opportunity in Vancouver. The Corner now sells regularly to about 300 customers, but business only began to pick up in 2010. The staff presently includes two salespeople and four office personnel, and Sally herself helps out on weekends.

Sales have grown, as has the Corner's reputation for quality crafts. The history is as follows:

	SALES	DISCOUNTS AND ALLOWANCES	NET SALES
2006	$164,950	$ 5,000	$159,950
2007	185,750	5,500	180,250
2008	176,100	5,200	170,900
2009	183,800	5,700	178,100
2010	239,500	9,500	230,000
2011	294,700	14,800	279,900
2012	372,300	$22,300	350,000

With an expanding business and a need for inventory, the Corner is now cash poor. Prices are getting higher every month, and Sally is a little worried. The net cash flow is only about $400 per month after allowance of a 3% discount for timely payments on account. So, she has engaged you as auditor and also asks for recommendations you might have about the cash flow situation. The Corner has never been audited.

During your review of internal control, you have learned the following about the four office personnel:

Janet Bundy is the receptionist and also helps customers. She is the daughter of the Bundy Department Store owner and a longtime friend of Sally. Janet helped Sally start the Corner. They run around together when Sally is in town. She opens all the mail, answers most of it herself, but turns over payments on account to Sue Kenmore.

Sue Kenmore graduated from high school and started working as a bookkeeper-secretary at the Corner in 2010. She wants to go to university but cannot afford it right now. She is very quiet in the office, but you have noticed she has some fun with her friends in her new BMW. In the office, she gets the mailed-in payments on account from Janet, takes payments over the counter in the store, checks the calculations of discounts allowed, enters the cash collections in the cash receipts journal, prepares a weekly bank deposit (and mails it), and prepares a list (remittance list) of the payments on account. The list shows amounts received from each customer, discount allowed, and amount to be credited to customer's account. She is also responsible for approving the discounts and credits for merchandise returned.

Ken Murphy has been the bookkeeper-clerk since 20X6. He also handles other duties. Among them, he

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receives the remittance list from Sue, posts the customers' accounts in the subsidiary ledger, and gives the remittance list to David Roberts. Ken also prepares and mails customers' monthly statements. Ken is rather dull, interested mostly in hunting on weekends, but is a steady worker. He always comes to work in a beat-up pickup truck—an eyesore in the parking lot.

David Roberts is the bookkeeping supervisor. He started work in 20X7 after giving up his small practice as a PA. He posts the general ledger (using the remittance list as a basis for cash received entries) and prepares monthly financial statements. He also approves and makes all other ledger entries and reconciles the monthly bank statement. He reconciles the customer subsidiary records to the accounts receivable control each month. David is very happy not to have to contend with the pressures he experienced in his practice as a PA.

Required:

a. Draw a simple flow chart of the cash collection and bookkeeping procedures.

b. Identify any reportable conditions or material weakness in internal control. Explain any reasons why you might suspect that errors or irregularities may have occurred.

c. Recommend corrective measures you believe necessary and efficient in this business.

DC 9-6 Tests of Controls, IT-Based Sales System. LO4, LO6 Garganey Corp. manufactures automobile dashboards and interior components for Big Motors Inc. (BMI). BMI requires that all its suppliers be connected to its computerized procurement and manufacturing system. BMI's production planning system generates components requirements lists, which are then transferred electronically to various suppliers' computers for them to bid on. Garganey's production system calculates the cost of manufacturing the components at the required times, including materials, labour, overtime charges, overhead, and profit. Garganey makes a bid on the order and, if its bid is accepted by BMI, BMI's production schedule for that component is downloaded to Garganey's production system so that the required parts will be manufactured and delivered to BMI's plants at the times they are required in the BMI assembly lines. When the components are completed, Garganey's system generates a shipping instructions document, which is signed by the trucking company that picks up the components and delivers them to BMI. When the components arrive at BMI, they are inspected and, if approved, payment for the order is automatically transferred from BMI's bank account to Garganey's bank account. Any adjustments for quantities short-shipped are deducted from the amount BMI transfers and an adjustment memo is communicated electronically to Garganey's sales system.

Required:

Develop an internal control audit program that will generate evidence about the effectiveness of Garganey's internal controls. Using the tests of controls procedures described in the chapter as a starting point, adapt the procedures to be suitable for the IT-based sales system used by Garganey.

DC 9-7 Flow chart Control Points. LO4, LO5, LO6 Each number of the flow chart in Exhibit DC9-7 locates a control point in the labour processing system of your auditee, Alouette Inc.

Required:

a. Make a list of the control points, and, for each point, describe the type or kind of internal control procedure that ought to be specified.

b. Assume that Exhibit DC9-7 is the system description in Alouette's prior year's audit file. During the current year, the company converted to an electronic security card system. Each employee is issued a security card with a magnetic stripe containing his or her identity code. At the start of the shift the employee swipes his or her security card to enter the factory floor. Using an internal clock, the scanner generates a start time entry in the system's attendance detail records file. The employee then reports to the floor supervisor to be assigned to a job for his or her shift. The supervisor uses a terminal that displays a real-time list of checked-in employees, and enters the job number assignment beside the employee's name. The job costing system automatically creates an open daily job transaction entry. At the end of the shift the employee swipes his or her card to exit the factory floor and the total shift time is entered to the open job transaction. The daily job transaction entry is then closed and a labour charge entry for the employee's shift is generated in the job costing system and in the payroll file.

You have been assigned to assess controls for the current year audit. Update Exhibit DC9-7 to reflect the new employee attendance and job costing systems described above. Identify control points in the new systems, and indicate control procedures that should be used to prevent errors in payroll and job costing.

DC 9-8 Audit Approach, Computer Service Organization. LO2, LO4 Eider Equipment Leasing Limited is in the financing lease business. It uses a service organization to compute lease payment schedules. Eider's customers sign standard equipment leases ranging from 3 to 15 years. The details of the leases are summarized and sent to the service organization for generating the schedules. Hard copy reports from the service organization are delivered to Eider monthly and used by its bookkeeper to generate entries in the company's general ledger system, which is run on a popular accounting software package.

Required:

a. Design two or more appropriate audit approaches for verifying leasing revenues in this auditee.

b. List factors that would indicate which approach will be most efficient and effective.

DC 9-9 Audit Approach Decision, Combined or Substantive. LO2, LO4 Golden Years Inc. owns and operates 20 rental retirement properties. It has a total of 9000 one-bedroom and 3000 two-bedroom rental units. Tenants pay rent monthly by giving a cheque to the property manager. The manager deposits the cheques at the nearest branch of Golden Years' bank and sends the deposit information and tenant listing to Golden

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EXHIBIT DC9-7

1

Beginning of shift attendance

Employee badge

Clock in

Card punch

Punched card record of clock in

Collect cards 20 min. after check-in time

Card to tape

2

Atten-dance detail records

Employee identity master tape

Process atten-dance data. Post to employee.

Direct access file by employee no.

3

Exception attendance report to foreman

4

Job time recording

Employee badge

Special cards (in rack)

Job cards (with job)

5

Record beginning and end of job and key in job data

Card punch

Collect and process periodically

Job transaction card

Post transaction

Direct access file by employee No.

6

Rejected transactions for analysis and correction

Years' head office, where the accounting manager enters the information into the sales journal and general ledger. The Accounting Manager reconciles the bank statements monthly.

You are in charge of auditing Golden Years' revenues and receivables for its 20X3 year-end. Golden Years's draft financial statements report rental revenues of $102.6 million, tenant receivables of $400,000, and net income is $5.9 million.

Required:

a. Indicate whether you would use a substantive or combined approach to audit Golden Years's revenues, giving your reasons.

b. Develop an audit program (list of audit procedures) to provide sufficient appropriate evidence that the rental revenues reported in the company's 20X3 financial statements are not materially misstated.

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APPENDIX 9A

Internal Control Assessment Aids for Audit Planning

This appendix provides an aid that auditors can use to assess company-level controls and control activities. Exhibit 9A–1 below provides an example of an internal control questionnaire for company-level controls and control activities. Its points apply to all the processes and accounting cycles that will be covered in Chapters 11 through 14 of Part 3 of the text. We will provide separate detailed internal control questionnaires for the controls related to each process in the relevant chapters, after the nature of each business process and accounting cycle has been explained: revenues/receivables/receipts (Chapter 11); purchases/payables/payments (Chapter 12); production and payroll (Chapter 13); and finance and investment (Chapter 14).

This aid can give you a sense of how auditors apply professional judgment to decide on the appropriate approach to obtaining assurance from control and substantive evidence in planning a particular audit engagement.

EXHIBIT 9A–1 Internal Control Questionnaire for Company-Level Controls and Control Activities

This questionnaire is designed to assist the auditor in assessing the strength of internal control. Internal control is divided into company-level controls and control activities.

- Company-level controls are: the overall control environment, management's risk assessment procedures, information systems and communication, and monitoring.
- Control activities include general and application controls. General controls are policies and procedures that apply to all information systems and business processes. Application controls are those that are specific to each of the main operating processes and their related accounting cycles.

INTERNAL CONTROL QUESTIONNAIRE

AUDITEE: ____________________

F/S PERIOD: ____________________

COMPANY-LEVEL CONTROLS	Auditor Responses	Audit File References
CONTROL ENVIRONMENT The control environment refers to management's overall attitude, awareness, and actions concerning the importance of internal control to address the risks of the business and reduce inherent risks and the risk of a material misstatement. Consider the following aspects and evidence of strength or weakness: **"Tone at the Top"** • Do management actions and attitudes show character, integrity, and ethical values? • Are audit committee and board of directors (or others responsible for governance of the organization) competent, knowledgeable, actively involved, and influential in the organization? • Does management have well-defined policies and objectives that communicate its commitment to integrity and ethical values? **Commitment to Competence** • Does management have sufficient experience to operate the business? • Does management assign authority and responsibility appropriately?		

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EXHIBIT 9A–1 Continued

COMPANY-LEVEL CONTROLS	Auditor Responses	Audit File References
• Does management provide accounting and key employees with the resources, training, and information necessary to discharge their duties? • Do management's hiring and promotion policies emphasize competence and trustworthiness? Management's Operating Style and Philosophy • Does management encourage a strong control environment? • Does the organizational structure provide a framework for establishing key areas of authority, responsibility, and reporting lines that promote strong internal control at all stages of planning, executing, and reviewing the organization's activities for achieving its objectives? • Do management actions remove or reduce incentives and opportunities for employees to act dishonestly? • Is there a mandatory vacation policy for employees performing key control functions? • Does management implement controls over information systems? • Does management maintain appropriate physical safeguards over cash, investments, inventory, and/or fixed assets? • Does management establish adequate controls over accounting estimates and choice of accounting principles, where applicable?		
MANAGEMENT'S RISK ASSESSMENT PROCESS For financial reporting purposes, management's risk assessment process should identify internal and external events and circumstances that can impair the organization's ability to initiate, record, process, and report financial data that is consistent with the assertions management makes in its financial statements. Consider the following aspects: • Has management established policies and assigned responsibility to personnel for identifying, evaluating, and mitigating risks? • Does management have an ongoing process to identify risk and ensure exposure to such risks is minimized? Risks include: – changes in business and regulatory operating environment – new personnel – changes in information systems – rapid change in operations – new technology – new business models, products, or activities, including financial instruments/derivatives – organizational restructuring – foreign expansion – new accounting standards • Does management independently evaluate the organization's internal control environment to assess its effectiveness?		
INFORMATION AND COMMUNICATIONS High-quality management information is an essential component of internal control. Creating and communicating information is relevant to operating decisions and to financial reporting objectives. The auditor is concerned mainly with the financial reporting information system, consisting of the procedures and records established to initiate, record, process, and report transactions, events, and conditions and to maintain accountability for the related assets, liabilities, and equity. Consider the following aspects: • Does management have documented policies and procedures to develop, operate, and maintain information systems, related business processes, and accounting cycles that produce reliable and timely financial information? • Has management implemented an information system that is well designed to achieve the following financial reporting objectives?: – identify and record all valid transactions related to the organization in their proper reporting period; – capture sufficient detail to permit proper classification, measurement, and presentation of transactions in the financial statements and note disclosures in accordance with generally accepted accounting principles or other appropriate basis of accounting. • Are appropriate lines of authority and reporting clearly established? • Does management gather information from and communicate information to appropriate people on a timely basis? • Is there a communication process available for people to report suspected improprieties? For example, has management established an effective whistle-blower program as it relates to financial reporting? • Is there a disaster recovery plan in place to ensure minimum disruption should management information, accounting records, or other important data be destroyed, damaged, or stolen?		
MONITORING Consider the following aspects: • Has management established effective monitoring procedures? • Does management have a business plan that is monitored against actual results? • Does management monitor compliance with internal control policies and procedures? • Does management investigate variances and take proper and timely corrective action?		

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EXHIBIT 9A–1 Continued

CONTROL ACTIVITIES	**Auditor Responses**	**Audit File References**
Control activities are the policies and procedures that ensure actions are taken to address risks that threaten the achievement of the entity's objectives. Control activities are part of the information system, can be manual or IT based, are directed toward the control objectives, and are applied at various organizational and functional levels. This questionnaire divides control activities questions into general controls and application controls. General controls tend to affect many or all of the underlying accounting processes, while application controls will relate to each specific accounting process. **General Controls** General controls are pervasive policies and procedures that tend to affect to most or all processes in the information system and most or all organizational levels. Consider the following: • Are there policies and procedures in place to: – prevent unauthorized access or changes to programs and data? – ensure the security and privacy of data? – control and maintain key systems? – protect assets susceptible to misappropriation? • Is management's approach to IT planning and new systems development adequate to ensure new systems and systems changes protect the integrity of data and processing? In particular, note procedures that ensure the following: completeness, accuracy, and authorization of data and processing; the existence of adequate management trails; and the protection of the continuity of IT operations by backup procedures and a formal disaster plan. • Are appropriate procedures in place for software and hardware upgrades and other systems maintenance? • Are day-to-day operations adequately controlled by IT support personnel to ensure data integrity? • Are access controls adequate? Consider whether internal access is monitored across the information system such that appropriate personnel have access only to files they need to do their jobs, and unauthorized access is prohibited. • For IT systems and applications run over the Internet or other telecommunications systems, is external access security adequately protected by firewalls, virus protection software, or other IT security features?		
Auditor's conclusion on the company-level and general controls: ____ ____	Prepared by __________ __________	Date __________
Application Controls Application controls relate to recording, processing, and reporting information. They will be specific to the business processes and related accounting cycles that generate financial information. Recording includes identifying and capturing the relevant information for transactions or events. Processing includes calculation, measurement, valuation, and summarization, whether performed by IT-based or manual procedures. Reporting relates to the preparation of financial reports, electronic or printed, that management uses for measuring and reviewing the entity's financial performance and reporting to stakeholders. For each accounting cycle, a separate detailed questionnaire should be completed that assesses the following aspects of information processing: • Are data integrity controls adequate? Identify and assess controls over data input to and processed in the accounting cycle that ensure data and processing are valid, complete, and accurate. Consider functions such as edit and validation checks, programmed reasonability checks, dollar limits, sequence numbering, internal confirmation of transaction data transferred from database files to the application, reconciliation, and other relevant control features. • Are access and authorization controls adequate, e.g., are access points for data entry and enquiry (terminal, desktop, laptop, hand-held device, etc.) set up to allow only designated functions to be performed and only authorized personnel to access data, processing, and output? Based on the application control assessment, the auditor will develop a detail plan setting out the planned audit approach, including decisions on whether to test controls as a component of audit evidence in addition to substantive evidence. Refer to the detailed Internal Control Questionnaires for each business process/accounting cycle provided in Chapters 11 to 14. This is where the auditor will document control assessments and their conclusion on whether to test controls in the overall audit approach.		

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CHAPTER 10

Audit Sampling

In this chapter, we review the general topic of audit sampling, which relies heavily on the concepts of materiality and risk—audit risk, inherent risk, control risk, and detection risk. Audit sampling is not an audit procedure in the same class as the procedures explained in previous chapters. Instead, it is a method of organizing the application of audit procedures, as well as a method of organizing the auditor's decision-making process. Sampling concepts, thus, serve as a useful decision aid for auditors and helps justify the audit opinion. Sampling concepts have taken on a greater importance in auditing standards, as now they are covered in their own Canadian audit standard, CAS 530. The reason for this is that audit sampling concepts clarify audit reasoning and introduce more rigour to the audit process. But complications can arise due to the fact different accounting firms use different statistical methods, and the different models create their own distinct concepts. In this chapter, we introduce the simplest statistical model, monetary-unit sampling (MUS), which does not have the complications of other models.

Statistical sampling is the more rigorous and formal application of sampling. However, only about one in six audits use statistical sampling of one form or another. These audits tend to be concentrated in the larger public accounting firms.

Nevertheless, what makes knowledge of statistical auditing valuable is that it clarifies the logic of the audit evidence-gathering process by using more precise concepts. Specifically, statistical auditing makes clearer the meaning of specific types of risks in auditing and some of the materiality concepts introduced in Chapter 5. In addition, auditing uses a different approach in statistics that allows a more straightforward alignment with audit objectives as represented by the concepts of audit assurance and audit risk. This is important, because many view the audit risk concept as the "engine room of the audit."[1] This chapter thus deals with the conceptual foundations of auditing that underlie the audit evidence-gathering process which you have covered in Chapters 5 to 9.

LEARNING OBJECTIVES

After completing this chapter, you will be able to do the following:

LO1 Explain the role of professional judgment in audit sampling decisions.

LO2 Distinguish audit sampling work from nonsampling work.

LO3 Compare and contrast statistical and nonstatistical sampling.

LO4 Differentiate between beta risk, alpha risk, sampling and nonsampling risk.

LO5 Develop a simple audit program for test of a client's internal control procedures.

a. Specify objectives, deviation conditions, populations, and sampling units.
b. Demonstrate some basic audit sampling calculations.
c. Evaluate evidence from control testing.

LO6 Develop a simple audit program for an account balance, considering the influences of risk and tolerable misstatement.

a. Specify objectives and a population of data.
b. Determine sample size and select sample units.
c. Evaluate monetary error evidence from a balance audit sample.

CHAPTER APPENDICES

Appendix 10A: Statistical Sampling Tables

Appendix 10B: More Advanced Statistical Sampling Concepts for Tests of Controls and Tests of Balances *(online)*

1 E. Turner, "How much is enough?" *CA Magazine*, March 2010, p. 49–51.

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In this and later chapters, we make extensive reference to AuG-41, a guideline in the *CICA Handbook* at the time of writing. However, this guideline is described as "temporary." It is, however, such a valuable learning tool that we rely on it extensively in this text. AuG-41 helps illustrate the evolution of auditor thinking and the understanding of the existing permanent standards. The same applies to other references to "temporary" Handbook sections.

EcoPak Inc.

Donna and Caleb have been invited to sit in EcoPak's boardroom to do their interim field work. They are planning to do the tests up to the end of September now, and to finish up later in February when they come back to do the year-end work. As they are meeting with the accounts receivable manager to coordinate how they will do their testing, Nima pops her head in and says, "Hi Donna. Hi Caleb. How are things going on the audit trail?" Donna explains that they are just starting their systems work and getting set up to test the volume credit notes.

"Oh, that is so interesting," Nima says. "You know, it's really been fun and challenging to be a CFO in a growing manufacturing business like EcoPak. But sometimes, I really miss the challenges of being an auditor out in the field, going into different clients all year round, figuring out all their different business risks, their systems and processes, and how to get the evidence to form an opinion on the financial statements. I am really interested to know what you are planning to do to test our volume credit notes because, to be honest, though I review the report for reasonability, there are so many variables at play that I find it hard to know what to expect the amount to be from month to month. And after the fraud we just dealt with in purchasing, I realize that these types of non-routine processes are particularly vulnerable to all kinds of errors and fraud!"

So, Donna gives a general outline to Nima of the test steps she is planning to use in her volume credit notes testing. Donna plans to use a judgmental sampling approach. Her sample will include the two largest credit notes for each of the six largest customers as key items. Then she will take a random sample from the rest of the population of credit notes issued. She will use her audit firm Meyer & Gustav (M&G)'s audit software to obtain her own list of the credit note transactions from EcoPak's system, and use that to identify her sample items and to do some other tests, such as verifying the totals, checking the numerical sequencing, and scrutinizing for any large or unusual items or patterns.

For each volume credit note sample item, Donna will vouch the credit note back to the monthly sales volume reports the clerk has used to determine the eligibility in accordance with the customer contracts, ensure the appropriate level was reached and the discount correctly calculated according to the contract, and then check that each credit issued has been approved by the manager. She will next trace each credit note forward to ensure it is correctly recorded in the sales and accounts receivable accounts in the general ledger. She will also take a small sample of credit notes from the clerk's file of credit note copies and trace back to customer account receivable ledgers to make sure they are recorded completely. If there are any discrepancies or unusual findings, she will follow up by discussions with the audit team, and further enquiries and document inspections, if required.

"That sounds very comprehensive, Donna! But I guess once you get going, it will go quickly," Nima remarks. "Oh yes, our interim testing will go pretty quickly, Nima. We have lots of other things to look at! But you probably will be really interested in the approach Caleb has come up with to assess the reasonability of the year-end sales and volume credit notes. It might be something that will help you with your monitoring." When Nima hears about Caleb's analytical procedure, she finds it very powerful, and agrees that it is a technique that she can use to make her own monitoring more robust.

INTRODUCTION TO AUDIT SAMPLING

LO1 Explain the role of professional judgment in audit sampling decisions.

Audit sampling is the application of an audit procedure to less than 100% of the items within an account balance population or class of transactions in order to evaluate some characteristic of the group.[2] The goal of audit sampling is to get a representative result for

2 CAS 530.05 (a).

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an account population or class of transactions. Testing is synonymous with sampling.[3] Sampling was part of the explanation of a control test, which was defined as (1) identifying the data population from which to select a sample of items and (2) describing an action to produce relevant evidence. It is important to understand some sampling theory because it helps explain some of the most important principles of auditing, such as the risk-based approach to auditing. Probability and sampling theory provide the foundations for much of the logic of auditing, including deciding when sufficient evidence has been gathered to support the audit opinion. Sampling theory is the basis of the audit risk model. Just like in your economics course when, for example, you see how demand equals supply works through equilibrium equations, a similar thing can happen with some math in clarifying audit and accounting concepts. For example, the basic audit risk model helps clarify the relationship between risk of material misstatement and detection risk. In the more advanced parts of this book, we probe a little further with math models in order to deepen your understanding of how risks work in auditing and financial reporting. This chapter begins that process.

audit sampling: testing less than 100% of a population (items in an account balance or class of transactions) to form a conclusion about some characteristic of the balance or class of transactions

This is an important chapter for understanding the logic of auditing. For example, the most fundamental risk concepts in auditing are the beta and alpha risks and we relate them to the audit risk model. All risks discussed here are either a form of beta risk or alpha risk. But the differences in the way alpha and beta risks behave, and their relative importance for the audit has a carry-over effect to the other risks based on them. Hence, we treat alpha and beta risk distinction as fundamental. We keep the technical details at a minimum. Supporting details are provided in Appendix 10B (available on Connect).

To understand the definition of audit sampling, you must keep the following definitions in mind. **Audit procedures** are the general audit techniques of Chapter 8 (recalculation/reperformance, observation, confirmation, enquiry, inspection, and analysis). An **account balance** is a control account made up of many constituent items; for example, an accounts receivable control account represents the sum of customers' accounts. A **class of transactions** refers to a group of transactions with common characteristics, such as cash receipts or cash disbursements, but not necessarily added together as an account balance in generally accepted accounting principles (GAAP) financial statements. A **population** is the set of all the elements that constitute an account balance or class of transactions; each of the elements within it is a **population unit**. When an auditor selects a sample of the population, each element selected is called a **sampling unit** (e.g., a customer's account, an inventory item, a debt issue, a cash receipt, a cancelled cheque, and so forth). A **sample** is a set of such sampling units. Specifically, audit sampling is less than 100% examination of items in a population for the purpose of getting a representative result of the population (CAS 530.05). An important professional judgment is how to define a population or class relative to audit objectives.

audit procedures: the general audit techniques of recalculation/reperformance, observation, confirmation, enquiry, inspection, and analysis

account balance: a control account made up of many constituent items

class of transactions: groups of accounting entries that have the same source or purpose; credit sales, cash sales, and cash receipts are three different classes

population: the set of all the elements that constitute an account balance or class of transactions

population unit: each element of a population

sampling unit: unit used for testing a client's population, for example, a customer's account, an inventory item, a debt issue, or a cash receipt

sample: a set of sampling units

How Risk and Materiality Are Used in Audit Sampling

Materiality and risk are key concepts in statistical sampling and auditing. This is indicated in CAS 530 by quotes, such as the following:

> The determination of an appropriate sample on a representative basis may be made using either statistical or nonstatistical methods. Whether statistical or non-statistical methods are used, their common purpose is to enable the auditor to reach a conclusion about an entire set of data by examining only a part of it. Statistical sampling methods allow the auditor to express in mathematical terms the uncertainty he or she is willing to accept and the conclusions of his or her test. The use of statistical methods does not eliminate the need for the auditor to exercise judgment. For example, the auditor has to determine the degree of audit risk he or she is willing to accept and make a judgment as to materiality.

The box on the next page shows how the auditor's professional judgment is applied when deciding how much audit work is required and how the audit finding will be interpreted.

3 Canadian Institue of Chartered Accountants, *Terminology for Accountants*, 4th edition. (CICA, 1992).

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PROFESSIONAL JUDGMENT AND THE EXTENT OF AUDIT TESTING

Auditing standards have noted that decisions concerning materiality and audit risk are the most significant made in the course of an audit because they form the basis for determining the extent of the auditing procedures to be undertaken. Also see CAS 320.06. This illustrates that professional judgment is critical to the appropriate application audit sampling.

To better understand this, imagine that the audit is a purely scientific endeavour in which the management assertions are hypotheses that have to be either supported (verified) or contradicted by the evidence. An analogy, but not one to be taken too literally, is to think of auditor opinions as being similar to a media opinion poll.

For example, an opinion poll in *The Toronto Star* reported that a mayoral candidate M.L. led with 51% of the decided vote, over candidate B.H. who had 46% support. This poll was the result of surveying 400 Toronto residents. A sample of this size is considered accurate to within 5 percentage points, 19 times out of 20. In other words, because of the uncertainties associated with the representativeness of the sample of 400, the best the statistician can conclude about M.L.'s prospects is that there is a 95% confidence level that his actual support is in the range 51% ± 5% = 46−56%. The width of this band around M.L.'s best point estimate of 51% is referred to as *sampling precision,* which is related to materiality. The confidence level is most relevant to the auditor when it is related to assurance level desired from the test. For some statistical models, this alignment with assurance is true only when the statistical test is designed a certain way, as discussed later in this chapter.

Conceptually, an auditor would like to conclude on the financial statements similar to the way a pollster does about populations of voters. For example, after audit testing, the auditor may like to conclude that a client's net income number is $200,000 ± $10,000, 19 times out of 20. The auditor could make this kind of declaration if the appropriate statistical samples were drawn from all the accounting components that make up net income. In this statistical sampling framework, the degree of accuracy or precision of the sample is related to materiality; that is, the ±$10,000 (or ±5% in the *Star* poll). Audit assurance is the statistical confidence; that is, 19 times out of 20, which is equal to 95%. Thus, if an auditor's report were interpreted purely statistically, "in all material respects" means that the difference between the audit estimate (audit value, or AV) based on audit testing and the reported amount (book value, or BV) is less than material. The level of audit assurance is captured by the words *in our opinion* in the auditor's report. Under this view, the standard audit report indicates, therefore, that there is a high level of assurance that there are no material factual misstatements in the financial statements. We can also look at the complement of assurance, audit risk, discussed in CAS 200, and interpret the standard audit report to mean there is a low level of risk that there are material misstatements in the financial statements after the audit.

Using a statistical sampling framework, the audit report decision will be based on a sufficient amount of testing so that the confidence interval around the auditor's best estimate AV will both include BV *and* be smaller than materiality; that is, the auditor will have achieved the planned level of assurance from the testing. For example, assume the auditor has done enough testing of a client with a reported net income of $198,000 to conclude with 95% confidence (assurance) that GAAP income is in the interval $198,000 ± $10,000. If materiality is set at 8% of reported income, it equals 0.08 × $198,000 = $15,840. As the achieved precision of $10,000 is less than materiality of $15,840, the auditor can conclude with at least 95% assurance that there is no material error in the reported net income of $198,000.

To reach such a conclusion, the auditor will have to plan the testing so that achieved precision is no larger than materiality. If BV − AV is greater than materiality, the auditor has not obtained the 95% assurance from testing and will either have to do more audit work or insist on an adjustment. Both options involve considerable professional judgment. However, statistical sampling has at least clarified the quantitative issues. Hopefully, this illustrates that statistical sampling does not eliminate professional judgment. But it can aid professional judgment and provide quantitative guidance.

Sampling and the Extent of Auditing

nature (of audit procedures): the six general techniques of an account balance audit program: recalculation/reperformance, confirmation, enquiry, inspection, observation, and analysis

Three aspects of auditing procedures are important—nature, timing, and extent. **Nature** refers to the six general techniques (recalculation/reperformance, confirmation, enquiry, inspection, observation, and analysis). Timing considers when procedures are performed. More will be said about timing later in this chapter. Audit sampling is concerned primarily with matters of extent—the amount of work done when the procedures are performed. In the context of auditing standards, nature and timing relate most closely to the appropriateness of the evidence, while extent relates most closely to its sufficiency (sample size). Since client files, such as inventory and accounts receivable, can contain thousands of accounting records, it is uneconomical to test them exhaustively and auditors consider the concept of testing carefully.

Testing is a means of gaining assurance that the amount of error in large files is not material. Statistical sampling is the formal theory supporting the concept of testing, but

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courts approved it long before statistical theories were introduced to auditing. The majority of testing in auditing was once done on a judgmental basis, but as accounting populations grew, auditors realized that statistical sample sizes could be much smaller than intuition would suggest. For this reason, statistical sampling became increasingly popular in the second half of the 20th century. While both testing methods are equally acceptable by auditing standards, the focus here is on statistics, as the theory underlying it formalizes the reasoning used in pure judgmental (haphazard) testing. Statistical sampling in auditing helps make more precise the key concepts of risk and materiality in auditing. Another advantage of statistical auditing is that it forces auditors to clarify their thinking in planning the audit. For example, statistical auditing forces auditors to define a population more precisely because the statistical conclusion applies only to the part of the population that was statistically sampled. This increased rigour can be useful when justifying the audit work in court, to regulators and to accountability boards. However, statistical sampling tends to be more time consuming and requires more training. Hence, there are definite tradeoffs that must be made. Another example of why professional judgment is needed.

The two types of audit programs introduced in Chapter 8 are summarized below. Note that both of these can be performed on a statistical or nonstatistical basis.

Two Kinds of Audit Programs: Two Purposes for Audit Sampling

INTERNAL CONTROL PROGRAM	BALANCE AUDIT PROGRAM
Purpose	**Purpose**
Obtain evidence about client's control objective compliance, including:	Obtain evidence about client's financial statement assertions, including:
Validity	Existence (Occurrence)
Completeness	Completeness
Authorization	Valuation
Accuracy	Ownership (Rights and obligations)
Classification	Presentation and disclosure
Accounting	
Proper period	
Sample	**Sample**
Usually from a class of transactions (population), such as:	Usually from items in an asset or liability balance (population), such as:
Cash receipts	Accounts receivable
Cash disbursements	Loans receivable
Purchases (inventory additions)	Inventory
Inventory issues	Small tool fixed assets
Sales on credit	Depositors' savings accounts
Expense details	Accounts payable
Welfare payments (eligibility)	Unexpired magazine subscriptions

REVIEW CHECKPOINTS

10-1 Define the following terms: audit sampling, population, population unit, and sample.

10-2 What role does professional judgment play in audit decisions regarding materiality, risk, and sampling?

10-3 How does audit assurance relate to audit risk?

10-4 How does sampling relate to forming an audit opinion on financial statements?

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Inclusions and Exclusions Related to Audit Sampling

LO2 Distinguish audit sampling work from nonsampling work.

Look again at the audit sampling definition, specifically the statement "for the purpose of evaluating some characteristics of the balance or class." This means that an audit procedure is considered audit sampling only if the auditor's objective is to reach a conclusion about the entire account balance or transaction class (the population) on the basis of the evidence obtained from sample. If the entire population is audited, or if it is only done to gain general familiarity, the work is not considered audit sampling.

Perhaps the distinction between audit sampling and other methods can be seen when considered against the following work that is *not* considered audit sampling:

- Complete (100%) audit of all the elements in a balance or class
- Analytical procedures that are overall comparisons, ratio calculations, and the like
- A **walk-through**—following one or a few transactions through the accounting and control systems in order to obtain a general understanding of the client's systems
- Methods such as enquiry of employees, obtaining written representations, obtaining enquiry responses via an internal control questionnaire, scanning accounting records for unusual items, and observation of personnel and procedures[4]
- Selecting specific items because of their high or key value or some other characteristic of special interest, such as suspected fraud (CAS 530)

walk-through: following one or more transactions through the accounting and control systems to obtain a general understanding of the client's systems

Several procedures *are* typically used in audit sampling applications: recalculation, physical observation of tangible assets, confirmation, and document examination. These procedures most often are applied to the audit of the details of transactions and balances.

REVIEW CHECKPOINTS

10-5 Give examples of auditing procedures that are not sampling applications.

10-6 List audit procedures likely to be applied on a sample basis.

Why Auditors Sample

LO3 Compare and contrast statistical and nonstatistical sampling.

Auditors use audit sampling when (1) the nature and materiality of the balance or class does not demand a 100% audit, (2) a decision must be made about the balance or class, and (3) the time and cost to audit 100% of the population would be too great. The latter point is based on the diminishing returns to testing illustrated in the end of chapter Application Case. The two sampling designs used are statistical and nonstatistical sampling. Exhibit 10–1 provides an overview of the different choices auditors can make about the extent of their testing.

Statistical Sampling

statistical sampling: audit sampling that uses the laws of probability for selecting and evaluating a sample from a population for the purpose of reaching a conclusion about the population

random sample: a set of sampling units so chosen that each population item has an equal likelihood of being selected in the sample

Statistical sampling uses the laws of probability for selecting and evaluating a sample from a population for the purpose of reaching a conclusion about the population. The essential points of this definition are that (1) a statistical sample is selected at random, and (2) statistical calculations are used to measure and express the results. Both conditions are necessary for a method to be considered statistical sampling rather than nonstatistical sampling.

A **random sample** is chosen so that each population item has a predictable probability of being selected in the sample (CAS 530.05). You cannot use statistical calculations with a nonrandom sample. The mathematical laws of probability don't apply to nonrandom samples, and basing such calculations on a nonrandom sample could be misleading.

Any appropriate sample size may be considered statistical sampling. Appropriate in this context means consistent with a statistical sampling model, such as MUS, chosen by the auditor. The model can then be used to calculate the sample size, which indicates the

4 "Audit sampling," *Audit and Accounting Guide* (AICPA, 1983), pp. 1–3.

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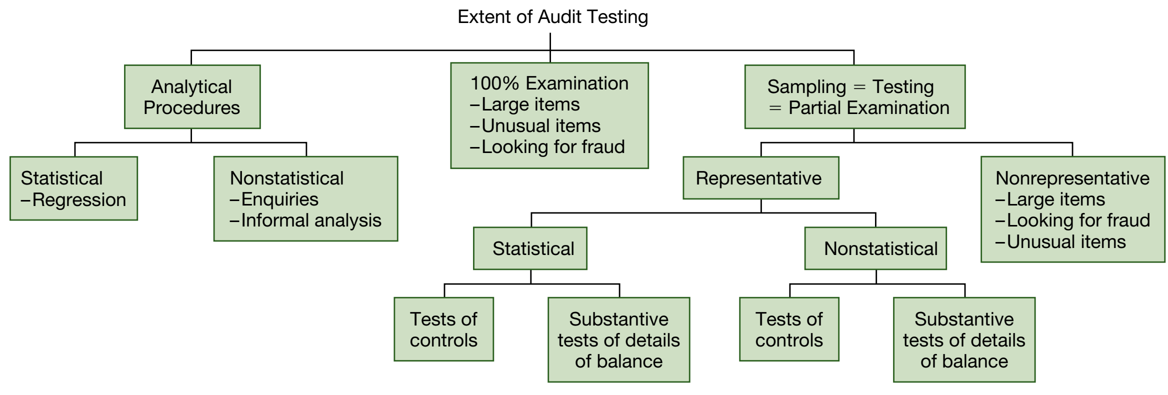
EXHIBIT 10–1 Extent of Audit Testing



sufficiency of audit work based on risk and materiality objectives. A statistical sampling approach can thus facilitate professional judgments on sufficiency and appropriateness of evidence as outlined in Exhibit 8-6. A sampling method is statistical by virtue of random selection of the sample coupled with statistical calculation of the results (CAS 530.05).

Nonstatistical Sampling

Nonstatistical (judgmental) sampling is audit sampling in which auditors do not use statistical calculations to express the results. Sample selection can be random sampling or some other selection technique. Auditors are fond of saying that nonstatistical sampling involves "consideration of sampling risk in evaluating an audit sample without using statistical theory to measure that risk." In this context, consideration means giving sampling risk some thoughtful attention without directly knowing or measuring its magnitude. Do not confuse sampling and nonsampling risk with statistical and nonstatistical sampling. They are not the same, as is further explained in the next learning objective.

nonstatistical (judgmental) sampling: choosing items in a population for audit testing and evaluating the findings based on the auditor's own knowledge and experience rather than statistical methods

USE OF STATISTICAL SAMPLING

Use statistical sampling when:

- Random numbers can be associated with population items.
- Objective results that can be defended mathematically are desired.
- The auditor has insufficient knowledge about the population to justify a nonstatistical sample.
- A representative (random) sample is required.
- Staff are adequately trained in statistical auditing.

Statistical sampling is advantageous because it:

- Requires a precise and definite approach to the audit problem.
- Incorporates evaluation showing a direct relation between the sample results and the entire population under audit.
- Requires auditors to specify, and even quantify, particular judgments on risk and materiality.
- Does not eliminate or reduce auditors' professional judgment.
- Allows more objective control of audit risks.
- Results in better planning and documentation when properly implemented (but can be more time consuming and costly because of the greater formalism required).

Beta Risk, Alpha Risk, Sampling Risk, and Non sampling Risk (beta and alpha risks are the most fundamental risk concepts in auditing)

LO4 Differentiate between beta risk, alpha risk, sampling and nonsampling risk.

Even when procedures are performed on a sample basis and sufficient evidence is obtained, a conclusion about the population characteristic can still be wrong. For example, suppose an auditor selected 100 sales invoices for audit and found no errors or irregularities in any of them. To conclude from this that there is no significant incidence of errors

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REVIEW CHECKPOINTS

10-7 Give three reasons why auditors may choose to use sampling.

10-8 What three choices are available to the auditor for deciding on the extent of audit procedures?

10-9 Are testing, partial examination, and sampling the same thing? Explain your response.

10-10 Distinguish between statistical and nonstatistical sampling.

10-11 Differentiate between representative and nonrepresentative testing. What client factors determine which is most appropriate in planning audit procedures?

10-12 What is the difference between a statistical representative test and a nonstatistical representative test?

10-13 Why can a nonrepresentative test *not* be done statistically?

and irregularities in the entire population of sales invoices might be wrong. How, you ask? The sample might not reflect the actual condition of the population. No matter how randomly or carefully the sample was selected, it might not be a good representation of the extent of errors and irregularities actually in the population.

sampling risk: the probability that an auditor's conclusion based on a sample might be different from the conclusion based on an audit of the entire population

Sampling risk is the probability that an auditor's conclusion based on a sample might be different from a conclusion based on an audit of the entire population. If an auditor with more time went through all the invoices and found multiple errors, your sample-based decision will be proven wrong. Apparently, your sample did not represent the population very well. Sampling risk expresses the probability of a wrong decision based on sample evidence, and it is a fact in both statistical and nonstatistical sampling methods. With statistical sampling, you can both measure and control it by auditing sufficiently large samples. With nonstatistical sampling, you can "consider" it without measuring it, something that requires experience and expertise. Other special aspects of sampling risk are discussed later in the sections on auditing control compliance and account balances.

alpha risk (type 1 error risk): the risk that the auditor will incorrectly reject an account balance that is not materially misstated; a type of sampling risk

beta risk (type II error risk): the risk that the auditor will incorrectly accept an account balance that is materially misstated; it can result in audit failure and so is considered to be a more serious problem for the audit than incorrect rejection; a type of sampling risk

Two types of sampling risk are alpha and beta risk. These risks apply to all audit procedures, whether statistical or not, but they are best introduced in a statistical context. **Alpha risk (type 1 error risk)** is the risk that the auditor concludes that the population is worse in terms of errors than it really is. **Beta risk (type II error risk)** is the risk that the auditor concludes that the population is better than it really is. Now, which risk covers the situation of the auditor's failing to detect a material misstatement? If you said beta risk you are correct. Beta risk covers the situation where the auditor concludes the population is better (i.e., immaterial misstatements) than it actually is (i.e., material misstatements). Auditors have developed more specific risk terms for various types of testing, but they are all either alpha- or beta-type risks. Beta and alpha risks are the most fundamental risk concepts in auditing. Keep this basic classification in mind to help you better follow the subsequent terminology.

How Sampling Risks Are Controlled in Statistical Auditing

When using statistical sampling concepts in auditing, we need to develop a decision rule, which must be used consistently if we are to control risks objectively. It is the assumption of the consistent use of a strict decision rule that allows the risks to be predicted and thus controlled via the sample size. The decision rule is frequently referred to as a hypothesis test, and the auditor is typically interested in distinguishing between two hypotheses:

Hypothesis 1: There exists a material misstatement in the total amount recorded for the accounting population.

Hypothesis 2: There exists no misstatement in the amount recorded for the accounting population.

The decision rule the auditor uses in statistical auditing is to select one of these two hypotheses based on the results of the statistical sample. The mechanics of this will be

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discussed later in this chapter and in Appendix 10B (available on Connect). For now, we are interested in depicting what happens to sampling risks (risk that arises when testing only a portion of the population statistically) when a consistent decision rule is used. This is when the summary concept of a probability of acceptance curve becomes useful. This curve can be used to represent all the possibilities of sampling risk about a sample result.

Probability of Acceptance Curve (or acceptance curve, for short)

Consider Exhibit 10–2, which plots the probability of acceptance of the recorded amount against total misstatement within the recorded amount of some accounting population, such as aggregate accounts receivable. The horizontal axis reflects total misstatement, while the vertical axis reflects probability.

In a perfect world of no uncertainty, auditors would want to have a zero probability of accepting a recorded amount having material misstatement (MM). However, the concept of testing or sampling only a part of a population requires the auditor to be willing to accept some uncertainty concerning the total population value. This is reflected in the fact that the probability of acceptance cannot be zero at MM with sampling. However, the auditor can design his or her audit so that this probability is appropriately low (see Exhibit 10–2).

An auditor using a consistent decision rule selecting one of the hypotheses discussed above with a given sample size over a range of possible errors will experience varying probabilities of acceptance, as indicated in Exhibit 10–2 This is what we mean by a probability of acceptance curve.

Note an important feature of this curve: As the error amount increases (going from left to right), the probability of acceptance goes down (as one would expect, because as the amount of error in a population increases, the chances that a sample of a given fixed size will accept the population will decrease). How fast the curve drops depends on a variety of factors, including the sample size, the statistical model, and to a lesser extent the error pattern in the population. It is important to remember that each sample size will have a different acceptance curve. Also, as the sample size increases, the curve shifts upward, until it looks like a rectangle, with a value of exactly one from zero errors to materially misstated (MM) errors. At MM, the "perfect" acceptance curve drops to zero, and it stays at zero as the amount of error increases to way above materiality. Note that a perfect acceptance curve results from doing a 100% examination of the population, and also that there is no alpha or beta risk with a perfect acceptance curve. You can think of the perfect curve as the ideal knowledge state for the auditor.

Concepts of Sampling Risk

When there is a less than perfect (i.e., less than 100%) examination with a given test, the probability-of-acceptance curve is useful for depicting the full range of sampling risks that the auditor may experience. This is summarized in Exhibit 10–2. To understand these risks, let us consider some scenarios. First, assume there is an immaterial amount of misstatement (i.e., left of MM in Exhibit 10–2), say, half MM. The probability-of-acceptance curve in Exhibit 10–2 tells us the probability of accepting any given amount of misstatement (including half MM). Is acceptance the correct decision given this amount of misstatement? The answer is "yes," because the amount of misstatement is less than material. Thus, the probability of acceptance gives us the probability of making the correct decision at half MM. Since the only other alternative in this simple framework is to reject the reported amount, an incorrect decision, this probability of making the incorrect decision must then be minus the probability of acceptance. This risk of incorrect decision when there is less than material misstatement (i.e., to the left of MM) is the alpha risk in auditing.

A completely different error is possible when there happens to be a material misstatement; that is, to the right of MM in Exhibit 10–2. Now, accepting the reported amount is the incorrect decision and the probability of accepting the recorded amount is, thus, the risk of accepting a material misstatement. This risk of accepting a material misstatement is the beta risk. The correct decision is to reject the reported amount when there is a material misstatement, and this equals one minus the probability of accepting the reported amount when there is a material misstatement, or one minus beta risk.

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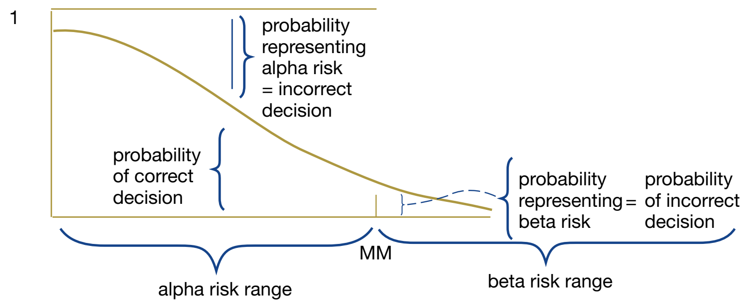
EXHIBIT 10–2



To recap, alpha risk can only occur when there is less than material misstatement, and alpha risk equals one minus the probability of acceptance when there is less than material misstatement. On the other hand, beta risk can only take place when there is a material misstatement, and beta risk equals the probability of acceptance of the recorded amount when there is material misstatement. (Due to rounding-off errors in calculating values for the tables given later, it is more convenient to say "accept up to and including" exactly material errors, and reject anything, even if just a penny, above it. That is the mathematical treatment, and the auditor should of course qualitatively re-evaluate all such situations.)

Another important thing to note is that as error increases, the probability of acceptance decreases, and, therefore, beta risk decreases. The maximum beta risk is thus at the smallest amount of material misstatement, which is at the point MM itself; that is, maximum beta risk is at MM. Hence, if the auditor controls beta risk at a specified level at MM, he or she automatically controls it at a lower level for errors greater than MM.

This is not true for alpha risk, however. An analysis of Exhibit 10–2 should make clear that as probability of acceptance decreases with increasing errors in the immaterial error range, alpha risk is increasing. Maximum alpha risk therefore occurs at just below MM and equals (at the limit) one minus beta risk at MM. For a numerical example, assume beta risk is controlled at half at MM. Then, we know that maximum alpha risk is: $1 - 0.05 = 0.95$. In practice, alpha risk is usually controlled only at zero errors by controlling alpha risk at its minimum level. Note that this concept of risk control is completely different from that of beta risk control, which is always done via the beta risk's maximum value.

The difference between behaviours of the two sampling risks and the different concepts of control of alpha and beta risks have important implications for auditors. First, note that it is a very good thing that we can control beta risk at its maximum! This is because beta risk is the more important risk for auditors. It is so important that some people characterize the reason for the existence of the audit profession as being to control beta risk. If auditors do not detect material misstatements in financial statements, then who will? Thus, beta risk can be said to relate to audit effectiveness.

Note also that beta risk is very treacherous. This is so because the auditor has no idea that a beta-type incorrect decision is being made. The sample evidence gives no indication that the amount of misstatement is material. The only way to control beta risk is by planning for it in advance during the sample planning stage of the audit. In statistical sampling formulas, this done through the calculation of the sample size using a planned precision for the test, similar to the polling example discussed above. More illustrations will be provided later in this chapter.

The consequences of an alpha-type error are much less dire for the auditor but could be important nevertheless. The auditor is aware that there may be problem because by

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rejecting a sample result, there is either a material misstatement or an alpha error is occurring. At this point, auditors have several options: (a) review evidence of related tests; (b) expand audit work by increasing the sample size of the test and related procedures (the audit risk model can assist in this task); (c) ask for an adjustment of the recorded amount of the population so that the estimated probability of material misstatement is reduced to an acceptable; or (d) perhaps modify the audit opinion based on the test results. The appropriate action, again, depends on professional judgment and the circumstances. The auditor should, however, be prepared to give good reasons for the decision. Generally, an alpha-type incorrect decision increases the amount of audit work unnecessarily, and thus it is characterized as an audit efficiency error. There is more complete discussion of auditor options at various stages of the audit later in the chapter.

Positive and Negative Approaches and Confidence Level

In the statistical literature, there is frequent reference to the concept of confidence level of a statistical test. How does this relate to alpha and beta risks as used in auditing? The answer depends on a number of things, such as on the way the hypothesis tests are constructed. Confidence level is related to the primary or null hypothesis of the test. Specifically, confidence level equals one minus risk of rejecting the null hypothesis when it is true. Thus, confidence level is dependent on the null hypothesis used. In auditing a distinctive statistical terminology has evolved over the years: if hypothesis 1 is the null hypothesis, then we are using the negative approach to hypothesis testing, and if hypothesis 2 is the null hypothesis, then we are using the positive approach to hypothesis testing. Under the negative approach, confidence level equals one minus beta risk, while under the positive approach confidence level equals one minus alpha risk.

The negative approach is the more important and common approach in auditing. Most importantly, is that the beta risk is controlled by selecting the appropriate confidence level, since confidence level equals one minus beta risk. This also means that the confidence level is aligned with the assurance level provided by the test. This can be seen by noting that beta risk is very similar to the definitions of the audit risk model and its various component risks. This aspect of the audit risk model is further discussed in the Application Case at the end of the chapter. The negative approach is normally used to statistically test internal controls. In particular, it underlies all attribute sampling tables and formulas. Monetary-unit sampling (MUS) discussed later in the chapter always uses the negative approach.

On the other hand, the positive approach frequently underlies formulas using the normal distribution assumption. The consequences of this are briefly discussed at the end of the chapter. Because of its simplicity and straightforward relationship to audit objectives, the negative approach is used throughout the remainder of the chapter. However, it should be noted that the positive approach is much more important in the sciences, and, in particular, the alpha risk, when associated with the null hypothesis of "no difference," is the more important risk of the sciences. Thus, your statistics course may have used a positive approach, and so within that course confidence level equals one minus alpha. Under the positive approach, there is a less-straightforward relationship between assurance, as the auditor uses that term, and the confidence level. Hence, under the positive approach the auditor needs to make adjustments to the confidence level in determining the assurance level provided by the statistical test. These adjustments are particularly important if the statistical test is to be used with the audit risk model.

If we use the negative approach, then the beta risk is controlled directly through the confidence level as discussed above. But then, how is alpha risk controlled using the negative approach? The first thing to remember is that alpha risk cannot be "controlled" the same way that beta is controlled (at beta's maximum level). As discussed above, you can only "control" alpha at its minimum value. This is true regardless of whether the positive or negative approach is used. With the formulas we use, this minimum alpha is zero.

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Under the negative approach, the way to reduce alpha throughout its range is to use a sample size that is bigger than the minimum for the confidence level of the test. Remember that under the negative approach, confidence level equals one minus beta, so you are already controlling beta once you set the confidence level. Any audit plan that wants to reduce alpha risk across the entire alpha risk range needs to do so by increasing the sample size beyond that of the minimum for the stated confidence level. This is illustrated in the end-of-chapter discussion case and discussed in more detail in Appendix 10B (available on Connect).

Note also that alpha and beta risks are very general in that they apply to both statistical and nonstatistical sampling. The profession has developed a proliferation of risk terms, but most of these relate to different sources of alpha- and beta-type errors at different stages of the audit process. For example, we have already noted that all the risks of the audit risk model, including risk of material misstatement, relate to beta-type errors. You can see this just by looking at the definition of beta risk and then comparing it with the definition of the other risks in the audit risk model. Thus, the alpha and beta risk distinction is the most fundamental categorization of risks in auditing.

We conclude this section with summaries of statistical versus nonstatistical sampling and nonsampling risks. The alpha and beta risk distinction applies to all of these situations, because the distinction applies to any audit situation where immaterial or material misstatements are possible. Since the auditor does not know which state, material or immaterial misstatement, is the true state (if the auditor did know for sure then he or she would not need to perform audit procedures), these alpha and beta risk distinctions apply to all of the following summaries. The importance of beta risk for auditing can be seen by noting that an audit deficiency of Chapter 4 can only occur when beta risk is unacceptably high. This occurs when not enough evidence has been gathered (to control beta risk at acceptable levels), or, after gathering the evidence, the risk of undetected material misstatements is too high (because of the number of errors found in testing).

USE OF NONSTATISTICAL SAMPLING

Use nonstatistical sampling when:

- Association of population items with random numbers is difficult and expensive.
- Strictly defensible results based on mathematics are not necessary.
- The auditor's knowledge about the population justifies a nonstatistical sample with expectation of a reasonable conclusion about the population.
- A representative (random) sample is not required; for example, when an efficient nonstatistical sample of large items leaves an immaterial amount unaudited.
- The population is known to be diverse, with some segments especially error prone.

Nonstatistical sampling is advantageous because:

- It permits a less rigidly defined approach to unique problems that might not fit into a statistical method.
- It permits the auditors to reapply evaluation judgments based on factors in addition to the sample evidence.
- It permits auditors to be less than definite about and omit quantification of particular judgments on risk and materiality.
- It permits auditors to assert standards of subjective judgment. (Thus, the alternative name is judgment sampling.)

nonsampling risk: the possibility of making a wrong decision, which exists in both statistical and nonstatistical sampling

Nonsampling risk includes the possibility of making a wrong decision, which exists in both statistical and nonstatistical sampling. Nonsampling risk's problem is that it cannot be measured. Auditors control it and believe they have reduced it to a negligible level through adequate planning and supervision of the audit, by having policies and procedures for quality control of their auditing practices, and by having internal monitoring and external peer review of their own quality control systems. Auditors are also more open to criticism and fault-finding when erroneous audit decisions result from nonsampling risk. External critics (judges, juries, peer reviewers) have few grounds for criticizing auditors who fall victim to sampling risk, provided that an audit sampling application is planned and executed reasonably well.

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EXAMPLES OF NONSAMPLING RISK

Performing inappropriate procedures: Auditor based the evaluation of inventory obsolescence on forecast sales without adequately evaluating the reasonability of the forecast assumptions.

Failure to consider test results appropriately: Auditor did not adequately investigate discrepancies in inventory counts and pricing, failing to note misstatements.

Neglecting the importance of analytical review: Auditor might have discovered client's failure to eliminate intercompany profits if year-to-year product mix, gross profit, and recorded eliminations had been analyzed.

Failure to maintain control over audit procedures: Auditor's lax attitude permitted client employees to tamper with records selected for confirmation.

Lack of professional skepticism: Auditor accepted client's unsupported verbal representations instead of gathering independent evidence to support management's assertions.

Accounting risk: Risks related to forecasting the future (risk of forecast errors), typically affecting the measurement or valuation assertions. Accounting risk cannot be eliminated by gathering more evidence, as it is related to auditee business risks not affected by audit procedures. The accounting risk concept helps in identifying deficiencies of accounting estimates that result in misleading financial reporting. Accounting risk and its control are discussed in Chapter 19 (available on Connect).

Nonsampling risk is all risk other than sampling risk. The audit risk (AR) model given in Chapter 6 is necessary to understanding the breadth of this definition:

$$\text{Risk Model: } AR = IR \times CR \times DR$$

Nonsampling risk can arise from any of the following:

- *Misjudging the inherent risk (IR).* An auditor who, in the first place, mistakenly believes that few material errors or irregularities occur will tend to do less work and, therefore, may fail to detect problems.
- *Misjudging the control risk (CR).* An auditor who is too optimistic about the ability of controls to prevent, detect, and correct errors and irregularities will tend to do less work, with the same results as misjudging the inherent risk.
- *Poor choice of procedures and mistakes in execution—related to detection risk (DR).* Auditors can select procedures inappropriate for the objective (e.g., confirming recorded accounts receivable when the objective is to find unrecorded accounts receivable), fail to recognize errors or irregularities when vouching supporting documents, or sign off on procedures when the work actually was not done.

The various risks in auditing are summarized in Exhibit 10–3 by the two broad categories of audit tests. This is the more traditional way of organizing audit risks, as it is based on the two major categories of audit procedures. Exhibit 10–3 focuses on beta risk, alpha risk, sampling, and nonsampling risks associated with gathering evidence. If the beta risks are at unacceptably high levels, then an audit deficiency occurs. This can result in report reservations as discussed in Chapter 4.

EXHIBIT 10–3 Summary of Risks in Audit Testing (categorized by type of test)

RISK	TESTS OF CONTROLS	SUBSTANTIVE TESTS OF BALANCE
Audit risk (AR)	CR* component of AR	RIA** or APR*** component of AR
Sampling risk	Risk of selecting a non-representative sample in tests of controls	Risk of selecting a nonrepresentative sample in substantive tests
Alpha risk	Controlled indirectly via tests of controls	Controlled indirectly via substantive tests
Beta risk	Controlled directly via value for CR	Controlled directly via values for RIA and APR
Nonsampling risk	All other risks associated with testing of controls	All other risks associated with substantive testing

*CR: Control risk, **RIA: Risk of incorrect acceptance, ***APR: Analytical procedures risk.

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Exhibit 10–4 organizes risk by the primary risk concepts of alpha and beta risk. The exhibit thus classifies risk by their relative importance (beta versus alpha). Note that the importance is reflected by the fact that all risks in the audit risk model fall in the beta risk column. This exhibit summarizes much of the rest of the risk discussion in this chapter.

EXHIBIT 10–4 Summary of Risks in Audit Testing (now categorized by alpha and beta risk types)

RISK	ALPHA RISK	BETA RISK
Audit risk (AR)	Not represented in AR model	AR and its components CR*, RIA** and APR*** components
Sampling risk	Statistical risk of incorrectly rejecting a population or class of transactions.	Statistical risk of incorrectly accepting a population or class of transactions.
Nonsampling risk	Judgmental risk of incorrectly rejecting a population or class of transactions.	Judgmental risk of incorrectly accepting a population or class of transactions.
Tests of controls risks	Risk of assessing control risk (CR*) too high (under-reliance on controls)	Risk of assessing control risk (CR*) too low (Over-reliance on controls)
Substantive procedures risks: Detection risk (DR) and its components RIA** and APR***	Risk of incorrect rejection (RIR)	Risk of incorrect acceptance (RIA)

*CR: Control risk, **RIA: Risk of incorrect acceptance, ***APR: Analytical procedures risk.

Sampling Methods and Applications

Audit sampling concerns the amount of work performed and the sufficiency of audit evidence obtained. The terminology of it includes many new concepts and definitions. The ones presented in earlier chapters, however, are general and apply to all phases of audit sampling. Knowing them allows you to "speak the language."

Auditors design audit samples to (1) evaluate control effectiveness in assessing control risk and (2) audit account balances in gathering direct evidence about financial statement assertions. These two parts will be covered in the next sections of the chapter. Each design is organized in terms of planning, performing, and evaluating audit sampling.

This chapter is presented in general terms, along the same lines as CAS 530, but with some basic formulas to clarify relationships. The chapter also reconciles with the *CICA Handbook* section 5300, the auditing guideline "Applying the Concept of Materiality," and the AICPA audit and accounting guide entitled "Auditing Sampling." (5300 and the AuG are replaced by CAS, but retained in CICA standards collection on a temporary basis for reference.)

REVIEW CHECKPOINTS

10-14 What is nonsampling risk? Give some examples.

10-15 Define sampling risk.

10-16 Does sampling risk always exist in both statistical and nonstatistical sampling? Explain your response.

10-17 Can sampling risk be avoided? Explain.

10-18 Can nonsampling risk be avoided? Explain.

10-19 Are auditors most likely to be sued successfully for sampling risk or for nonsampling risk?

10-20 What two types of audit programs are ordinarily used as written plans for audit-procedures?

10-21 What are control tests? What purpose do they serve?

TEST OF CONTROLS FOR ASSESSING CONTROL RISK

LO5 Develop a simple audit program for a test of a client's internal control procedures.

Auditors must assess control risk to determine the nature, timing, and extent of other audit procedures. Final evaluations of internal control are based on evidence obtained in the review and testing phases of an evaluation. It is difficult to describe control risk assessments as they depend entirely on judgments made in the circumstances of each specific situation.

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For example, an auditor might learn that a company requires the bookkeeper to match a shipping order with each sales invoice before recording a sale, as a control against the recording of fictitious sales. Now, suppose this control test shows a number of invoices without supporting shipping orders, causing sales possibly to be overstated. More extensive work on accounts receivable using confirmation, enquiries, and analytical review related to collectability would deal with this control deficiency. This shows how control testing provides only indirect evidence of the monetary accuracy of the accounts. Failure to have a matching shipping order only increases the probability of a monetary misstatement but is not guarantee of a misstatement; the shipping orders might have been misplaced and the recorded sales invoice might still be correct. Only further substantive work, such as direct confirmation with the customer, would provide convincing evidence of a misstatement.

This example related a specific control (matching sales invoices with shipping orders) to a specific set of audit procedures directed toward a possible problem (overstatement of sales and receivables). Generally, auditors reach judgments about control risk as shown in Exhibit 10–5. Some situations call for a nonquantitative expression, and some for a quantitative expression. The quantitative ranges overlap, communicating that auditors cannot put exact numbers on these kinds of evaluations.

EXHIBIT 10–5 Auditor's Assessment of Control Risk

	JUDGMENT EXPRESSION OF CONTROL RISK	
EVALUATION OF INTERNAL CONTROL	NONQUANTITATIVE	QUANTITATIVE
Excellent control, both as specified and in compliance	Low (1)	10%–30%
Good control, but lacks something in specification or compliance	Moderate (2)	20%–70%
Deficient control, either in specification or compliance or both	High (3)	60%–95%
Little or no control	Maximum	100%

If combining inherent and control risk evaluation is easier, then "low," "moderate," and "high" mean the following:
1. Low combined inherent and control risk.
2. Moderate combined inherent and control risk.
3. High combined inherent and control risk.

SAMPLING STEPS FOR TESTS OF CONTROL

Audit sampling is a structured, formal approach and plan for conducting control. The seven-step framework helps auditors plan, perform, and evaluate control test results. It also helps auditors accomplish an eighth step—careful documentation of the work and reasoning—by showing each of the seven areas to be described in the working papers. The first seven steps are as follows:

LO5a Specify objectives, deviation conditions, populations, and sampling units.

1. Specify the audit objectives.
2. Define the deviation conditions.
3. Define the population.
4. Determine the sample size.
5. Select the sample.
6. Perform the control tests.
7. Evaluate the evidence.

Plan the Procedures

The first three steps are the phase of **problem recognition**. When a client describes the control system, the implicit assertion is, "These controls work; people comply with the control procedures and achieve the control objectives." The auditors' question (problem) is, "Is it so? Are the validity (and other) control objectives achieved satisfactorily?"

problem recognition: the first three steps of the sampling method

Test of controls is always directed towards producing evidence of the client's performance of its own control procedures. Thus, auditors' procedures should produce evidence about the client's achievement of the seven control objectives.

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Specify the Audit Objectives

A validity control procedure; for example, the client's procedure of requiring a shipping order to be matched with a sales invoice before a valid sale is recorded. The specific objective of an auditor's test of controls audit procedure could be, "determine whether recorded sales invoices are supported by matched shipping orders." The audit procedure itself would be, "select a sample of recorded sales invoices and vouch them to supporting shipping orders."

The matching of sales invoices to shipping orders is a *key control* and important here. Auditors should identify and audit only the key controls. Incidental controls are not relied on to reduce control risk, and auditing them for compliance just wastes time.

Define the Deviation Conditions

The terms *deviation, error, occurrence,* and *exception* are synonyms in test of controls sampling. They all refer to departure from a prescribed internal control procedure; for example, an invoice is recorded with no supporting shipping order (bill of lading). Deviation conditions need to be defined at the outset so that the auditors will know a deviation when they see one. As an assistant accountant, you would prefer to be instructed to "select a sample of recorded sales invoices, vouch them to supporting shipping orders, and document cases where the shipping order is missing," rather than, "check recorded sales invoices for mistakes." The latter instruction does not clearly define the deviation conditions and can increase nonsampling risk.

This example is oversimplified, but this vouching procedure for compliance evidence might be used to obtain evidence about several control objectives at the same time. The invoice can be compared with the shipping order for evidence of actual shipment (validity), reviewed for credit approval (authorization), prices compared with the price list (authorization and accuracy), quantity billed compared with quantity shipped (accuracy), recalculated (arithmetic accuracy), compared for correspondence of shipment date and record date (proper period), and traced to postings in the general ledger and subsidiary accounts (accounting).

Exhibit 10–6 shows some deviation conditions laid out in a working paper designed to record the control testing results for a sample of sales invoices.

attribute sampling: in control testing this is the type of audit sampling in which auditors look for the presence or absence of a control condition

Test of controls audit sampling is also called **attribute sampling**—sampling in which auditors look for the presence or absence of a control condition. In response to the audit question, "For each sales invoice in the sample, can a matched shipping order be found?" the answer can be only yes or no. With this definition, auditors can count the number of deviations and use the count when evaluating the evidence. Attribute sampling can also be useful in balance auditing; an example is shown in the box on page 396.

Define the Population

Specifying the control test (compliance) audit objectives and the deviation conditions usually define the population; that is, the set of all elements in the balance or class of transactions. In our example, the population consists of all the recorded sales invoices, and each invoice is a population unit. In **classical attribute sampling**, a sampling unit is the same thing as a population unit.[5]

classical attribute sampling: when a sampling unit is the same thing as an invoice or population unit

Population definition is important because audit conclusions can only be made about the population the sample was selected from. For example, evidence from a sample of recorded sales invoices cannot be used for a conclusion about completeness. Controls related to the completeness objective (in this case, control over failure to record an invoice for goods shipped) can only be audited by sampling from a population representing goods shipped (the shipping order file) and not by sampling from the population of recorded invoices.

5 Monetary-unit sampling (MUS), however, defines a sampling unit differently as the monetary (dollar) value of the sampling unit. In effect each recorded dollar is viewed as a sampling unit. This allows wider use of attribute sampling as a substantive test, and greatly simplifies formulas that need to be learned with statistical auditing. Monetary-unit sampling is explained in detail in Appendix 10B on Connect.

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EXHIBIT 10–6 Test of Controls Audit Documentation

Index *M* By *J* Date *11-*
Review *G.* Date *11-*

KINGSTON COMPANY
Test of Controls Over Recorded Sales
December 31, 20X2

Invoice number	Date	Amount	Bill of lading	Credit approved	Approved prices	Quantities match	Arithmetic accurate	Dates match	Posted to customer
35000	Mar. 30	$ 3,000							
35050	Mar. 31	$ 800			X				
35100	Apr. 2	$ 1,200					Y		
35150	Apr. 3	$ 1,500			Y				
35200	Apr. 5	$ 400							
35250	Apr. 6	$ 300	X			X	Y	X	
32100	Jan. 3	$ 1,000							
32150	Jan. 4	$ 200							
34850	Mar. 25	Missing	X	X	X	X	X	X	
34900	Mar. 26	$ 100			Y				
34950	Mar. 27	$ 200							
Sample = 200		$98,000							
Uncorrected deviations			4	9	5	6	3	7	0

X = Uncorrected deviation.
Y = Deviation occurred but was detected and corrected later.

The timing of the audit work complicates population definition. Control tests ideally should be applied to transactions executed throughout the entire period under audit. However, auditors often perform control tests at an interim date—a date some weeks or months before the client's year-end date—when the entire population is not available for audit. Doing the work at an interim date is fine, but auditors cannot ignore the period between the interim date and the year-end. Strategies for control in the period after the interim date are explained later.

The question of how well the **physical representation of the population** corresponds to the population itself also complicates the population definition. The physical representation of the population is the auditor's frame of reference for selecting a sample. It can be a journal listing of recorded sales invoices, a file drawer full of invoice copies, a computer file of invoices, or another physical representation. The sample actually will be selected from the physical representation, so it must be complete and correspond with the actual population. The physical representation of the recorded sales invoices as a list in a journal is fairly easy to visualize. However, an auditor should make sure that periodic listings (e.g., monthly sales journals) are added correctly and posted to the general ledger sales accounts. In our example, a selection of individual sales invoices from the sales journal is known to be from the complete population of recorded sales invoices, but some physical representations are not so easy to assess for the completeness of correspondence to their population.

physical representation of the population: the auditor's frame of reference for selecting a sample; for example, a journal listing of recorded sales invoices

These issues are not changed much whether the records are in electronic or hardcopy form. Electronic records are usually based on the design of an originating hard copy. Hence sampling of an electronic population is not that different from a hard copy population. Of course, it is much easier to read through and summarize an electronic population

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and so 100% exams are more common in an IT audit environment. However, at some point auditors need to reconcile the electronic records with facts in the real world. It is this more time consuming reconciliation process with other information that largely makes sampling relevant in an IT audit.

A BALANCE AUDIT APPLICATION OF ATTRIBUTE SAMPLING

Attribute control test samples usually are drawn from a class of transactions in order to obtain evidence about compliance with control objectives. Attribute samples may be used for balance audit purposes. This example suggests an attribute sample to obtain evidence about an ownership (rights) financial statement assertion.

Question: A lessor is in the business of leasing autos, large trucks, tractors, and trailers. Is it necessary for the auditors to examine the titles to all the equipment?

Answer: It is not necessary, unless some extraordinary situation or circumstance is brought to light, for the auditors to examine titles to all the equipment. Random test verification of title certificates or proper registration of vehicles should be made.

Source: AICPA Technical Practice Aids, 8330.02.

The Procedures

LO5b Demonstrate some basic audit sampling calculations.

The next three performance steps represent the phase of **evidence collection** of the sampling method. These steps are performed to obtain the evidence.

evidence collection: steps 4, 5, and 6 of the sampling method, which are performed to get the evidence

Determine the Sample Size

Sample size—the number of population units to audit—should be determined thoughtfully. Some auditors operate on the "magic number theory" (e.g., select 30, because that is what we have always used on this audit). But a magic number may not provide enough evidence or it may be too large a sample. Auditors must consider four influences on sample size: sampling risk, tolerable deviation rate, expected population deviation rate, and population size.

Sampling Risk (CAS 530.05) Beta risk and alpha risk are the two major categories of sampling risk. Sampling risk is defined as the probability that a conclusion based on the audit of a sample might be different from a conclusion based on an audit of the entire population. In other words, when using evidence from a sample for testing controls, an auditor might decide that (1) control risk is very low when, in fact, it is not (i.e., a beta risk error), or (2) control risk is very high when, in fact, it is not so bad (i.e., an alpha risk error). The more you know about a population (from a larger sample), the less likely you are to reach a wrong conclusion, or the lower the sampling risk will be of making either of the two decision errors. More will be said about these risks in the section on evaluation.

In terms of our example, the important sampling risk is the probability that the sample will reveal few or no recorded sales invoices without supporting shipping orders when, in fact, the population contains many such deviations. This result would lead to the erroneous conclusion that the control worked well. Auditing a larger sample reduces the probability of finding few deviations when many exist. Thus, sample size varies inversely with the amount of sampling risk an auditor is willing to take. We will illustrate with calculations after covering some more concepts.

Tolerable Deviation Rate (CAS 530.05) Auditors should have an idea of how rates of deviation in the population correspond with control risk assessments. Perfect control compliance is not necessary, so the question is rather what rate of deviation in the population signals control risk of 10%, 20%, or 30%, and so forth, up to 100%? Suppose an auditor believes that $90,000 of sales invoices could contain control deviations without causing a minimum material misstatement in the sales and accounts receivable balances. If the total gross sales are $8.5 million, this judgment implies a **tolerable deviation rate** of about 1% ($90,000/$8.5 million). Since this 1% rate marks the minimum material misstatement, it indicates a low control risk (say, 0.05), and it justifies a great deal of reliance on internal control in the audit of the sales and accounts receivable balances.

tolerable deviation rate: rate of deviation that can exist without causing a minimum material misstatement in a test of controls procedure

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However, there can be more than one tolerable deviation rate. Each successively higher rate is associated with a higher control risk. Continuing with our example, higher tolerable deviation rates could be associated with higher control risks as follows:[6]

DEVIATION RATE (%)	CONTROL RISK
1	0.05
2	0.10
4	0.20
6	0.30
8	0.40
10	0.50
12	0.60
14	0.70
16	0.80
18	0.90
20	1.00

Since sample size varies inversely with the tolerable deviation rate, the auditor who wants to assess control risk at 0.05 (tolerable rate = 1%) will need to audit a larger sample of sales transactions than another auditor who is willing to assess control risk at 0.40 (tolerable rate = 8%). The desired control risk level and its tolerable rate are a matter of auditor choice.

The tolerable rate is not a fixed rate until the auditor decides what control risk assessment suits the audit plan, at which point it becomes a decision criterion involved in the sampling application. Some auditors express the tolerable rate as a number (necessary for statistical calculation of sample size), while others do not put a number on it. Appendix 10B on Connect contains more explanation about determining various tolerable rates.

Expected Population Deviation Rate (CAS 530, Appendix 2) Auditors usually know of or suspect some control performance conditions. They could have last year's audit experience with the client or information from a predecessor auditor, which informs them about the client's personnel, working conditions, and general control environment. This knowledge contributes to an **expectation about the population deviation rate**, an estimate of the ratio of the number of expected deviations to population size. If there was a 1% deviation in last year's audit, this year's expected rate could be 1% as well. Auditors can also stipulate a zero expected deviation rate, which will produce a minimum sample size for audit. The reason for using expected error rate greater than zero is solely for the purpose of reducing alpha risk over its range. Some accounting firms as a matter of policy use an expected rate of zero errors in budgeting for an audit. The rationale is that auditee's should pay extra if the audit is less efficient as a result of finding some errors.

expectation about the population deviation rate: an estimate of the ratio of the number of expected deviations to population size

From a common-sense perspective, the expected rate of deviation must be less than the tolerable rate, as there would be no reason to perform any test of controls if the auditor expected to find more. Also, the closer the expected rate is to the tolerable rate, the larger is the sample needed to reach a conclusion that deviations do not exceed the tolerable rate. Thus, sample size varies directly with the expected deviation rate. Some auditors will express the expected rate as a number (necessary for statistical calculations of sample size), while others will not put a number on it.

The simplified approach we use in this chapter to illustrate the calculations does not quantify the expected population deviation—effectively, the expected rate is zero. This expected error rate results in use of the smallest statistical sample sizes possible, consistent with auditor beta risk and materiality objectives. Some auditors use these smallest statistical sample sizes as a guide to the minimal amount of testing even for nonstatistical sampling (e.g., see the American Institute of Certified Public Accountants [AICPA], "Audit Sampling

6 Accounting firms have different policies for associating tolerable deviation rates with control risk categories. Some start with a minimum rate of 1%, and others start with higher rates.

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Guide," May 1, 2008, edition, p. 34). Statistical sample size calculations can, thus, be an important guide in all audit sampling situations (CAS 530). The application case at the back of the chapter shows that the primary purpose of quantifying the expected deviation rate is to control the alpha risk. Appendix 10B on Connect explains how to work with nonzero expected population deviation rates.

Population Size Common sense probably tells you that samples should be larger for bigger populations (a direct relationship). While your common sense is accurate, practically speaking, the appropriate sample size for a population of 100,000 units may be only two or three sampling units larger than that for a 10,000-unit population. Not much difference! By using the same calculation for both populations, your sample size for the 10,000 population is proportionally bigger, and thus more conservative. The general principle is that if you use the simplified formulas for very large populations, you end up with slightly conservative results. Many practicing auditors find this trade-off worthwhile.

The four influences on sample size in this section, and summarized in Exhibit 10–7, are applicable to both statistical and nonstatistical sampling.

EXHIBIT 10–7 Sample-Size Relationships: Test of Controls Auditing

	PREDETERMINED SAMPLE SIZE WILL BE:		
SAMPLE SIZE INFLUENCE	HIGH RATE OR LARGE POPULATION	LOW RATE OR SMALL POPULATION	SAMPLE SIZE RELATIONSHIP
1. Acceptable sampling risk	Smaller	Larger	Inverse
2. Tolerable deviation rate	Smaller	Larger	Inverse
3. Expected population deviation rate	Larger**	Smaller	Direct
4. Population	Larger*	Smaller*	Direct

*Effect on sample size is quite small for population of 1,000 or more.
**Effect of this is explained in Appendix 10B on Connect. Many auditors do not quantify the expected rate because it relates to the less serious alpha risk control not the more serious beta risk as discussed earlier this chapter.

Calculating Sample Size The preceding discussion of sample-size determinants gives you a general understanding of the four influences on sample size. Next, we consider the simplified way of calculating sample sizes with a brief overview of basic formulas and tables used in statistical auditing.

Some basic formulas provide an overview of the most fundamental mechanics of statistical auditing. Two key points at which the formulas and tables are used in statistical sampling are (1) sample size planning and (2) sample evaluation. With one commonly used approach, called **monetary-unit sampling (MUS)**, the same formula and table can be applied to both tests of controls and substantive tests of balances. MUS is common because it is effective, efficient, and the easiest approach to use. MUS can be used for control tests either with MUS selection or with physical representation of a transactions population.

monetary-unit sampling (MUS): a modified form of attributes sampling that permits auditors to reach conclusions about monetary amounts as well as compliance deviations

We begin by illustrating use of MUS formulas in sample-size planning for tests of control. The following discussion is based on the table given in Appendix 10A, and using the formula $R = nP$; R is the value from the table in Appendix 10A n is the sample size, and P stands for the precision, or accuracy, desired for the statistical test. Note that this table gives a unique R value for each combination of K (number of errors) and confidence level. Since, as explained earlier, MUS uses the negative approach, confidence level = one minus beta risk. Therefore, the auditor controls beta with MUS by picking the appropriate confidence level. Selection of the K value influences the alpha risk. Specifically, the higher the K value used, the lower is the alpha risk over much of its range. With a valid MUS sample size the alpha risk is always controlled at zero when there are no errors.

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For planning audit sample sizes using the basic equation R = nP and solving for n, we get the equation n = R/P. This equation for n summarizes the key factors affecting the sufficiency of audit evidence: the relationship between confidence level (R value) and materiality (P value), and the extent of audit testing (sample size n). That is, the amount of audit work is directly proportional to the confidence level and inversely proportional to the materiality level used.

For tests of controls and substantive tests, solve for n (as above) in the formula R = nP, where $R = {}_{CL}R_K$ is a confidence-level (CL) factor that is unique for each combination of CL and K from the table of values for R given in Appendix 10A (page 427). P is based on overall materiality or specific materiality as discussed in CAS 320 and Chapter 5. With non-MUS models sometimes the overall or specific materiality is adjusted lower in sample planning thereby creating the performance materiality concept of CAS 320 and tolerable misstatement concept of CAS 530.A3. For tests of controls a further complication is created by the need to link control deviation rates to the adjusted materiality, as discussed above. This is likely why CAS 530.05 introduces the tolerable rate of deviation and distinguishes it from tolerable misstatement. The tolerable rate of deviation is represented as a rate or proportion. The auditor must use professional judgment in specifying K, CL, and planned P. The effects of these various decisions on sample size are summarized in Exhibit 10–7. Using these concepts results in the simplified approach described in this section.

P is the amount, as a rate, that the auditor considers the tolerable rate of deviation for the population being tested. When being set, it has to take into consideration the additive effect of errors in other accounting populations representing other balances or transaction streams. In this stage of sampling, the planned P might be an amount lower than the tolerable rate of deviation so that the auditor can reduce alpha risk. Firm practice varies: Alpha risk can be indirectly controlled through the *planned* K value, the *planned* P value, or a combination of the two. The most common strategy is to use K = 0 and a *planned* P in the range of half to full tolerable rate of deviation. whichever the auditor deems more appropriate in the circumstances. We discuss these options further in Appendix 10B on Connect. Here, the calculations are simplified by assuming that planned P is set equal to the tolerable rate of deviation. This results in the smallest sample size possible for the stated confidence level and precision. This smallest sample size is used by many firms as a guide to sufficient sample sizes for all representative sampling, whether statistical or nonstatistical (e.g., see AICPA, "Audit Sampling Guide," May 1, 2008, edition, p. 34). These properties are illustrated in the Application Case at the end of this chapter.

In the formula CL = 1 − beta risk, beta risk is the risk that the test will fail to detect a tolerable rate of deviation when it exists—the risk of incorrect acceptance (RIA). Alpha risk is the risk of concluding that there is a material misstatement when, in fact, the misstatements are immaterial—the risk of incorrect rejection (RIR).

To illustrate the calculations using the table of R values in Appendix 10A, let us assume the auditor wants a confidence level of 95%, uses K = 0 to make the sample planning as simple as possible (this results in the smallest sample size for the planned confidence level), and sets planned P so that it equals the tolerable deviation rate, which we assume here is 0.05, so planned P = 0.05. Using our formula n = R/P and the table, you should get the following results: n = 3.0/0.05 = 60, so that your planned sample size, given these objectives, is 60. We will use this sample size to evaluate the sample results a little further on.

Working with tables based on the above formulas will minimize the use of formulas. For example, the simplified table titled "Table to Determine Sample Sizes for Tests of Control Using the MUS Approach" in Appendix 10A is constructed using the calculations with formulas in the preceding paragraph. A table is usually based on some formula or algorithm. When using such a table, the auditor only needs to identify the required beta risk (= 1 − CL) and tolerable deviation rate. In constructing the table, the expected error rate is zero (K = 0), thereby leading to the smallest sample size possible for the stated confidence level and tolerable rate. This table is restricted to the most common beta risk levels of 0.10 and 0.05 and the most commonly used tolerable deviation rates. Thus, the table is quite small. To figure out the sample size, the auditor looks up the number in the

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table that is at the intersection of the desired beta risk and tolerable rate. Using a desired beta risk of 0.05 (or, equivalently, a desired confidence level of 0.95) and tolerable rate for tests of controls of 0.05, then the table gives 60 as the desired sample size. The same size sample could have been calculated using the formula. Your instructor will indicate to you which approach is to be used in your course.

A NOTE ON TESTING OF CONTROLS FOR AUDITS OF INTERNAL CONTROL STATEMENTS

Section 404 of the Sarbanes-Oxley Act introduced a requirement for management to prepare internal control statements and have them audited. This requirement led to PCAOB's Auditing Standard No. 2.

What does testing of controls mean in this new context? First, internal control statements focus on company-level control objectives such as "tone at the top," corporate codes of conduct, and corporate governance in general. Second, the focus is on the design of internal control at a specific point in time. Third, auditors need to utilize an authoritative framework for evaluating the design. For example, the Public Company Accounting Oversight Board (PCAOB) requires that the following be considered as part of the framework of suitable internal control criteria for purposes of reporting on internal control: control environment, risk assessment, control activities, information and communication, and monitoring. This chapter stresses testing of detailed control activities.

Select the Sample

Auditing standards express two requirements for samples: (1) Sampling units must be selected from the population an audit conclusion will apply to, ideally from transactions executed throughout the period under audit; and (2) a sample must be representative of the population it is drawn from. Thus, a sample mirrors the characteristics of the population, but auditors cannot guarantee its representativeness. After all, that is what sampling risk is all about—the probability that the sample might not mirror the population well enough.

Auditors can try to attain representativeness by selecting random samples—each unit in the population has an equal probability of being included in the sample. Intentionally or accidentally excluding a segment of a population can render a sample nonrepresentative. Random samples are often selected by assigning a number to each population unit (sometimes the units are prenumbered forms), and then choosing a selection of random numbers to make up the sample. A printed random number table (one is provided in Appendix 10A) or a computerized random number generator, such as the RAND function in Excel, will generate a list of random numbers. This method is known as **unrestricted random selection**.

unrestricted random selection: using a printed random number table or computerized random number generator to obtain a list of random numbers

Systematic random selection is another popular method. It is especially popular with MUS. To use it, the population size and a predetermined sample size are needed. A random starting place in the physical representation (list of sales invoices recorded in a sales journal, for example) is chosen, and then every Kth unit is selected, where the value for K is population size divided by sample size. For example, if 10,000 invoices, numbered from 32071 to 42070, were issued and you want a sample of 200, first randomly choose a starting place, say invoice 35000, then select every Kth = 10,000 divided by 200 = 50th invoice. So, the next invoice would be 35050, then 35100, then 35150, and so on. If the end of the list is reached before 200 are selected, cycle back to the sequence beginning invoice, 32071, and continue. Most systematic samples are selected using five or more random starts in the population. MUS can use systematic sampling as just described or work with the dollar value of the transactions processed instead. The population size is then the monetary value of the population. For example, assume the 10,000 invoices had a total value of $10,000,000, then the sampling interval would be $50,000; that is, select every 50,000th dollar. This means finding the invoice associated with that dollar and continuing as previously described.

systematic random selection: using a predetermined population and sample size and random starting places

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With sample selection there is a critical distinction between statistical and nonstatistical audit sampling. In statistical sampling evaluation, the sample must be random, while in nonstatistical plans, auditors sometimes use sample selection methods where randomness and representativeness cannot easily be evaluated. **Haphazard selection** refers to any unsystematic way of selecting sample units; for example, closing your eyes and dipping into a file drawer of sales invoices to pick items. You may pick only the crumpled ones that stick out, and they may be different from most of the other invoices in the drawer. Also, your method cannot be described so that someone can **replicate** it. Some auditors describe haphazard sampling as choosing items without any special reason for including or excluding items, thus obtaining a **representative sample**. However, because it is hard to document and impossible to replicate, haphazard selection should be considered only as a last resort.

haphazard selection: unsystematic way of selecting sample units

replicate: re-perform a selection procedure and get the same sample units

representative sample: sample that mirrors the characteristics of the population being studied

Block sampling is the practice of choosing segments of contiguous transactions; for example, choosing the sales invoices processed on randomly chosen days, say February 3, July 17, and September 29. Implicitly, the block-sampling auditor has defined the population unit as a business day (260 to 365 of them in a year) and has selected three—not much of a sample. Block sampling is undesirable because it is hard to get a representative sample of blocks efficiently; having enough blocks means there is a huge number of invoices to audit for compliance.

block sampling: choosing segments of contiguous transactions; undesirable because it is hard to get a representative sample efficiently

Some auditors try to get the best of both worlds and use statistical sampling formulas to determine the sample size (as explained above) but combine this with haphazard selection which is commonly used in auditing. Sample sizes determined using the formulas are frequently much smaller than your intuition would suggest. This helps explain the initial popularity of statistical sampling—it greatly reduced audit work! However, these formulas are valid only with random selection or close approximations to random selection.

Haphazard sampling is intended to be representative of a population but rigorous random or systematic selection is *not* used. Thus, the probability of selecting a particular item becomes unpredictable. Research by Hall illustrates one source of such unpredictability: bias due to nonsampling errors.[7] Specifically, judgmental biases arise from items that stand out or draw attention (brightly coloured items, large items, isolated items of inventory or files), or items that are easier to access. When auditors use haphazard sampling they should be trained in de-biasing procedures if they want this type of evidence to be acceptable in court. Otherwise, the auditor must be prepared to nonstatistically sample a very large proportion of the population (30% or more). For example, in many practical situations, the auditor would need to test about 10 times more items than the sample size formulas with true random selection indicate. That is quite a penalty to pay for not using true random selection! This illustrates another advantage of the more formal statistical sampling—potentially smaller amounts of testing can result, as documented by this article.

Another practical reason why auditors would want to use statistical sampling is that it allows an objective measure of the sampling risk; specifically, the risk of failing to detect a material misstatement (beta risk). Statistical sampling allows calculation of a measurable risk that an auditor is taking in the testing process. The disadvantage of this is the extra training required to use statistical methods properly. Auditors have been deterred by the training costs associated with using statistics, but the Hall article shows that it is just as important to get training in correctly applying nonstatistical representative sampling! Failure to do so puts the auditor at risk of not properly applying audit procedures.

Perform the Control Tests

An internal control program consists of procedures designed to produce evidence about the effectiveness of a client's internal control performance, and now you are ready to obtain the evidence. The control tests are explained in Chapter 8.

7 Hall et al., "How reliable is haphazard sampling?" *CPA Journal*, January 2006.

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REVIEW CHECKPOINTS

10-22 Why can poor controls over the existence of sales result in an overstated accounts receivable balance at year-end?

10-23 In control testing, why is it necessary to define a compliance deviation in advance? Give seven examples of compliance deviations.

10-24 Which judgments must an auditor make when deciding on a sample size?

10-25 Describe the influence of each judgment on sample size.

10-26 Name and describe four sample selection methods.

The Evidence

LO5c Evaluate evidence from control testing.

evidence evaluation: final step of the sampling method; to evaluate the evidence and make justifiable decisions about the control risk

risk of assessing the control risk too high: probability that the compliance evidence in the sample indicates high control risk when the actual (but unknown) degree of compliance would justify a lower control risk assessment

risk of assessing the control risk too low: probability that the compliance evidence in the sample indicates low control risk when the actual (but unknown) degree of compliance does not justify it

The final step is **evidence evaluation** of the sampling method. First, you determined whether each specified key control procedure worked satisfactorily. Then you gathered relevant compliance evidence. Now you need to evaluate the evidence and make justifiable decisions about the control risk.

Evaluate the Evidence

Test of controls audit sampling provides evidence of whether a client's internal control procedures are being followed satisfactorily. Compliance evidence, therefore, is very important for the conclusion about control risk. When auditors evaluate sample-based compliance evidence, there are two sampling risk decision errors they might make: assessing the control risk too low or assessing it too high. The **risk of assessing the control risk too low** is the probability that the compliance evidence in the sample indicates low control risk when the actual (but unknown) degree of compliance does not justify it. This can lead to failure to do the necessary additional work and threatens the effectiveness of the audit. This is the beta risk for tests of controls. On the other hand, the **risk of assessing the control risk too high** is the probability that the control test evidence in the sample indicates high control risk when the actual (but unknown) degree of compliance justifies a lower control risk assessment. This is the alpha risk for tests of controls. Assessing the control risk too high triggers more audit work than was planned and threatens the efficiency of the audit.

Audit efficiency is important, but audit effectiveness is more important. For this reason, auditing standards require only a low risk of assessing the control risk too low, especially when this decision error could cause an auditor to do significantly less work on the related account balances. These risks and decisions are illustrated in Exhibit 10–8. Keeping these risks in mind, evaluating evidence includes calculating the sample deviation rate, comparing it with the tolerable rate, and following up all the deviations discovered.

SUPERSEDED TERMINOLOGY: OVERRELIANCE AND UNDERRELIANCE

Several years ago, professional terminology was changed from "reliance on control" to "assessment of control risk." However, old habits die hard, and you will probably still encounter these uses of control terminology:

Overreliance is the result of realizing the risk of assessing control risk too low. If auditors think control risk is low when in fact it is higher, they will over rely on internal control and restrict other audit procedures when they actually should perform more work. Overreliance is the same as beta risk of tests of controls.

Underreliance is the result of realizing the risk of assessing control risk too high. If auditors think control risk is high when in fact it is lower, they will under rely on internal control and perform more audit work when less work would suffice. Underreliance risk is the same as alpha risk of tests of controls.

Calculate the Sample Deviation Rate The first piece of hard evidence is the sample deviation rate. Suppose an auditor selected 60 recorded sales invoices and vouched them to shipping orders (bills of lading), finding one without shipping orders. The sample

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EXHIBIT 10–8 The Test of Controls Audit Sampling Decision Matrix

ACTUAL STATE OF INTERNAL CONTROLS (ACTUAL POPULATION DEVIATION RATE)	SAMPLE POPULATION DEVIATION RATE	
	LESS THAN TOLERABLE RATE	GREATER THAN TOLERABLE RATE
The deviation rate is less than the tolerable rate, so the control is performed satisfactorily.	Correct decision	Control risk too high decision error (Alpha risk for tests of controls)
The deviation rate is greater than the tolerable rate, so the control is not performed satisfactorily.	Control risk too low decision error (Beta risk for tests of controls)	Correct decision

deviation rate is 1/60 = 1.7%. This is the best single-point estimate of the actual, but unknown, deviation rate in the population. However, you cannot say that the deviation rate in the population is exactly 2%. Chances are the sample is not exactly representative; the actual but unknown population deviation rate could be lower or higher.

Judge the Deviation Rate in Relation to the Tolerable Rate and the Risk of Assessing the Control Risk Too Low Suppose the auditor in the example believed the tolerable rate was 5% (same as in planning a few pages earlier), justifying a control risk assessment of CR = 0.40. In a nonstatistical sampling case, this auditor is supposed to think of the sample deviation rate (1.7%) in relation to the tolerable rate (5%), and about the risk (of assessing control risk too low) that the actual, but unknown, deviation rate in the population exceeds 8%. The decision in this case depends on the auditor's experience and expertise. The nonstatistical auditor might conclude that the population deviation rate is probably 8% because the sample deviation rate of 2% is so much lower. The *CICA Handbook* guideline AuG-41, paragraph 42, suggests this logic. AuG-41 does not assume that the auditor is using statistical sampling. However, it must assume that the auditor used a minimal sample size as determined by a statistical formula, because the population is always rejected statistically when the sample size is too small (this happens because beta risk is larger than planned and to get it smaller a larger sample is needed). If too small a sample size is selected, the statistical formulas always reject, even if no errors are found.

Sample Evaluation Things are more explainable, in text, with a quantitative model, such as statistical sample evaluation, which explains why statistical sampling is more popular. Sample evaluation essentially involves solving for P in the formula $R = nP$ so that $P = R/n$. When P is calculated in this way it is referred to as *achieved P,* or the *achieved UEL* (upper error limit). Achieved P is calculated after the sample has been taken and the results are known. This means that the number of errors (K) detected by the sample is already known, the confidence level (CL = 1 − beta risk) is known, and the sample size taken is already known. Thus, we can solve for achieved UEL = achieved $P = R/n$, where $R = {}_{CL}R_K$, CL is the specified confidence level, and K is the number of errors *found* in the sample (not the number expected as in sample-size planning).

The auditor establishes decision criteria by first assigning a number to the risk of assessing the control risk too low, say 5%, and then assigning a number to the tolerable rate, say 5%. A statistical table is then used to calculate a sampling error-adjusted upper limit, which is the sample deviation rate adjusted upward to allow for the idea that the actual population rate could be higher. In this example, the adjusted limit, the UEL, can be calculated as 5%. This is obtained with the MUS formula and table by solving for achieved precision (achieved P) as follows; achieved $P = R/n$ using K = 1 (number of errors actually found in the sample) to get the R value with K = 1 and 95% CL (beta risk = 0.05) which is R = 4.75. Now calculate the achieved $P = R/n = 4.75/60 = 0.08$. The statistical decision rule is based on comparing the 0.08 to tolerable (0.05). This finding means "the probability is more than 5% that the actual but unknown population deviation rate is greater than 5%." The decision criterion was "the actual but unknown population

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deviation rate needs to be 5% or lower, with 5% risk of assessing the control risk too low." So, the decision criterion is not satisfied, and the control risk assessment (0.40) associated with the 5% tolerable rate cannot be justified.[8]

From a critical thinking perspective, this justification step (step 4 of Exhibit 4–1 on page 96) uses statistical theory to support the conclusion. Many would view such a conclusion as better supported than one based on nonstatistical sampling. One of the advantages of statistical auditing is that it makes sample evaluation less ambiguous, as is illustrated next.

The 0.08 is the maximum error at the specified confidence level (0.95). This is then compared with what is material or tolerable. The basic rule is that, if achieved P, or UEL, is greater than material or tolerable, reject the population—otherwise, accept it. Compare this rule with AuG-41, paragraph 42, and note that this monetary-unit sampling (MUS) rule is less ambiguous. In the case of tests of controls, rejection of the population is equivalent to assessing control risk as high; that is, there is no (or reduced) reliance on controls.

As in sample planning, the use of appropriate tables eliminates the need for the formulas. For example, Appendix 10A has tables entitled "Table to Evaluate Sample Results for Tests of Controls . . ." These tables provide for two widely used confidence levels: 95% and 90%, the equivalent to planned beta risk levels of 5% and 10%, respectively. The table values are the interaction of sample sizes (left-hand column) and number of errors. In our illustration, we use 0.05 beta risk (= 1 − 95% CL) and a sample size of 100 to get a UEL of 7% (rounded up) for this confidence level. This conservative UEL of 7% can be interpreted as the maximum error rate at 95% CL. The decision rule is to accept reliance on the controls (or accept the population) if the UEL is less than tolerable; otherwise, reject or reduce reliance (or reject the population error as unacceptable). This result is more conservative (higher UEL) than in the paragraph above, but done with tables, not formulas. You can get a more accurate value of 6.3% by dividing the R value at the top (6.3) by the sample size (100). Your instructor will tell you which approach to use in your course.

Achieved P can always be interpreted as the maximum error rate for the specified CL. There are additional complications for substantive testing, but these formulas are the only thing necessary for a conceptual understanding. These formulas or tables of MUS are so simple and so effective that they are now the most widely used in audit practice.

MUS is also so widely used because taking an appropriate sample does not require advance knowledge of the recorded amount of the population, as the other statistical approaches do. This makes MUS particularly appropriate for audits involving continuous, online, real-time reporting of sales and purchases as might be demanded in ecommerce audits. This is further explained in Appendix 10B on Connect.

Follow-Up All Deviations The evaluation described so far has been mostly quantitative in nature, involving counts of deviations, deviation rates and tolerable rate, and risk judgment criteria. Qualitative evaluation through determining the nature and cause of the deviations is also necessary. A single deviation can be the tip of the iceberg—a sign of pervasive deficiency. Auditors are obligated by the standard of due audit care to investigate known deviations so that nothing important will be overlooked.

error analysis: qualitative evaluation of control risk

Qualitative evaluation is sometimes called **error analysis** because each deviation from a prescribed control procedure is investigated to determine its nature, cause, and probable effect on financial statements. The analysis is essentially judgmental and involves a decision on whether the deviation is (1) a pervasive error in principle affecting all like transactions or just the one, (2) a deliberate control breakdown or unintentional, (3) a result of misunderstood instructions or careless inattention to control duties, or (4) directly or remotely related to a money-amount measurement in the financial statements. Clearly, different qualitative perceptions of the seriousness of a deviation result from error analysis findings.

8 Changing the example to suppose deviations were found creates a problem for the nonstatistical sampler. He or she must think harder about the evidence (a 5.5% sample rate) in relation to the tolerable rate (8%) and acceptable risk. The statistical sampler can measure the UEL at 8.3%, which is greater than the 8% tolerable rate at 10% risk of overreliance. The control fails the decision criterion test. Appendix 10B on Connect contains more information about making these calculations using statistical tables and formulas.

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When the decision criteria are not satisfied and the preliminary conclusion is that the control risk is high, the auditors need to decide what to do next. The deviation follow-up can lead to more account balance audit work by making changes to the nature, timing, and extent of other audit procedures. If you suspect the sampling results overstate the actual population deviation rate (i.e., that alpha risk is occurring), you can perform the control tests on more sample units in hopes of deciding that the control risk is actually lower. However, when faced with the preliminary "nonreliance" decision, you should never manipulate the quantitative evaluation by raising the tolerable rate or setting the risk of assessing the control risk too low. Supposedly, these two decision criteria were carefully determined in the planning stage, and only new information is a good basis for easing them.

Timing of Test of Controls Audit Procedures

Earlier, you learned that auditors can perform the control testing at an interim date—a date before the client's year-end date. When control testing is early, an audit manager must decide what to do about the remaining period (e.g., the period October through December after doing test of controls auditing in September for a December 31 year-end audit).

The decision turns on several factors: (1) The results of the work at interim might, for example, indicate poor control performance and high control risk; (2) enquiries made after interim may show that a particular control procedure has been abandoned or improved; (3) the length of the remaining period may be short enough to forego additional work or long enough to suggest a need for continuing the test of controls audit; (4) the dollar amounts affected by the control procedure may have been much larger or much smaller than before; (5) evidence obtained about control as a byproduct of performing substantive procedures for the remaining period may show enough about control performance that separate work on this is unnecessary; or (6) work performed by the company's internal auditors may be relied on for the remaining period.

Depending on these circumstances, an auditor can decide to (1) continue the test of controls because knowledge of control performance is necessary to justify restriction of other audit work or (2) stop further test of controls audit work because (*a*) there is enough evidence derived from other procedures or (*b*) information shows the control has failed, control risk is high, and other work will not be restricted. Whatever the judgment, audit effectiveness and efficiency should always be uppermost in the auditor's mind.

REVIEW CHECKPOINTS

10-27 In test of controls auditing, why should auditors be more concerned with the risk of assessing the control risk too low than with that of assessing it too high?

10-28 What important decision must be made when test of controls auditing is performed and control risk is evaluated at an interim date several weeks or months before the client's fiscal year-end?

SUBSTANTIVE PROCEDURES FOR AUDITING ACCOUNT BALANCES

LO6 Develop a simple audit program for an account balance, considering the influences of risk and tolerable misstatement.

When audit sampling is used for auditing the assertions in account balances, the monetary amount of the population units is the main interest, not the presence or absence of control deviations, as is the case with attribute sampling. **Substantive tests of details auditing** is done to obtain direct evidence about the dollar amounts and disclosures in the financial statements.

Substantive-purpose procedures include analytical procedures and test (audit) of details of transactions and balances. Analytical procedures involve overall comparisons of account

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substantive tests of details auditing: performance of procedures to obtain direct evidence about the dollar amounts and disclosures in the financial statements

balances with prior balances, financial relationships, nonfinancial information, budgeted or forecasted balances, and balances derived from estimates calculated by auditors (refer to the discussion of analytical procedures in Chapter 8). Analytical procedures are usually not applied on a sample basis. So, substantive procedures for auditing details are the normal procedures used in account balance audit sampling.

Risk Model Expansion

detection risk (DR): the risk that the auditor's procedures will fail to find a material misstatement that exists in the accounts

analytical procedures risk (APR): the risk that analytical procedures will fail to detect material misstatements (beta risk associated with APR)

risk of incorrect acceptance (RIA): decision to accept a balance as being materially accurate when the balance is materially misstated

Up to now you have worked with a conceptual risk model that included **detection risk (DR)**. Detection risk is actually a combination of two risks: **analytical procedures risk (APR)** is the probability that analytical procedures will fail to detect material errors, and the **risk of incorrect acceptance (RIA)** is the probability that test-of-detail procedures will fail to detect material errors. The two types of procedures are considered independent, so detection risk is $DR = APR \times RIA$, and the expanded risk model is:

$$AR = IR \times CR \times APR \times RIA$$

This model is still a conceptual tool. It can now be used to help you understand some elements of sampling for auditing the details of account balances. First, recognize that auditors exercise professional judgment in assessing the inherent risk (IR), control risk (CR), analytical procedures risk (APR), and audit risk (AR). If these four risks are given, you can then manipulate the model to express the RIA:

$$RIA = \frac{AR}{IR \times CR \times APR}$$

With AR, IR, and APR held constant, RIA varies inversely with CR; that is, the higher the planned CR, the lower the planned RIA, and vice versa. Furthermore, this is also true of the risk of material misstatement concept (RMM) of CAS 530, since $RMM = IR \times CR$.

More about Sampling Risk

Substantive-purpose procedures produce the evidence enabling an auditor to decide whether an account balance is materially in conformity with GAAP. Thus, auditors run the sampling risks of making one of two decision errors. The RIA represents the decision to accept a balance as being materially accurate when, in fact (unknown to the auditor), the balance is materially misstated. This is the beta risk for a substantive test. The other decision error risk, the **risk of incorrect rejection**, represents the decision that a balance is materially misstated when, in fact, it is not. This is the alpha risk for a substantive test. These sampling risk relationships are shown in Exhibit 10–9.

risk of incorrect rejection: the decision to accept a balance as being materially misstated when it is not

Incorrect Acceptance (Beta Risk)

The risk of incorrect acceptance (RIA) is considered the more important of the two decision error risks. When an auditor decides an account book balance is materially accurate (hence, needs no adjustment), the audit work on that account is considered finished, the decision is documented in the working papers, and the audit team proceeds to work on other accounts. If the account is, in fact, materially misstated, an unmodified opinion on the financial statements is unwarranted and the effectiveness of the audit is damaged.

Incorrect Rejection (Alpha Risk)

When an auditor decides an account book balance is materially misstated, more audit work is performed to determine the adjustment. The risk is that the book balance really is a materially accurate representation of the (unknown) actual value, and the audit manager may recommend an unnecessary adjustment.

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EXHIBIT 10–9 The Account Balance Audit Sampling Decision Matrix

AUDIT DECISION ALTERNATIVES (BASED ON SAMPLE EVIDENCE)	UNKNOWN ACTUAL ACCOUNT BALANCE IS:	
	Materially* accurate	Materially* misstated
The book value of the account is materially accurate.	Correct decision	Incorrect acceptance
The book value of the account is materially misstated.	Incorrect rejection	Correct decision

*Materially in this context refers to the "material misstatement" assigned to the account balance. It is either the overall materiality or the specific materiality discussed in Chapter 5.

Incorrect rejection is not as serious as incorrect acceptance. When auditors first begin to think a balance may contain a material misstatement, they try to determine why this occurred. To estimate the amount, more evidence will be sought. The data will be reviewed for a source of systematic error and the amounts of errors will be analyzed carefully. Client personnel may do a complete analysis to determine a more accurate account balance.

If the initial decision was, in fact, an incorrect rejection, this other work allows the auditors to decide if the recorded amount is really misstated or the sample was not representative. Hence, steps will be taken to determine the amount of error, and there is a chance for the error to be reversed. Incorrect rejection can affect the efficiency of an audit by causing unnecessary work.

Materiality and Tolerable Misstatement

Determining a threshold for the materiality of misstatements in financial statements is a tough problem under any circumstances. Audit sampling for substantive audits of particular account balances adds another wrinkle. Auditors must also decide on an amount of material misstatement—a judgment of the amount of monetary misstatement that may exist in an account balance or class of transactions. As discussed in Chapter 4, this materiality may be the overall materiality or the specific materiality of CAS 320 in Chapter 5. In MUS, these are the only materialities needed, as explained in the discussion case in the back. Note that both these materialities relate directly to user needs. In other words, MUS does not need to consider the complications introduced by the performance materiality concept of CAS 320.09 or the related tolerable misstatement concept of 530.A3 based on performance materiality. These concepts are needed by other statistical models, not MUS. The use of these concepts in CAS 530 illustrates the impact of using a variety of quantitative models that are possible in statistical sampling. It all depends on which one is being used for a particular line item in the financial statements which the population represents.

When you see the word "materiality" or "material" in this book, henceforth, it refers to user-needs materiality. This is a key audit planning judgment. The way we use the term, therefore, is not an artifact of the statistical model. Audit risk (AR), therefore, is the risk that all the audit work on an account balance will not reveal a user-needs material misstatement. This concept is further discussed in Appendix 10B on Connect.

In this stage of sampling, the planned P might be an amount lower than overall or specific materiality of Chapter 5, so that the auditor can reduce alpha risk. Firm practice varies: Alpha risk can be indirectly controlled through the *planned* K value, the *planned* P value, or a combination of the two. The most common strategy is to use $K = 0$ and a *planned* P in the range of half to full overall or specific materiality, whichever the auditor judges more appropriate in the circumstances. We discuss these options further in Appendix 10B on Connect. Here, the calculations are simplified by assuming that planned P is set equal to overall or specific materiality.

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SAMPLING STEPS FOR ACCOUNT BALANCE AUDIT

Sampling for the audit of account balances is similar to the steps of test of controls audit sampling. An example related to auditing receivables illustrates these steps; test of controls sampling was illustrated with the audit of a control procedures for sales invoices. This work can produce independent evidence of sales overstatement resulting from a breakdown of the control or other causes. The seven-step framework helps auditors plan, perform, and evaluate account balance detail audit work. It also helps auditors accomplish an eighth step—careful documentation of the work—by showing each of the seven areas to be described in the working papers. The first seven steps are as follows:

1. Specify the audit objectives.
2. Define the population.
3. Choose an audit sampling method.
4. Determine the sample size.
5. Select the sample.
6. Perform the substantive-purpose procedures.
7. Evaluate the evidence.

Plan the Procedures

LO6a Specify objectives and a population of data.

The three planning steps are the problem-recognition phase of the sampling method. When a client presents the financial statements, they might make the following assertions: the trade accounts receivable exist (existence) and are *bona fide* obligations owed to the company (ownership); all the accounts receivable are recorded (completeness); they are stated at net realizable value (valuation); and they are properly classified as current assets, presented, and disclosed in conformity with GAAP (presentation). Each assertion represents a hypothesis (problem) to be tested.

Specify the Audit Objectives

hypothesis testing: when auditors hypothesize that the book value is materially accurate regarding existence, ownership, and valuation

When sampling to confirm accounts receivables, the specific objective is to decide whether the client's assertions about existence, rights (ownership), and valuation are materially accurate. This auditing is **hypothesis testing**—the auditors hypothesize that the book value is materially accurate about existence, ownership, and valuation. The evidence will enable them to accept or reject the hypothesis. The audit objective is to determine the monetary misstatement by comparing the recorded balances to the balances found through the evidence.

Define the Population

CAS 530 says that auditors must ensure that the population is appropriate for the specific objectives of the audit procedure, and that it is complete. A population of the recorded accounts receivable balances suits the objective of obtaining evidence about existence, ownership, and valuation. It also suits the related objective of obtaining evidence about sales overstatement. In the case of accounts receivable, each customer's account balance is a population unit. If obtaining evidence about completeness and sales understatement were the objectives, the recorded accounts receivable would be the wrong population.

Ordinarily, the sampling unit is the same as the population unit. Sometimes, however, it is easier to define the sampling unit as a smaller part of a population unit. For example, an auditor may want to audit samples of individual invoices for customers instead of working with each customer's balance.

Since a sample will be drawn from a physical representation of the population (e.g., a printed trial balance or computer file of customers' accounts), the auditors must determine

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whether it is complete. Re-adding the trial balance and reconciling it to the control account total does this.

Auditing standards (CAS 530) require auditors to use their judgment in deciding if any population units should be removed from the population and audited separately (not sampled) because sampling risk (risk of incorrect acceptance or incorrect rejection) with respect to them is not justified. Suppose, for example, the accounts receivable amounted to $400,000, but six of the customers had balances of $10,000 or more, for a sum of $100,000. The next-largest account balance is less than $10,000. If materiality is $10,000, the six accounts are considered **individually significant items** because each exceeds the material misstatement amount, and they should be removed from the population and audited completely.

individually significant items: items in account balances that exceed the material misstatement amount; in audit sampling these should be removed from the population and audited completely

In the jargon of audit sampling related to account balances, subdividing the population is known as **stratification**. The total population is subdivided by account balance size. For example, a small number of accounts totalling $75,000 may be the first (large balance) of, say, four strata. The remaining three strata might each contain a total of approximately $75,000 in recorded balances, but each is made up of a successively larger number of customer accounts with successively smaller account balances. Stratification can be used to increase audit efficiency (smaller total sample size). A stratification example appears in the following box.

stratification: subdividing the population in an audit sample by, for example, account balance size

STRATIFICATION EXAMPLE—SELECTING SAMPLE SIZES

The stratification below subdivides the population into a first stratum of six individually significant accounts and four other strata, each with approximately one-fourth ($75,000) of the remaining dollar balance. This is a typical situation where there are a greater number of accounts of smaller value.

The example allocates 90 items to the last four strata. This is referred to as *stratified sampling*. When each stratum gets one-fourth of the sample size, the sample is skewed toward the higher-value accounts: the second stratum has 23 out of 80 sample items, and the fifth stratum has 23 out of 910 items.

STRATUM	BOOK VALUE	NUMBER	AMOUNT	SAMPLE
1	Over $10,000	6	$100,000	6
2	$625–$9,999	80	75,068	23
3	$344–$624	168	75,008	22
4	$165–$343	342	75,412	22
5	$1–$164	910	74,512	23
		1,506	$400,000	96

This stratification deals with a normal situation in which the variability of the account balances and errors in them tend to be larger in the high-value accounts than in the low-value accounts. As a consequence, the sample includes a larger proportion of the high-value accounts (23/80) and a smaller proportion of the low-value accounts (23/910). In addition to size or variability, stratification can be based on other qualitative characteristics the auditor considers important, such as individual, location, date, product, and so forth.

Choose an Audit Sampling Method

An auditor must decide whether to use statistical or nonstatistical sampling methods. If statistical sampling is chosen, another choice needs to be made. In statistical sampling, classical variables sampling methods utilizing normal distribution theory are available. However, MUS, which uses attribute sampling theory, is used more widely in practice. Some of the technical characteristics of the statistical methods are explained more fully in Appendix 10B on Connect.

The calculation examples shown later in this chapter use the MUS method. This calculation is relatively simple and illustrates the important points.

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Perform the Procedures

LO6b Determine sample size and select sample units.

The next three steps represent the evidence-collection phase of the sampling method. Figuring sample size correctly for account balance auditing is an important aspect of this and requires consideration of several influences. Figuring a sample size in advance helps guard against underauditing (not obtaining enough evidence) and overauditing (obtaining more evidence than needed). It also can control the cost of the audit. An arbitrary sample size could be used for the accounts receivable confirmation procedures, but if it turned out to be too small, processing more confirmations might be impossible before the audit report deadline. Alternative procedures could become costly and time consuming. A predetermined sample size is not as important in other situations where the auditors can increase the sample simply by choosing more items from those available in the client's office.

Determine the Sample Size

Whether using statistical or nonstatistical sampling methods, auditors first need to establish decision criteria for the risk of incorrect acceptance (beta risk for substantive testing), the risk of incorrect rejection (alpha risk for substantive testing), and material misstatement. Also, auditors may want to estimate the expected dollar amount of misstatement. These decision criteria should be determined before any evidence is obtained from a sample.

Risk of Incorrect Acceptance, or Beta Risk of the Substantive Test. The audit risk model can be your guide in assessing this risk. A suitable RIA depends on the assessments of inherent risk, control risk, and analytical procedures risk. The RIA varies inversely with the combined product of the other risks. The larger the combined product of the other risks, the smaller will be the allowable RIA.

Suppose, for example, two different auditors, both believing 0.05 is an acceptable level of audit risk (AR), independently assess the client's control risk and their own analytical procedures and arrive at the following conclusions.

Auditor A believes the inherent risk is high (IR = 1.0), the control risk is moderate (CR = 0.50), and analytical procedures will not be performed (APR = 1.0). Audit procedures need to be planned so that the risk of incorrect acceptance will be about 10%.

$$\text{RIA} = \text{AR}/(\text{IR} \times \text{CR} \times \text{APR}) = 0.05/(1.0 \times 0.50 \times 1.0) = 0.10$$

Auditor B believes the inherent risk is high (IR = 1.0), the control risk is very low (CR = 0.20), and analytical procedures will not be performed (APR = 1.0). Audit procedures need to be planned so that the risk of incorrect acceptance will be about 25%.

$$\text{RIA} = \text{AR}/(\text{IR} \times \text{CR} \times \text{APR}) = 0.05/(1.0 \times 0.20 \times 1.0) = 0.25$$

Use the model with caution. You can learn from these examples that auditor A's account balance sampling work must provide less risk than auditor B's. Since sample size varies inversely with the risk of incorrect acceptance, auditor A's sample will be larger. In fact, when the control risk is lower, as B's is, the acceptable RIA is higher. Thus, auditor B's sample of customers' accounts receivable can be smaller than auditor A's sample.

Risk of Incorrect Rejection, or Alpha Risk Like the risk of incorrect acceptance, the RIR exists both in statistical and nonstatistical sampling. It can be controlled, usually by auditing a larger sample, and sample size varies inversely with the RIR. MUS deals with incorrect rejection (alpha risk) by increasing sample size above the minimum associated with using K = 0 in sample planning. The simplified approach to sample planning we use here sets K = 0 so that the sample size is the smallest possible for the stated confidence level and materiality.

Material Misstatement MM—which can be either a performance materiality or overall materiality depending on the auditor's judgment for the line item being tested—also must

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be considered in both nonstatistical and statistical sampling. In statistical sampling, MM must be expressed as a dollar amount or as a proportion of the total recorded amount. The sample size varies inversely with the amount of misstatement considered material. The greater the materiality, the smaller the sample size needed.

Expected Dollar Misstatement Auditors estimate an **expected dollar misstatement** amount based on last year's audit findings or on other knowledge of the accounting system. Increasing the expectations of dollar misstatement has the effect of increasing the sample size. This done through reducing the planned precision in planning the sample size. The purpose of doing this is to reduce alpha risk throughout its range. The more dollar misstatement expected, the larger the sample size should be. So, sample size varies directly with the amount of expected dollar misstatement. The main reason for using expected errors is to control alpha risk, as discussed earlier in this chapter. See the chapter Application Case for an illustration and Appendix 10B on Connect to further understand this technical point.

expected dollar misstatement: a preliminary estimate of expected monetary misstatements in a total monetary value recorded for a population

Variability within the Population Auditors using nonstatistical sampling must take into account the degree of dispersion, or typical skewness, of some accounting populations. **Skewness** is the concentration of a large proportion of the dollar amount in only a small number of the population items. For example, \$100,000 (25%) of the total accounts receivable is in six customers' accounts, while the remaining \$300,000 is in 1500 customers' accounts.

skewness: the concentration of a large proportion of the dollar amount in only a small number of the population items

As a general rule, auditors should be careful about populations whose unit values range widely, say from \$1 to \$10,000. In this case, for your population to be representative, you would need to take a larger sample than if the range were only from \$1 to \$500. Sample size should vary directly with the range of population unit values. Populations with high variability should be stratified, as shown in the stratification example.

When classic statistical sampling methods are used, there must be an estimate of the population **standard deviation**, which is a measure of the population variability. When using MUS, this estimate is not needed as the unit of selection is each recorded dollar rather than the account balance. Thus, there is no variability in the population of recorded dollars, as each dollar has the same value. (See Appendix 10B on Connect for more details.)

standard deviation: a measure of population variability

MUS sample sizes can be calculated as they are for tests of controls. The same sample planning formula can be applied as long as all monetary amounts are converted to a rate or percentage. Thus, for example, if you have an accounts receivable population with a balance of \$10,000,000, you determine materiality to be \$300,000, and you wish to plan a sample size for confirming receivables with 95% confidence level, then first convert materiality as a rate by calculating its proportion of the recorded value: $P = 300{,}000/10{,}000{,}000 = 0.03$. This is simply putting materiality in relative terms. Now you can apply the formula as before to calculate the sample size: $n = R/P = 3.0/0.03 = 100$.

As you can see, the calculation of sample sizes under MUS are very similar for both tests of controls and tests of balances. The calculations for both are summarized in Exhibit 10–10.

You can now prove to yourself the efficiency effects of relying on internal controls using the audit risk model. In the above receivables example, assume you desired 95% CL because you planned audit risk at 0.05, and you assessed inherent and control risk at the maximum of 1.0. Hence, you had to get all your assurance from the substantive test using a detection risk (DR) of 0.05. The DR is the same as beta risk or the risk of incorrect acceptance. Now, assume that you assessed control risk below maximum at 0.50 (instead of at maximum at 1.0); then, using the risk model, you can prove to yourself that DR is revised to 0.10; that is, you accept more risk (get less assurance) from your substantive testing. This is reflected by the reduced sample size: $n = R/P = 2.31/0.03 = 77$ (always round up to ensure sample is large enough). You have thus reduced your substantive testing by 23 ($100 - 77$) as a result of your increased reliance on internal controls. This is a simple example, but it illustrates the basic principle of internal control reliance using the audit risk model.

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These influences are summarized in Exhibit 10–11.

EXHIBIT 10–10 Sufficiency of Audit Evidence

SUMMARY OF SIMPLIFIED CALCULATIONS OF SAMPLE SIZE		
KEY CONCEPTS	TESTS OF CONTROLS	SUBSTANTIVE TESTS OF BALANCE
Basic Formula	R = nP	R = nP
Assessment of materiality or tolerable error rate	P = tolerable error rate	P = materiality as a proportion of the recorded balance
Assessment of beta risk = 1 × confidence level = 1 −CL	Beta risk is based on CR from Audit risk model	Beta risk is RIA of audit risk model
R value	From table use K = 0 and desired confidence level	From table use K = 0 and desired confidence level
Extent of testing = sample size	$n = \frac{{}_{CL}R_K}{P}$	$n = \frac{{}_{CL}R_K}{P}$

CR = control risk, n = sample size, RIA = risk of incorrect acceptance.

EXHIBIT 10–11 Sample Size Relationships: Audit of Account Balances Using MUS

	PREDETERMINED SAMPLE SIZE WILL BE:		
SAMPLE SIZE INFLUENCE	HIGH RATE OR LARGE AMOUNT	LOW RATE OR SMALL AMOUNT	SAMPLE SIZE RELATION
1. Risk of incorrect acceptance	Smaller	Larger	Inverse
2. Risk of incorrect rejection*	Smaller	Larger	Inverse
3. Tolerable misstatement	Smaller	Larger	Inverse
4. Expected misstatement*	Larger	Smaller	Direct

*These effects are discussed in the online Appendix 10B on Connect. They are ignored under the simplified approach used here, and many practitioners treat these effects as insignificant.

Select the Sample

As was the case with test of controls audit samples, account balance samples must be representative. The same selection methods as discussed for tests of controls can be used for MUS in substantive testing. Unrestricted random selection and systematic MUS selection will obtain random samples for statistical applications. Appendix 10B on Connect outlines unique features of MUS selection in more detail. Haphazard and block selection methods have the same drawbacks as they have in test of controls audit samples.

Perform the Substantive-Purpose Procedures

The basic assertions in a presentation of accounts receivable are that they exist, they are complete (no receivables are unrecorded), the company has the right to collect the money, they are valued properly at net realizable value, and they are presented and disclosed properly in conformity with GAAP. A substantive-purpose audit program consists of account balance–related procedures designed to produce evidence about these assertions. The procedures listed in the box on page 416 will obtain the evidence related to each assertion (shown in parentheses).

The confirmation procedures should be performed for all the sampling units, and other procedures performed as necessary for evidence relating to existence, ownership, and valuation. It is important to audit all the sample units, even the hard ones. Auditing just those customers whose balances are easy might bias the sample. Sometimes, however, you will be unable to audit a sample unit; there may be no response to the confirmation requests,

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sales invoices supporting the balance can't be found, and no payment was received after the confirmation date. Auditing standards contain the following guidance in this situation:

- If your evaluation conclusion isn't affected by the misstated balance, then you can let it go. If your evaluation conclusion is to accept the book value, the account should not be big enough to change that. If your evaluation conclusion is already to reject the book value, this account misstatement just reinforces the decision.
- If considering the entire balance to be misstated would change an acceptance decision to a rejection decision, you may need to expand the sample, perform the procedures on them (other than confirmation), and re-evaluate the results.
- If control risk related to the balance was assessed to be low, you should consider whether this finding contradicts the low control risk assessment.

REVIEW CHECKPOINTS

10-29 Write the expanded risk model. What risk is implied for "test of detail risk" when IR = 1.0, CR = 0.40, APR = 0.60, AR = 0.048, tolerable misstatement = $10,000, and the estimated standard deviation in the population = $25?

10-30 Explain why control risk is inversely related to the risk of incorrect acceptance.

10-31 Why does the alpha risk affect audit efficiency and the beta risk affect audit effectiveness?

10-32 When auditing account balances, why is an incorrect acceptance decision considered more serious than an incorrect rejection decision?

10-33 What should be the relationship between tolerable misstatement in the audit of an account balance and the amount of monetary misstatement considered material to the overall financial statements?

10-34 What general set of audit objectives can you use as a frame of reference for specific objectives for the audit of an account balance?

10-35 What audit purpose is served by stratifying an account balance population and by selecting some units from the population for 100% audit verification?

The Evidence

LO6c Evaluate monetary error evidence from a balance audit sample.

The final step represents the evidence evaluation and decision-making phase of the sampling method. Your decisions about existence, ownership, and valuation need to be justifiable by sufficient, competent quantitative and qualitative evidence. You should be concerned first with the quantitative evaluation of the evidence. Qualitative follow-up is also important and is discussed later.

Evaluate the Evidence

Quantitative evaluation of substantive tests of balances using MUS is the same as that for tests of controls. For example, reject if achieved P is greater than or equal to materiality; otherwise accept the population total recorded amount. The complications arise from possible variability of the misstatements when calculating achieved P. Appendix 10B on Connect outlines how to deal with these complications. Exhibit 10–12 summarizes these statistical evaluations.

Auditing standards for this are not written with a particular approach, such as MUS, in mind. Instead, they deal with general features of quantitative evaluation already captured by the particular approaches of formulas, and we review these general considerations here.

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The reconciliation to particular calculations with MUS is given in Appendix 10B on Connect. These are the basic steps in quantitative evaluation:

known misstatement: the total amount of actual monetary error found in a sample

likely misstatement: the projection of a known misstatement identified in a representative sample to the whole population

projected misstatement: the estimated amount of likely misstatement in a population based on extrapolating a misstatement discovered in a sample (known/identified misstatement) over the whole population

- Figure the total amount of actual monetary error, the **known misstatement**, found in the sample.
- Project the known misstatement to the population. The projected amount is the **likely misstatement**.
- Compare the likely misstatement (also called the **projected misstatement**) to the material misstatement for the account and consider that (1) the risk of incorrect-acceptance—that likely misstatement is calculated to be less than material misstatement even though the actual misstatement in the population is greater, or (2) the risk of incorrect rejection—that likely misstatement is calculated to be greater than material misstatement, even though the actual misstatement in the population is smaller. This decision can be made statistically thus reducing nonsampling error with the test. Details are given in Appendix 10B on Connect.

Amount of Known Misstatement Hypothetical audit evidence from the sample for the previous stratification example is shown in the box on page 409. In this example, total accounts receivable is $400,000, while $100,000 of the total is in six large balances, which are to be audited separately. The remainder is in 1500 customer accounts whose balances range from $1 to $9999. Suppose the audit team selected 90 of these accounts and applied the confirmation or vouching procedures to each of them, and the evidence showed $136 of net overstatement of the recorded amounts. This amount is the known misstatement for this sample of 90 customer accounts.

EXHIBIT 10–12 Evaluating Sample Results

EVALUATING SAMPLE RESULTS*		
KEY CONCEPTS	TESTS OF CONTROL	SUBSTANTIVE TESTS OF BALANCE
Basic formula	$R = nP$	$R = nP$
Solve for achieved P	$P = \frac{R}{n}$	$P = \frac{R}{n}$
Basic decision rule	If achieved P > tolerable error rate, then reject; otherwise, accept reliance on control.	If achieved P > materiality, then reject; otherwise, accept the recorded total for the population.
Consequence of decision:		
If accept	Can rely on controls to extent planned at stated confidence level.	Can accept clients recorded amount at stated confidence level.
If reject	Need to rely on controls less than expected.	Need to sample more or insist on an adjustment (adjust to most likely value as indicated by sample mean extrapolated to the population).

*n is known, and R is known based on detected errors, K, and planned CL.

Project the Known Misstatement to the Population To make a decision about the population, the known misstatement in the sample is projected to the population. The sample must be representative, because, if it is not, a projection can produce a misleading number. As an extreme example, suppose one of the six large accounts, which were all audited, contained a $600 disputed amount. Investigation showed the customer was right and management agreed, so the $600 is the amount of known misstatement. If an auditor takes this group of six accounts as being representative of the population, projecting the $100 average misstatement ($600/6) to 1506 accounts ($100 × 1506) would project a total misstatement of $150,600, compared with the recorded accounts receivable total of $400,000. This projection is neither reasonable nor appropriate. Nothing is wrong with the calculation method. The nonrepresentative "sample" is the culprit in this absurd result.

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Consider Sampling Risks These are risks of making wrong decisions (incorrect acceptance or incorrect rejection) in both nonstatistical and statistical sampling. The smaller the sample, the greater both risks are. Common sense tells you that the less you know about a population because of a small sample, the more risk you run of making a wrong decision.

Auditing guidance suggests you can use your experience and professional judgment to consider the risk. If the projected likely misstatement is considerably less than tolerable misstatement, chances are good that the total actual misstatement in the population will be less than tolerable misstatement. However, when projected likely misstatement is close to material misstatement, the risk of incorrect acceptance may exceed the acceptable risk (RIA) that an auditor initially established as a decision criterion (see AuG-41, paragraph 42).

The risk of incorrect rejection is a similar situation. Again, the judgment depends on the size of the sample and the kinds and distribution of misstatements discovered. This judgment can be significantly aided by using statistical theory, as explained in Appendix 10B on Connect.

Auditors take the rejection decision seriously and conduct enough additional investigation to determine the amount and adjustment required—extra work that mitigates the risk of incorrect rejection. In the example, if the sample of 90 customers' accounts had shown total misstatement of $900 (yielding the $15,000 projected misstatement using the average difference method), most auditors would consider the evidence insufficient to propose a significant adjustment. (However, correction of the $900 should not by itself be a sufficient action to satisfy the auditors.)

When using nonstatistical sampling, auditors use their experience and expertise to take risks into account. Statistical samplers can add statistical calculations to these considerations of sampling risk.

Qualitative Evaluation The numbers are not enough. Auditors are required to follow up each monetary difference to determine whether it arose from (a) misunderstanding of accounting principles, (b) simple mistakes or carelessness, (c) an intentional irregularity, or (d) management override of an internal control procedure. Auditors also need to relate the differences to their effect on other amounts in the financial statements. For example, overstatements in accounts receivable may indicate overstatement of sales revenue.

Likewise, you should not overlook the information that can be obtained in account balance auditing about the performance of internal control procedures—the dual-purpose characteristic of auditing procedures. Deviations (or absence of deviations) discovered when performing substantive procedures can help confirm or contradict an auditor's previous conclusion about control risk. If many more monetary differences than expected arise, the control risk conclusion may need to be revised and more account balance auditing work done.

Knowledge of the source, nature, and amount of monetary differences is very important in explaining the situation to management and directing additional work to areas where adjustments are needed. The audit work is not complete until the qualitative evaluation and follow-up is done.

Evaluate the Amount of Misstatement The *CICA Handbook* guideline AuG-41 requires the aggregation of known misstatement (identified misstatement, in the guideline) and projected likely misstatement (likely aggregate misstatement, in the guideline). The aggregation is the sum of (a) known misstatement in the population units identified for 100% audit, and (b) the projected likely misstatement for the population sampled. The theory underlying (b) is that the projected likely misstatement is the best single estimate of the amount that would be determined if all the accounts in the sampled population had been audited. You can see the importance of sample representativeness in this regard. This aggregation should be judged in combination with other misstatements found in the audit of other account balances to determine whether the financial statements taken as a whole need to be adjusted and, if so, in what amount.

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sampling error: the amount by which a projected likely misstatement amount could differ from an actual (unknown) total as a result of the sample not being exactly representative

possible misstatement: the further misstatement remaining undetected in the units not selected in the sample

The evaluation of amounts is not over yet, however. It cannot be said that the projected likely misstatement is the exact amount that would be found if all the units in the population were audited. The problem arises from **sampling error**—the amount by which a projected likely misstatement amount could differ from an actual (unknown) total as a result of the sample's not being exactly representative. Of course, auditors are mostly concerned with the possibility that the actual total misstatement might be considerably more than the projected likely misstatement.

This sampling phenomenon gives rise to the concept of **possible misstatement**, or maximum possible misstatement, (the third kind, in addition to known and likely misstatement), which is interpreted in AuG-41 as the further misstatement remaining undetected in the units not selected in the sample. Nonstatistical auditors use their experience and professional judgment in considering additional possible misstatement. Statistical auditors, however, use statistical calculations to measure possible misstatement.

In Appendix 10B on Connect, the basic example shows how to calculate a possible misstatement. For the illustration here, if the possible misstatement is less than the amount considered material ($10,000), then it could be judged as acceptable (assuming no qualitative factors come into play). If the possible misstatement were higher than $10,000, then the evidence would suggest that the misstatement in the account exceeds $10,000. For a more complete discussion of the evaluation of statistical substantive testing of details results see Appendix 10B on Connect.

Timing of Substantive Audit Procedures

extending the audit conclusion: performing substantive-purpose audit procedures on the transactions in the remaining period and on the year-end balance to produce sufficient competent evidence for a decision about the year-end balance

Account balances can be audited, at least in part, at an interim date. When this work is done before the company's year-end date, auditors must extend the interim-date audit conclusion to the balance sheet date. **Extending the audit conclusion** involves performing substantive-purpose audit procedures on the transactions in the remaining period and on the year-end balance to produce sufficient competent evidence for a decision about the year-end balance. It is unreasonable to audit a balance (say, accounts receivable) as of September 30, and then, without further work, accept the December 31 balance.

If the company's internal control over transactions that produce the balance under audit is not particularly strong, you should time the substantive detail work at year-end instead of at interim. Likewise, if rapidly changing business conditions predispose managers to misstate the accounts (try to slip one by the auditors) the work should be timed at year-end. In most cases, careful scanning of transactions and analytical review comparisons should be performed on transactions that occur after the interim date.

As an example of the process, accounts receivable confirmation can be done at an interim date. Later, efforts must be made to ascertain whether controls continued to be reliable. You must scan the transactions of the remaining period, audit any new large balances and update work on collectability, especially with analysis of cash received after the year-end.

Audit work is performed at interim for two reasons: (1) to spread the accounting firms' workload so that not all the work on clients is crammed into December and January and (2) to make the work efficient and enable companies to report audited financial results soon after the year-end. Some well-organized companies with well-planned audits report their audited figures as early as five or six days after their fiscal year ends.

BALANCE AUDIT SAMPLING FAILURE

The company owned surgical instruments that it lent and leased to customers. The auditors decided to audit the existence of the assets by confirming them with the customers who were supposed to be holding and using them. From the population of 880 instruments, the auditors selected eight for confirmation, using a sampling method that purported to produce a representative selection.

Two confirmations were never returned, and the auditors did not follow up on them. One returned confirmation indicated that the customer did not have the instrument in question; the auditors were never able to find it. Nevertheless, the auditors concluded that the $3.5 million recorded amount of the surgical instrument assets was materially accurate.

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Judges who heard complaints on the quality of the audit work concluded that it was not performed in accordance with generally accepted auditing standards (GAAS) because the auditors did not gather sufficient evidence concerning the existence and valuation of the surgical instruments. GAAS requires auditors to project the sample findings to the population. The auditors did not do so. They never calculated (nonstatistical) the fact that $1,368,750 of the asset amount could not be confirmed or found to exist. The sample of eight was woefully inadequate, both in sample size and in the proportionately large number of exceptions reported. There was a wholly insufficient statistical basis for concluding that the account was fairly stated under generally accepted accounting principles (GAAP).

Source: U.S. Securities and Exchange Commission, Administrative Proceeding File No. 3–6579 (Initial Decision, June 1990).

REVIEW CHECKPOINTS

10-36 What kind of evidence evaluation consideration should an auditor give to the dollar amount of a population unit that cannot be audited?

10-37 What are the three basic steps in quantitative evaluation of monetary amount evidence when auditing an account balance?

10-38 The projected likely misstatement may be calculated, yet further misstatement may remain undetected in the population. How can auditors take the further misstatement under consideration when completing the quantitative evaluation of monetary evidence? How is this done by formula?

10-39 What additional considerations are in order when auditors plan to audit account balances at an interim date several weeks or months before the client's fiscal year-end date?

APPLICATION CASE WITH ANALYSIS

MUS with Critical Thinking about Risk-Based Auditing

The MUS concepts introduced in this chapter are good illustrations of the application of critical thinking, although the issues of it may be hidden in the assumptions underlying the mechanics of applying MUS. Can you identify the critical thinking (CT) steps, as outlined in Exhibit 4–1, in the MUS decision making as described in this chapter?

ANALYSIS

Through MUS, the auditor arrives at a value for an accounting population. This is done by representative sampling (CAS 530).

Step 1 of CT (learn the views of others): In the sampling context, this step is represented by obtaining from management the total amount recorded for the population or some other claim about a population (e.g., that proper internal controls have been applied to the transactions of the reporting period).

The auditor's views of the population for sampling purposes are relevant here. With MUS, the population is viewed as dollar units, with the total dollar amount recorded representing a population of individual dollars. The more traditional view, statistical sampling using normal distribution-based tests, is of a population consisting of individual accounts or physical units of varying values (e.g., a population of individual accounts receivable or inventory items). These differences in viewpoints have consequences for the two theories themselves.

To summarize, beta risk is the more serious as it relates directly to the audit risk model and its components, depending on whether we are talking about tests of controls or substantive tests. Beta risk relates to audit effectiveness because the audit fails if it fails to detect a material misstatement. Alpha risk, instead, relates to audit efficiency; it results in the auditors' doing unnecessary work to clear up their mistake, something they are aware of by the end of the audit. This risk is implicitly controlled by the K value, as the higher the K value used in sample-size planning, the lower the alpha risk and the larger the sample size. Another way to lower alpha risk is to use a planned precision that is lower than overall or specific materiality. A common way to make this adjustment is to subtract expected errors from the

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overall or specific materiality. When auditors develop planned precision this way they are really reducing alpha risk over much of its range (Remember that alpha risk is controlled only at its lowest level, it grows automatically with the amount of misstatement and reaches a peak at materiality).

The differing theories result in planning differences, most notably in whether or not tolerable misstatements or performance materialities of CAS 530.05 need to be less than overall materiality or specific materiality. These issues have also been historically related to whether materiality allocation is included in audit planning. Under MUS no allocation is needed. This means that MUS can restrict itself to using overall and specific materialities based on user needs in evaluating the sample results. In MUS, if the precision used in planning the sample size is a performance materiality, then the only reason for this is to help control alpha risk. The MUS formula examples below show this. For other statistical approaches things are a bit more complicated. For these other statistical approaches, the model requirements, not user needs, make materiality allocation necessary.

MUS accommodates user needs by allowing the use of specific materialities of Chapter 5 without affecting the use of overall materialities in other populations. Also, the results of individual tests can be combined, as shown below, and the results compared with materiality for financial statements as a whole. In general, the process of combining the results of multiple tests is much simpler under MUS, and helps explain its popularity.

Step 2 (identify the claims at issue): Management claims (asserts) that the recorded amount is materially correct, and the main claim at issue is whether this is true or if, in fact, the population amount is materially in error. The auditor must verify the assertion with the help of the statistical test.

Step 3 (reasons for the competing claims): Management will refer to its system of internal controls, corporate governance, and past track record. The auditor must be skeptical and consider the alternative claim that there is a material misstatement in the recorded amount, and show that the risk of this claim is at an appropriately low level (i.e., at an acceptable level).

Step 4 (evaluate the arguments): An argument, essentially, gives good reasons for a claim or conclusion. In statistical decision making, logically structured reasoning (see Appendix 3A on Connect for more details) follows a pattern that is consistent with decision making throughout auditing and accounting.

The pattern of logical argumentation is as follows. First, identify assumptions (including theories), models, concepts, and principles that guide the overall reasoning process. MUS's distinctiveness is in viewing the population of interest as a population of dollar units and then applying attribute sampling theory to the dollar-unit population. With theories, many assumptions need to be made; some are more controversial than others and critical thinking focuses on the more controversial ones, aiming to demonstrate their reasonableness. Often, the issues are a matter of firm policy and much of the justification is embedded in firm practice manuals and policies.

Second, gather the evidence in conformity with the theory and consistent with the goal of the audit procedure. This includes proper specification of the population to be evaluated, as discussed in the chapter. For example, in representative sampling, each unit of the population must have a predictable chance of being selected. This is absolutely essential for objectively controlling sampling risk, which is the primary advantage of statistical audit techniques.

Third, reach a conclusion about the population that is consistent with the theory. For MUS, the conclusion is reached using the following decision rule:

Decision Rule (1):

If achieved P > materiality or tolerable deviation rate, then reject the recorded amount for the population; otherwise, accept it.

This simple decision rule is effectively an evaluation of management's claim that there is no material error in the population or that no intolerable deviation rates exist in it.

Step 5 (reach a conclusion): The decision rule above indicates the quantitative result. The auditor must also consider qualitative aspects of the sample information, such as nature and cause of errors, before coming to a decision (CAS 530 and AuG-41). The above decision rule has already incorporated key quantitative risk and materiality considerations in the decision-making process.

Further Elaboration of the Critical Thinking Aspects of Adopting Dollar Unit Sampling (DUS)

Once a formal theory, such as MUS, has been accepted to assist in auditor decision making, it can be used to illustrate some basic concepts of auditing. For example, using our formulas and R value tables we can illustrate the law of diminishing returns on testing that explains why auditors use the sampling (testing) concept. For example, assuming materiality has a value of .01 (1%), then the sample sizes (n = R/P) for confidence levels of 80%, 95%, and 99%, respectively (equivalent beta risks of 20%, 5%, and 1%), are as follows: 161, 300, and 451. Confidence levels translate roughly to assurance levels obtained from these samples. Thus, auditors using a materiality of 1% get assurance of 80% for sample size of 161, 95% assurance for sample size of 300, and 99% assurance for sample size of 451. These assurance levels relate to specific assertions, such as existence, depending on the audit purpose of the test. *Testing* is a generic term used for all types of sampling, whether random or not.

The above calculations indicate the first 80% of assurance is achieved with a sample size of 161. To get an additional 15% assurance (to 95%), the necessary sample size almost doubles. In other words, the auditor gets less assurance for each additional item sampled. Note that to get an additional 4% assurance beyond 95%, the original sample

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size must almost triple. The final 1% assurance comes through testing the entire population. If, for instance, the population consisted of 10,000 items of varying amounts such as inventory items (not unusual for a medium-sized auditee), the final 1% assurance eliminating all uncertainties regarding existence involves testing an additional 9,549 (10,000 − 451) items! This explains why auditors use sampling and illustrates the diminishing returns on testing—it is rarely economical to eliminate the last bit of uncertainty in order to get 100% assurance. Since assurance equals 1 − risk, this also explains why auditors don't wish to fully eliminate risk (nor are clients willing to pay for it) but will settle for some acceptable level of it.

Illustration Showing Why There Is No Need to Allocate Materiality with MUS

With our formula, we can also show why there is no need to allocate materiality with MUS. This is important because if you use a statistical method other than MUS, the auditor can be required to use performance materialities, and related tolerable misstatements derived from them, that are based on the needs of the statistical method, not on user needs. This is an important advantage of MUS. Through these illustrations, we show that the CAS 320 and 530 concepts of performance materiality and related tolerable misstatements are driven by the specific statistical model used to perform the test. Specifically, MUS does not need to use these concepts to achieve the auditor's objective of detecting misstatements of greater then specific or overall materiality. For example, assume accounts receivable has a reported balance of $20 million, inventory has a balance of $10 million, and overall materiality is $1 million. If we wanted 95% confidence level to verify existence of accounts receivable via confirmation procedures, the sample size would be $n = R/P = 3/(1/20) = 60$. If we wanted 95% confidence level to verify existence of inventory via inventory counts, the sample size would be $n = R/P = 3/(1/10) = 30$. Note that the sum of these two sample sizes is the same as it would be if we treated inventory and receivables as one monetary-unit population, in which case the sample size for the combined population (at 95% confidence level) would be $n = R/P = 3/(1/30) = 90$. Thus, by individually testing the populations associated with receivables and inventory using the same overall materiality of $1 million, the auditor can get the same 95% confidence for the combined population as for the separate populations. All the auditor needs to do is add up the errors from the two samples and evaluate as though one sample of a dollar-unit population of $90 million were tested. In this way, the auditor can also get 95% confidence level on the overall conclusion for the combined population. The crucial point is that the same materiality is used for the overall evaluation as for the individual inventory and receivables valuations. There is no need to use different performance materialities for the components that are smaller than the overall materiality of $1 million with MUS. However, if user needs dictate a specific materiality smaller than overall materiality, that can be accommodated by MUS.

If there were a lower specific materiality, say, $0.5 million, for receivables, then the sample size for receivables would have been 3/(0.5/20) = 120. If this new sample size were combined with that of inventory using the overall materiality of $1 million, then the total sample size to evaluate the risk of overall material misstatement for the combined population is 120 + 30 = 150. This is more than sufficient to detect material misstatement equal to overall materiality in the combined populations because the calculation in the preceding paragraph shows that the sample size needed for that is 90. This bigger sample size at the same confidence level (equals one beta risk of 0.05) means that the alpha risk for the combined test has been reduced over the alpha risk range. Sampling theory predicts you will get some benefit from the increased testing, and, in this case, that benefit takes the form of reduction in alpha risk, because the beta risk (and confidence level) for the test has been kept at a constant level. However, this is not the necessarily the case for all statistical tests when materialities smaller than overall would be required to get the same confidence level for the combined population. MUS can use smaller materialities for specific populations to meet specific user needs, but it does not require this, whereas non-MUS models can require smaller materiality, such as the performance materiality. This requirement has been referred to as materiality allocation. The need for complex materiality allocation rules has been introduced to auditing primarily because of normal distribution-based tests, further demonstrating how the needs of specific sampling models can affect audit reasoning about evidence gathering.

The calculations in the preceding paragraph also illustrate the chief effect of using smaller performance materialities. Assume that the $0.5 million materiality was a performance materiality instead of a specific (user needs–based) materiality. For example, assume the auditor expected misstatements of $0.5 million. One way audit firms adjust for the user needs–based materiality to get a performance-based materiality is to subtract the expected misstatements from the user-needs materiality. In this case, subtract $0.5 million of expected misstatements from the $1 million of overall to get $0.5 million of performance materiality, to plan the sample size using performance materiality as indicated above.

The important distinction to remember is as follows: Use smaller performance materiality to reduce alpha risk when planning sample sizes, and use overall or specific materiality to control the beta risk. Since alpha risk can also be controlled by using a higher K value (effectively, more errors expected in the sample) we can summarize most concisely how the major risks and materiality are controlled by the following characterization of the MUS formula for sample size:

$$n = ({}_{\text{alpha}}\,R_{\text{beta}}) / (\text{user-based materiality as a proportion of book value})$$

This formula attempts to concisely summarize the preceding discussion by showing the relationship of extent of audit work n and alpha risk, beta risk, and user-based materiality. Alpha risk is affected by the K value chosen. That is why

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you see alpha as the left side subscript for R. User-based materiality means overall or specific materiality of Chapter 5. And beta risk at this user-based materiality is controlled by choosing the confidence level from the R value table.

Auditing as a Bayesian Reasoning Process

Perhaps the most important influence on audit reasoning is the Bayesian view of evidence (i.e., use of Bayes' Theorem and Bayesian logic to evaluate the evidence). Auditors tend to adopt the Bayesian philosophy. The important thing about this view for auditors is that under the Bayesian view of evidence the auditor interprets statistical test results as statements about the probability of material misstatement. If the only audit evidence is the MUS statistical test, and if the auditor accepts the population, then under the Bayesian perspective the auditor can interpret the confidence level as the probability of less than material misstatement and the beta risk as the probability of material misstatement. This view permeates audit reasoning to the point of being reflected in the audit risk model. For our purposes, the importance of the Bayesian view is that it allows the assurance to correspond to the confidence level and the beta risk to the probability of material misstatement. Under this Bayesian view, it can be shown that decision rule (1) is equivalent to the following:

> Decision Rule (2):
> If probability of material misstatement is greater than acceptable risk then reject; otherwise, accept the recorded amount.

The interesting aspect of decision rule (2) is that it can be applied to all types of risk, not just sampling risk. In particular, this decision rule can be applied to the components of the audit risk model and to the accounting risk concept. Thus decision rule (2) provides a means for introducing consistency in reasoning for financial reporting involving estimates as well as for other auditing issues. Consistency in reasoning is important to good logic, and it is best that audit reasoning processes can be defended as logical. Inconsistencies in reasoning indicate that there is a contradiction, which, in turn, indicates flawed and illogical reasoning. It would be very difficult for an auditor to defend his or her work if the courts or the Canadian Public Accountability Board (CPAB) can show there is an unresolved contradiction. In fact, philosophers have shown that contradictions can be used to represent lying (i.e., stated belief contradicts actual belief).

Chapter 4 distinguishes accounting deficiencies from audit deficiencies. If auditors are to deal with these deficiencies consistently, then a reasoning process like decision rule (2) is one way of doing so. Note that, since decision rule (2) focuses on risks, it is fully consistent with risk-based auditing and offers a way to deal with accounting risks of financial reporting as well as audit risk. We illustrate this in the Application Cases of Chapters 19 and 21, where suitable criteria for financial reporting are discussed.

SUMMARY

- Audit sampling was explained in this chapter as an organized method to make decisions. Two kinds of decisions were shown: (1) assessment of control risk and (2) the decision about whether financial statement assertions in an account balance are fairly presented. The method is organized by two kinds of audit programs to guide the work on these two decisions: (1) the internal control program and (2) the balance audit program. The audit sampling itself can be attribute sampling for test of controls and balance audit (variables) sampling for auditing the assertions in an account balance.
- Audit sampling is a method of organizing the application of audit procedures and a disciplined approach to decision problems. Both types of sampling were explained in basic terms of planning the audit procedures, performing the audit procedures, and evaluating the evidence produced by the audit procedures. The latter process was reinforced with some differences and dollar unit sampling (DUS) projections of misstatement amounts. The mechanics were illustrated in the last section.
- Risk in audit decisions was explained in the context of nonsampling and sampling risk, with sampling risk further subdivided into two types of decision errors: (1) assessing control risk too low and incorrect acceptance of a balance and (2) assessing control risk too high and incorrect rejection of an account balance. The first pair damages the effectiveness of audits, and the second pair damages the efficiency of audits.
- Audit programs for test of controls procedures and balance audit procedures were illustrated and integrated with earlier chapters. One of the goals of this chapter was to enable students to be able to understand these procedural programs in the context of audit sampling. The other goal was to clarify the concepts of risk and materiality introduced in the earlier chapters.

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KEY TERMS

account balance
alpha risk (type 1 error risk)
analytical procedures risk (APR)
attribute sampling
audit procedures
audit sampling
beta risk (type II error risk)
block sampling
class of transactions
classical attribute sampling
detection risk (DR)
error analysis
evidence collection
evidence evaluation
expectation about the population deviation rate
expected dollar misstatement
extending the audit conclusion
haphazard selection
hypothesis testing
individually significant items
known misstatement
likely misstatement
monetary-unit sampling (MUS)
nature (of audit procedures)
nonsampling risk
nonstatistical (judgmental) sampling
physical representation of the population
population
population unit
possible misstatement
problem recognition
projected misstatement
random sample
replicate
representative sample
risk of assessing the control risk too high
risk of assessing the control risk too low
risk of incorrect acceptance (RIA)
risk of incorrect rejection
sample
sampling error
sampling risk
sampling unit
skewness
standard deviation
statistical sampling
stratification
substantive tests of details auditing
systematic random selection
tolerable deviation rate
unrestricted random selection
walk-through

EXERCISES AND PROBLEMS

EP 10-1 Sampling and Nonsampling Audit Work. LO3 The accounting firm of Mason & Jarr performed the work described in each separate case below. The two partners are worried about properly applying standards regarding audit sampling. They have asked for your advice.

Required:

Write a report addressed to them, stating whether they did or did not observe the essential elements of audit sampling standards in each case:

a. Mason selected three purchase orders for raw materials from the LIZ Corporation files, and from there traced each one through the accounting system. He saw the receiving reports, purchasing agent's approvals, receiving clerks' approvals, the vendors' invoices (now stamped paid), the entry in the cash disbursement records and the cancelled cheques. This work gave him a firsthand familiarity with the cash disbursement system, and he felt confident about understanding related questions in the internal control questionnaire completed later.

b. Jarr observed the inventory taking at SER Corporation. She had an inventory list of the different inventory descriptions with the quantities taken from the perpetual inventory records. She selected the 200 items with the largest quantities and counted them after the client's shop foreman had completed his count. She decided not to check out the count accuracy on the other 800 items. The shop foreman miscounted in 16 cases. Jarr concluded the rate of miscount was 8%, so as many as 80 of the 1000 items might be counted wrongly. She asked the foreman to recount everything.

c. CSR Corporation issued seven series of short-term commercial paper notes near the fiscal year-end to finance seasonal operations. Jarr confirmed the obligations under each series with the independent trustee for the holders, studied all seven indenture agreements and traced the proceeds of each issue to the cash receipts records.

d. At the completion of the EH&R Corporation audit, Mason obtained written representations, as required by auditing standards, from the president, the chief financial officer, and the controller. He did not ask the chief accountant at headquarters or the plant controllers in the three divisions for written representations.

EP 10-2 Test of Controls Audit Procedure Objectives and Control Deviations. LO5 This exercise asks you to specify control test objectives and define deviations in connection with planning the test of controls audit of Kingston Company's internal controls.

Required:

a. For each control cited below, state the objective of an auditor's test of controls audit procedure.

b. For each control cited below, state the definition of a deviation from the control.

1. The credit department supervisor reviews each customer's order and approves credit by making a notation on the order.
2. The billing department must receive written notice from the shipping department of actual shipment to a customer before a sale is recorded. The sales record date is supposed to be the shipment date.

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3. Billing clerks carefully look up the correct catalogue list prices for goods shipped and recheck the amounts billed on invoices for the quantities of goods shipped.
4. Billing clerks review invoices for intercompany sales and mark each one with the code "9," so that they will be posted to intercompany sales accounts.

EP 10-3 Timing of Test of Controls Audit Procedures. LO5 Auditor Magann was auditing the authorization control over cash disbursements. She selected cash disbursement entries made throughout the year and vouched them to paid invoices and cancelled cheques bearing the initials and signatures of people authorized to approve the disbursements. She performed the work on September 30, when the company had issued cheques numbered from 43921 to 52920. Since 9000 cheques had been issued in nine months, she reasoned that 3000 more could be issued in the three months before the December 31 year-end. About 12,000 cheques had been issued last year. She wanted to take one sample of 100 disbursements for the entire year, so she selected 100 random numbers in the sequence 43921 to 55920. She audited the 80 cheques in the sample that were issued before September 30, and she held the other 20 randomly selected cheque numbers for later use. She found no deviations in the sample of 80—a finding that would, in the circumstances, cause her to assign a low (20%) control risk to the probability that the system would permit improper charges to be hidden away in expense and purchase inventory accounts.

Required:
Take the role of Magann and write a memo to the audit manager (dated October 1) describing the audit team's options with respect to evaluating control performance for the remaining period, October through December.

EP 10-4 Evaluation of Quantitative Test of Controls Evidence. LO5 Assume you audited control compliance in the Kingston Company for the deviations related to a random selection of sales transactions, as shown in Exhibit EP 10-4. For different sample sizes, the number of deviations was as Exhibit EP 10-4.

Required:
For each deviation and each sample, calculate the rate of deviation in the sample (sample deviation rate).

EXHIBIT EP10-4

	SAMPLE SIZES									
	30	60	80	90	120	160	220	240	260	300
Missing sales invoice	0	0	0	0	0	0	0	0	0	0
Missing bill of lading	0	0	0	0	0	1	2	2	3	3
No credit approval	0	3	6	8	10	14	17	23	26	31
Wrong prices used	0	0	0	0	2	4	8	9	9	12
Wrong quantity billed	1	2	4	4	4	5	5	5	5	5
Wrong invoice arithmetic	0	0	0	0	1	2	2	2	2	3
Wrong invoice date	0	0	0	0	0	2	2	2	2	2
Posted to wrong account	0	0	0	0	0	0	0	0	0	0

EP 10-5 Stratification Calculation of Projected Likely Misstatement Using the Ratio Method. LO6 The stratification calculation example in the chapter shows the results of calculating the projected likely misstatement using the difference method. Assume the results shown in Exhibit EP 10-5 were obtained from a stratified sample.

Required:
Apply the ratio calculation method to each stratum to calculate the projected likely misstatement (PLM). What is PLM for the entire sample?

EXHIBIT EP10-5

			SAMPLE RESULTS		
STRATUM	POPULATION SIZE	RECORDED AMOUNT	SAMPLE	RECORDED AMOUNT	MISSTATEMENT AMOUNT*
1	6	$100,000	6	$100,000	$ −600
2	80	75,068	23	21,700	−274
3	168	75,008	22	9,476	−66
4	342	75,412	22	4,692	−88
5	910	74,512	23	1,973	23
	1,506	$400,000	96	$137,841	$−1,005

*A negative misstatement indicates overstatement of the book value, and a positive misstatement indicates understatement.

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EP 10-6 Determining Risk of Incorrect Acceptance. LO6 In the dialogue between the Kingston auditors, Fred said, "Our analytical procedures related to receivables didn't show much. The total is down, consistent with the sales decline, so the turnover is up a little. If any misstatement is in the receivables total, it may be too small to be obvious in the ratios."

Jack replied, "That's good news if the problems are immaterial. Too bad we can't say analytical procedures reduce our audit risk. What about internal control?"

Fred responded: "I'd say it's about a 50–50 proposition. Sometimes control seemed to work well; sometimes it didn't. I noticed a few new people doing the invoice processing last week when we were here for a conference. Incidentally, I lump the inherent risk problems and internal control risk problems together when I think about internal control risk. Anyway, firm policy is to plan a sample for a low overall audit risk for the receivables."

Required:

Based on this dialogue information, use the expanded risk model to determine a test of detail risk. Relate this risk to sample-size determination.

DISCUSSION CASES

DC 10-1 Application to Accounts Receivable. LO6 Toni Tickmark has been assigned to plan the audit of the Cajuzzi Corporation, and is currently planning the circularization (confirmation) of accounts receivable. Cajuzzi sells a number of products in the personal health care field but its mainstay is a portable whirlpool unit for use in bathtubs called the "Ecstasizer." Offering the same therapeutic muscle-relaxing benefits as built-in units costing up to four times more, the Ecstasizer has been an outstanding success and is largely responsible for the 14% jump in sales this year.

Cajuzzi has five major categories of customers: wholesalers, department store chains, drug stores, hardware stores, and sporting goods stores. Because the health care industry is highly competitive and a number of "clones" are appearing on the market, Cajuzzi has an aggressive sales strategy coupled with fairly liberal credit policies. Viewing onsite store displays as its primary advertising media, Cajuzzi actually gives each customer a display unit for demonstration purposes. These costs are charged to promotion expense. It is the stated objective of the company to have every store in the country displaying its products.

New customers are extended credit using a very liberal credit policy, and terms are net/30. Cajuzzi will not stop shipments unless balances are more than 120 days old. Customers' credit status is returned to normal as soon as the overdue balances are paid. Cajuzzi is loathe to write off any account unless the customer is actually insolvent or has given intent not to pay.

SCHEDULE A CAJUZZI—FIVE-YEAR FINANCIAL SUMMARY (IN $1000s)

	20X0	20X1	20X2	20X3	20X4
Sales	84,000	85,000	83,000	86,000	98,000
A/R (6/30)	11,000	12,500	12,000	13,000	18,000
Allowance for doubtful accounts	1,260	1,275	1,245	1,290	1,470
Pre-tax income	3,300	2,400	3,200	3,900	5,000
Total assets	25,000	25,000	26,000	26,000	29,000

SCHEDULE B CAJUZZI—ACCOUNTS RECEIVABLE SUMMARY JUNE 30, 20X4

RANGE	NUMBER OF CUSTOMERS	TOTAL $
$100,000–$500,000	6	$ 1,800,000
75,000–99,999	20	1,700,000
50,000–74,999	35	2,000,000
25,000–49,999	30	1,100,000
15,000–24,999	100	1,900,000
10,000–14,999	120	1,400,000
Less than 10,000	16,220	8,100,000
	16,531	$18,000,000

CAJUZZI—AGED TRIAL BALANCE AT 06/30/X4

TIME FRAME (IN DAYS)	TRIAL BALANCE
0–30	$8,350,000
31–60	$5,740,000
61–90	$2,105,000
91–120	$1,350,000
More than 120 days	$ 455,000

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Schedule A contains a five-year summary of key financial data, and Schedule B has a summary of accounts receivable at the year-end circularization date (June 30, 20X4). This is the second year that Toni's firm has been the auditor of Cajuzzi, and her first year on the engagement. Last year's working papers showed that the 50 largest accounts were circularized, which was coverage of 20% ($2,600,000). Overstatement of accounts receivable of $190,000 was discovered, but no adjustment was proposed as the error was deemed immaterial.

(ICAO adapted)

Required:

a. Critique last year's (20X3) approach to the circularization of receivables and the subsequent disposition of errors discovered.

b. What is meant by random (representative) selection, and why is it the most fundamental principle of sampling theory? Under what conditions is nonrandom selection appropriate?

c. What is meant by the terms *sampling error* and *nonsampling error?* What steps can the auditor take to control these?

d. Design a sampling plan for the circularization of receivables for Cajuzzi at June 30, 20X4. Cajuzzi's product line includes the following:

- Bathtub whirlpool units
- Exercise equipment (rowers, bikes, and mini-gyms)
- Heating pads, massage units, and footbaths
- Air purifiers and ionizers
- "Healthware" cooking utensils
- Skin care products and vitamin supplements
- Track suits, footwear, and sportswear

DC 10-2 Statistical Confirmation of Receivables. LO6 You are about to commence the audit of Delta Ltd. (See Exhibit DC 10-2.) This is the first time you have worked in the field without direct supervision by a senior, and you are, of course, anxious to do a good job. The senior has preceded you in visiting the client and has left you an audit file containing the following:

- An internal control questionnaire indicating no serious deficiencies in internal control over accounts receivable
- An aged accounts receivable listing prepared by the client
- Confirmation control schedule
- Returned confirmations

The confirmation control shows the following information:

- Number of accounts in the receivables subledger at December 31 = 65
- Number of positive confirms mailed = 15
- Number of negative confirms mailed = 30

The client year-end, December 31, was selected as the circulation date. Trade terms are 2/10, net/30. Confirmation results are as follows:

1. Eight positive confirms returned indicating full agreement
2. One positive confirm returned indicating the balance was correct but this is the outstanding balance as at November 30, 20X2, not December 31, 20X2
3. One positive confirm returned stating the balance was correct but should also reflect a credit memo issued January 5, 20X3
4. One positive confirm returned stating the company uses an open invoice system and is unable to respond
5. One positive confirm responding that the amount shown is incorrect because it does not reflect the 2% cash discount taken January 3, 20X3
6. One positive and three negative confirms returned by the post office marked "No Such Address"
7. One positive confirm stating that the balance was correct but that the company refuses to pay because of defective product quality
8. One positive confirm not returned, even after two follow-up requests
9. Two negative confirms returned with no notations made by customers
10. One negative confirm returned stating the customer owed more than the balance shown
11. One negative confirm returned stating that the balance was correct but asking for an extension of credit terms
12. One negative confirm returned stating "Sue us"

The *first* page of the aged trial balance supplied by the client for Delta as at December 31 is shown in Exhibit DC 10-2.

Notes made by the senior indicate the following additional information:

- Abbey is an employee of Delta
- The $700 Babbitt account represents a consignment shipment
- The $500 October balance of Cabal has been formalized by a note receivable
- The Cadenza balance represents a deposit; no shipments have been made to them yet

Another note in the working-paper file indicates that the client asked you not to send confirmation requests to Dacron Ltd. because they are worried about jeopardizing the ongoing collection efforts for the $3,000 past-due balance. Also, you were requested not to circularize Cadaver because Delta is extremely happy to have such a large account and wants to avoid bothering them in any way.

Required:

Analyze the evidence already obtained and describe any further procedures required to complete the audit of accounts receivable.

(ICAO adapted)

DC 10-3 Projected Likely Misstatement. LO6 When Marge Simpson, PA, audited the Candle Company inventory, a random sample of inventory types was chosen for physical observation and price testing. The

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EXHIBIT DC 10-2

DELTA LTD. AGED TRIAL BALANCE					
ACCOUNT	BALANCE	DEC	NOV	OCT	PRIOR
	(CR)				
Aardwark Enterprises	$ 4,200	$ 2,100	$2,100		
Abacus Inc.	900				$900
Abalone Co.	5,500	1,000	3,200	$1,200	
Abbey, Fred	(600)	(600)			
Abstract Enterprises	1,100	500	400		200
Babbitt Inc.	700	700			
Bacchus Co.	6,000	2,000	4,000		
Cabal Ltd.	1,000			500	500
Cacao Enterprises	(900)				(900)
Cadaver Inc.	30,000	30,000			
Cadenza Co.	(1,200)	(1,200)			
Dacron Ltd.	3,100	100		3,000	
Subtotal (first page)	$49,800	$34,600	$9,700	$4,700	$700

sample size was 80 different types of candles and candle-making inventory. The entire inventory contained 1740 types, and the amount in the inventory control account was $166,000. Simpson had already decided that a misstatement of as much as $6000 in the account would not be material. The audit work revealed the following eight errors in the sample of 80.

BOOK VALUE	AUDIT VALUE	ERROR AMOUNT
$600.00	$622.00	$ (22.00)
15.50	14.50	(1.00)
65.25	31.50	(33.75)
83.44	53.45	(29.99)
16.78	15.63	(1.15)
78.33	12.50	(65.83)
13.33	14.22	$ (.89)
93.87	39.87	(54.00)
$966.50	$803.67	$(162.83)

The negative difference indicates overstatement of the recorded amount.

Required:

Calculate the projected likely misstatement using the difference method. Discuss the decision choice of accepting or rejecting the $166,000 book value (recorded amount) without adjustment.

DC 10-4 Exercises in Applying the Basic Formula and Using the R Value Table in Appendix 10A. LO5 The following Exhibit DC 10-4 gives auditor judgment and audit sampling results for six populations. Assume large population sizes.

Required:

a. For each population, did the auditor select a smaller sample size than is indicated by using the tables for determining sample size (assume K = 0 in sample size planning)? Explain the effect of selecting either a larger or a smaller size than those determined in the tables.

b. Calculate the sample deviation rate and the achieved P or upper error limit for each population.

c. For which of the six populations should the sample results be considered unacceptable? What options are available to the auditor?

d. Why is analysis of the deviations necessary even when the populations are considered acceptable?

e. For the following terms, identify which is an audit decision, a nonstatistical estimate made by the auditor, a sample result, and a statistical conclusion about the population:

1. Estimated population deviation rate
2. Tolerable deviation rate
3. Acceptable risk of overreliance on internal control
4. Actual sample size
5. Actual number of deviations in the sample
6. Sample deviation rate
7. Achieved P or upper error limit

EXHIBIT DC 10-4

	1	2	3	4	5	6
Tolerable deviation rate or error rate as a percentage (equals materiality for the test)	6	3	8	5	20	15
Acceptable risk of overreliance on internal control in percentage = Beta Risk = 1 − Confidence Level	5	5	10	5	10	10
Actual sample size	100	100	60	100	20	60
Actual number of deviations (errors) in the sample	2	0	1	4	1	8

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CRITICAL THINKING

CT 10-1 LO4 Does nonsampling risk include improper application of GAAP? Discuss.

CT 10-2 LO4 Do you think the general decision rule "if achieved P > materiality, then reject; otherwise accept the population" should be applied to all estimates in financial reporting whether statistical or not? Discuss.

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APPENDIX 10A

Statistical Sampling Tables

R VALUE TABLE

CONFIDENCE LEVELS				K VALUE: NUMBER OF SAMPLE ERRORS	CONFIDENCE LEVELS		
75%	80%	85%	90%		95%	97.5%	99%
R	R	R	R		R	R	R
1.39	1.61	1.90	2.31	0	3.00	3.69	4.51
2.70	3.00	3.38	3.89	1	4.75	5.58	6.64
3.93	4.28	4.73	5.33	2	6.30	7.23	8.41
5.11	5.52	6.02	6.69	3	7.76	8.77	10.05
6.28	6.73	7.27	8.00	4	9.16	10.25	11.61
7.43	7.91	8.50	9.28	5	10.52	11.67	13.11
8.56	9.08	9.71	10.54	6	11.85	13.06	14.58
9.69	10.24	10.90	11.78	7	13.15	14.43	16.00
10.81	11.38	12.08	13.00	8	14.44	15.77	17.41
11.92	12.52	13.25	14.21	9	15.71	17.09	18.79
13.03	13.66	14.42	15.41	10	16.97	18.40	20.15

TABLE OF RANDOM DIGITS

32942	95416	42339	59045	26693	49057	87496	20624	14819
07410	99859	83828	21409	29094	65114	36701	25762	12827
59981	68155	45673	76210	58219	45738	29550	24736	09574
46251	25437	69654	99716	11563	08803	86027	51867	12116
65558	51904	93123	27887	53138	21488	09095	78777	71240
99187	19258	86421	16401	19397	83297	40111	49326	81686
35641	00301	16096	34775	21562	97983	45040	19200	16383
14031	00936	81518	48440	02218	04756	19506	60695	88494
60677	15076	92554	26042	23472	69869	62877	19584	39576
66314	05212	67859	89356	20056	30648	87349	20389	53805
20416	87410	75646	64176	82752	63606	37011	57346	69512
28701	56992	70423	62415	40807	98086	58850	28968	45297
74579	33844	33426	07570	00728	07079	19322	56325	84819
62615	52342	82968	75540	80045	53069	20665	21282	07768
93945	06293	22879	08161	01442	75071	21427	94842	26210
75689	76131	96837	67450	44511	50424	82848	41975	71663
02921	16919	35424	93209	52133	87327	95897	65171	20376
14295	34969	14216	03191	61647	30296	66667	10101	63203
05303	91109	82403	40312	62191	67023	90073	83205	71344
57071	90357	12901	08899	91039	67251	28701	03846	94589

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78471	57741	13599	84390	32146	00871	09354	22745	65806
89242	79337	59293	47481	07740	43345	25716	70020	54005
14955	59592	97035	80430	87220	06392	79028	57123	52872
42446	41880	37415	47472	04513	49494	08860	08038	43624
18534	22346	54556	17558	73689	14894	05030	19561	56517
39284	33737	42512	86411	23753	29690	26096	81361	93099
33922	37329	89911	55876	28379	81031	22058	21487	54613
78355	54013	50774	30666	61205	42574	47773	36027	27174
08845	99145	94316	88974	29828	97069	90327	61842	29604
01769	71825	55957	98271	02784	66731	40311	88495	18821
17639	38284	59478	90409	21997	56199	30068	82800	69692
05851	58653	99949	63505	40409	85551	90729	64938	52403
42396	40112	11469	03476	03328	84238	26570	51790	42122
13318	14192	98167	75631	74141	22369	36757	89117	54998
60571	54786	26281	01855	30706	66578	32019	65884	58485
09531	81853	59334	70929	03544	18510	89541	13555	21168
72865	16829	86542	00396	20363	13010	69645	49608	54738
56324	31093	77924	28622	83543	28912	15059	80192	83964
78192	21626	91399	07235	07104	73652	64425	85149	75409
64666	34767	97298	92708	01994	53188	78476	07804	62404
82201	75694	02808	65983	74373	66693	13094	74183	73020
15360	73776	40914	85190	54278	99054	62944	47351	89098
68142	67957	70896	37983	20487	95350	16371	03426	13895
19138	31200	30616	14639	44406	44236	57360	81644	94761
28155	03521	36415	78452	92359	81091	56513	88321	97910
87971	29031	51780	27376	81056	86155	55488	50590	74514
58147	68841	53625	02059	75223	16783	19272	61994	71090
18875	52809	70594	41649	32935	26430	82096	01605	65846
75109	56474	74111	31966	29969	70093	98901	84550	25769
35983	03742	76822	12073	59463	84420	15868	99505	11426

Source: The Rand Corporation, *A Million Random Digits with 100,000 Normal Deviates* (Glencoe: Free Press, 1955), p. 102.
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TABLE FOR DETERMINING SAMPLE SIZE FOR TEST OF CONTROL USING THE MUS APPROACH
TOLERABLE RATE OF DEVIATIONS OR ERRORS

	0.01	0.02	0.03	0.04	0.05	0.06	0.07	0.08	0.09	0.10	0.15	0.20
BETA RISK = 0.05	300	150	100	75	60	50	43	38	34	30	20	15
BETA RISK = 0.10	231	116	77	58	47	39	33	29	26	24	16	12

TABLE TO EVALUATE SAMPLE RESULTS FOR TEST OF CONTROLS USING MUS APPROACH: COMPUTED UELs AS A PERCENT (ACHIEVED Ps) FOR CONFIDENCE LEVEL = 95%

Beta Risk = 0.05

R VALUE	3	4.75	6.3	7.76	9.16	10.52	11.85	13.15	14.44	15.71	16.97
Actual Number of Errors Found in the Sample											
Sample Size	0	1	2	3	4	5	6	7	8	9	10
20	15	*	*	*	*	*	*	*	*	*	*
25	12	19	*	*	*	*	*	*	*	*	*
30	10	16	*	*	*	*	*	*	*	*	*

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35	9	14	18	*	*	*	*	*	*	*	*
40	8	12	16	20	*	*	*	*	*	*	*
45	7	11	14	18	*	*	*	*	*	*	*
50	6	10	13	16	19	*	*	*	*	*	*
55	6	9	12	15	17	20	*	*	*	*	*
60	5	8	11	13	16	18	20	*	*	*	*
65	5	8	10	12	15	17	19	*	*	*	*
70	5	7	9	12	14	16	17	19	*	*	*
75	4	7	9	11	13	15	16	18	20	*	*
80	4	6	8	10	12	14	15	17	19	20	*
90	4	6	7	9	11	12	14	15	17	18	19
100	3	5	7	8	10	11	12	14	15	16	17
125	3	4	6	7	8	9	10	11	12	13	14
150	2	4	5	6	7	8	8	9	10	11	12
175	2	3	4	5	6	7	7	8	9	9	10
200	2	3	4	4	5	6	6	7	8	8	9
250	2	2	3	4	4	5	5	6	6	7	7
300	1	2	3	3	4	4	4	5	5	6	6

TABLE TO EVALUATE SAMPLE RESULTS FOR TEST OF CONTROLS USING MUS APPROACH: COMPUTED UELs AS A PERCENT (ACHIEVED Ps) FOR CONFIDENCE LEVEL = 90%

Beta Risk = 0.10

R VALUES	2.31	3.89	5.33	6.69	8.00	9.28	10.54	11.78	13.00	14.21	15.41
Actual Number of Errors Found in the Sample											
Sample Size	0	1	2	3	4	5	6	7	8	9	10
20	12	20	*	*	*	*	*	*	*	*	*
25	10	16	*	*	*	*	*	*	*	*	*
30	8	13	18	*	*	*	*	*	*	*	*
35	7	12	16	20	*	*	*	*	*	*	*
40	6	10	14	17	20	*	*	*	*	*	*
45	6	9	12	15	18	*	*	*	*	*	*
50	5	8	11	14	16	19	*	*	*	*	*
55	5	8	10	13	15	17	20	*	*	*	*
60	4	7	9	12	14	16	18	20	*	*	*
65	4	6	9	11	13	15	17	19	20	*	*
70	4	6	8	10	12	14	16	17	19	*	*
75	4	6	8	9	11	13	15	16	18	19	*
80	3	5	7	9	10	12	14	15	17	18	20
90	3	5	6	8	9	11	12	14	15	16	18
100	3	4	6	7	8	10	11	12	13	15	16
125	2	4	5	6	7	8	9	10	11	12	13
150	2	3	4	5	6	7	8	8	9	10	11
175	2	3	4	4	5	6	7	7	8	9	9
200	2	2	3	4	4	5	6	6	7	8	8
250	1	2	3	3	4	4	5	5	6	6	7
300	1	2	2	3	3	4	4	4	5	5	6

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Performing the Audit

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PART 3 Performing the Audit

CHAPTER 11

The Revenues, Receivables, and Receipts Process

This chapter starts with a prelude to Part 3, giving an overview of how the audit planning links to performing the audit in the four main business processes of a typical organization. It then offers a concise view of the accounting cycle for the business processes related to accepting customer orders, delivering goods and services to customers, accounting for customer sales and accounts receivable, collecting and depositing cash received from customers, and reconciling bank statements. The chapter describes the control considerations, typical control tests, and substantive audit programs used in the revenue, receivables, and receipts process. Special technical notes on auditing the existence assertion using confirmations and on auditing bank reconciliations are provided. An Application Case with analysis is given at the end of the chapter to demonstrate the performance of audit procedures in situations where errors or frauds might be discovered in the revenues, receivables, and receipts process.

EcoPak Inc.

Caleb and Donna completed their interim audit work on the systems and controls at EcoPak on schedule. Shree has also completed her work on the IT systems, finding they are designed well and provide effective controls over authorization of transactions, accuracy, and completeness of processing the data. The audit team's interim work has identified a strong control environment and general controls in the company, since Nima has made of point of ensuring that good processes have been

LEARNING OBJECTIVES

After completing this chapter, you will be able to do the following:

LO1 Describe the revenues, receivables, and receipts process, including typical risks, transactions, account balances, source documents, and controls.

LO2 Describe the auditor's control risk assessment and control tests for auditing control over customer credit approval, delivery, accounts receivable, cash receipts, and bank statements.

LO3 Explain how the auditor's risk assessment procedures and control testing link to the key assertions and audit objectives in designing a substantive audit program for the cash account balance.

LO4 Describe the typical substantive procedures used to address the assessed risk of material misstatement in the main account balances and transactions in the revenues, receivables, and receipts process.

LO5 Explain the importance of the existence assertion for the audit of cash and accounts receivable.

LO6 Identify considerations for using confirmations when auditing cash and accounts receivable.

LO7 Describe the audit of bank statement reconciliations and how auditors identify accounts receivable lapping and suspicious cash transactions.

CHAPTER APPENDICES

Appendix 11A: Internal Control Questionnaires

Appendix 11B: System Documentation Examples for the Revenues, Receivables, and Receipts Process

Appendix 11C: Example of an Audit Engagement File Index *(online)*

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implemented, including appropriate segregation of duties to the extent possible given the size of the company. Nima performs many key reconciliation and review controls procedures, and analyzes all the accounts for the year-end to make sure any posting or misclassification errors are corrected prior to preparing the draft financial statements, before the auditors even see them.

One weakness the team noted was that Mike's user ID gives him access to both the inventory and sales processes, which are considered incompatible functions. Nima explains that they set it up that way because Mike sometimes has to work quite closely on customer relations when a new customized product is being developed: "This was the easiest way for him to get all the information he needs to make sure the customer gets what they want and the new pricing is appropriate." To fully assess this risk, the team has verified that Mike has no access to any financial accounting processes, so the risk of misstatement is reduced.

The audit team concluded there are effective control procedures in the sales processing and credit note processing functions that can be relied on as a basis for planning lower extents of substantive work on the sales transactions. Boris reviewed the files and was satisfied with their work and the reasonableness of their conclusions. He agrees that Mike's access is probably not a big problem, but that it should be mentioned to the board as a management letter recommendation to consider whether a more customized access profile could be implemented to meet Mike's information needs. He does warn the team, however, "You guys are VERY lucky on this audit. Nima is highly qualified and seems to run a tight ship in the accounting area, so it looks like this could be a very clean audit. But even so, don't let your guard down. We need sufficient evidence beyond the fact that management has good controls, and misstatements are always possible!"

The time is now approaching to begin making arrangements with EcoPak's management to visit their business to complete the year-end audit work. Boris asked Donna to carry on with preparing the substantive audit programs for his review so that he can finalize the assignment of audit staff to the year-end. Since Caleb will be starting with the cash balance audit, she prepares that plan first and goes over it with him so he will be ready to go when they get back to the EcoPak offices. Donna uses the firm's template program form as a starting point, then tailors it for EcoPak's business and its processes, and for the team's findings, to date, on its internal control. Based on the results of their control tests, Donna concludes that there are strong controls in place for the existence, completeness, and ownership assertions of the cash balance, so this can be taken into account in the extent of further testing of these assertions. They did not perform control tests specifically related to the valuation and presentation of cash, as it would be more efficient to simply rely on substantive procedures for these assertions. Taking into account their inherent risk assessments and their control findings, Donna designs an audit program for cash, with further procedures to respond to the residual risk of misstatement, applying the audit risk model to determine the residual risk for each assertion. She then turns her attention to tailoring the other substantive programs for the R/R/R, and then for the rest of EcoPak's processes. Tariq wants to review the completed planning file early next week before a meeting he has scheduled with Kam, Mike, and Zhang. This means she needs to get it to Boris by Friday morning to give him time to review it first. Once all the reviews are completed, Donna and Caleb head out to EcoPak's offices to complete their field work.

PERFORMING AN INDEPENDENT FINANCIAL STATEMENT AUDIT

PRELUDE TO PART 3: LINKING AUDIT PLANNING TO PERFORMANCE

You are about to begin Part 3 of the text, which illustrates how the audit activities, concepts, and tools presented in Part 2 are applied in practice to perform audits. In Part 3, simplified business situations will be used as examples to illustrate the links from planning considerations to actually doing the audit work.

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Recall that the auditor's understanding of the auditee's business—its environment, risks, systems, and controls—were discussed in Part 2. This understanding is the basis for developing an appropriate overall audit strategy, which should reflect the preliminary decisions on the scope of the audit. As covered in Chapters 4 and 5, the scope defines the entity and the financial information that is the subject of the audit opinion. The strategy also sets out the audit's timing and the approach to be used to gather sufficient appropriate evidence. As discussed in Chapter 5, the overall audit strategy also involves the following:

- Determining appropriate materiality levels for planning purposes
- Assessing the auditee's industry, legal, and regulatory environment; generally accepted accounting principles (GAAP); and changes in the company's management, information systems, or operations that can affect financial reports
- Identifying material financial statement components and high risk audit areas
- Determining the audit evidence required to assess internal control effectiveness (If the auditor is required to provide an assurance report on management assertions about internal control effectiveness, this additional responsibility is included here.)
- Deciding, on a preliminary basis, if controls will be tested; what substantive evidence requirements there are; and what the timing for the procedures will be

Auditee resources and cooperation required in the overall strategy are communicated to auditee management and those people charged with its governance so that arrangements for access to records and personnel for interim and final audit work can be made. The audit firm's internal resource needs are also specified in the overall strategy: How many audit staff are required and what experience levels do they need? Are audit staff with special expertise in IT or tax issues required? Will external experts be required for valuation assistance? Will other offices of the audit firm be involved for multi-location businesses, or will the work of other audit firms be used?

Overall audit strategy development also sets out a schedule for audit team meetings, timing of the process, and experience levels required for working paper reviews. The auditor's assessment of management's internal controls is made at the company and application levels (transactions, balances, and disclosures, and the assertions of each). Details of this assessment were covered in Part 2, but this prelude provides a questionnaire guiding the auditor in this assessment for the overall strategy development stage of the audit.

The overall strategy is the basis for the detailed audit plan and the specific programs that make up the audit. A process view sees a business as being composed of several separate processes and related accounting cycles. This view of a business is useful for an organization's management and its systems development purposes, and it is likely also to be an effective approach in most audit engagements. The separate processes we will examine in Part 3 are as follows:

- Revenues, receivables, and receipts process (Chapter 11)
- Purchases, payables, and payments process (Chapter 12)
- Production and payroll process (Chapter 13)
- Finance and investment process (Chapter 14)

detailed audit plan: an audit planning document outlining the nature, timing, and extent of audit procedures to assess risk of financial statement misstatement and obtain the necessary audit evidence for each assertion for all significant transactions, balances, and disclosures, including staffing decisions and time budgets

Even though organizations may differ, generally, these four processes cover the key functions that need to be managed in every organization. The **detailed audit plan** for each process includes specific audit programs that take effectiveness and efficiency into consideration in (1) specifying the nature, extent, and timing of audit procedures to assess inherent and control risk, and (2) planning further audit procedures that will be done to reduce these risks to an acceptably low level in issuing an audit opinion. The detailed audit plan also covers decisions about managing the audit team: direction for less-experienced staff, especially regarding the exercising of professional skepticism; supervision and review of their work; and the time budgets required. Finally, the evidence gained from the audit procedures and other events uncovered will form feedback to the audit planning process

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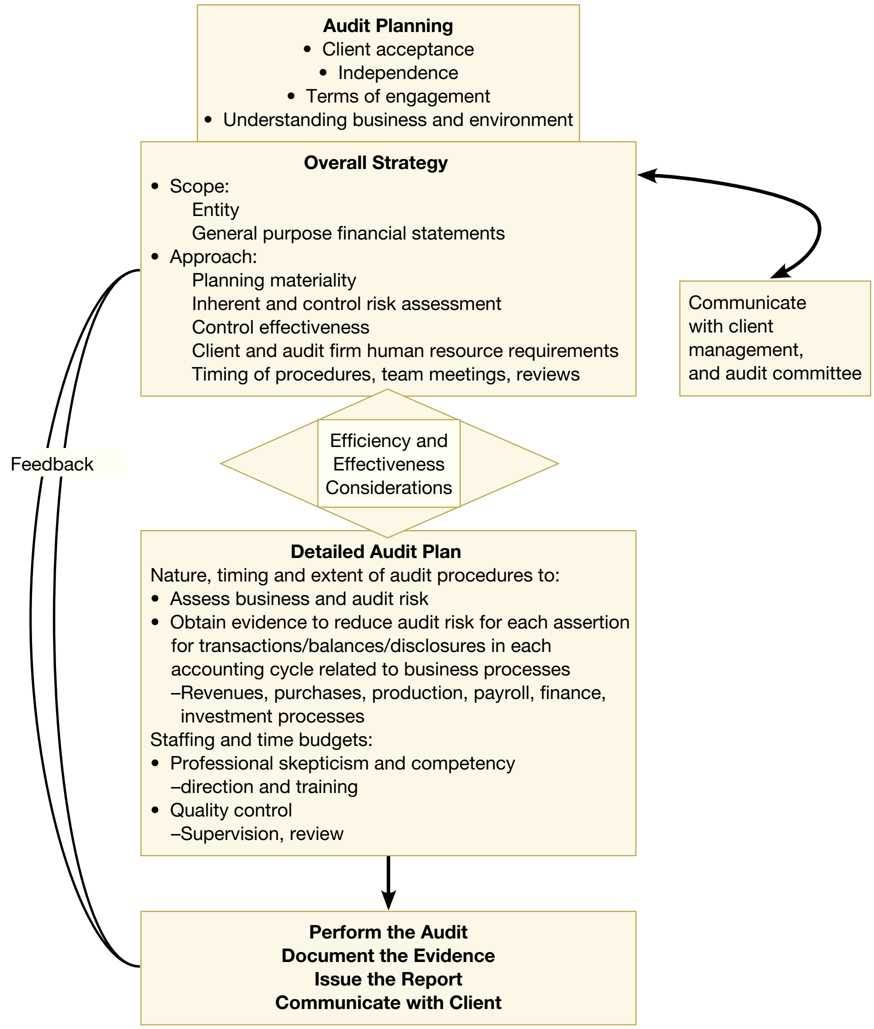
and indicate how the current or future overall strategy and audit plan should be modified in their **scope,** timing, or extent. The diagram below summarizes this development process for the overall strategy and the detailed audit plan.

scope: the entity and the financial statements that will be covered by the audit engagement, and the client documents and records to be examined to provide the necessary audit evidence

Relating Audit Planning to Audit Performance



Business Processes and Accounting Cycles: The Big Picture

To keep things as simple as possible, the design and execution of audit programs for each business process will be focused on individually, even though the processes are all interrelated. Exhibit 6–12, "Capturing an Organization's Business Processes in Its Financial Statements," (see page 216) gave a "big picture" view of how the processes fit together in an organization. The shares and debt coming into the entity and being invested in capital

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assets are handled mainly in the financing and investing process (Chapter 14); creation of goods and services involves the purchases, payables, and payments process (Chapter 12) as well as the production and payroll processes (Chapter 13); and generation of revenues is handled in the revenue, receivables, and receipts process (Chapter 11).

The Balance Sheet Approach to Auditing

The financial statements covered by the auditor's opinion are part of the big picture approach as well. Exhibit 6–19, "The Financial Reporting Process in an Auditee Company," (see page 231) expanded the picture to show the role of business processes and controls in capturing information about the entity's events and environment into its accounting system, allowing production of a set of general purpose financial statements. The full set of statements—that is, the balance sheet, statement of income and comprehensive income, cash flow statement, and statement of shareholders' equity—are all connected so that a change in one particular statement will flow through to all the related accounts in the other statements. This interrelationship mirrors that among the different business processes and is also the basis of what is known as the balance sheet approach to auditing. By focusing on balance sheet accounts and changes in them, we are also gaining assurance about the rest of the financial statement accounts that are connected to it.

As an example of this interrelationship, a high level of audit assurance about the change in net assets and shareholder transactions is also assurance that the net income amount is correct and that only the allocations within the income statement need to be verified as reasonable. This verification often can be done by using mainly analytical procedures rather than more costly vouching or confirmation. This interrelationship reflects the control provided by the double-entry accounting system and the financial statement definitions set out in GAAP. Illustrating how the strengths of the accounting and reporting framework are helpful in pulling all of the audit work together for completion of the audit.

Organization of Chapters 11 through 16

The organization of Chapters 11 to 14 illustrates how the audit plan is performed in the processes. Each chapter follows this pattern:

- An overview of the business risks and the transactions, balances, and disclosures in that process is given.
- Significant risks of misstatement at the assertion level are analyzed.
- An example of the process and the main accounts related to it is given.
- Key control assertions and risks, the types of control activities that would address those risks, and procedures auditors can use to assess controls are covered.
- Examples of alternative controls tests follow, should the auditors decide that reliance on effective controls would be cost-effective in reducing risk of not detecting a material misstatement.
- Examples of substantive audit programs are presented, showing the link from risk assessment at the assertion level, to control evaluation, to substantive evidence gathering that could be used in a particular context to reduce audit risk to an acceptable level.
- An Application Case with analysis illustrating accounting problems in that process and how audit procedures can uncover them is offered.
- A chapter summary reviews the learning objectives covered and provides an overview of the balance sheet approach to analyzing financial statement components. This approach considers the relationships among accounts and how they can be used for developing analytical procedures and for assessing the impact of the types of misstatements commonly discovered in each process.

Part 3 concludes with two chapters covering issues that the auditor must address to complete the audit and form an audit opinion. Chapter 15 covers audit procedures for

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revenues and expenses, and procedures for auditing the cash flow statement. It also discusses the evaluation of potential unrecorded liabilities by obtaining lawyers' confirmation letters, the review of subsequent events, management representation letters, and the management letter. The standards for documenting the audit work in the final audit file are reviewed, and the overall review of evidence obtained. Chapter 16 explains how auditors apply judgment in assessing misstatements and their materiality, proposing financial statement adjustments to management, forming an audit opinion, and preparing the appropriate form of audit report to attach to the financial statements. Auditor responsibilities if there is a discovery of material facts subsequent to issuing the report and auditor communications throughout an engagement are also covered here.

Note that there are many references in Part 3 to details of *generally accepted auditing standards* (GAAS) issued in the *CICA Handbook* as CASs, as well as in ISAs. Since this text is aimed at students who will most likely be auditing under Canadian or international GAAS, the text refers, for the most part, to the auditing and assurance recommendations set out by the standard-setting boards of the Canadian Institute of Chartered Accountants (CICA) (CASs) and the International Federation of Accountants (IFAC) (ISAs). The U.S. auditing standards are similar in principle to their Canadian and international counterparts, and U.S. standard setters are moving toward harmonization with international GAAS. The American Institute of Certified Public Accountants (AICPA) has a set of clarified auditing standards based on ISAs coming into effect for private companies for periods ending on or after December 15, 2012. However, U.S. pronouncements and standard setting are structured somewhat differently in response to unique U.S. legal, regulatory, and political circumstances. This text refers to U.S. standards when they are likely to lead to similar developments in future Canadian or international GAAS. For those who wish to learn more about U.S. GAAS, refer to the Public Companies Accounting Oversight Board (PCAOB) and AICPA websites for specific details.

UNDERSTANDING THE REVENUES, RECEIVABLES, AND RECEIPTS PROCESS

LO1 Describe the revenues, receivables, and receipts process, including typical risks, transactions, account balances, source documents, and controls.

Revenue creation is the focus of strategy and business processes for any organization because revenues provide the cash flows that are its lifeblood. The auditor must understand the business's method of generating revenues and the use of them in the operation of the business in order to assess the business risk and the risk that the financial statements are misstated, as discussed in Chapter 6. In a for-profit business, costs incurred must generate enough sales revenue to provide profits to sustain operations and also provide investment returns to owners and creditors. A not-for-profit organization also must generate enough revenues to pay for the activities necessary to achieve its charitable or other purposes.

Assertion-Based Risk Assessment for Revenues, Receivables, and Receipts

To assess risks in the revenue-generating processes, the auditor mainly considers the revenue and cash receipts transactions, as well as the accounts receivable balances. Important presentation and disclosure issues relating to revenues include revenue recognition policies, related-party transactions, commitments, and economic dependencies.

At the assertion level, risks related to the existence/occurrence and ownership of revenues may arise if management chooses overly aggressive revenue recognition policies (e.g., Nortel), perhaps because of management incentives or pressure to meet performance targets. Complex sales arrangements that involve multiple deliverables with differing rights of return by customers, or complex revenue recognition situation, such as long-term contracts, may also increase the existence and ownership risks as revenue may be recognized inappropriately. Ownership risks may exist where managers have the ability to transfer funds between related entities under their control (e.g., Enron, Hollinger). Completeness risks relate to recordkeeping and custodial controls over cash receipts; these

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money laundering: engaging in specific financial transactions in order to conceal the identity, source, and/or destination of money resulting from an illegal act, which may involve organized crime, tax evasion, or false accounting

must ensure that all revenues the business earns are received by the company and recorded in full. Fraudulent misappropriation of cash by employees is a key completeness risk in the revenue process. Because substantial flows of funds may be involved in the revenue processes of some businesses (e.g., financial services, banking), **money laundering**—processing monetary profits of crime to cover up their sources and convert them to "clean" cash—is also an ownership risk related to the revenue transactions. Valuation and ownership risks can exist when substantial revenues are generated in foreign countries because of currency exchange risks and potential restrictions on removing money from those countries. Presentation and disclosure risks include revenue recognition policy explanations, reporting significant revenue categories separately, accruals of complex revenue streams, such as royalties or long-term contracts, reporting the extent of barter transactions (e.g., in e-commerce), or disclosing contractual commitments to sell inventory at fixed prices. These are only some examples of risks that may exist in a particular business. You can see how an auditor's in-depth understanding of the auditee's business, the revenue-generating strategy that drives it, and the environment it operates in are critical to a comprehensive assessment of business risks and the possible financial misstatements that these risks can lead to.

This chapter uses simple examples to outline the business processes and related accounting cycles for recording and controlling revenues, accounts receivable, and cash receipts. It explains the control activities that are important in these processes, how to evaluate and test these controls, and how to design and implement the substantive audit tests that provide evidence that the resulting financial statements are fairly reported. The risk of nonexistent or incorrectly valued revenues or receivables can often be addressed by confirmation and analytical procedures. Control tests in the revenue transaction processes may also provide assurance that the controls effectively lower the risk of material misstatement, thereby reducing the amount of assurance required from substantive evidence. Revenue completeness usually relies on controls and control testing; substantive testing alone may not provide sufficient evidence for the completeness assertion for revenues.

Revenues, Receivables, and Receipts Process: Typical Activities

Exhibit 11–1 presents a skeleton overview picture of typical activities in the revenues, receivables, and receipts process in a business entity.[1] The basic process functions, shown in bold, are as follows: (1) receiving and processing customer orders, (2) credit granting, (3) delivering goods and services to customers, (4) billing customers and accounting for accounts receivable, and (5) collecting and depositing cash received from customers. As you follow the exhibit, you can track some of the elements of the control structure, shown in the ovals. Further examples of controls related to this process are provided in Appendix 11A, Exhibit 11A–2.

In practice, you would have obtained a detailed organizational chart as part of the audit planning. This chart identifies the specific auditee personnel responsible for the various functions in the process. These are the people you will work with to design and perform your audit work. Your audit documentation for significant processes will be the form of *system narratives, flowcharts* or *process tables:* these are described next.

REVIEW CHECKPOINTS

11-1 What is the basic sequence of activities and related accounting in the revenues, receivables, and receipts process?

11-2 What are some risks of material misstatement in the assertions for revenues?

1 This picture is not a flowchart. Flowcharts are illustrated in Appendix 11B.

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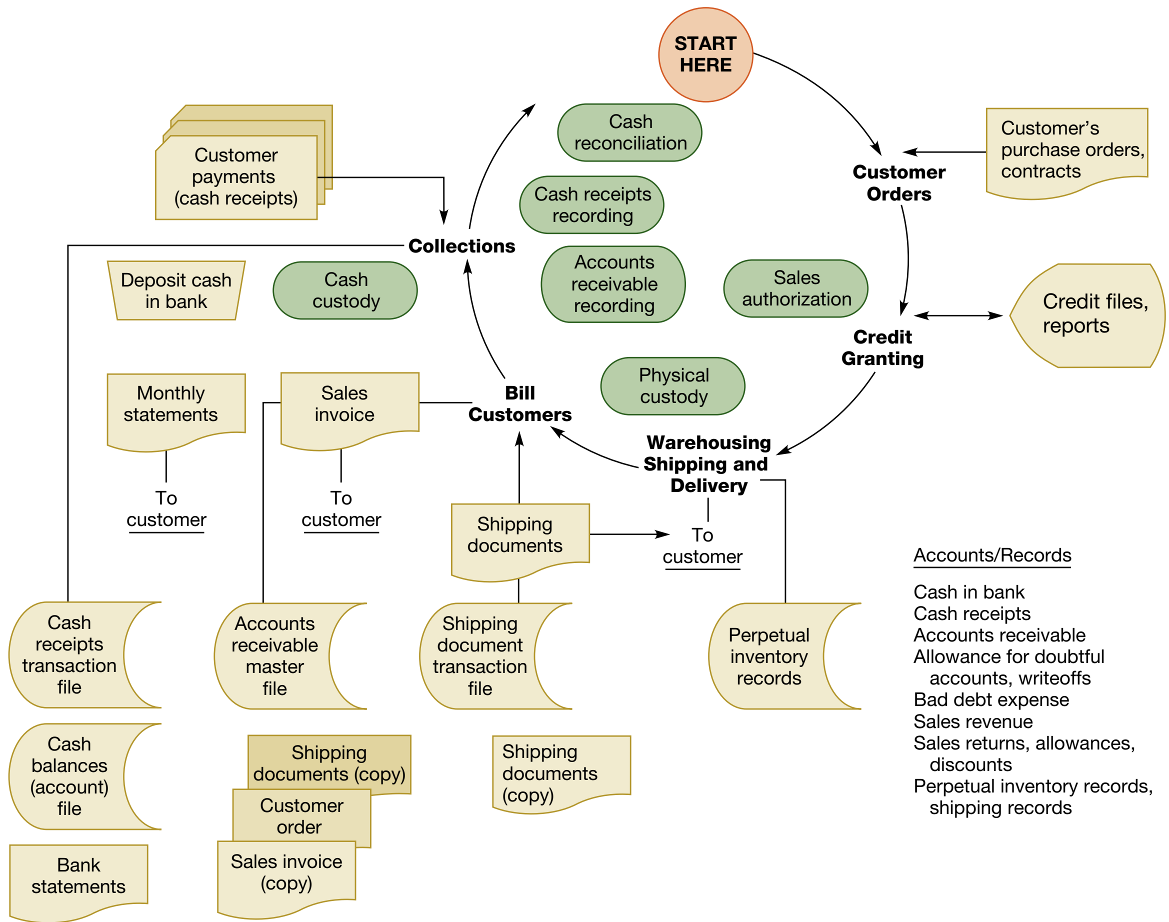
EXHIBIT 11–1 Revenues, Receivables, and Receipts Process: Overview Diagram of Typical Activities



Revenues and Accounts Receivable: Processing and Controls

This section gives a narrative description of a system for processing customer sales orders. Alternative documentation formats, such as a flowchart diagram or a process table, could be used for this description, and examples of these formats are provided in Appendix 11B. At the starting point, company personnel receive the customer's purchase order and create a sales order, entering it in a computer terminal. The computer system then performs automatic authorization procedures—determining whether the customer is a regular or new customer, approving credit, and checking the availability of inventory. (If inventory is short, a back order is entered.) Once these authorizations are in a computer system, access to the master files for additions, deletions, and other changes must be limited to responsible persons; otherwise, it is possible that orders are processed for fictitious customers, credit is approved for bad credit risks, and packing slips are created for goods that do not exist in the inventory.

When a customer order passes the authorizations, the system (1) creates a record in the pending order master file, (2) transmits a packing slip to the stockroom and shipping department, and (3) updates the inventory master file to show the commitment (removal) of the inventory. The pending order and the packing slip should be numbered in a numerical sequence so that the system can determine if any transactions have not been completed

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(completeness objective of control). The packing slip is the stockkeeper's authorization to release inventory to the shipping department and the shipping department's authorization to release goods to a trucker or the customer.

The company's control system will feature important types of control activities designed to prevent things from going wrong. The control activities include employee procedures relating to keeping custody of assets and records, properly recording transactions and events, and performing reconciling procedures to check the completeness and integrity of the records by comparison to other summaries, reports, or the actual assets themselves. These control activities, and what could go wrong if they are ineffective or missing, are described in more detail below.

Custody

Physical custody of inventory starts with the stockroom or warehouse. Custody is transferred to the shipping department when the packing slip is authorized. As long as the system works, custody is under proper control. However, if the stockkeeper or the shipping department personnel have the power to change the quantity shown on the packing slip, they can cause errors in the system by billing the customer for too small or too large a quantity. With collusion, this can allow inventory to be stolen; for example, shipping a customer more than they will be billed for, covered up by the alterations in the records. (This is a combination of custody and recording functions, a segregation-of-duties control weakness. A computer record or log of such changes is a control procedure creating an electronic audit trail.)

Custody of the accounts receivable records implies the power to enter those records directly or to enter transactions to alter them (e.g., transfers, returns, allowance credits, write offs). Ideally, personnel with the ability to enter accounts receivable records do not also have sole authorization over the entries or the ability to perform reconciliations, as this can reduce the probability of catching that the person's recording errors, such as omitting part of a sales order from a sales invoice. This kind of combination of authorization and recording responsibility is another example of a control weakness due to a lack of segregation of incompatible duties.

Recording

When delivery or shipment is complete, the shipping personnel enter the completion of the transaction in the system, which (1) produces a bill of lading shipping document, evidence of an actual delivery or shipment; (2) removes the pending order from the inventory recording system; and (3) produces a sales invoice (prenumbered the same as the order and packing slip) that bills the customer for the quantity shipped, according to the bill of lading. Shipping personnel who have the power to enter or alter these transactions or to intercept the invoice that is supposed to be sent to the customer have undesirable combinations of authorization, custody, and recording responsibilities. This is a control weakness because it provides an opportunity for employees to commit a fraud by misappropriating inventory and concealing it in the accounting records. Another authorization in the system is the price list master file containing product unit prices for billing customers. Those with power to alter this file have the ability to authorize price changes, which could allow the employee to undercharge a favoured customer, and even to get kickbacks as part of a fraud scheme, so this function needs to be segregated from people who record customer receivables and receipts.

Periodic Reconciliation

The most frequent reconciliation is the comparison of the sum of customers' unpaid balances with the accounts receivable control account total in the general ledger. Usually, this reconciliation is done with an aged trial balance—a list of the customers and their balances—with the balances classified in columns indicating the different age categories (e.g., current, 10–30 days past due, 31–60 days past due, 61–90 days past due, and over 90 days past due). Internal auditors, or employees who are independent of the inventory and receivables recording functions, can perform periodic comparison of the customers' obligations (according to the customers) with the recorded amount by sending confirmations to the customers. (Refer to the special note on using confirmations later in this chapter.)

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Cash Receipts and Cash Balances: Processing and Controls

There are numerous ways to receive payments: cash and cheques over the counter, through the mail, by receipt in a lockbox, and via electronic funds transfer. In a lockbox arrangement, a fiduciary (e.g., a bank) opens the box, lists the receipts, deposits the money, and sends the remittance advices showing the amount received from each customer to the company. While most companies need little authorization to accept a payment, authorization is important for approving discounts and allowances taken. Receiving cash and approving discounts is another example of incompatible duties that provide an opportunity for employees to defraud the company. A flowchart diagram of a manual system for processing cash receipts is shown in Appendix 11B–2.

Custody

In many organizations, someone takes the cash and cheques, which gives them custody of the physical cash for a time. Control over this custody can vary: Responsibility can be rotated so that one person does not have this custody all the time; there could be teams of two or more people, so they would need to collude to steal money; or there could be arrangements outside the company for actual cash custody (e.g., the lockbox arrangement, or direct deposit to the company's bank account). Since initial custody cannot be avoided, it is good control to prepare a list of the cash receipts as early in the process as possible, and then separate the actual cash from the bookkeeping documents. The cash goes to a cashier or treasurer's office, where a bank deposit is prepared and made. The list goes to the accountants, who record the cash receipts. This list simply may be a stack of the remittance advices received with the customers' payments. Many organizations use electronic payment systems (e.g., debit and credit card readers in stores or for Internet sales). These systems reduce the amount of physical cash in custody, relying instead on programmed systems control to ensure the payments transferred are authorized and complete.

CAREFUL RECONCILIATION

Suppose the cashier who prepares the remittance list had stolen and converted Customer A's cheques for personal use. The cashier knows this will work only until Customer A complains that the company has not given it credit for its payments. So, the cashier later puts Customer B's cheques in the bank deposit, but shows Customer A on the remittance list; thus, the accountants give Customer A credit. So far, so good for preventing Customer A's complaint, but now Customer B needs to be addressed. This "lapping" of customer payments to hide an embezzlement can be detected by a bank reconciliation comparison of the cheques deposited (Customer B) with the remittance credit recorded (Customer A). Sometimes, the lapping is covered by issuing a credit note for Customer B. This illustrates the importance of proper authorization and control of credit notes.

SHIPPING EMPLOYEE CAUGHT BY COMPUTER!

A customer paid off a shipping department employee to change the quantity on the packing slip and bill of lading to a smaller quantity than was actually shipped. This caused the customer's invoices to be understated. The employee did not know that a computer log recorded all the entries altering the original packing slip record. An alert internal auditor noticed the pattern of "corrections" made by the shipping employee. A trap was laid by initiating fictitious orders for this customer, and the employee was observed making the alterations.

Recording

The accountants who record cash receipts and credits to customer accounts should not handle the cash. They should use the remittance list to make entries to the cash and accounts receivable control accounts and to the customers' accounts receivable subsidiary account records. In fact, a good error-checking procedure is to have control account and subsidiary account entries made by different people. Then, later, the accounts receivable

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entries and balances can be compared (reconciled) to determine whether the proper source documents (remittance lists) were used to make error-free accounting entries.

Periodic Reconciliation

Bank account reconciliations should be prepared carefully. Deposit slips are compared with cash remittance lists, and the totals should be traced to the general ledger entries. Likewise, paid cheques should be traced to the cash disbursements listing (journal) and the general ledger. The reconciliation should be done by someone other than the accountant, such as the office manager or administrative assistant. (Refer to the special note on auditing bank reconciliations later in this chapter.)

REVIEW CHECKPOINTS

11-3 What purpose is served by prenumbering sales orders, shipping documents (packing slips and bills of lading), and sales invoices?

11-4 Why is controlled access to computer programs and master files (such as credit files and price lists) important in a control environment?

11-5 Why is it a control weakness if the same employee can authorize inventory transfers and record accounts receivable entries?

11-6 Why should a list of cash remittances be made and sent to the accounting department? Is it easier to send the cash and cheques to the accountants so that they can enter accurately the credits to customers' accounts?

Audit Evidence in Management Reports and Data Files

Management generates a variety of reports providing important audit evidence for revenues, accounts receivable, and cash receipts. Some examples follow.

Pending Order Master File

This file contains sales transactions started but not yet completed in the system, and thus not recorded as sales and accounts receivable. Old orders may represent shipments actually made, but for some reason the shipping department did not enter the shipping information (or entered an incorrect code that did not match the pending order file). The pending order backlog can be reviewed for evidence relating to the completeness assertion for recorded sales and accounts receivable.

Credit Check Files

The computer system may make automatic credit checks, but up-to-date maintenance of the credit information is very important. Customers' credit status is concerned with possibly uncollectible receivables, and this is important audit evidence about the valuation assertion. Credit checks on old or incomplete information are not good credit checks. A sample of the files can be tested for current status, or the company's records can be reviewed for evidence of updating operations.

Price List Master File

The computer system may produce customer invoices automatically, but, if the master price list is wrong, the billings will be wrong. The computer file can be compared with an official price source for accuracy and authorization. (As a control, an employee should perform this comparison every time the prices are changed.) Incorrect pricing can lead to revenues and receivables being measured incorrectly, affecting the valuation assertion.

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Sales Detail (Sales Journal) File

This file should contain the detailed sales entries, including the shipping references and dates. It can be scanned for entries without shipping references (fictitious sales) and for matching recording dates with shipment dates (sales recorded before shipment). This file also contains the population of debit entries to the accounts receivable, so this evidence is relevant to the existence/occurrence assertion for revenues and receivables. When there are high volumes of sales entries, these files can be tested with computer assisted auditing techniques (CAATs). Some examples of CAATs include the following:

- Auditor-designed analyses of customers or geographic regions assessed as high risk
- Scrutiny for unusually large entries that can indicate fraud or error
- Scrutiny for items in round numbers, same values, or just below some control dollar limit that occur more frequently than expected
- Verification of numerical continuity of invoices and agreement to general ledger entries

Sales Analysis Reports

The auditor can perform analytical procedures on a variety of sales analyses. Sales classified by product line or region is information for the business segment disclosures. Those classified by period or by sales employee can show unusually high or low volumes that may need investigation if error is suspected. This information can provide evidence related to completeness and existence, or occurrence, of revenues, and it is also useful for assessing the proper presentation or classification of revenue information in the financial statements, as shown in the following box relating to presentation of quarterly sales figures.

PEAKS AND VALLEYS

During the year-end audit, the independent auditors reviewed the weekly sales volume reports classified by region. They noticed that sales volume was very high in region 2 for the last two weeks of March, June, September, and December. The volume was unusually low in the first two weeks of April, July, October, and January. In fact, the peaks far exceeded the volume in all the other six regions. Further investigation revealed that the manager in region 2 was holding open the sales recording at the end of each quarterly reporting period in an attempt to make the quarterly reports look good.

Aged Accounts Receivable Trial Balance

The list of accounts receivable balance details is called the **accounts receivable subsidiary ledger**. The summary of the subsidiary ledger by invoice dates is called the **aged A/R trial balance**. If the general ledger control account total is larger than the sum in the aged trial balance, too bad! A receivable amount not identified with a customer cannot be collected! The trial balance is the population used for confirmation. (See the special notes on the existence assertion and on using confirmations, later in this chapter.) The aging information is used in assessing the allowance for doubtful accounts. (An aged trial balance is shown in Exhibit 11–9.) The credit department uses the aged trial balance for follow-up of overdue and delinquent customer accounts. This is important evidence for assessing the existence, completeness, and valuation assertions for accounts receivable.

accounts receivable subsidiary ledger: a detailed listing of outstanding accounts receivable balances by individual customer that adds up to the total balance in the general ledger accounts receivable "control" account; reconciliation of the subsidiary ledger and the control account is an important control procedure and a key audit test

aged A/R trial balance: a list of all outstanding accounts receivable balances organized by how long they have been outstanding; used to manage collection and assess the accounting requirement to provide an allowance for possible uncollectible accounts

Cash Receipts Journal

The cash receipts journal contains all the detail for cash deposits and credits to various accounts and is the population of entries that should be the credits to accounts receivable for customer payments. It also contains any adjusting or correcting entries resulting from the bank account reconciliation. These entries may signal the types of accounting errors or manipulations that happen in the cash receipts accounting and provide evidence relating to existence and completeness of cash and accounts receivable.

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REVIEW CHECKPOINTS

11-7 What accounting records and files could an auditor examine to find evidence of unrecorded sales, inadequate credit checks, and incorrect product unit prices?

11-8 Suppose you selected a sample of customers' accounts receivable and wanted to find supporting evidence for the entries in the accounts. Where would you go to vouch the debit entries? What would you expect to find? Where would you go to vouch the credit entries? What would you expect to find? What assertions are you finding evidence about?

CONTROL RISK ASSESSMENT

LO2 Describe the auditor's control risk assessment and control tests for auditing control over customer credit approval, delivery, accounts receivable, cash receipts, and bank statements.

control risk assessment: process the auditor uses to understand the client's internal control that will be sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and to design and perform further audit procedures; required to comply with the second examination standard of generally accepted auditing standards

walk-through: following one or more transactions through the accounting and control systems to obtain a general understanding of the client's systems

Control risk assessment governs the nature, timing, and extent of substantive audit procedures that will be applied in the audit of the accounts in the revenues, receivables, and receipts processes. These accounts (listed in the lower right corner of Exhibit 11–1) include the following:

- Cash in bank
- Cash receipts
- Accounts receivable
- Allowance for doubtful accounts
- Bad debt expense
- Sales revenue
- Sales returns, allowances, and discounts
- Perpetual inventory records and shipping records

Information about the control structure often is gathered though internal control questionnaires, introduced in Chapter 9. A selection of other questionnaires for both general controls and application controls over cash receipts, sales revenues, and accounts receivable is found in Appendix 11A. These questionnaires provide details of desirable control policies and procedures. The questions are organized under headings that identify the important control objectives: environment, validity, completeness, authorization, accuracy, classification, accounting, and proper period recording.

General information about internal controls can also be gathered by a **walk-through** procedure. Here the auditors take a single example of a transaction and "walk it through" from its initiation to its recording in the accounting records. The revenue, receivables, receipts process walk-through involves following a sale from the initial customer order through credit approval, delivery of goods or services, and billing, to the entry in the sales journal and subsidiary accounts receivable records, and finally to its subsequent collection and cash deposit. Sample documents are collected, and employees in each department are questioned about their specific duties. Walk-throughs (1) verify or update the auditors' understanding of the auditee's sales/accounts receivable accounting system and control procedures and (2) show whether the controls the auditee reported in the internal control questionnaire are actually in place. The walk-through, combined with enquiries, can contribute evidence about appropriate separation of duties, a basis for assessing control risk to be low. However, a walk-through is too limited in scope to provide sufficient evidence of whether the control procedures were operating effectively during the period under audit. A larger sample of transactions for detail testing is necessary to provide actual control performance evidence.

General Control Considerations

Control procedures for proper segregation of responsibilities should be in place and operating. Exhibit 11–1 shows that this involves authorization of sales and credit by persons who do not have custody, recording, or reconciliation duties. Custody of inventory and cash is by those who do not directly authorize credit, record the accounting entries, or reconcile

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the bank account. Recording (accounting) is performed by those who do not authorize sales or credit, handle the inventory or cash, or perform reconciliations. Periodic reconciliations should be performed by employees who do not have authorization, custody, or recording duties related to the same assets. Combinations of two or more of these responsibilities in one person, one office, or one information system may open the door for errors and fraud.

Cash management commonly requires people who handle cash to be insured under a **fidelity bond**—an insurance policy that covers most kinds of cash embezzlement losses. Fidelity bonds do not prevent or detect embezzlement, but failing to carry the insurance exposes the company to complete loss when embezzlement occurs. However, a company must prove its losses before it can collect on them—another good reason for internal controls.

fidelity bond: a type of insurance policy that covers theft of cash by employees

The control structure includes general controls and also application control activities that provide for detailed control-checking procedures. The following set of procedures should take place:

1. Sales orders entered only with a customer order
2. Credit-check code or manual signature recorded by authorized means
3. Inventory and the shipping area access restricted to authorized persons
4. Access to billing programs and blank invoice forms restricted to authorized personnel
5. Sales and accounts receivable recorded only when all supporting shipping documentation is in order (i.e., sales and receivables recorded as of the date the goods were shipped or services were provided, and cash receipts recorded as of the date the payments were received)
6. Customer invoices compared with bills of lading and customer order detail to verify that quantities billed match quantities shipped and that the goods were shipped in correct quantities and pricing to proper locations
7. Pending order files reviewed to ensure timely billing and recording
8. Bank statements reconciled in detail, monthly

The "Fictitious Revenue" box that follows contains an illustration of improper period recording. It is one of a class of widespread financial reporting problems commonly referred to as **revenue recognition problems**. Many of the financial restatements filed with securities regulators by public companies involve revenue recognition, most of these dealing with premature revenue recognition.

revenue recognition problems: techniques used by financial statement preparers to manipulate reported revenues resulting in low-quality earnings

Timing is critical to many accounting issues. For example, major retailers that buy in bulk receive discounts from suppliers if they meet sales targets. But how are these rebates accounted for? The prudent practice is to wait until the targets are met. However, companies such as now-bankrupt Kmart in the U.S. and Royal Ahold in the Netherlands, once the world's third-largest food retailer, appear to have booked these payments before they were earned. In 2001–2002, Ahold may have booked entire rebates as profit in the first year of multi-year agreements, thereby overstating profits by as much as $500 million. Its chief executive officer and chief financial officer both resigned in February 2002. Ahold has been referred to as "Europe's Enron." Controls related to proper timing in the recording of transactions are becoming more important in the current environment.

FICTITIOUS REVENUE

A Mississauga (Ontario) computer peripheral-equipment company was experiencing slow sales, so the sales manager entered some sales orders for customers who had not ordered anything. The invoices were marked "hold," while the delivery was to a warehouse owned by the company. The rationale was that these customers would buy the equipment eventually, so why not anticipate the orders! (However, it is a good idea not to send them the invoices until they actually make the orders, hence the "hold.") The "sales" and "receivables" were recorded in the accounts, and the financial statements contained overstated revenue and assets.

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Control Tests

An organization should have input, processing, and output control procedures in place and operating in order to prevent, detect, and correct accounting errors. You studied the general control objectives in Chapter 9 (validity, completeness, authorization, accuracy, classification, accounting, and proper period recording). Exhibit 11–2 puts these in the perspective of the revenue process with examples of specific objectives. Study this exhibit carefully as it expresses the control objectives in specific examples rather than in the abstract.

The last general objective relates to recording sales in the proper period, a problem of timing, a growing concern to the profession. One of the most important audit procedures in this process is the **sales cutoff** test, concerning the proper allocation of transactions to the correct period, either before or after a specific date. Allocation is essential to correctly including all period's revenues and expenses, and not including those of other periods. The shipment of goods at year-end is a critical component of this. Recognition of sales is tied to passage of title from seller to buyer—the point when the risks and rewards of ownership are transferred, and when the shipment or delivery of the auditee's inventory is made. Objective 7 in Exhibit 11–2 refers to shipment date.

sales cutoff: recording sales transactions in the proper period

EXHIBIT 11–2 Internal Control Objectives: Revenue Process (Sales)

GENERAL OBJECTIVES	EXAMPLES OF SPECIFIC OBJECTIVES
1. Recorded sales are *valid* and documented.	Customer purchase orders support invoices. Bills of lading or other shipping documentation exist for all invoices. Recorded sales in sales journal supported by invoices.
2. Valid sales transactions are recorded *completely* with none omitted.	Invoices, shipping documents, and sales orders are prenumbered and the numerical sequence is checked. Overall comparisons of sales are made periodically by a statistical or product-line analysis.
3. Sales are *authorized* according to company policy.	Credit sales approved by credit department. Prices used in preparing invoices are from authorized price schedule.
4. Sales invoices are *accurately* prepared.	Invoice quantities compared with shipment and customer order quantities. Prices checked and mathematical accuracy independently checked after invoice prepared.
5. Sales transactions are properly *classified.*	Sales to subsidiaries and affiliates classified as intercompany sales and receivables. Sales returns and allowances properly classified.
6. Sales transaction *accounting* is proper.	Credit sales posted to customer's individual accounts. Sales journal posted to general ledger account. Sales recognized in accordance with generally accepted accounting principles.
7. Sales transactions are recorded in the *proper period.*	Sales invoices recorded on shipment date.

FOB shipping: terms of sale indicating that title to goods sold transfers from seller to buyer when the goods are handed over from the seller to the shipping company that will ultimately deliver them to the buyer; can give rise to an amount of inventory-in-transit at year-end that is owned by an auditee company (the buyer) that is not physically on hand at the client's premises

FOB destination: terms of sale indicating that title to goods sold transfers from seller to buyer when the goods reach the buyer's destination; can give rise to an amount of inventory-in-transit at year-end that is owned by an auditee company (the seller) that is not physically on hand at the client's premises

dual-direction testing: audits both control over completeness in one direction and control over validity in the other

Shipment of inventory is closely tied to the audit of inventory so we will defer that discussion to Chapter 12. The relationship between all of these illustrates that the processes are not independent of each other, the important point here being that sales cutoff related to proper recording of sales for the period is closely linked to inventory shipments to customers and to the shipping terms (**FOB shipping** or **FOB destination**). The effect of shipping terms on cutoff tests is also explained in Chapter 12.

Some control tests can be used to effectively test procedures in more than one way at the same time. **Dual-direction testing**, for instance, audits both control over completeness in one direction and control over validity in the other. Completeness determines if all the sample transactions that occurred were recorded (none omitted), and validity determines

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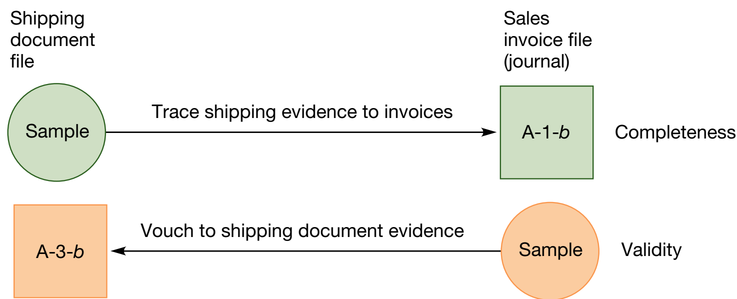
if recorded transactions actually occurred (were real). An example of the first direction is examining a sample of shipping documents (from the file of all shipping documents) to determine whether invoices were prepared and recorded. The second direction is determining whether supporting shipping documents exist, and verifying the actual shipment. The content of each file is compared with the other. This is illustrated in Exhibit 11–3.

Exhibit 11–4 contains a selection of control tests, many of which are steps verifying the content and character of sample documents from one file against the content and character of documents in another file. This process leads to objective evidence about the effectiveness of controls and the reliability of accounting records. These samples are usually attribute samples similar to those you studied in Chapter 10.

Control objectives tested by the audit procedures are also shown in Exhibit 11–4. These test of controls procedures produce evidence that helps auditors determine whether the specific control objectives listed in Exhibit 11–2 were achieved. Appendix 11A illustrates internal control questionnaires used in deciding on the extent of the testing in Exhibit 11–4. (This exhibit is very general and not affected by whether manual or IT-based procedures are used to record a transaction.) Exhibits 11–5 and 11–6 will later illustrate two of the substantive audit programs that would be affected by the control testing results illustrated in Exhibit 11–4.

EXHIBIT 11–3 Dual Direction of Test Audit Samples



Note: The A-1-*b* and A-3-*b* codes refer to control tests listed in Exhibit 11–4.

EXHIBIT 11–4 Control Tests for Sales, Cash Receipts, and Receivables

	CONTROL OBJECTIVE
A. Sales	
1. Select a sample of shipping documents:	
a. Scan for missing numbers.	Completeness
b. Trace to related sales invoices.	Completeness
2. Scan sales invoices for missing numbers in the sequence.	Completeness
3. Select a sample of recorded sales invoices (sales journal):	
a. Perform recalculations to verify arithmetic accuracy.	Accuracy
b. Vouch to supporting shipping documents. Note dates and quantities.	Validity Accuracy Proper period
c. Vouch prices to approved price lists.	Authorization
d. Vouch credit approval.	Authorization
e. Trace posting to general ledger and proper customer account.	Accounting
4. Observe customer order handling and invoice preparation work.	Environment
B. Cash Receipts	
1. Select a sample of recorded cash receipts (cash receipts journal):	
a. Vouch to deposit slip and remittance list.	Validity
b. Trace to bank statement.	Validity
c. Trace posting to general ledger accounts.	Accounting
d. Trace posting to subsidiary accounts.	Accounting

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EXHIBIT 11–4 Continued

	CONTROL OBJECTIVE
B. Cash Receipts (continued)	
2. Select a sample of remittance lists (or daily cash reports):	
a. Trace to cash receipts journal.	Completeness
b. Trace journal posting to general ledger.	Accounting
c. Trace to bank statement.	Accuracy
3. Observe the work habits of cashiers and their interactions with persons who keep cash records.	Environment
C. Accounts Receivable	
1. Trace sales invoices to accounts receivable posting (procedure A-3-*e* above).	Accounting
2. Trace cash receipts to accounts receivable posting (procedure B-1-*d* above).	Accounting
3. Select a sample of credit memos:	
a. Review for proper approval.	Authorization
b. Trace to posting in customers' accounts.	Accounting
4. Select a sample of customers' accounts:	
a. Vouch debits to supporting sales invoices.	Validity
b. Vouch credits to supporting cash receipts documents and approved credit memos.	Validity
5. Observe mailing of monthly customer statements.	Validity

Summary: Control Risk Assessment

The auditor must evaluate the evidence obtained from an understanding of the internal control structure and from control tests, two of the phases of control risk assessment work (see Chapter 9). If the control risk is assessed very low, the substantive audit procedures on the account balances can be limited in cost-saving ways. For example, the accounts receivable confirmations can be sent on a date prior to the year-end, and the sample size can be fairly small.

On the other hand, if tests of controls reveal weaknesses (such as posting sales without shipping documents, charging customers the wrong prices, and recording credits to customers without supporting credit memos), the substantive procedures will need to be designed to lower the risk of failing to detect material error in the account balances. For example, the confirmation procedure may need to be scheduled on the year-end date with a large sample of customer accounts. Descriptions of control deficiencies, weaknesses, and inefficiencies are incorporated in a management letter to auditee management. Significant control deficiencies must also be communicated to those charged with governance.

STANDARDS CHECK

CAS 265

6. (b) Significant deficiency in internal control—A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance. (Ref: Para. A5)

9. The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. (Ref: Para. A12–A18, A27)

10. The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis: (Ref: Para. A19, A27)

(a) In writing, significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances; and (Ref: Para. A14, A20–A21)

(b) Other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. (Ref: Para. A22–A26)

Source: *CICA Handbook—Assurance,* 2012.

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ACCOUNTS RECEIVABLE CONFIRMATION FINDINGS AND PRIOR CONTROL ASSESSMENT

Accounts receivable confirmation is a substantive procedure designed to obtain evidence of the existence and gross amount (valuation) of customers' balances directly from the customer. If such confirmations show numerous exceptions, however, auditors will be concerned with the controls over the details of sales and cash receipts transactions, even if previous control assessment seemed to show little control risk. This indicates a reassessment of control risk that may call for additional substantive procedures.

REVIEW CHECKPOINTS

11-9 What account balances are included in the revenues, receivables, and receipts process?

11-10 What specific control policies and procedures (in addition to separation of duties and responsibilities) should be in place and operating in a control structure governing revenue recognition and cash accounting?

11-11 What is a walk-through of a sales transaction? How can the walk-through work complement the use of an internal control questionnaire?

11-12 What are the two important characteristics of a control test? What actions are typically used to perform control tests?

11-13 What is dual-direction testing of controls? What are the objectives of dual-direction testing in auditing the revenues, receivables, and receipts process?

LO3 Explain how the auditor's risk assessment procedures and control testing link to the key assertions and audit objectives in designing a substantive audit program for the cash account balance.

This section of the chapter will present a detailed exhibit of a substantive audit program, using the EcoPak case that has accompanied the previous chapters as the example audit. For this exhibit, we choose the cash account balance audit program, since cash is an account that is affected by the revenue, receivables, and receipts process and all the other processes as well. The cash balance audit is usually completed as early as possible in the audit, because knowing the cash balance is fairly stated is an important foundation for obtaining sufficient audit evidence overall. Exhibit 11–5 shows how an auditor would respond to the questionnaire by noting the findings from the risk assessments and control testing done to date. These assessments are then the basis for assessing risk, assertion by assertion. Based on the assertion-level risks, the auditor specifies the audit procedures that need to be performed. This is a very challenging exercise in applying professional judgment! The exhibit can give you a realistic idea of how auditors respond to their risk assessments at the assertion level by obtaining evidence that is relevant to the higher risk assertions in each account balance and transaction stream.

The example program provided is comprehensive and includes some procedures that might not be performed if the risk of material misstatement for the related assertion is quite low. Many auditors prefer to use comprehensive audit program templates to start off, however, as it can give them another chance to think through their prior decisions about risk and evaluate the cost-benefit of performing audit procedures. Sometimes, a simple and quick procedure can provide good evidence that might as well be obtained. This is often the case for the cash balance, the account we will be looking at in this exhibit. Many auditors find it worthwhile to do a very thorough audit of cash, even if the risk of misstatement is quite low, just because the consequences of missing a big misstatement here would be so devastating to the auditor's reputation (the Parmalat audit failure is a good example). So, many auditors will decide to obtain confirmation of every bank account, even those with small balances or minimal activity during the audited period. On the other hand, for more costly, time-consuming procedures, such as confirmation of accounts receivable

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EXHIBIT 11–5 Example of Substantive Audit Program Responding To Assessed Risk of Material Misstatement

AUDIT PROGRAM				
AUDITEE: *ECOPACK INC.*				**FILE INDEX**: *A-100*
FINANCIAL STATEMENT PERIOD: *y/e DECEMBER 31, 20x1*				
ACCOUNT: *CASH BALANCE*				
Consider risk assessment findings:	High √	Moderate √	Low √	Provide specific risk description or Audit file documentation reference:
	High	Moderate	Low	
What fraud risk level has been assessed related to this account? (e.g., theft of assets, unrecorded or fictitious transactions, inappropriate journal entries)		√		*No indicators of fraud have been noted by staff, but cash is vulnerable to fraud so risk is more than low.[Ref: 522]*
What is the assessed risk level for this account at the financial statement level? (e.g., consider business risks, entity level control environment, risk assessment and monitoring, general IT controls, management override, going-concern risks, related-party transactions)		√		*See overall risk assessment at financial statement level.[520]*
What is the assessed inherent risk level at the assertion level for:	High	Moderate	Low	*[584]*
Existence		√		
Completeness		√		
Ownership		√		
Valuation			√	
Presentation	√			
If tests of key controls have been conducted, what is the assessed control risk? (*Note:* if no controls were tested control risk must be assessed as "high")	High	Moderate	Low	*[585]*
Existence			√	
Completeness			√	
Ownership			√	
Valuation	√			
Presentation	√			
Residual detection risk to be reduced by performing substantive procedures.	High	Moderate	Low	*[605]*
Existence			√	
Completeness			√	
Ownership			√	
Valuation		√		
Presentation	√			
Substantive audit program in response to assessed risks:				
Substantive audit procedures	Assertions for CASH: evidence is related to [E,C,O,V,P]	Timing	Extent (if applicable)	Working paper documentation reference
(Of the procedures listed below, perform those considered necessary to provide sufficient appropriate evidence to address the assessed risks and reduce risk of material misstatement to acceptable level.)				
1. Prepare a "Lead Sheet" with a list of all cash accounts and current- and prior-period balances. Tie current balances in to period-end general ledger. Agree prior balances to prior-period audit file and financial statements, if available.	ECV	*Feb/X2*	*100%*	*A-1*

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2. Analytical procedures: Develop expectations for cash balances and interest income/expense, based on enquiries and your understanding of business. Enquire about any unusual cash transactions or balances.	ECV	Feb/X2	N/A	A-10
3. Obtain confirmations from all banks auditee has dealt with (request from banks using standard bank confirmation form).	ECOVP	Jan/X2	100%	A-20
4. Review the bank confirmation for loans, collateral, or guarantees.	P	Feb/X2	100%	A-20
5. Obtain auditee-prepared reconciliations of all bank accounts. For each bank account, perform the following:		Feb/X2		A-30
a. Trace the bank balance on the reconciliation to the bank confirmation.	ECOV		100%	A-30
b. Trace the reconciled book balance to the general ledger.	ECV		100%	A-30
c. Verify a sample of outstanding cheques and outstanding deposits to source documents.	V		210 largest cheques 2100% deposits	A-30
d. Recalculate the arithmetic on auditee-prepared bank reconciliations.	V		100%	A-30
e. Ensure all differences are explained by valid timing differences or bank errors, or are adjusted by appropriate journal entries	ECOVP		100%	A-31
6. Ask the auditee to request cutoff bank statements for a period after the financial statement date (e.g., two weeks or one month); to be mailed directly to the audit firm; in a low risk audit, an account-detail report directly from the auditee's online banking can be used.	ECOVP	Feb/X2	Reviewed online bank account detail under audit control as of Feb 6, 20x2	A-40
a. Trace deposits in transit on the reconciliation to bank deposits early in the next period.	E		100%	A-40
b. Trace outstanding cheques on the reconciliation to cheques cleared in the next period.	C		10 largest cheques	A-40
c. Prepare a schedule of interbank transfers for a period of 10 business days before and after the year-end date. Verify the dates of book entries for these transfers agree with bank entries and reconciliation items, if any, to ensure amounts are only counted in cash balance once.	EC	Feb/X2	10 days	A-40
d. If any material outstanding cheques at period end have not cleared by the end of the audit field work, confirm the related disbursements with the payee.	C	End of field work	100%	n/a (none)
7. If significant amounts of cash are held outside bank accounts at period end, count cash funds in the presence of an auditee representative.	ECOV	Dec 31, 20X1	100%	n/a (none)
8. Enquire if any outstanding cheques have been prepared but not mailed at period end, verifying if these are material should be reclassified as accounts payable.	EP	Dec 31, 20X1	100%	Enquired of Nima, CFO-none (representation letter point, 350)
9. Ensure all foreign currency cash balances have been translated to reporting currency at the correct period-end rate.	V	Dec 31, 20X1	100%	A-1 All bank accounts CDN$
10. Ensure all cash is properly presented on the balance sheet and in the cash flow statement.	P	Mar/X2	100%	120
11. Ensure all required disclosures related to cash balances and banking terms are provided in the financial statement notes.	P	Mar/X2	100%	120
12. Obtain written management representations on matters such as compensating balance agreements, debt covenants, restrictions on cash, or other disclosure issues.	P	Audit report date		350

AUDITOR'S CONCLUSIONS

Based on my professional judgment, the evidence obtained is sufficient and appropriate to conclude that the risk of material misstatement of the *CASH BALANCE* is acceptably low.

Prepared by *Donna Eadona* Date *Feb 12, 20x2*

Reviewed by *Tariq Karic* Date *Feb 14, 20x2*

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balances, auditors may decide to limit their extents or not perform the procedure at all if they assess the risk as very low.

The audit program starts off with the auditor's risk assessments from the planning stages, and the auditor's conclusions based on performing the control tests (such as those set out in the example in Exhibit 11–4). The control test results allow the auditor to conclude on the control risk level that is appropriate for deciding on the *nature, timing,* and *extent* of the substantive procedures that should be performed to reduce the risk of not detecting a material misstatement to an acceptably low level. A detailed audit program such as the one shown in Exhibit 11–5 shows the list of procedures describing the "nature" of each (this refers to the kinds of evidence-gathering methods to be used), the planned "extents" (this could be a sample size, or an indication that all the relevant items will be looked at), and the "timing" (when the auditors plan to perform the procedure, which could be at the period-end date in the case of procedures such as cutoff and counts; or during the field work visits, for procedures such as those involving analysis, confirmations, and examination of source documents; or at the audit report date, for such procedures as obtaining management's final representations about the accounts).

Looking more closely at the responses in Exhibit 11–5 we see that the audit senior, Donna, has recorded the assessments of risk at the assertion level based on the overall risk assessment procedures and control tests performed to date. We assume she concluded that there is a moderate risk of fraud in this account and that risk at the overall financial statements level is also moderate, based on the overall assessment performed earlier in the planning and approved by the engagement partner. The audit file index references (e.g., "522" in red) indicate where the risk-assessment work and conclusions have been documented in the audit file. The index references are based on the audit-file indexing example shown in Appendix 11C (available on Connect).

For the inherent risk assessments, Donna has concluded that, ignoring controls, there is a moderate inherent risk that cash might be misstated by errors, such as not recording cash they have paid out (the cash therefore does not exist anymore from EcoPak's perspective), not recording cash received (therefore, EcoPak's cash balance is not complete), or not deducting outstanding cheques issued from the bank account in the bank reconciliation (the cash is now "owned" by the payee on the cheque, not by EcoPak). Assuming EcoPak has only Canadian dollar bank accounts, she has assessed a low inherent risk for valuation. For presentation, she has assessed a high inherent risk, which we can assume is based on such concerns as inaccuracies arising in a manual preparation of the cash flow statement and disclosure of complex banking arrangements, since EcoPak relies quite heavily on bank lines of credit for its operating and financing cash needs. Her reference to file index "584" indicates a working paper where these assessments are explained in more detail.

Turning to Donna's control risk assessments, we can note that—based on testing the identified strengths in controls relating to existence, completeness, and valuation—Donna has concluded lower control risk for these assertions, such that further substantive procedures related to those assertions can be fairly limited. However, in the case of valuation and presentation, where controls were not tested, more extensive tests of details and other substantive procedures are performed, since the auditors have no basis for reducing their reliance on substantive evidence. Despite what the actual control risk is in such cases, if they are not tested the auditor simply proceeds on the basis that the control risk is high.

Based on the inherent and control risk assessments, Donna has determined how much residual risk is left. This residual risk must be reduced by detection procedures: gathering substantive evidence to bring the risk of material misstatement down to the acceptable level for the audit (i.e., the planned acceptable audit risk level). In the case of the existence, completeness, and ownership assertions, Donna assessed a moderate inherent risk of material misstatement, and the assessed combined risk of material misstatement was lowered considerably by strong controls (low control risk). This means there is little risk left and only limited substantive procedures are required (in comparison, say, to another audit where these controls were not as effective). For the valuation assertion, inherent risk was assessed to be low but no controls were tested in relation to it, so some moderate substantive evidence still needs to be obtained to make sure the cash valuation is appropriate. In the case of the presentation assertion, this was assessed with a high inherent risk and no

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controls were tested for it, so all the assurance required will need to come from substantive sources. Using her assertion-level risk assessments, Donna is now in a position to identify the procedures required to obtain the required substantive evidence to support her conclusion on EcoPak's year-end cash balance.

Based on the risk assessments, in the detailed substantive program section of Exhibit 11–5, Donna has selected appropriate types of substantive tests and procedures and decided on how extensive the procedures need to be, as well as the optimal time to perform the procedures. This substantive audit program form is also used to summarize the audit findings by providing reference to the audit file pages where the work is documented, and to record the auditor's final conclusion based on the evidence obtained. You can appreciate how the audit program illustrated in Exhibit 11–5 helps the audit firm to schedule staff to perform the work, gives the staff assigned to do the work a very helpful set of instructions to follow, and gives the audit manager and partner a concise, efficient way to review the adequacy of the audit work performed.

SUBSTANTIVE AUDIT PROGRAMS FOR THE REVENUE, RECEIVABLES, AND RECEIPTS PROCESS

LO4 Describe the typical substantive procedures used to address the assessed risk of material misstatement in the main account balances and transactions in the revenues, receivables, and receipts process.

This section provides further examples of substantive procedures that are used for other elements of the revenue, receivables, and receipts process of a typical business. These examples are concise lists of basic substantive procedures, along with the related assertions they address. Exhibit 11–6 shows a program for auditing accounts receivable and notes receivable account balances, and Exhibit 11–7 is a program for auditing revenue transactions.

The programs illustrated in Exhibits 11–6 and 11–7 are generic, not tailored to a specific audit engagement's risk assessments, like Exhibit 11–5 is. It is important to note that a full risk assessment illustrated in Exhibit 11–5 would always be done in each audit program to design an appropriate set of audit procedures linked to the assessed risks at the assertion level in each auditee's specific circumstances.

EXHIBIT 11–6 Audit Program for Accounts and Notes Receivable: Selected Substantive Procedures

AUDITEE: *ECOPACK INC.*				**FILE INDEX:** *C-100*
FINANCIAL STATEMENT PERIOD: *y/e DECEMBER 31, 20x1*				
ACCOUNT: *ACCOUNTS & NOTES RECEIVABLE BALANCES*				
Substantive audit program in response to assessed risks:				
Substantive audit procedures	Assertions for ACCOUNTS & NOTES RECEIVABLE: evidence is related to [E,C,O,V,P]	Timing	Extent (if applicable)	Working paper documentation reference
(Of the procedures listed below, perform those considered necessary to provide sufficient appropriate evidence to address the assessed risks and reduce risk of material misstatement to acceptable level)				
1. Obtain an aged trial balance of individual customer accounts. Recalculate the total and trace to the general ledger control account.	E,C			
2. Send confirmations to all accounts over $X. Select a random sample of all remaining accounts for confirmation.	E,C,V			
a. Investigate differences reported by customers.				
b. Perform alternative procedures on accounts that do not respond to positive confirmation requests.				
(1) Vouch cash receipts after the confirmation date for subsequent payment.				
(2) Vouch sales invoices and shipping documents.				

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EXHIBIT 11–6 Continued

3. Evaluate the adequacy of the allowance for doubtful accounts.	V			
a. Vouch a sample of *current* amounts in the aged trial balance against sales invoices to determine whether amounts aged current should be aged past due.				
b. Compare the current-year write-off experience to the prior-year allowance.				
c. Vouch cash receipts after the balance sheet date for collections on past-due accounts.				
d. Obtain financial statements or credit reports and discuss with the credit manager collections on large past-due accounts.				
e. Calculate an allowance estimate using prior relations of write-offs and sales, taking under consideration current economic events.				
4. Review the bank confirmations, loan agreements, and minutes of the board for indications of pledged, discounted, or assigned receivables.	O,P			
5. Inspect or obtain confirmation of notes receivable.	E,C,V			
6. Recalculate interest income and trace to the income account.	V			
7. Obtain written management representations regarding pledge, discount, or assignment of receivables, and about receivables from officers, directors, affiliates, or other related parties.	E,C,O,V,P			
8. Review the adequacy of control over recording of all charges to customers (completeness), audited in the sales transaction test of controls audit program.	C,V			

AUDITOR'S CONCLUSIONS
Based on my professional judgment, the evidence obtained is sufficient and appropriate to conclude that the risk of material misstatement of the *ACCOUNTS & NOTES RECEIVABLE BALANCES* is acceptably low.

Prepared by ______________________ Date ______________________

Reviewed by ______________________ Date ______________________

EXHIBIT 11–7 Audit Program for Revenue Transactions: Selected Substantive Procedures

AUDITEE: *ECOPAK INC.*	**FILE INDEX**: *705*			
FINANCIAL STATEMENT PERIOD: *y/e DECEMBER 31, 20x1*				
ACCOUNT: *REVENUES TRANSACTIONS*				
Substantive audit program in response to assessed risks:				
Substantive audit procedures	Assertions for REVENUES evidence is related to [E,C,O,V,P]	Timing	Extent (if applicable)	Working paper documentation reference
(Of the procedures listed below, perform those considered necessary to provide sufficient appropriate evidence to address the assessed risks and reduce risk of material misstatement to acceptable level)				
1. Select a sample of recorded sales invoices and vouch to underlying shipping documents.	E,V,O			
2. Select a sample of shipping documents and trace to sales invoices.	C			
3. Obtain production records of physical quantities sold and calculate an estimate of sales dollars based on average sale prices.	V			
4. Compare revenue dollars and physical quantities with prior-year data and industry economic statistics.	E,C,V			

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EXHIBIT 11–7 Continued

5. Select a sample of sales invoices prepared a few days before and after the balance sheet date and vouch to supporting documents for evidence of proper cutoff.	E,C			
6. Review accounting policies for revenue recognition and ensure they comply with the company's financial reporting framework and are properly disclosed.	P			

AUDITOR'S CONCLUSIONS
Based on my professional judgment, the evidence obtained is sufficient and appropriate to conclude that the risk of material misstatement of the *REVENUES* is acceptably low.

Prepared by ______________________________ Date ______________________________

Reviewed by ______________________________ Date ______________________________

SPECIAL NOTE: THE EXISTENCE ASSERTION

LO5 Explain the importance of the existence assertion for the audit of cash and accounts receivable.

When considering assertions and obtaining evidence about accounts receivable and other assets, auditors must put emphasis on the existence and ownership (rights) assertions. (For liability accounts, the emphasis is on the completeness assertion, as will be explained in Chapter 12.) This priority is placed on existence because companies and auditors have been accused of giving unmodified opinion audit reports on financial statements that overstated assets and revenues and understated expenses. For example, credit sales recorded too early (fictitious sales) result in overstated accounts receivable and overstated sales revenue, and failure to amortize prepaid expenses results in understated expenses and overstated current assets.

Discerning the population of assets to audit for existence and ownership is easy because the company has asserted their existence by putting them on the balance sheet. The audit procedures described in the following sections can be used to obtain evidence about the existence and ownership of accounts receivable and other assets.

Recalculation

Assets that depend largely on calculations are amenable to auditors' recalculation procedures. For example, expired prepaid expenses are recalculated using vouching of basic documents, such as loan agreements (prepaid interest), rent contracts (prepaid rent), and insurance policies (prepaid insurance). Depreciation expenses are recalculated using original acquisition and payment documents and term (useful life) estimates. A bank reconciliation is a special kind of calculation, and it can be audited. (See the special note on auditing a bank reconciliation later in this chapter.)

Inspection of Physical Assets

Inventories and fixed assets can be inspected and counted (there is more on inventory observation in Chapter 12). Titles to autos, land, and buildings can be vouched, sometimes using public records. Petty cash and undeposited receipts can be observed and counted, but the cash in the bank cannot. Securities held as investments can be inspected if documents are held by the auditee.

Confirmation

Letters of confirmation can be sent to banks and customers, asking for a report of the balances owed the company. Likewise, if securities held as investments are in the custody of

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banks or brokerage houses, the custodians can be asked to report the names, numbers, and quantity of the securities held for the company. In some cases, inventories held in public warehouses or out on consignment can be confirmed with the other party. (Refer to the special note on confirmations later in this chapter.)

Enquiry

While enquiries to management do not provide convincing evidence about existence and ownership, enquiries always should be made about the company's agreements to maintain compensating cash balances (these may not be classifiable as "cash" among the current assets), the pledge or sale of accounts receivable with recourse in connection with financings, and the pledge of other assets as collateral for loans.

Inspection of Documents: Vouching

Evidence of ownership can be obtained by studying the title documents for assets. Examination of loan documents may yield evidence of the need to disclose assets pledged as loan collateral.

Inspection of Documents: Scanning

Assets are supposed to have debit balances, and auditors can scan accounts receivables, inventory, and fixed assets for credit balances that usually reflect errors in the recordkeeping; for example, customer overpayments, failure to post purchases of inventory, and depreciation of assets more than cost. Audit software can be used to scan large files. The names of debtors can be scanned for officers, directors, and other related parties, to identify amounts that need to be reported and disclosed separately in the financial statements.

Analysis

A variety of analytical comparisons may be employed, depending on the circumstances and the nature of the business. Comparisons of asset and revenue balances with recent history may help detect overstatements. Relationships such as receivables turnover, gross margin ratio, and sales-asset ratios can be compared with historical data and industry statistics for evidence of overall reasonableness. Account interrelationships also can be used in analytical review. For example, sales returns and allowances and sales commissions generally vary directly with dollar sales volume, bad debt expense usually varies directly with credit sales volume, and freight expense varies with the physical sales volume. Accounts receivable write-offs should be compared with earlier estimates of doubtful accounts.

REVIEW CHECKPOINTS

11-14 Why is it important to place emphasis on the existence and ownership (rights) assertions when auditing cash and accounts receivable?

11-15 Which audit procedures are usually the most useful for auditing the existence and ownership (rights) assertions? Give some examples.

SPECIAL NOTE: USING CONFIRMATIONS

LO6 Identify considerations for using confirmations when auditing cash and accounts receivable.

The confirmation audit procedure was introduced in Chapter 8. This special note gives some details about using confirmations in the audit of cash and accounts receivable. The use of confirmations for cash balances and trade accounts receivable is considered

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a generally accepted audit procedure.[2] However, auditors may decide not to use them if suitable alternative procedures are available and applicable in particular circumstances. Justifications for the decision not to use confirmations for trade accounts receivable in a particular audit should be documented. Acceptable reasons could be that (1) receivables are not material; (2) confirmations would be ineffective, based on prior-years' experience or knowledge that responses could be unreliable; and (3) other substantive test of details procedures provide sufficient appropriate evidence, and the assessed combined level of inherent risk and control risk associated with the financial statement assertions being audited is low.

STANDARDS CHECK

CAS 505

External Confirmation Procedures

7. When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:
   (a) Determining the information to be confirmed or requested; (Ref: Para. A1)
   (b) Selecting the appropriate confirming party; (Ref: Para. A2)
   (c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and (Ref: Para. A3–A6)
   (d) Sending the requests, including follow-up requests when applicable, to the confirming party. (Ref: Para. A7).

13. If the auditor has determined that a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence, alternative audit procedures will not provide the audit evidence the auditor requires. If the auditor does not obtain such confirmation, the auditor shall determine the implications for the audit and the auditor's opinion in accordance with CAS 705. (Ref: Para. A20).

Source: *CICA Handbook—Assurance,* 2012.

SIMPLE ANALYTICAL COMPARISON

The auditors prepared a schedule of the monthly credit sales totals for the current and prior years. They noticed several variations, but one, in November of the current year, stood out in particular. The current-year credit sales were almost twice as large as in any prior November. Further investigation showed that a computer error had caused the November credit sales to be recorded twice in the control accounts. The accounts receivable and sales revenue were materially overstated as a result.

A DECISION NOT TO USE ACCOUNTS RECEIVABLE CONFIRMATIONS

Surepart Manufacturing Company sold all its production to three auto manufacturers and six aftermarket distributors. All nine of these customers were well-known companies that typically paid their accounts in full by the tenth day of the following month. The auditors were able to vouch the cash receipts for the full amount of the accounts receivable in the bank statements and cash receipts records in the month following the Surepart year-end. Confirmation evidence was not considered necessary in these circumstances as the risk of material misstatement was deemed to be very low.

Confirmations of Cash and Loan Balances

The standard bank confirmation form shown in Exhibit 11–8 is used to confirm deposit and loan balances. (Other confirmation letters are used to confirm contingent liabilities, endorsements, compensating balance agreements, lines of credit, and other financial instruments

2 CAS 505.

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EXHIBIT 11–8 Bank Confirmation Form

Bank Confirmation

Areas to be completed by client are marked §, while those to be completed by the financial institution are marked †

FINANCIAL INSTITUTION § (Name, branch and full mailing address) CONFIRMATION DATE § (All information to be provided as of this date) (See Bank Confirmation Completion Instructions)	CLIENT (LEGAL NAME) § The financial institution is authorized to provide the details requested herein to the below-noted firm of accountants § ______________ Client's authorized signature Please supply copy of the most recent credit facility agreement (initial if required) § ______________

1. LOANS AND OTHER DIRECT AND CONTINGENT LIABILITIES (If balances are nil, please state.)

NATURE OF LIABILITY/ CONTINGENT LIABILITY †	INTEREST (Note rate per contract)		DUE DATE †	DATE OF CREDIT FACILITY AGREEMENT †	AMOUNT AND CURRENCY OUTSTANDING †
	RATE †	DATE PAID TO †			

ADDITIONAL CREDIT FACILITY AGREEMENT(S) ______________
Note the date(s) of any credit facility agreement(s) not drawn upon and not referenced above † ______________

2. DEPOSITS/OVERDRAFTS

TYPE OF ACCOUNT §	ACCOUNT NUMBER §	INTEREST RATE §	ISSUE DATE (If applicable) §	MATURITY DATE (If applicable) §	AMOUNT AND CURRENCY (Brackets if Overdraft) †

EXCEPTIONS AND COMMENTS (See Bank Confirmation Completion Instructions.)†

STATEMENT OF PROCEDURES PERFORMED BY FINANCIAL INSTITUTION †
The above information was completed in accordance with the Bank Confirmation Completion Instructions.

______________ BRANCH CONTACT ______________
Authorized signature of financial institution — Name and telephone number

Please mail this form directly to our public accountant in the enclosed addressed envelope.

Name:
Address:

Telephone:
Fax:

Source: Developed by the Canadian Bankers Association and the Canadian professional accounting associations.

and transactions. The standard form and illustrative letters are reproduced in the PA's professional engagement manuals.) A word of caution is in order: While financial institutions may note exceptions to the information typed in a confirmation and may confirm items omitted

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from it, the auditor should not rely solely on the form to satisfy the completeness assertion, insofar as cash and loan balances are concerned. Officers and employees of financial institutions cannot be expected to search their information systems for balances and loans that may not be immediately evident as assets and liabilities of the auditee company. However, it is a good idea to get bank confirmation of zero balances on accounts the company represents as closed during the year. (If a nonzero balance is confirmed, the auditors have evidence that some asset accounting has been omitted in the company records.)

The auditor should also be alert for evidence of transactions with banks or bank accounts other than those for which there are general ledger accounts. For example, loan documents or cheques written on other banks may come to light during scanning or other document examination procedures. Enquiries of management should be made to assess whether bank confirmations should be obtained from these banks and whether any financial statement impact exists.

Confirmation of Accounts and Notes Receivable

Confirmations provide evidence of existence and, to a limited extent, of valuation of accounts and notes receivable. Those to be confirmed should be documented in the working papers with an aged trial balance. A partial aged trial balance is shown in Exhibit 11–9, annotated to show the auditor's work. Accounts for confirmation can be selected at random or in accordance with another plan consistent with the audit objectives. Statistical methods are useful for determining the sample size, and audit software accessing receivables files could be used to select and print the confirmations.

EXHIBIT 11–9 Illustration of Audit Working Paper—Aged Accounts Receivable Trial Balance (Partial)

C-20

ECOPAK INC.
ACCOUNTS RECEIVABLE
December 31, 20X1

Prepared DD
Date 1-12-20X2
Reviewed BP
Date 1-17-X2

	Current	Aged 30-60 Days	Aged 61-90 Days	Aged Over 90 Days	Total	Collection Current	Collection Past Due
Ace Specialties	12,337 ✗				12,337 ✗PC"	12,337	
Bakery Supreme	712				712	712	
Charley Cafes	1,486 ✗	420 ✗			1,906 ✗PC	1 ,486	420
Deli Delites				755	755		
...							
Waffles Unlimited			531 ✗		531 ✗PC		531
Zedd's				214	214		214
Balance per books	335,000	30,000	20,000	15,000	400,000 (g)	320,000	25,000
Billing errors	(11,000)		(1,000)		(12,000) (1)		
Adjusted balance	324,000	30,000	19,000	15,000	388,000		

✗ Traced to accounts receivable subsidiary ledger.

PC Positive confirmation mailed Jan. 4. Replies C-230

" No reply to positive confirmation, vouched charges to invoices.

g Traced to general ledger control account.

(1) Billing error adjustment explained on working paper C-220

Note: See C-220 for analysis of doubtful accounts and our test of reasonableness

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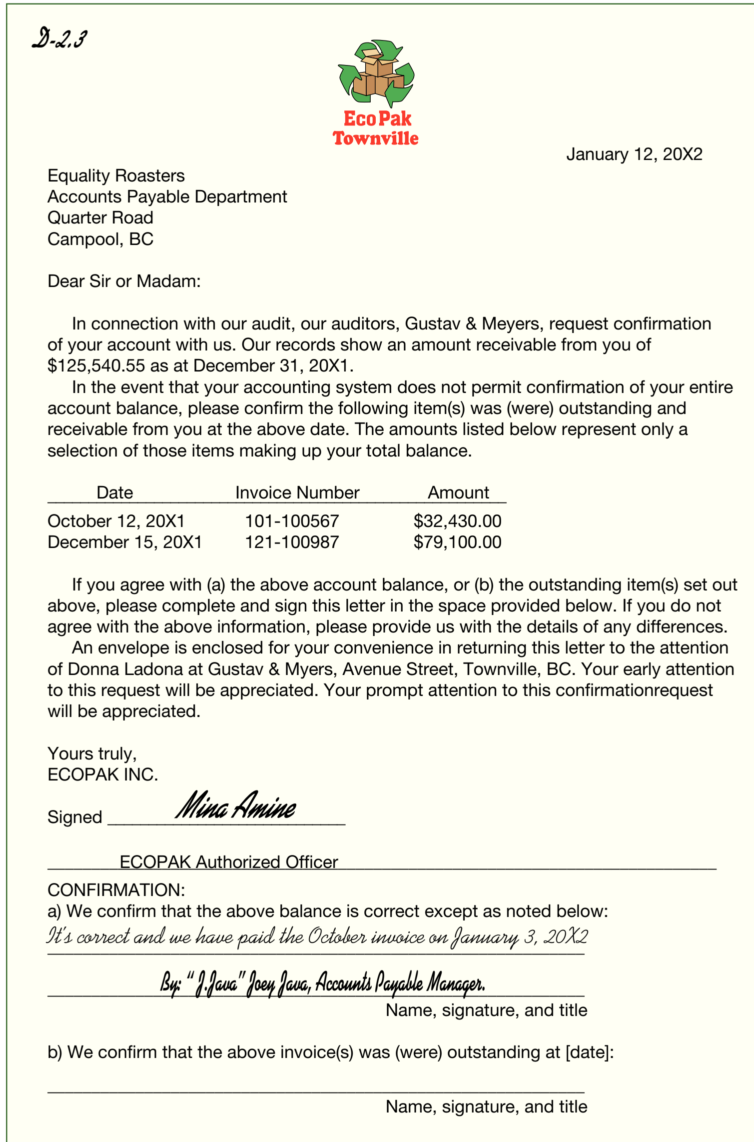
However, confirmations of accounts, loans, and notes receivable may not produce sufficient evidence regarding the ownership (rights) assertion. Debtors may not be aware that the auditee has sold its accounts, notes, or loans receivable to financial institutions or to the public (as collateralized securities). Auditors need to perform additional enquiry and details procedures to get evidence of the ownership of the receivables and of the appropriateness of disclosures related to financing transactions secured by receivables.

Positive and Negative Confirmations

Confirmations can be either positive or negative type. An example of a positive confirmation of accounts receivable that could be used in the EcoPak audit is shown in Exhibit 11–10. It gives the customer the option of confirming their total balance owing, or of selected invoices if their system makes agreeing the total balance infeasible. A variation of the positive confirmation is the blank form, which does not contain the balance;

EXHIBIT 11–10 Positive Confirmation Letter



D-2.3

EcoPak
Townville

January 12, 20X2

Equality Roasters
Accounts Payable Department
Quarter Road
Campool, BC

Dear Sir or Madam:

In connection with our audit, our auditors, Gustav & Meyers, request confirmation of your account with us. Our records show an amount receivable from you of $125,540.55 as at December 31, 20X1.

In the event that your accounting system does not permit confirmation of your entire account balance, please confirm the following item(s) was (were) outstanding and receivable from you at the above date. The amounts listed below represent only a selection of those items making up your total balance.

Date	Invoice Number	Amount
October 12, 20X1	101-100567	$32,430.00
December 15, 20X1	121-100987	$79,100.00

If you agree with (a) the above account balance, or (b) the outstanding item(s) set out above, please complete and sign this letter in the space provided below. If you do not agree with the above information, please provide us with the details of any differences.

An envelope is enclosed for your convenience in returning this letter to the attention of Donna Ladona at Gustav & Meyers, Avenue Street, Townville, BC. Your early attention to this request will be appreciated. Your prompt attention to this confirmationrequest will be appreciated.

Yours truly,
ECOPAK INC.

Signed *Mina Amine*

ECOPAK Authorized Officer

CONFIRMATION:

a) We confirm that the above balance is correct except as noted below:

It's correct and we have paid the October invoice on January 3, 20X2

By: "J.Java" Joey Java, Accounts Payable Manager.

Name, signature, and title

b) We confirm that the above invoice(s) was (were) outstanding at [date]:

Name, signature, and title

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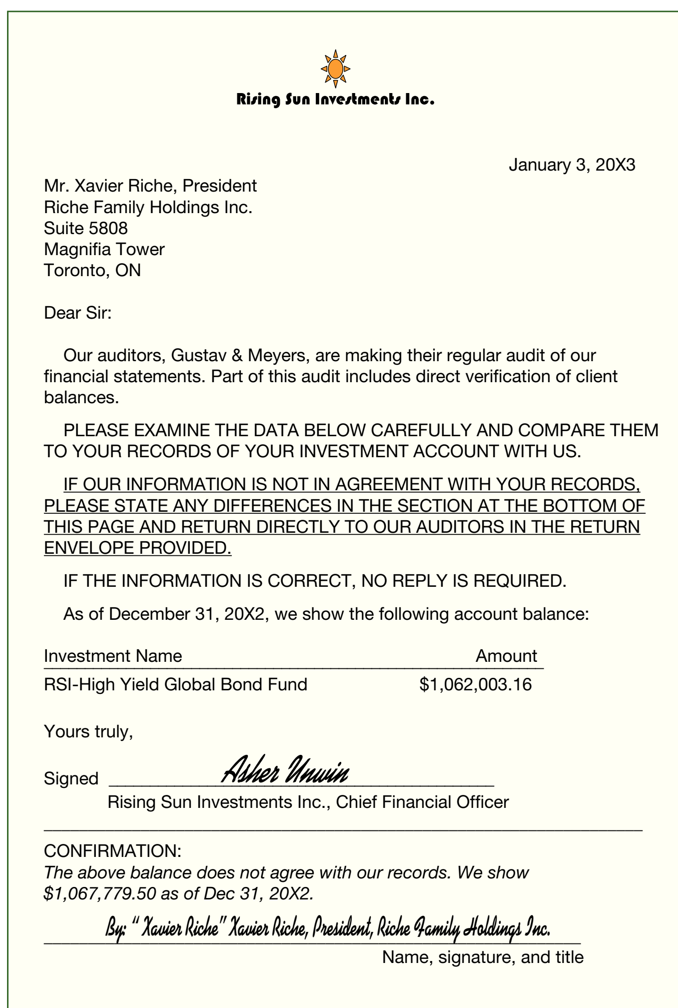
customers are asked to fill it in themselves. The blank positive confirmation may produce better evidence because the recipients need to get the information directly from their own records instead of just signing the form and returning it with no exceptions noted. (However, the effort involved may result in a lower response rate.)

Exhibit 11–11 shows an example of a negative confirmation form (since EcoPak's auditors are assumed to only use the positive type of confirmation, this example is for a different audit). Note that the positive form asks for a response, while the negative form asks for a response only if something is wrong with the balance. Thus, lack of response to negative confirmations is considered as evidence that nothing is wrong. For this reason, CAS 505 states that evidence from negative confirmations is less reliable than evidence from positive confirmations, and it requires that negative confirmations be used only when the auditor has reason to believe the recipients will not disregard the request. For example, in the audit of an investment management business (such as the one illustrated in Exhibit 11–11), if the balance of a client's investment account has been understated, he or she would be very motivated to respond to the confirmation request, to get this error corrected. A customer with an outstanding account payable balance, however, may be less motivated to confirm their liability. So, negative confirmation for accounts receivables is unlikely to provide sufficient evidence in many audits.

EXHIBIT 11–11 Negative Confirmation Letter



Rising Sun Investments Inc.

January 3, 20X3

Mr. Xavier Riche, President
Riche Family Holdings Inc.
Suite 5808
Magnifia Tower
Toronto, ON

Dear Sir:

Our auditors, Gustav & Meyers, are making their regular audit of our financial statements. Part of this audit includes direct verification of client balances.

PLEASE EXAMINE THE DATA BELOW CAREFULLY AND COMPARE THEM TO YOUR RECORDS OF YOUR INVESTMENT ACCOUNT WITH US.

IF OUR INFORMATION IS NOT IN AGREEMENT WITH YOUR RECORDS, PLEASE STATE ANY DIFFERENCES IN THE SECTION AT THE BOTTOM OF THIS PAGE AND RETURN DIRECTLY TO OUR AUDITORS IN THE RETURN ENVELOPE PROVIDED.

IF THE INFORMATION IS CORRECT, NO REPLY IS REQUIRED.

As of December 31, 20X2, we show the following account balance:

Investment Name	Amount
RSI-High Yield Global Bond Fund	$1,062,003.16

Yours truly,

Signed *Asher Unwin*
Rising Sun Investments Inc., Chief Financial Officer

CONFIRMATION:
The above balance does not agree with our records. We show $1,067,779.50 as of Dec 31, 20X2.

By: "Xavier Riche" Xavier Riche, President, Riche Family Holdings Inc.
Name, signature, and title

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STANDARDS CHECK

CAS 505

Negative Confirmations

15. Negative confirmations provide less persuasive audit evidence than positive confirmations. Accordingly, the auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present: (Ref: Para. A23)
    (a) The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion;
    (b) The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous account balances, transactions or conditions;
    (c) A very low exception rate is expected; and
    (d) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

Source: *CICA Handbook—Assurance,* 2012.

The positive form is used when individual balances are relatively large or when accounts are in dispute. They may ask for information about either the account balance or specific invoices, depending on knowledge about how customers maintain their accounting records. The negative form is used only when inherent risk and control risk are considered low, when a large number of small balances is involved, and when customers can be expected to consider the confirmations properly.

A special positive confirmation letter that may be used for possibly inappropriate bill-and-hold transactions is illustrated in Exhibit 11–12. While bill-and-hold sales transactions are not necessarily a GAAP violation when customers have actually requested this arrangement,

EXHIBIT 11–12 Confirmation Request for a Bill-and-Hold Transaction

[Client Letterhead]

[Date]

[Name and address of customer
employee with sufficient
authority to commit customer]

Dear [Name]:

Our auditors [PA firm name and address] are auditing our financial statements at [balance sheet date]. Please compare the following information with your records and report directly to our auditors whether that information is correct:

We sold you [product description] on [date] for [total sales price] under your purchase order [date and number].

[Product description] has been sold to you on our normal payment terms as described in our invoice [number and date] and those terms have not been modified. There are no written or oral amendments to the terms specified in the purchase order.

At your request we are holding [product description] at your risk on our premises, and title has passed to you.

You requested us to hold [product description] for you because [description of business reason for delayed shipment].

There are no written or oral amendments to the terms specified in the purchase order.

You are obligated to pay us [total sales price] by [payment due date].

Please use the enclosed preaddressed, postage-paid reply envelope. Because this response is needed for our auditors to complete their audit, we would appreciate a prompt response.

Very truly yours,

[Signature and title of authorized client representative]

If the above information is correct, please confirm. If your understanding of anything described above differs in any respect, please explain.

____

____

____

Date: ______________________________

Signed: ______________________________

Source: AICPA

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they have often been associated with financial fraud and should be investigated. It is the substance rather than the form of the transaction that is important. According to IAS 18, *Revenue,* the following conditions should be met for revenue recognition to be appropriate, including for any bill-and-hold sales arrangements:

(14) Revenue from the sale of goods shall be recognised when all the following conditions have been satisfied:
- *(a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;*
- *(b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;*
- *(c) the amount of revenue can be measured reliably;*
- *(d) it is probable that the economic benefits associated with the transaction will flow to the entity; and*
- *(e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.*

(15) The assessment of when an entity has transferred the significant risks and rewards of ownership to the buyer requires an examination of the circumstances of the transaction. In most cases, the transfer of the risks and rewards of ownership coincides with the transfer of the legal title or the passing of possession to the buyer. This is the case for most retail sales,

(16) If the entity retains significant risks of ownership, the transaction is not a sale and revenue is not recognised.

These points illustrate that auditors must have a good understanding of the auditee, its business, and its products in order to identify the warning signs of revenue recognition misstatements and fraud. The bill-and-hold confirmation is an example of a confirmation request to verify the substance of a transaction from the customer's point of view.

Controlling Delivery and Receipt of Confirmations

Delivering confirmations to the intended recipient is a problem that requires auditors' careful attention. Auditors need to control the confirmations, including the addresses to which they are sent, to ensure they were not mailed to company accomplices who provided false responses. Features of the reply, such as postmarks, fax responses, letterhead, e-mail, telephone, or other characteristics that may suggest false responses should be carefully reviewed. Auditors should follow up electronic and telephone responses by returning the call if the number is known, looking up telephone numbers, or using a directory to determine the respondent's address to verify their origin. Furthermore, with the lack of response to a negative confirmation there is no guarantee that the intended recipient received it unless the auditor carefully controlled the mailing.

The **response rate** for positive confirmations is the proportion of the number returned to the number sent. This varies depending on from whom the confirmations are sought, but generally the auditor is aiming at a 100% response. Nonresponses are tolerated if the amounts can be verified by other audit procedures. The **detection rate** is the ratio of the number of misstatements reported to auditors to the number of actual account misstatements. Research indicates recipients detect account misstatements to varying degrees. Negative confirmations tend to have lower detection rates than positive confirmations, and detection rates for misstatements favouring recipients (i.e., an accounts receivable understatement) also tend to be less likely. Overall, positive confirmations appear to be more effective than negative confirmations, but results depend on the type of recipients, the size of the account, and the type of account being confirmed. Confirmation effectiveness depends on attention to these factors and on prior-years' experience with particular accounts.

response rate: the proportion of the number of confirmations returned to the number sent

detection rate: the ratio of the number of misstatements reported to auditors to the number of actual account misstatements

Second and third requests for positive confirmations should be sent to nonrespondents. If there is no response or the response specifies an exception to the auditee's records, alternative substantive procedures should be done to audit the account. These procedures include finding sales invoice copies, shipping documents, and customer orders to verify the existence of sales transactions. They also include finding evidence of customer payments in cash receipts and bank statements.

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When random sampling is used, all selected accounts in the sample should be audited rather than substituting an easier-to-audit customer account into the sample as a replacement for one that does not respond to a confirmation request. If the amount cannot be verified by confirmation or alternative procedures, the auditor has to consider that the account balance does not exist.

Confirmation at Dates Other Than Year-End

Confirmation of receivables may be performed at an interim date to help the audit firm spread work throughout the year and avoid the pressures that occur around December 31. Also, the audit can be completed sooner after the year-end date if confirmation has been done earlier. Internal control over transactions affecting receivables is the biggest concern when confirming accounts before the balance sheet date. The following additional procedures should be considered when confirmation is done at an interim date:

1. Obtain a summary of receivables transactions from the interim date to the year-end date.
2. Obtain a year-end trial balance of receivables, compare it with the interim trial balance, and obtain evidence and explanations for large variations.
3. Consider additional confirmations as of the balance sheet date if balances have increased materially or a material new customer balance has been added.

Summary: Confirmations

Confirmations of cash balances, loans, accounts receivable, and notes receivable can provide very reliable audit evidence. Confirmation is usually required to provide sufficient appropriate audit evidence, unless auditors can justify substituting other procedures in a particular audit. The bank confirmation is a standard positive form. Confirmations for accounts and notes receivable can be in positive or negative form, and the positive form may be a blank confirmation.

Auditors must control confirmations to ensure that responses are received from the real debtors and not from persons intercepting the confirmations to give false responses. Responses by fax, email, telephone, or other means not written and signed by a recipient should be followed up. Second and third requests should be sent for positive confirmation responses, and nonresponding customers should be audited by alternative procedures. Accounts in a sample should not be left unaudited (e.g., "They didn't respond"), and easy-to-audit accounts should not be substituted for hard-to-audit ones in a sample. These techniques might raise the apparent response rate, but they do not increase the persuasiveness of the audit evidence obtained.

Confirmations yield evidence about existence and gross valuation. However, the fact that a debtor admits to owing the debt does not mean he can pay. While confirmations can give some clues about collectability of accounts, other procedures must audit this. Confirmations of accounts, notes, and loans receivable provide only partial evidence of the ownership (rights) assertion of these financial assets, so other corroborating evidence of ownership must be obtained.

REVIEW CHECKPOINTS

11-16 List the information an auditor should ask for in a standard bank confirmation sent to an auditee's bank.

11-17 Distinguish between positive and negative confirmations. Under what conditions would you expect each type of confirmation to be appropriate?

11-18 Distinguish between confirmation response rate and confirmation detection rate.

11-19 What are some of the justifications for not using confirmations of accounts receivable on a particular audit?

11-20 What special care should be taken with regard to examining the sources of accounts receivable confirmation responses?

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SPECIAL NOTE: AUDIT OF BANK RECONCILIATIONS

LO7 Describe the audit of bank statement reconciliations and how auditors can identify accounts receivable lapping and suspicious cash transactions.

The company's bank reconciliation is the primary means of valuing cash in the financial statements. The amount of cash in the bank is almost always different from the amount in the books (financial statements), and the reconciliation purports to explain the difference. A company-prepared bank reconciliation is audited; auditors should not prepare the reconciliation as this is a company control function.

A bank reconciliation is shown in Exhibit 11–13. The bank balance is confirmed and cross-referenced to the bank confirmation working paper. The reconciliation is recalculated, the outstanding cheques and deposits in transit totals are recalculated, and the book balance is traced to the trial balance (which has been traced to the general ledger). The reconciling items should be vouched to determine whether outstanding cheques really were not paid and that deposits in transit actually were sent to the bank before the reconciliation date. The auditor vouches the bank reconciliation items against a **cutoff bank statement**—a complete bank statement, including all paid cheques and deposit slips for a 10- to 20-day period following the reconciliation date, or the next regular monthly statement, received directly by the auditors. Note that the cash balance audit program in Exhibit 11–5 includes detailed substantive procedures related to auditing the bank reconciliation and Exhibit 11–8 shows the bank confirmation form used in practice.

cutoff bank statement: a complete bank statement, including all paid cheques and deposit slips for a 10- to 20-day period following the reconciliation date

EXHIBIT 11–13 Bank Reconciliation

```
                                  ECOPAK INC.
A-20                BANK RECONCILIATION-NORTH COUNTRY BANK       Prepared  C.C. 1/10/X3
                               General Account                   Reviewed  JRA 1/10/20X2
                                  12/31/20X1
                              (Prepared by client)

Balance per bank statement                                            506,100  c
Add:
   Deposit in transit as of 12/31/X1                                   51,240  n
Deduct outstanding cheques:                                           557,340
         Date         No.       Payee
         --------     ----    ---------------------
         12/10/X0     842     Ace Supply Company              500 ^
         11/31/X1     1280    Ace Supply Company            1,800 ✓
         12/15/X1     1372    Northwest Lumber Co.         30,760 ✓
         12/28/X1     1412    Gibson & Johnson              7,270 ✗
         12/30/X1     1417    North Country payroll        20,000 ✓
         12/30/X1     1418    Ace Supply Company            2,820 ✓
         12/30/X1     1419    City Utilities                2,030 ✓
         12/30/X1     1420    Howard Coatings Inc.          8,160 ✓
                                                          -------
Balance per book                                                       73,340
                                                                      -------
                                                                      484,000  f
                                                                      -------
                                                                      -------
```

Note: Obtained cutoff bank statement 1/9/X2 (A-23)
f Footed
c Confirmed by bank, standard bank confirmation (A-22)
n Vouched to cutoff bank statement, deposit recorded by bank on 1/3/X2. Vouched to duplicate deposit slip validaged 1/3/X2
✓ Vouched to paid cheque cleared with cutoff bank statement.
✗ Vouched to statement from law firm.
^ Amount in dispute per controller.

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Vouching outstanding cheques and deposits in transit is a matter of comparing cheques that cleared in the cutoff bank statement with the list of outstanding cheques, for evidence that all cheques written prior to the reconciliation date were on the list of outstanding cheques. The deposits shown in transit should be recorded by the bank in the first business days of the cutoff period. If otherwise, they may have been made up from receipts of the period after the reconciliation date. Other documents should be vouched for large outstanding cheques not cleared in the cutoff period. These procedures are keyed and described by tick marks in Exhibit 11–13.

Accounts Receivable Lapping

When the business receives many payments from customers, cheques listed on a sample of deposit slips (from the reconciliation month and other months) are compared with the detail of customer credits listed on the day's posting to customer accounts receivable (daily remittance list or other record of detail postings) in a detailed audit. This is a test for **accounts receivable lapping**—a manipulation of accounts receivable entries to hide a theft or fraud. For example, an employee steals a payment by collecting from customer A without recording the payment. Before customer A's account becomes past due and attracts attention of a credit manager, customer B's similar-sized payment is credited to customer A's account. Then, before customer B's account goes past due, a payment from customer C is credited to customer B's account, and so on. This fraud may grow and go on indefinitely. The audit procedure is to look for credits given to customers who did not make payments on the day in question. An example of this type of comparison is given in Audit 11.1 in the Application Case and Analysis at the end of this chapter.

accounts receivable lapping: a manipulation of the accounts receivable entries to hide a theft or fraud

Suspicious Cash Transactions

While examining the bank reconciliation auditors should be alert for large cash transactions with no apparent business purpose. These may indicate the possibility of **cheque kiting** or management **window dressing** between affiliated companies. Cheque kiting is a scam that involves building up apparent balances in one or more bank accounts based on uncollected (float) cheques drawn against similar accounts in other banks. Kiting involves depositing money from one bank account into another, using a hot cheque. There are insufficient funds to cover this cheque, but that is dealt with by another hot cheque from another bank account before the first cheque clears. The customer uses the time it takes for cheques to clear as an unauthorized loan without any interest charge. To continue, kites evolve to include more banks and more cheques until the number of banks involved and the distances between them make it difficult for the perpetrator to control the kite scheme. Within Canada, new technologies and procedures in the banking industry have greatly reduced the float time in clearing cheques between financial institutions, making kiting much more difficult to do. For example, electronic scans of cheques can process deposits before a kite can be started, and software detecting suspicious transactions can identify an attempted kite. Management may engage in window dressing the balance sheet by transferring large sums of cash between different entities under control close to the period end. Recording the transfer-out slightly late, or the inflow slightly early, can result in the cash appearing in two places at once. This can inflate current assets and may help conceal a bank covenant violation based on the current ratio.

cheque kiting: the practice of building up apparent balances in one or more bank accounts based on uncollected (float) cheques drawn against similar accounts in other banks

window dressing: in financial reporting, the inappropriate manipulation of account balances by management, usually at the end of a period, to make the financial position or performance reported in the financial statements appear more attractive to users; often involves using accounting policies, journal entries, or actual cash transactions between related parties that have no real business purpose, resulting in artificial embellishment of the company's results or liquidity to obtain some benefit. (i.e., salaries and bonuses that depend on how well the company performed)

Professional money managers working for cash-conscious businesses try to have minimal unused balances in their accounts, and their efforts sometimes can look like suspicious transfers. Tight cash flows can motivate window dressing or kiting, however. Window dressing to inflate cash balances deceitfully amounts to fraudulent financial reporting. When kiting is done intentionally to take money from the bank or to increase interest income, this can lead to criminal charges. These are some characteristic signs of cheque kiting schemes:

- Frequent deposits and cheques in the same accounts
- Frequent deposits with cheques written on the same (other) banks

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- Short time lag between deposits and withdrawals
- Many large deposits made on Thursdays or Fridays to take advantage of the weekend
- Large periodic balances in individual accounts with no apparent business explanation
- Low average balance compared with high level of deposits
- Many cheques made payable to other banks
- Bank willingness to pay against uncollected funds (bank has extended a line of credit on the company's bank account)
- Cash withdrawals with deposit cheques drawn on another bank
- Cheques drawn on foreign banks with lax banking laws and regulations

Auditors can detect the signs of cheque kiting in reviews of bank account activity. But criminal cheque kiters often destroy the banking documents. If a company cannot or will not produce its bank statements, with all deposit slips and cancelled cheques, the auditors should be wary. Since cash is the key account and most operating transactions run through it, an inability to obtain sufficient evidence to audit cash will probably result in a pervasive limitation on the audit scope, and an inability to form an audit opinion on the financial statements. If cash transfers are recorded in the books, negative balances resulting from cheques drawn on insufficient funds will appear. Perpetrators may try to hide kiting by not recording the deposits and cheques. Such maneuvers may be detectable in a bank reconciliation audit.

A key audit test for both inappropriate window dressing and kiting is preparing a **bank transfer schedule** in which all interbank transfers a few days before and after the year-end are traced to the accounting records. This schedule shows each cheque amount, the name of the paying bank (with the book recording date and the cheque clearing date), and the name of the receiving bank (with the book deposit date and the bank clearing date), using information taken from the cancelled cheques and the cleared deposits in the bank statements. The purpose of this schedule is to see that both sides of the transfer transaction are properly recorded in the same period. You may note that this test is similar in design to a cutoff test for transaction processing.

bank transfer schedule: an audit analysis summarizing all the transfers between the auditee's bank accounts in the days just before and after the period end, to verify each amount transferred is included in only one account at the period end, not double counted

Summary: Bank Reconciliations, Lapping, and Kiting

The combination of all the procedures performed on the bank reconciliation provides evidence of existence, valuation, and proper cutoff of the bank cash balances. Auditors use a cutoff bank statement to obtain independent evidence of the proper listing of outstanding cheques and deposits in transit on a bank reconciliation.

Note that if the auditor reperforms the bank reconciliation it is a substantive procedure because it yields direct evidence on monetary misstatements. However, if the auditor checks that bank reconciliations are performed on a regular basis, this is a test of controls that provides only indirect evidence on the risk of monetary misstatements.

Additional procedures might detect attempts at lapping accounts receivable collections and kiting cheques. Auditing the details of customer payments listed in bank deposits in comparison with details of customer payment postings (remittance lists) will show lapping. To detect kiting, auditors must be alert to the signs of kites, and prepare schedules of interbank transfers.

REVIEW CHECKPOINTS

11-21 What is a cutoff bank statement? How is it used by auditors?

11-22 What is lapping? What procedures can auditors employ for its detection?

11-23 What is cheque kiting? How might auditors detect kiting?

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APPLICATION CASE WITH ANALYSIS

Detecting Misstatements in the Revenue, Receivables, and Receipts Process

INTRODUCTION

This Application Case contains specific examples of tests of controls and *substantive audit procedures* used to gather evidence in the revenue, receivables, and receipts process. The purpose of substantive audit procedures differs from that of test of controls in that substantive procedures are designed to obtain direct evidence about the dollar amounts in account balances, while tests of controls obtain evidence about the company's performance of its own control procedures. Substantive procedures include tests of details of balances and transactions as well as focused analytical procedures. Substantive procedures must follow the assessment of control risk as auditors cannot rely exclusively on controls. Dual-purpose procedures can be designed that cover substantive and control testing purposes simultaneously.

In this Application Case, as well as in those of subsequent chapters, each audit case situation describes an error or fraud that occurred, followed by an audit approach analysis that explains the audit objective (assertion), controls relevant in the business process, tests of controls, and substantive procedures that could be considered in an approach to the case. The audit approach section presumes that the auditors do not know everything about the situation. (As a student of the case, you have inside information.) Each audit situation is set up with the following framework:

CASE DESCRIPTION

This offers the background of what happened in the case: the dollar amount of overstated assets and revenue, or understated liabilities, and expenses that resulted; the method or cause of the misstatement (accidental error, intentional irregularity, or fraud attempt); the failure of controls that made it possible; and the amounts involved.

Audit Trail

This is a set of telltale signs of erroneous accounting and missing or altered documents.

AUDIT APPROACH ANALYSIS

This section contains the following parts: audit objective and controls relevant in the process.

Audit Objective

This refers to the recognition of a financial statement assertion for which evidence needs to be obtained. The assertions are about existence of assets, liabilities, revenues, and expenses; their valuation; their complete inclusion in the account balances; the rights and obligations inherent in them; and their proper presentation and disclosure in the financial statements. (These assertions were introduced in Chapter 6.)

Controls Relevant in the Process

This is a recognition of the control procedures that should be used by an organization to prevent and detect errors and fraud.

AUDIT PROCEDURES

These are evidence gathering procedures—test of controls, dual-purpose procedures, tests of details of balance.

AUDIT RESULTS

This is a summary of the auditors' findings and their implications.

In the end-of-chapter review section, similar discussion cases allow you to test your ability to design audit procedures for the detection of errors or fraud.

DISCUSSION CASE

Jack's first year on the audit trail has been an exciting one. He has worked on many audits and gained experience in a wide variety of situations that have helped him develop his professional judgment. While meeting with some new junior audit staff members, Jack describes three very different experiences in auditing the revenue, receivables, and receipts process. The three audit situations he encountered provide a lot of insight into the risk of material misstatements. The first case involved misstatement due to employee embezzlement, the second involved fraudulent financial reporting by management, and the third was an unintentional error by the accounting department.

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AUDIT 11.1 The Embezzling Cashier

CASE DESCRIPTION

Cash embezzlement by an employee at a new audit client, Sports Equipment Inc. (SEI), an equipment retailer, caused overstated accounts receivable, overstated customer discounts expense, and understated cash sales. SEI also failed to earn interest income on funds "borrowed." Over a six-year period, D. Bakel, the assistant controller of SEI, built up a $350,000 average balance in a Sport Equipment Company (SEC) account, which earned a total of $67,500 in interest that should have been earned by SEI. By approving the "extra" discounts, Bakel also skimmed 2% of about $1 million in annual sales, for a total of $120,000. Since SEI would have had net income before taxes of about $1.6 million over the six years, Bakel's embezzlement took about 12.5% of the income.

SEI maintained accounts receivable for school boards in the region; its other customers received credit only by using their own credit cards. Bakel was the company cashier, receiving all the incoming payments on school board accounts and credit card accounts, as well as all the other cash and cheques taken over the counter. Bakel prepared the bank deposit (and delivered the deposit to the bank), listing all the cheques and currency; prepared a remittance worksheet (daily cash report) that showed amounts received, discounts allowed on school board accounts, and amounts to credit to the accounts receivable; and reconciled the bank statement. No one else reviewed the deposits or the bank statements except the independent auditors.

Bakel opened the bank account in the name of Sport Equipment Company (SEC), after properly incorporating the company with the government Ministry of Commerce. He took over-the-counter cash and cheques and school board payments from the SEI receipts and deposited them in the SEC account. No one, including the bank, noticed the difference between the rubber stamp endorsements for the two similarly named corporations. Bakel kept the money in the SEC account, earning interest on it, and then wrote SEC cheques to SEI to replace the "borrowed" funds. In the meantime, new SEI receipts were being deposited to SEC. When Bakel deposited SEC cheques in SEI, giving the schools credit, an additional 2% customer discount was approved. Thus, the school boards received proper credit later, but SEC paid in a discounted amount.

Audit Trail

SEI's bank deposits showed fairly small currency deposits as Bakel was nervous about taking too many cheques, so preferred cash. As shown in the examples below, the deposit slips listed the SEC cheques Bakel deposited, as the bank tellers usually check this. The remittance worksheet, on the other hand, did not show SEC cheques but rather receipts from school boards and currency, and not many over-the-counter cheques from customers. The transactions became complicated enough that Bakel had to use the computer in the office to keep track of the school boards that needed to get credit. There were no vacations for this hard-working cashier because the discrepancies might be noticed by a substitute employee.

AUDIT APPROACH ANALYSIS

Audit Objective

The auditor's objective was to obtain evidence determining whether the accounts receivable recorded on the books represented claims against real customers in the gross amounts recorded.

Controls Relevant to the Process

The authorization related to cash receipts, custody of cash, recording of cash transactions, and bank statement reconciliation should be separate duties assigned to different people. Independent review of one or more of these duties should be performed as a supervisory control designed to detect errors and fraud.

Unfortunately, at SEI, Bakel had all these duties. (While recording was not actually performed, Bakel provided the source document—the remittance worksheet that the other accountant used to make the cash and accounts receivable entries.) According to the company president, the only "control" was the diligence of "our long-time, trusted, hard-working assistant controller." Assessing the control risk on this new audit, Jack's audit team identified serious control weaknesses. By "thinking like a crook" to imagine ways these control weakness could allow Bakel to commit fraud, the auditors discovered the scheme for cash theft and accounts receivable lapping.

AUDIT PROCEDURES

Dual-Purpose Tests

Since Bakel's honest and diligent performance were the "control" of the accounting and control procedures that should have been performed by two or more people, the auditors performed a dual-purpose test of controls and substantive details of cash receipts transactions as they relate to accounts receivable credits. The samples and direction of test procedure are as follows:

(a) Validity direction—select a sample of customer accounts receivable, and reconcile payment credits to remittance worksheets and bank deposits, including recalculation of discounts allowed according to sales terms (2%), classification (customer name), identification, and correspondence of receipt date to recording date.

(b) Completeness direction—select a sample of remittance worksheets (or bank deposits), vouch details to bank deposit slips (trace details to remittance worksheets if the sample is bank deposits), and trace forward to complete accounting posting in customer accounts receivable.

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Test of Details of Balance

The auditors sent positive confirmations on all 72 school board accounts. Since there was a control risk of incorrect accounting, the accounts receivable confirmation was performed at the year-end date, using positive confirmations. Blank confirmations were used, and the "sample" included all the accounts, since the number was not too large.

AUDIT RESULTS

The audit tests showed four cases of discrepancy where the responses stated that the boards had paid the balances before the confirmation date. Follow-up procedures on their accounts receivable credit in the next period showed they had received credit in remittance reports, and the bank deposits had shown no cheques from the school boards, but had contained a cheque from Sports Equipment Company. To further investigate, the auditors used the Internet, telephone book, chamber of commerce directory, and a visit to a local Ministry of Commerce office to determine the location and identity of Sport Equipment Company. Further investigation of SEC revealed the connection of Bakel, who was confronted and then confessed.

BANK DEPOSIT SLIP		CASH REMITTANCE REPORT				
Jones	25	Name	Amount	Discount	AR	Sales
Smith	35					
Hill Dist.	980	Jones	25	0	0	25
Sport Equip	1563	Smith	35	0	0	35
Currency	540	Hill Dist.	980	20	1000	0
Deposit	3143	Marlin Dist.	480	20	500	0
		Waco Dist.	768	32	800	0
		Currency	855	0	0	855
		Totals	3143	72	2300	915

AUDIT 11.2 Bill Early, Bill Often!

CASE DESCRIPTION

McGossage Company is a long-time audit client of Jack's firm that had been experiencing profit pressures for two years now. A recessionary economy reduced profits, but the company reported net income decreases that were not as severe as other companies in its industry. In the audit, it was discovered that employees were recording sales too early and failing to account for customer discounts taken, resulting in overstated sales and receivables, understated discounts expense, and overstated net income.

As misstatements go, some of these were on the materiality borderline. Sales were overstated 0.3% and 0.5% in the prior and current year, respectively. Accounts receivable were overstated 4% and 8%. But the combined effect was to overstate the division's net income by 6% and 17%. Selected data were as follows:

	ONE YEAR AGO		CURRENT YEAR	
	REPORTED	ACTUAL	REPORTED	ACTUAL
Sales	$330.0	$329.0	$350.0	$348.0
Discounts expense	1.7	1.8	1.8	2.0
Net income	6.7	6.3	5.4	4.6

In McGossage's grocery products division, sales had been recorded for orders prepared for shipment but not actually shipped until later. Employees backdated the shipping documents. Gross profit on these "sales" was about 30%. Customers took discounts on payments, but the company did not record them, leaving the debit balances in the customers' accounts receivable instead of charging them to discounts and allowances expense. Company accountants were instructed to wait 60 days before recording discounts taken.

The division vice-president and general manager knew about these accounting practices, as did a significant number of the 2500 employees in the division. The division managers were under orders to achieve profit objectives they considered unrealistic, thus creating pressure on them to misstate the financial results.

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Audit Trail

The customers' accounts receivable balances contained amounts due for discounts the customers already had taken. The cash receipts records showed payments received without credit for discounts. Discounts were entered monthly by a special journal entry. The unshipped goods were on the shipping dock at year-end, with papers showing earlier shipping dates.

AUDIT APPROACH ANALYSIS

Audit Objective

The auditors' objectives were to obtain evidence determining if sales were recorded in the proper period, if gross accounts receivable represented the amounts due from customers at year-end, and if discounts expenses were recognized in the proper amount in the proper period.

Controls Relevant to the Process

The accounting procedures manual should state that sales are to be recorded on the date of shipment (or when title passes, if later); management overrode this control procedure by having shipping employees date the shipping papers incorrectly. Cash receipts procedures call for discounts to be authorized and recorded when they are taken by customers; management overrode this control procedure by giving instructions to delay the recording.

AUDIT PROCEDURES

Tests of Controls

Use questionnaires and enquiries to determine the company's accounting policies, as it is possible that employees and managers would conceal these from auditors unless asked directly. Pointed questions about revenue recognition and discount recording policies might elicit revealing answers.

Dual-Purpose Procedures

Select a sample of cash receipts, examine them for authorization, recalculate the customer discounts, and trace them to accounts receivable input for recording of the proper amount on the proper date. Select a sample of shipping documents and vouch them to customer orders, then trace them to invoices and to recording in the amounts receivable input with proper amounts on the proper dates. These tests follow the tracing direction—data representing the beginning of transactions (cash receipts, shipping) is traced through the company's accounting process.

Tests of Details of Balance

Confirm a sample of customer accounts. Use analytical relationships of past years' discount expense to a relevant base (sales, sales volume) to calculate an overall test of the discounts expense. Record shipping details including relevant dates for any inventory on the shipping dock at year end and trace to the sales invoice to check dating.

AUDIT RESULTS

The managers lied to the auditors about their revenue and expense timing policies. The sample of shipping documents showed no dating discrepancies because the employees had inserted incorrect dates. The analytical procedures on discounts did not show the misstatement because the historical relationships were too erratic to show a deficient number (outlier). However, the sample of cash receipts transactions showed that discounts were not calculated and recorded at time of receipt. Additional enquiry led to discovery of the special journal entries and admission of the recording delay. Two customers in the sample of 65 confirmations responded with exceptions that turned out to be unrecorded discounts. Two other customers in the confirmation sample complained that they did not owe for late invoices on December 31. Follow-up showed the shipments were goods on the shipping dock noticed by auditors during the December 31 inventory taking. The shipping documents were dated December 26. The sales recording had them recorded as "bill and hold" on December 29.

AUDIT 11.3 Thank Goodness It's Friday

CASE DESCRIPTION

In the audit of Alpha Brewery Corporation (Alpha), Jack's audit team found that overstated sales caused net income, retained earnings, current assets, working capital, and total assets to be overstated. Overstated cash collections did not change the total current assets or total assets, but they increased the amount of cash and decreased the amount of accounts receivable by an offsetting amount, affecting the quick ratio that Alpha's bank monitors. Alpha recorded sales of $672,000 and gross profit of $268,800 over the January 1–4 period. Cash collections on customers' accounts amounted to $800,000.

Alpha generally has good control policies and procedures related to authorization of transactions for accounting entry, and the accounting manual has instructions for recording sales transactions in the proper accounting period. The company regularly closes the accounting process each Friday at 5 p.m. to prepare weekly management reports. The year-end date (cutoff date) is December 31,

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and, in 20X0, December 31 was a Monday. However, the accounting was performed through Friday as usual, and the accounts were closed for the year on January 4.

Audit Trail

All the entries were properly dated after December 31, including the sales invoices, cash receipts, and shipping documents. However, the trial balance the financial statements were prepared from was dated December 31, 20X0, even though the accounts were actually closed on January 4. Nobody noticed the slip of a few days because the Friday closing was normal.

AUDIT APPROACH ANALYSIS

Audit Objective

The auditors' objectives were to obtain evidence to determine the existence, completeness, and valuation of sales for the year ended December 31, 20X0, and of the cash and accounts receivable as of December 31, 20X0.

Controls Relevant to the Process

The company had in place proper instructions for dating transactions on the actual date they occurred, entering sales and cost of goods sold on the day of shipment, and entering cash receipts on the day received in the company offices. An accounting supervisor should have checked the entries through Friday to make sure the dates corresponded with the actual events and that the accounts for the year were closed with Monday's transactions.

AUDIT PROCEDURES

Tests of Controls

In this case, the auditors needed to be aware of the company's weekly routine closing and of the possibility that the Monday occurrence of December 31 might cause a problem. Asking the question "Did you cut off the accounting on Monday night this week?" might elicit the "Oh, we forgot!" response. It would be normal to sample transactions around the year-end date to determine if they were recorded in the proper accounting period. To do this, they selected transactions from 10 days before and after the year-end date and inspected the dates on supporting documentation.

Tests of Details of Balance

For sales overstatements, the auditors confirmed a sample of accounts receivable. If the accounts were too large, the auditors expected the debtors to say so, thus leading to detection of sales overstatements. Cash overstatement was audited by examining the bank reconciliation to see whether deposits in transit (the deposits sent late in December) actually cleared the bank early in January. Obviously, the January 4 cash collections could not reach the bank until at least Monday, January 7. That is too long for a December 31 deposit to be in transit to a local bank.

The completeness of sales recordings was audited by selecting a sample of sales transactions (and supporting shipping documents) in the early part of the next accounting period (January 20X1). Sales of 20X0 could be incomplete if recording of December shipments had been postponed until January, and this procedure would detect them if the shipping documents were dated properly. The completeness of cash collections (and accounts receivable credits) was audited by examining the cash deposits early in January for any sign of holding cash without entry until January.

In this case the existence objective was more significant to discovering the problem than the completeness objective; after all, the January 1–4 sales, shipments, and cash collections did not "exist" in December 20X0.

AUDIT RESULTS

The test of controls sample from the days before and after December 31 quickly revealed the problem. Company accounting personnel were embarrassed, but there was no intent to misstate the financial statements. This was a simple error. The company readily made the following adjustment:

	DEBIT	CREDIT
Sales	$672,000	
Inventory	403,200	
Accounts receivable	800,000	
Accounts receivable		$672,000
Cost of goods sold		403,200
Cash		800,000

REVIEW CHECKPOINTS

11-24 In the Audit 11.1 case, name one bank reconciliation control procedure that could have revealed signs of embezzlement.

11-25 What feature(s) of a cash receipts internal control system would be expected to prevent the cash receipts journal and recorded cash sales from reflecting more than the amount shown on the daily deposit slip?

11-26 In the Audit 11.2 case, what information might have been obtained from each of the following: enquiries, detail test of controls procedures, observations, and confirmations?

11-27 With reference to the Audit 11.3 case, how would an understanding of the business and management reporting system have contributed to discovery of the open cash receipts journal cutoff error?

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SUMMARY

The learning objectives addressed in this chapter are summarized as follows:

- The revenue, receivables, receipts process consists of customer order processing, credit checking, goods shipping, customer billing, accounts receivable accounting, cash receipts collection and accounting. Companies reduce control risk by having a suitable separation of authorization, custody, recording, and periodic reconciliation duties. Error-checking procedures of comparing customer orders and shipping documents are important for billing customers the right prices for the delivered quantities. Otherwise, many things could go wrong—from sales to fictitious customers or those with bad credit to billings for the wrong quantities at the wrong prices at the wrong time.
- Auditors consider environmental and general controls, and then assess specific application controls. Internal control questionnaires often used in practice are provided in the appendix to illustrate the nature of the auditor enquiries and observations used to assess control risk. Controls activities may be tested through observation, inspection and reperformance procedures. Examples of control tests in this process were provided.
- Substantive programs are developed by linking the auditor's risk assessments to the risks of material misstatements in revenue transactions, accounts receivable balance, and cash receipts transactions. A detailed example showing the process documenting and linking risk assessments to the design of an audit program of substantive procedures was provided for one example, the cash balance. Similar linking exercises would be used to develop substantive audit procedures in response to the assessed risks at the assertion level for all the significant classes of transactions, account balances and disclosures.
- Generic substantive audit programs were illustrated by providing examples of typical substantive procedures that would be considered, depending on the risks assessed in each particular case.
- Three topics were given special technical notes in the chapter. The existence assertion is very important in the audit of cash and receivables assets, as misleading financial statements often include overstated assets and revenue. A section was devoted to the use of confirmations for obtaining evidence of asset existence from outside parties. Bank reconciliations were shown to be an audit opportunity to recalculate the amount of cash reported in the financial statements and to look for signs of accounts receivable lapping and cheque kiting.

Cash collection is a critical point for asset control. Many cases of embezzlement occur in this process. This chapter concluded with an application case and analysis that told the stories of three cash embezzlement schemes, including the practice of lapping accounts receivable.

Analysis of Financial Statement Relationships

The audit of the revenues, receivables, and receipts processes verify that there is not a material misstatement in the balance of accounts receivable and the two transaction streams that run through it—revenues and cash receipts. In the balance sheet approach to auditing, we can analyze the accounts receivable balance changes and the financial statement items related to them by analyzing the continuity of the accounts receivable account over the period being audited. A **continuity schedule** is a working paper that shows the movements in the account balances and the other financial statement amounts that should tie in with them. Exhibit 11–14 below illustrates a continuity schedule for the accounts receivable balance.

continuity schedule: a working paper that shows the movements in an account balance from the beginning to the end of the period under audit; used to analyze the account balance changes and the other financial statement items related to them

As these relationships illustrate, procedures to audit the revenues, receivables, and receipts allow assessment of whether all components of this system are reported accurately in the financial statements. These relationships also indicate analytical procedures that can detect material misstatements. For example, the ratios measuring collection period or number of days of sales in A/R can indicate nonexistent sales revenues or receivables that are not likely to be collected.

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EXHIBIT 11–14 Continuity Schedule for the Accounts Receivable Balance

AUDITED AMOUNT	FINANCIAL STATEMENT WHERE AMOUNT IS REPORTED
Opening balance of accounts receivable	Balance sheet (prior year comparative figures)
Add: Revenues from credit sales	Income statement (component of total revenues)
Deduct: Cash received against accounts receivable	Cash flow statement (direct method)
Deduct: Uncollectible accounts written off	Balance sheet (change in allowance for doubtful Accounts)*
Ending balance of accounts receivable	Balance sheet (current year figures)

***Note:** The bad debt expense and the allowance for doubtful accounts balance can be analyzed using the same technique. Question EP11-7 at the end of the chapter asks you to provide the continuity schedule for the allowance for doubtful accounts and to identify the related financial statement items that it will have to be agreed to in the audit file.

Misstatement Analysis

These relationships also can be used to analyze the impact of misstatements discovered in the audit. For example, consider the impact if a cutoff error occurs and a cash receipt that was received on December 31, 20X1 was not recorded till January 2, 20X2. In the continuity schedule above, the cash receipts transaction total deducted from accounts receivable will be too small, leading to an overstatement of accounts receivable (and an understatement of the cash balance).

As another example, consider if a sale on account for $13,000 was recorded on December 31, 20X1, and the auditor's cutoff testing revealed the shipment did not occur until the first week of the following year. In this case, sales revenues in the income statement will be overstated. Also, the amount of revenues added in to the accounts receivable balance in the continuity schedule above will be overstated by $13,000, leading to an overstatement in the balance sheet. The misstatement also will affect the inventory and cost of sales—assuming a gross margin of 40%, the inventory and costs of sales will be understated by $7800. As required by CAS 450, the auditor must accumulate misstatements identified during the audit, other than those that are clearly trivial. A worksheet used for this purpose is illustrated in Exhibit 16–1 of Chapter 16. This sales cutoff error will be carried forward, as well as the related error in inventory cutoff. The accumulated misstatements worksheet shows the impact of all misstatements on the balance sheet and income statement, and sets out the debits and credits of proposed adjusting entries to correct them, if management chooses to do so.

KEY TERMS

accounts receivable lapping
accounts receivable subsidiary ledger
aged A/R trial balance
bank transfer schedule
cheque kiting
continuity schedule
control risk assessment
cutoff bank statement
detailed audit plan
detection rate
dual-direction testing
fidelity bond
FOB destination
FOB shipping
money laundering
response rate
revenue recognition problems
sales cutoff
scope
walk-through
window dressing

EXERCISES AND PROBLEMS

EP 11-1 Cash Receipts: Control Objectives and Control Examples. LO1, LO2

Required:
Prepare a table similar to Exhibit 11–4 on (internal control objectives) for cash receipts.

EP 11-2 Cash: Substantive Audit Procedures on Bank Reconciliation. LO3, LO5, LO7 The following auditee-prepared bank reconciliation is being examined by you during an audit of the financial statements of Cynthia Company:

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CYNTHIA COMPANY BANK RECONCILIATION VILLAGE BANK ACCOUNT 2 DECEMBER 31, 20X0		
Balance per bank **(a)**:		$18,375.91
Deposits in transit **(b)**:		
12/30	$1,471.10	
12/31	2,840.69	4,311.79
Subtotal		22,687.70
Outstanding cheques **(c)**:		
837	6,000.00	
1941	671.80	
1966	320.00	
1984	1,855.42	
1985	3,621.22	
1987	2,576.89	
1991	4,420.88	(19,466.21)
Subtotal		3,221.49
NSF cheque Returned		
12/29 **(d)**:		200.00
Bank charges		5.50
Error: cheque no. 1932		148.10
Customer note collected by the bank ($2,750 plus $275 interest **(e)**:		(3,025.00)
Balance per books **(f)**:		$ 550.09

Required:

Indicate one or more audit procedures that should be performed in gathering evidence in support of each of the items (***a***) through (***f***) above.

(AICPA adapted)

EP 11-3 Sales Cutoff and Cutoff Bank Statement. LO2, LO5, LO7

Required:

a. You wish to test Houston Corporation's sales cutoff at June 30. Describe the steps you should include in this test.

b. You obtain a July 10 bank statement directly from the bank. Explain how this cutoff bank statement should be used:
   1. in your review of the June 30 bank reconciliation, and
   2. to obtain other audit information.

(AICPA adapted)

EP 11-4 Alternative Accounts Receivable Procedures. LO1, LO5, LO6 Several accounts receivable confirmations have been returned with the notation "verification of vendor statements is no longer possible because our data processing system does not accumulate each vendor's invoices."

Required:

What alternative auditing procedures could be used to audit these accounts receivable?

(AICPA adapted)

EP 11-5 Accounts Receivable Audit Procedures. LO1, LO4, LO5 During the audit of the December 31, 20X5, financial statements, the auditor identifies cash amounts received subsequent to December 31, 20X5, and traces these amounts to the cash account in the general ledger and to the accounts receivable subledger balances at December 31, 20X5.

Required:

a. What kind of procedure is this? What evidence does it provide regarding which financial statement assertion?

b. What records or documents would the auditor need to look at to identify cash amounts received after the year-end?

EP 11-6 Accounts Receivable Audit Procedures. LO4, LO6 The auditor is considering confirming zero-balance accounts from the auditee's accounts receivable subledger to provide evidence concerning the completeness assertion for accounts receivables and sales.

Required:

a. What are the advantages and limitations of this procedure?

b. How would the decision to use this procedure relate to the auditor's control assessment? In particular, discuss the kinds of controls the auditee would be expected to have and the procedures the auditor could use to test them.

EP 11-7 Continuity Schedule for Allowance for Doubtful Accounts. LO4

Required:

a. Complete the following continuity schedule indicating how the movements in the allowance for doubtful accounts tie into other amounts in the financial statements.

b. Prepare an audit program listing the procedures that can be used to audit the accounts in this system. Demonstrate how your audit program addresses all the relevant assertions.

AUDITED AMOUNT	FINANCIAL STATEMENT WHERE AMOUNT IS REPORTED
Opening balance of allowance for doubtful accounts	
Add:	
Deduct:	
Ending balance of allowance for doubtful accounts	

EP 11-8 Cutoff Bank Statement for Auditing the Bank Reconciliation. LO7

Velma Inc. is a very modern company that strives to be paperless in all its administrative functions. Velma has arranged with its bank to receive all its banking transaction information online, through the bank's online banking website. Velma's auditor want to get a cutoff bank statement as of January 20, 20X1, to complete the audit of the bank reconciliation.

Required:

a. Explain what a cutoff bank statement is and its purpose in auditing the bank reconciliation.

b. Describe one way that Velma's auditor can obtain a cutoff bank statement if the bank is unable to provide a paper copy.

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DISCUSSION CASES

DC 11-1 Internal Control Questionnaire for Book Buy-Back Cash Fund. LO2 Taylor, a PA, has been engaged to audit the financial statements of University Books Incorporated. University Books maintains a large, revolving cash fund exclusively for the purpose of buying used books from students for cash. The cash fund is active all year because the nearby university offers a large variety of courses with varying start and completion dates throughout the year.

Receipts are prepared for each purchase. Reimbursement vouchers are periodically submitted to replenish the fund.

Required:

Construct an internal control questionnaire to be used in evaluating the system of internal control over University Books' use of the revolving cash fund to buy back books. The internal control questionnaire should elicit a yes or no response to each question. Do not discuss the internal controls over books that are purchased.

(AICPA adapted)

DC 11-2 Test of Controls Audit Procedures for Cash Receipts. LO1, LO2 You are the in-charge auditor examining the financial statements of the Gutzler Company for the year ended December 31. During late October, with the help of Gutzler's controller, you completed an internal control questionnaire and prepared the appropriate memoranda describing Gutzler's accounting procedures. Your comments relative to cash receipts are as follows:

All cash receipts are sent directly to the accounts receivable clerk with no processing by the mail department. This clerk keeps the cash receipts journal, prepares the bank deposit slip in duplicate, posts from the deposit slip to the subsidiary accounts receivable ledger, and mails the deposit to the bank.

The controller receives the validated deposit slips directly (unopened) from the bank. She also receives the monthly bank statement directly (unopened) from the bank and promptly reconciles it.

At the end of each month, the accounts receivable clerk notifies the general ledger clerk, by journal voucher, of the monthly totals of the cash receipts journal for posting to the general ledger.

Each month, the general ledger clerk records the total debits to cash from the cash receipts journal. The clerk also, on occasion, makes debit entries in the general ledger cash account from sources other than the cash receipts journal; for example, funds borrowed from the bank. Certain standard auditing procedures listed below already have been performed by you in the audit of cash receipts:

All columns in the cash receipts have been totalled and cross-totalled.

Postings from the cash receipts journal have been traced to the general ledger.

Remittance advices and related correspondence have been traced to entries in the cash receipts journal.

Required:

Considering Gutzler's internal control over cash receipts and the standard auditing procedures already performed, list all other auditing procedures that should be performed to obtain sufficient audit evidence regarding cash receipts control and give the reasons for each procedure. Do not discuss the procedures for cash disbursements and cash balances. Also, do not discuss the extent to which any of the procedures are to be performed. Assume adequate controls exist to ensure that all sales transactions are recorded. Organize your answer sheet as follows:

Other Audit Procedures	Reason for Other Audit Procedures

(AICPA adapted)

DC 11-3 Cash Receipts: Weaknesses and Recommendations. LO2 The Pottstown Art League operates a museum for the benefit and enjoyment of the community. During hours when the museum is open to the public, two volunteer clerks positioned at the entrance collect a $5 admission fee from each nonmember patron. Members of the Art League are permitted to enter free of charge on presentation of their membership cards.

At the end of each day, one of the clerks delivers the proceeds to the treasurer. The treasurer counts the cash in the presence of the clerk and places it in a safe. Each Friday afternoon, the treasurer and one of the clerks deliver all cash held in the safe to the bank, and they receive an authenticated deposit slip that provides the basis for the weekly entry in the cash receipts journal.

The board of directors of the Pottstown Art League has identified a need to improve the system of internal control over cash admission fees. The board has determined that the cost of installing turnstiles or sales booths or otherwise altering the physical layout of the museum will greatly exceed any benefits that may be derived. However, the board has agreed that the sale of admission tickets must be an integral part of its improvement efforts.

Required:

The board of directors has requested your assistance. Prepare a report for presentation and discussion at their next board meeting that identifies the weaknesses in the existing system of cash admission fees and suggests recommendations.

(AICPA adapted)

DC 11-4 Control Weaknesses: Shipping and Billing. LO2 Ajax Inc. recently implemented a new accounting

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system to process the shipping, billing, and accounts receivable records more efficiently. During the interim work of Ajax's auditors, an assistant completed the review of the accounting system and the internal controls. The assistant determined the following information concerning the new computer systems and the processing and control of shipping notices and customer invoices:

The computer system documentation consists of the following items: program listings, error listings, logs, and database dictionaries. The system and documentation are maintained by the IT administrator. To increase efficiency, batch totals and processing controls are not used in the system.

Ajax ships its products directly from two warehouses, which forward shipping notices to general accounting. There, the billing clerk enters the price of the item and accounts for the numerical sequence of the shipping notices. The billing clerk also manually prepares daily adding machine tapes of the units shipped and the sales amounts. The computer processing output consists of the following:

a. A three-copy invoice that is forwarded to the billing clerk.
b. A daily sales register showing the aggregate totals of units shipped and sales amounts that the billing clerk compares with the adding machine tapes.

The billing clerk mails two copies of each invoice to the customer and retains the third copy in an open invoice file that serves as a detail accounts receivable record.

Required:

a. Prepare a list of weaknesses in internal control (manual and computer), and for each weakness make one or more recommendations.
b. Suggest how Ajax's computer processing over shipping and billing could be improved through the use of remote terminals to enter shipping notices. Describe appropriate controls for such an online data entry system.

DC 11-5 Bank Reconciliation: Cash Shortage. LO4, LO7 The Patrick Company had poor internal control over its cash transactions. Facts about its cash position at November 30 were the following:

The cash books showed a balance of $18,901.62, which included undeposited receipts. A credit of $100 on the bank statement did not appear on the books of the company. The balance according to the statement was $15,550.

When you received the cutoff bank statement on December 10, the following cancelled cheques were enclosed: No. 6500 for $116.25, No. 7126 for $150.00, No. 7815 for $253.25, No. 8621 for $190.71, No. 8623 for $206.80, and No. 8632 for $145.28. The only deposit was in the amount of $3,794.41 on December 7.

The cashier handles all incoming cash and makes the bank deposits personally. He also reconciles the monthly bank statement. His November 30 reconciliation is shown below.

Balance, per books, November 30	$18,901.62	
Add: Outstanding cheques:		
8621	$ 190.71	
8623	206.80	
8632	145.28	442.79
		19,344.41
Less: Undeposited receipts		3,794.41
Balance per bank, November 30		15,550.00
Deduct: Unrecorded credit		100.00
True cash, November 30		$15,450.00

Required:

a. You suspect that the cashier has stolen some money. Prepare a schedule showing your estimate of the loss.
b. How did the cashier attempt to conceal the theft?
c. Based only on the information above, name two specific features of internal control that are missing.
d. If the cashier's October 31 reconciliation is known to be in order and you start your audit on December 5, what specific auditing procedures could you perform to discover the theft?

(AICPA adapted)

DC 11-6 Receivables Audit Procedures. LO3, LO4, LO6, LO7 The ABC Appliance Company, a manufacturer of small electrical appliances, deals exclusively with 20 distributors situated throughout the country. At December 31 (the balance sheet date), receivables from these distributors aggregated $875,000. Total current assets were $1.3 million.

With respect to receivables, the auditors followed the procedures outlined below in the course of the annual audit of financial statements:

1. Reviewed the system of internal control and found it to be exceptionally good.
2. Reconciled the subsidiary and control accounts at year-end.
3. Aged accounts—none were overdue.
4. Examined detail sales and collection transactions for February, July, and November.
5. Received positive confirmations of year-end balances.

Required:

Criticize the completeness or incompleteness of the above program, giving reasons for your recommendations concerning the addition or omission of any procedures.

(AICPA adapted)

DC 11-7 Rent Revenue. LO4 You were engaged to conduct an audit of the financial statements of Clayton Realty Corporation for the year ending January 31. The examination of the annual rent reconciliation is a vital portion of the audit. The following rent reconciliation was prepared by the controller of

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Clayton Realty Corporation and was presented to you. You subjected it to various audit procedures:

CLAYTON REALTY CORPORATION RENT RECONCILIATION FOR THE YEAR ENDED JANUARY 31	
Gross apartment rents (Schedule A)	$1,600,800*
Less vacancies (Schedule B)	20,000*
Net apartment rentals	1,580,300
Less unpaid rents (Schedule C)	7,800*
Total	1,572,500
Add prepaid rent collected (Schedule D)	500*
Total cash collected	$1,573,000

Schedules A, B, C, and D are available to you but have not been illustrated. You have conducted an assessment of the control risk and found it to be low. Cash receipts from rental operations are deposited in a special bank account.

Required:

What substantive audit procedures should you employ during the audit in order to substantiate the validity of each of the dollar amounts marked by an asterisk (*)?

(AICPA adapted)

DC 11-8 Business Risk, Evidence Analysis, Sales Detail. LO1, LO3, LO4 Rosella is the senior in charge of the current-year audit of Harrier Limited, a company that designs and manufactures highly sophisticated machines used to make precision plastic parts and instruments. The machines have a high dollar value (ranging from $500,000 to over $1,000,000) and there is a long lead time between receiving a customer's order and specifications, designing the machine, building it, and testing it. Because of these business factors, sales do not tend to follow a regular pattern, but certain constraints exist that can be used to analyze the reasonability of sales for audit purposes. Customer orders are tracked as the "backlog" file, and sales can be expected to follow the backlog after allowing for design, manufacturing, and testing time. This takes between two and three months, on average. Another factor is the physical limitation of the factory and equipment: There are 12 job stations where machines can be built, so a maximum of 12 machines can be in the work-in-process inventory at any one time.

Harrier's shares are privately held by its founder and president, and several outside investors, but it issued bonds to the public several years ago and is subject to debt covenants that require it to maintain a working capital ratio of 1.5 to 1.0 and a debt to equity ratio of 0.5 to 1.0 at each year-end. In addition, no dividends or management bonuses can be paid out unless the net income before taxes is at least $1,000,000. The draft statements for the current year meet all covenants and show a net income before taxes of $1,300,000.

In reviewing the monthly sales for the current year, Rosella notices several anomalies. First, 15 machines were shipped in December, the last month of the current year, while in December of the prior year only six were shipped. The average monthly shipment volume is between five and six machines. Also, the average gross profit on sales in prior years, and in most months, is approximately 40%. The gross profit on the December sales is 75%. The annual sales were $66 million, with $15 million of this occurring in December. The annual gross profit is $33 million, with $11 million of this occurring in December. While scrutinizing the cash records for the first month of the new year to look for unaccrued liabilities, Rosella notices some large amounts paid for travel expenses for employees and for shipments of "spare parts" to customers. Enquiries of the employees reveals that they are engineers and technicians who were required to spend two or three weeks in various cities where the December machine sales were shipped in order to "work out the bugs" and add some parts to these machines.

Required:

a. What are the main business risks in Harrier Limited? What are the risks of financial statement misstatements that Rosella should be aware of?

b. What types of evidence collection procedures were used and what assertions do they provide evidence about?

c. Analyze the information Rosella obtained and offer reasonable explanations for the sales anomalies noted. What additional enquiries should Rosella make to form an opinion on the operating results reported in Harrier's draft financial statements? What is your conclusion on the draft sales and gross profits amounts, based on your analysis of the facts given?

d. Harrier's revenue recognition policy is to recognize revenue when the machines are shipped and title passes to customers. This point occurs when the machines are loaded on the truck at Harrier's factory. Given this policy, what adjustment (if any) would be required in Harrier's current financial statements given the conclusion you reached in part (c) above?

DC 11-9 Negative Confirmations. LO1, LO4, LO6, LO7 The auditor of a stock brokerage company, Roller Securities Inc., sends out negative confirmations of account details for a sample of about 50% of the stock brokerage's customers, selected at random. Historically, 2–5% of the confirmations have been returned, and the majority of the discrepancies reported have been understatements. Investigation of the discrepancies rarely indicates an error on Roller Securities Inc.'s part. Usually, they are explained by transactions that are in progress or pending over the year-end, by late payments on the customer's part, or other mistakes in the customer's own records.

Required:

a. Describe the inherent risks and the internal control risks that exist for customer accounts at Roller Securities Inc.

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b. Discuss the advantages and disadvantages of using negative confirmations to provide audit evidence about the assertions in this case. Comment on the persuasiveness of the evidence the negative confirmations provide; do you think it can be sufficient to support the auditor's opinion?

DC 11-10 Substantive Testing for Sales. LO1, LO4 Parts Inc. sells electrical components to large department stores and also has a few cash sales to electricians. Sales invoices are prepared for all sales. Cash sales are recorded to the cash receipts journal and cash is deposited to the bank each day. All sales to large stores are credit sales and are handled by sales clerks by telephone or fax.

The sales clerk takes the customer's request, checks the authorized customer list for credit limits (if it is a credit sale), prepares the sales invoice, and sends one copy to the inventory control department, who sends the ordered goods to the shipping department. For cash sales, the inventory control clerk brings the items sold to the sales counter and the goods are given to the purchaser at the time of sale. For credit sales, the shipping clerk signs the inventory control copy of the sales invoice and then prepares a shipping invoice. A third copy of the sales invoice is forwarded to the accounting department so that a clerk can enter the sale into the sales journal. The shipping invoices are maintained in the shipping department in case a shipment needs to be checked. All goods are shipped FOB shipping point.

Required:

a. Design two audit procedures, in addition to sample selection, that will provide evidence of the occurrence/existence of sales. Identify the procedure (trace, compare, vouch, and so on) and the documents you are using, and explain why these procedures will show whether recorded sales are valid.

b. Design two audit procedures that will provide evidence of the completeness of sales. Identify the procedure (trace, compare, vouch, and so on) and the documents you are using, and explain why these procedures will show whether recorded sales are complete.

(CGA-Canada adapted)

DC 11-11 Municipal Government, Employee Theft. LO2, LO3, LO4 This case is modelled on the Application Case and Analysis in the chapter.

Case Description: In the audit of a municipal government, the auditors discovered that receivables for property taxes were overstated because the tax assessor stole some taxpayers' payments. J. R. Shelstad had been the tax assessor–collector for 15 years in the Ridge Municipal District, a large metropolitan area. Known as a "good personnel manager" Shelstad pocketed 100–150 counter payments each year, in amounts of $500–$2,500, stealing about $200,000 a year for a total of approximately $2.5 million. The district had assessed about $800–$900 million per year in property tax revenues, so the annual theft was less than 1%. Nevertheless, the taxpayers got mad.

In Shelstad's assessor–collector office, staff processed tax notices on a computer system and generated 450,000 tax notices each October. An office copy was printed and used to check "paid" when payments were received. Payments were processed by computer and a master file of accounts receivable records (tax assessments, payments) was kept on the computer hard drive.

Shelstad was a good personnel manager, who often took over the front desk at lunchtime so the teller staff could enjoy lunch together. During these times, Shelstad took tax payments over the counter, gave the taxpayers a counter receipt, and pocketed some of the money, which was never entered in the computer system.

Shelstad eventually resigned when the district's assessor–collector office was eliminated upon the creation of a new region-wide tax agency.

Audit Trail: The computer records showed balances due from many taxpayers who had actually paid their taxes. The book of printed notices was not marked "paid" for many taxpayers who had received counter receipts. These records and the daily cash receipts reports (cash receipts journal) were available at the time the independent auditors performed the most recent annual audit in April. To keep his fraud going and prevent auditors from detecting it, Shelstad persuaded the auditors that the true "receivables" were the delinquencies turned over to the region's legal counsel. Their confirmation sample and other work were based on this population. Thus, confirmations were not sent to fictitious balances that Shelstad knew had been paid. When Shelstad resigned in August, a power surge permanently destroyed the hard drive where the receivables file was stored, and the cash receipts journals could not be found. When the new regional agency managers took over the tax assessment, they noticed that the total of delinquent taxes disclosed in the audited financial statements was much larger than the total turned over to the region's legal counsel for collection and foreclosure.

AUDIT APPROACH ANALYSIS

Audit Objective: The auditors' objective is to obtain evidence determining if the receivables for taxes (delinquent taxes) represent genuine claims collectible from the taxpayers.

Controls Relevant in the Municipal Tax Revenue Process: The municipal system for establishing the initial amounts of taxes receivable was fine. Professional staff appraisers and the independent appraisal review board established the tax base for each property, and the municipal council set the price (tax rate). The computer system authorization for billing was validated on these two inputs.

The cash receipts system was well designed, calling for preparation of a daily cash receipts

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report (cash receipts journal that served as a source input for computer entry). This report was always reviewed by the "boss," Shelstad.

Unfortunately, Shelstad had the opportunity and power to override the controls and become both cash handler and supervisor. He made the decisions about sending delinquent taxes to the region's legal counsel for collection, but the ones he knew to have been paid but stolen were withheld.

Required:

Describe in detail the audit procedures you would perform in this case. Consider tests of control, and substantive tests such as dual-purpose tests of transactions and/or tests of details of balance. In particular, identify the information that could have been obtained from confirmations directed to the real population of delinquent accounts receivable (i.e., including the ones that had been stolen by Shelstad). Which tests do you consider likely to detect Shelstad's theft? Why?

DC 11-12 Audit of Revenue with Accounting for Different Components. LO1, LO3, LO4

It is Monday, September 13, 2010. You, a PA, work at Fife & Richardson LLP, a PA firm. Ken Simpson, one of the partners, approaches you mid-morning regarding Brennan & Sons Limited (BSL), a private company client for which you performed the August 31, 20X9, year-end audit.

"It seems there have been substantial changes at BSL this year," Ken explains. "I'm going there tomorrow, and since you will be on the audit again this year, it would be beneficial for you to come. I took the liberty of retrieving information from last year's files so you can refresh your memory about this client (Exhibit DC11-12-1)."

The next day, you and Ken meet with Jack Wright, the accounting manager at BSL. Jack gives you the internally prepared financial statements (Exhibits DC11-12-2 and DC11-12-3). To your surprise, there are also financial statements for two new companies. Jack quickly explains that BSL incorporated two subsidiaries in January 20X0, each with the same year-end as BSL:

Brennan Transport Ltd. (Transport) – 100% owned by BSL

Brennan Fuel Tank Installations Inc. (Tanks) – 75% owned by BSL

EXHIBIT DC11-12-1 Excerpt from Permanent File

Date of incorporation:	October 27, 1982	
Year end:	August 31	
Ownership:	50 common shares	Harold Thomas
	50 common shares	Kyle Stanton

EXHIBIT DC11-12-2 Internal Financial Statements—Balance Sheets

BRENNAN & SONS LIMITED BALANCE SHEET
AS AT AUGUST 31
(IN THOUSANDS OF DOLLARS)

	2009	2010		
	(audited)	(unaudited)		
	BSL	BSL	Transport	Tanks
Assets				
Cash	$ 467	$ 75	$ 67	$ 82
Accounts receivable	970	603	119	–
Inventory	10	500	–	15
	1,447	1,178	186	97
Note receivable	–	431 (note 1)	–	–
Property, plant, & equipment	4,768	13,400	400	80
Investment in subsidiaries	–	2	–	–
Intangible asset	–	–	–	20 (note 2)
	$6,215	$15,011	$586	$197
Liabilities				
Accounts payable	$ 315	$ 813	$128	$166
Note payable	–	–	431 (note 1)	–
Mortgage payable	100	6,500	–	–
	415	7,313	559	166
Shareholders' Equity				
Common stock	1	1	1	1 (note 3)
Retained earnings	5,799	7,697	26	30
	5,800	7,698	27	31
	$6,215	$15,011	$586	$197

Notes:
1. Note receivable/payable for sale of trucks and trailers from BSL to Transport, interest at 8%
2. Training costs for Sean Piper, owner/installer
3. Includes Sean's equity interest

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You diligently take notes during the meeting (Exhibit DC11-12-4). Jack states that BSL will prepare consolidated financial statements for audit based on Canadian Generally Accepted Accounting Principles (GAAP) to satisfy the bank's request.

Ken asks that you work on the overall planning for these engagements. As part of your planning, he asks you to discuss the new accounting issues that arise as a result of the changes during the year, and to evaluate their implications for the engagements.

Nature of the business: BSL operates as a scrap metal dealer and processor. It buys used scrap metal from individuals and businesses, then bundles the different metals and sells them in larger quantities at a higher price to bigger recycling businesses. BSL's revenue fluctuates significantly because of the volatility in the market rates for steel and non ferrous metals. To help control costs, BSL uses its own trucks and trailers to do the pickups. BSL earns additional revenue by providing transportation services to other businesses and by renting out the trucks during slower periods.

As part of BSL's overall strategy, the owners admit a willingness to take risks. They monitor the marketplace and are always on the lookout for new business opportunities. They even found a piece of land on the outskirts of the city that they thought would be great for a dump they considered operating themselves. They decided not to make an offer, but may reconsider in 2010.

For BSL's 2009 audit, materiality was set at $70,000.

Required:

Prepare a memo to the audit engagement partner discussing the planning for the BSL audit engagement. Your memo should discuss planning considerations for the audit of the consolidated financial statements, the risk assessments, and materiality decisions for the overall audit strategy. As part of your planning, discuss the new revenue accounting issues that arise as a result of the changes during the year and evaluate their implications for the engagement. [Assume that BSL will use ASPE as its financial reporting framework. Given the timing of the case, ASPE can be adopted, and it will meet the bank's requirement for "Canadian GAAP".]

(CICA 2010, adapted.)

EXHIBIT DC11-12-3 **Internal Financial Statements—Income Statements**

BRENNAN & SONS LIMITED
INCOME STATEMENT
FOR THE YEAR ENDED AUGUST 31,
(IN THOUSANDS OF DOLLARS)

	2009 (audited)	2010 (unaudited)		
	BSL (12 months)	BSL (12 months)	Transport (8 months)	Tanks (8 months)
Revenue				
Scrap metal	$11,000	$10,003	$ –	$ –
Transportation services	900	300 (note 4)	700 (note 4)	–
Fuel tank installations	–	–	–	320
	11,900	10,303	700	320
Cost of sales				
Scrap metal	1,600	1,440	–	–
Transportation services	700	340	550	–
Fuel tank installations	–	–	–	220
Gross margin	9,600	8,523	150	100
General & administration (note 5)	8,491	7,930	90	50
Interest expense	9	120	16	–
Income before other income	1,100	473	44	50
Other income				
Gain on sale of equipment	–	84	–	–
Gain on sale of property	–	2,500	–	–
Interest income	–	16	–	–
Property rental	–	90 (note 6)	–	–
Income before income tax	1,100	3,163	44	50
Income tax	440	1,265	18	20
Net income	$ 660	$ 1,898	$26	$30

Notes:

4. Transport took over transportation services in January
5. 20X0 General & administration includes amortization
6. $10,000 per month from Transport and $5,000 per month from Tanks for six months

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EXHIBIT DC11-12-4 Notes from Your Meeting with Jack Wright

BSL continues to operate the scrap metal business. BSL's management thinks the price of metal is going to go up in the near future, and has therefore started stockpiling for the first time. Unfortunately, BSL does not really have an inventory tracking system in place. If, in fact, it turns out that stockpiling is a good way for BSL to make money, it will install a better system. The company did its best to log each of the amounts going into the stockpile as it was added, knowing that an amount for its year-end inventory balance would need to be determined. BSL also used a known engineering formula to come up with an estimate for year-end inventory and tried to measure the different piles of metal as a way of counting what was on hand at August 31, 2010. The different methods came up with different amounts, so management went with the initial amount based on the log. Jack noted that we would have had a good laugh at the different ways they tried to measure the piles if we'd been there to see it.

As soon as it was incorporated on January 1, 2010, Transport took over BSL's transportation operations. Transport provides transportation services to BSL and external customers, the same as BSL did. BSL sold the trucks to Transport in late January at fair market value. However, Transport didn't have the funds to buy the equipment, so BSL issued a note receivable at what Jack believed to be the market interest rate.

Tanks installs and maintains pre-engineered, above-ground fuel storage tank systems, a new line of business for BSL. Sean Piper, a good friend of one of BSL's owners, approached BSL last fall with the idea. Sean was willing to take the necessary training to become a certified fuel tank installer, and he wanted 50% ownership in Tanks. The owners of BSL agreed it was a great opportunity but wanted more control. The parties settled on Sean's receiving 25% ownership of Tanks.

As part of the agreement, BSL was required to provide a guarantee pertaining to Tanks' licensing application to the environmental authority, since Tanks was a newly formed corporation. Although other vendors sell the same tanks and installation services separately, Tanks only sells the tank combined with installation and service. The tank is marked up by 20% on the price paid and is sold including installation and a five-year maintenance package for a total of $40,000. One hundred percent of the revenue is recognized when the sales agreement is signed by the customer. The tank is then delivered and installed at the customer's site within two to three weeks of signing. The fuel tanks need to be pressure-tested every year, and the measurement gauge needs to be checked. Tanks will perform the maintenance services for customers for the first five years. Thereafter, Tanks will offer to continue to perform the maintenance for a contract price of $5000 a year.

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APPENDIX 11A
Internal Control Questionnaires

Exhibit 11A-1 provides an example of the type form that could be used to guide the auditor's assessment of the effectiveness of application controls in the two main classes of transactions and the main account balance in the revenues/receivables/receipts process. Note that in practice, forms like this can provide only a general starting point, and the actual audit work must always be tailored to the specifics of each engagement.

Exhibit 11A–2 provides few examples of the types of controls one expects to find in a typical system, such as the one illustrated in Exhibit 11-1 of the chapter.

EXHIBIT 11A–1 Internal Control Questionnaires Revenues, Receivables, and Receipts Process

INTERNAL CONTROL QUESTIONNAIRE FOR REVENUES, RECEIVABLES, AND RECEIPTS PROCESS AUDITEE: ______________________ F/S PERIOD: ______________________	Auditor Responses	Audit File References
OVERALL COMPANY-LEVEL CONTROL AND GENERAL CONTROL ACTIVITIES ASSESSMENT		
(Refer to responses recorded for questions in Exhibit 9A–1 in Appendix 9A) Are company-level and general control activities adequate as they apply to the revenues, receivables, and receipts components of the information system? • Consider the impact of any weakness in company-level and general control activities on planned audit approach and procedures. • Assess the potential for weaknesses to result in a material misstatement of the financial information generated from this accounting cycle. If a significant risk of misstatement is assessed, perform procedures to determine extent of any misstatement. Consider adequacy of the following general controls in place in the revenue, receivables, and receipts process to: — Prevent unauthorized access or changes to programs and data — Ensure the security and privacy of data — Control and maintain key systems — Protect assets susceptible to misappropriation — Ensure completeness, accuracy, and authorization of data and processing — Ensure that adequate management trails exist		
APPLICATION CONTROL ASSESSMENTS CASH RECEIPTS TRANSACTIONS APPLICATION CONTROLS **Environment and general control relevant to this application:** 1. Are receipts deposited daily, intact, and without delay? 2. Does someone other than the cashier or accounts receivable bookkeeper take the deposits to the bank? 3. Are the duties of the cashier entirely separate from recordkeeping for notes and accounts receivable? from general ledger recordkeeping? Is the cashier denied access to receivables records or monthly statements? 4. Are employees with access to cash covered by fidelity insurance against embezzlement losses (also called “fidelity bonding” of employees)? **Application Control Assessment:** **Validity objective:** 5. Is a bank reconciliation performed monthly by someone who does not have cash custody or record-keeping responsibility? 6. Are the cash receipts journal entries compared with the remittance lists and deposit slips regularly? **Completeness objective:** 7. Does the person who opens the mail make a list of cash received (a remittance list)? 8. Are currency receipts controlled by mechanical devices? Are machine totals checked by the internal auditor? 9. Are prenumbered sales invoice or receipts books used? Is the numerical sequence checked for missing documents?		

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EXHIBIT 11A–1 Continued

Authorization objective: 10. Does a responsible person approve discounts taken by customers on their payments on account? **Accuracy objective:** 11. Is a regular (e.g., monthly) bank reconciliation performed by the internal auditor or someone other than the employee making the deposits? 12. Is the remittance list compared with the deposit by someone other than the cashier? **Classification objective:** 13. Does the accounting manual contain instructions for classifying cash receipts credits? **Accounting objective:** 14. Does someone reconcile the accounts receivable subsidiary to the control account regularly (to determine whether all entries were made to customers' accounts)? **Proper period objective:** 15. Does the accounting manual contain instructions for dating cash receipts entries the same day as the date of receipt?		
SALES TRANSACTIONS APPLICATION CONTROLS **Environment and general control evaluation relevant to this application:** 1. Is the credit department independent of the marketing department? 2. Are non-routine sales controlled by the same procedures described below? For example, sales to employees, COD sales, disposals of property, cash sales, and scrap sales. **Application Control Assessments:** Consider whether the auditee has appropriate policies and procedures in place to meet the following control objectives: **Validity objective:** 3. Is access to the sales invoicing process restricted to appropriate personnel? 4. Are prenumbered bills of lading or other shipping documents produced and completed in the shipping department? **Completeness objective:** 5. Are sales invoices prenumbered? 6. Is the sequence checked for missing invoices? 7. Is the shipping document numerical sequence checked for missing bills of lading numbers? **Authorization objective:** 8. Are all credit sales approved by the credit department prior to shipment? 9. Are sales prices and terms based on approved pricing lists and credit policies? 10. Are returned sales credits and other credits supported by documentation as to receipt, condition, and quantity, and approved by a responsible officer? **Accuracy objective:** 11. Are shipped quantities compared with invoice quantities? 12. Are sales invoices checked for error in quantities, prices, extensions and totals, freight allowances, and against customers' orders? 13. Is there an overall check on arithmetic accuracy of period sales data by a statistical or product-line analysis? 14. Are periodic sales data reported directly to general ledger accounting independent of accounts receivable accounting? **Classification objective:** 15. Does the accounting manual contain instructions for classifying sales and are employees following these instructions? **Accounting objective:** 16. Are summary journal entries approved before posting? **Proper period objective:** 17. Does the accounting manual contain instructions to date sales invoices on the shipment date, and are employees following these instructions?		
ACCOUNTS RECEIVABLE BALANCE APPLICATION CONTROLS **Environment and general controls relevant to this application:** 1. Are customers' subsidiary records maintained by someone who has no access to cash? 2. Is the cashier denied access to the customers' records and monthly statements? 3. Are delinquent accounts listed periodically for review by someone other than the credit manager? 4. Are written-off accounts kept in a memo ledger or credit report file for periodic access? 5. Is the credit department separated from the sales department? 6. Are notes receivable in the custody of someone other than the cashier or accounts receivable record-keeper? 7. Is custody of negotiable collateral in the hands of someone not responsible for handling cash or keeping records? **Application Control Assessments**: Consider whether the auditee has appropriate policies and procedures in place to meet the following control objectives:		

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EXHIBIT 11A–1 Continued

Validity objective: 8. Are customers' statements sent to them regularly (e.g., monthly) by the accounts receivable department? 9. Are direct confirmations of accounts and notes obtained periodically by the internal auditor? 10. Are differences reported by customers routed to someone outside the accounts receivable department for investigation? 11. Are returned goods checked against receiving reports? **Completeness objective:** (Refer to completeness questions in the sales and cash receipts questionnaires.) 12. Are credit memo documents prenumbered and the sequence checked for missing documents? **Authorization objective:** 13. Is customer credit approved before orders are shipped? 14. Are write-offs, returns, and discounts allowed after discount date subject to approval by a responsible officer? 15. Are large loans or advances to related parties approved by the directors? **Accuracy objective:** 16. Do the internal auditors confirm customer accounts periodically to determine accuracy? **Classification objective:** 17. Are receivables from officers, directors, and affiliates identified separately in the accounts receivable records? **Accounting objective:** 18. Does someone reconcile the accounts receivable subsidiary to the control account regularly? Proper period objective: (Refer to proper period objective questions in the sales and cash receipts questionnaires.)		
Auditor's conclusion on the effectiveness of application controls in the revenue/receipts/receivables process: ____________________ ____________________	Prepared by _______ _______	Date _______

EXHIBIT 11A–2 Examples of Controls in a Revenues, Receivables, and Receipts Process, Relating to Exhibit 11–1

- Each system terminal allows access only to designated functions. For example, the terminal at the shipping dock cannot be used to enter initial sales information or to access the payroll database.
- An identification number and password (issued on an individual-person basis) are required to enter the sales and each command that a subsequent action has been completed. Unauthorized entry attempts are logged and immediately investigated. Further, certain passwords have "read only" (cannot change any data) authorization. For example, the credit manager can determine the outstanding balance of any account or view online "reports" summarizing overdue accounts receivable, but cannot enter credit memos to change the balances.
- All input information is immediately logged to provide restart processing should any terminal become inoperative during the processing.
- A transaction code calls up on the terminals a full screen "form" that appears to the operator in the same format as the original paper documents. Each clerk must enter the information correctly or the computer will not accept the transaction. This is called **online input validation** and utilizes validation checks, such as missing data, check digit, and limit tests.
- All documents prepared by the computer are sequentially numbered, and the number is stored as part of the sales record in the accounts receivable database.
- A daily search of the pending order database is made by the computer system, and sales orders outstanding more than seven days are listed on a report accessible to marketing management.

online input validation: inputting information correctly or computer will not accept the transaction; uses validation checks, such as missing data, check digit, and limit tests

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APPENDIX 11B

System Documentation Examples for the Revenues, Receivables, and Receipts Process

This appendix provides examples of systems documentation prepared using flowchart and tabular diagram formats. These formats may be use in lieu of, or in addition to narrative descriptions. Exhibit 11B–1 diagrams an IT-based system for processing customer sales orders and accounts receivable. Exhibit 11B–2 show a manual system of processing cash receipts, and Exhibit 11B–3 shows the same system using an input/process/output table as the documentation format. The narrative descriptions of these systems in the chapter correspond to the activities and records shown in these diagrams.

EXHIBIT 11B–1 Sales and Accounts Receivable Processing Flowchart Example: IT-Based System

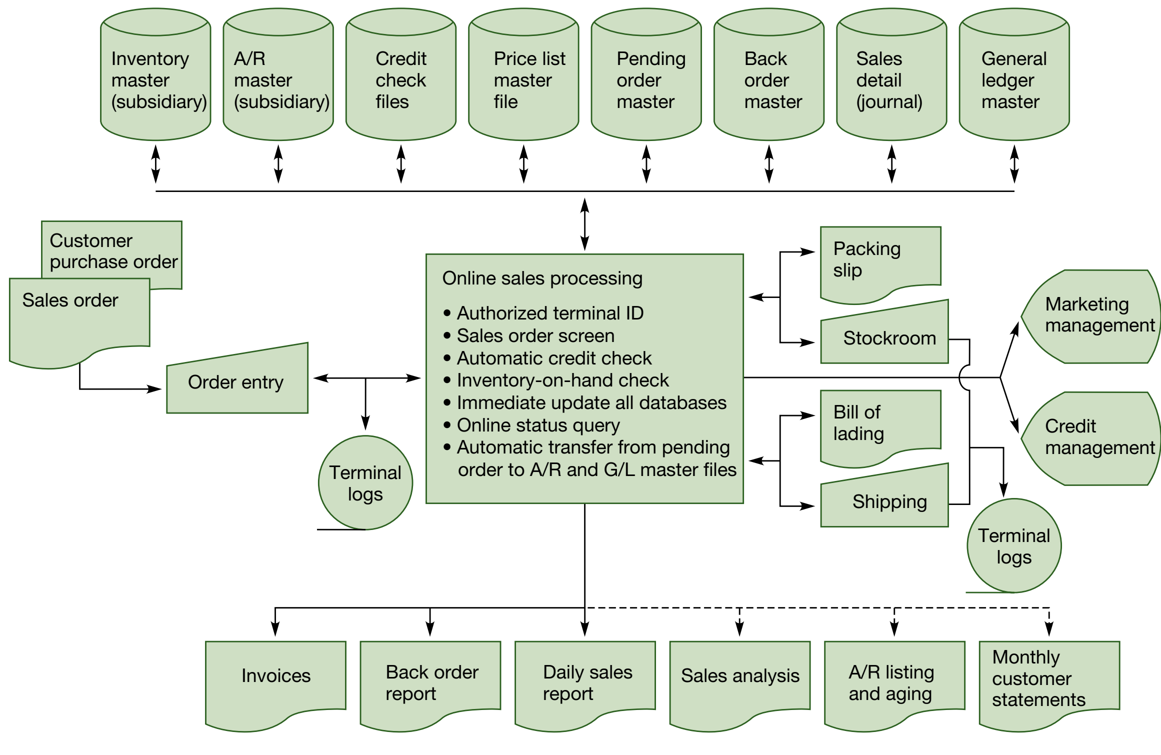

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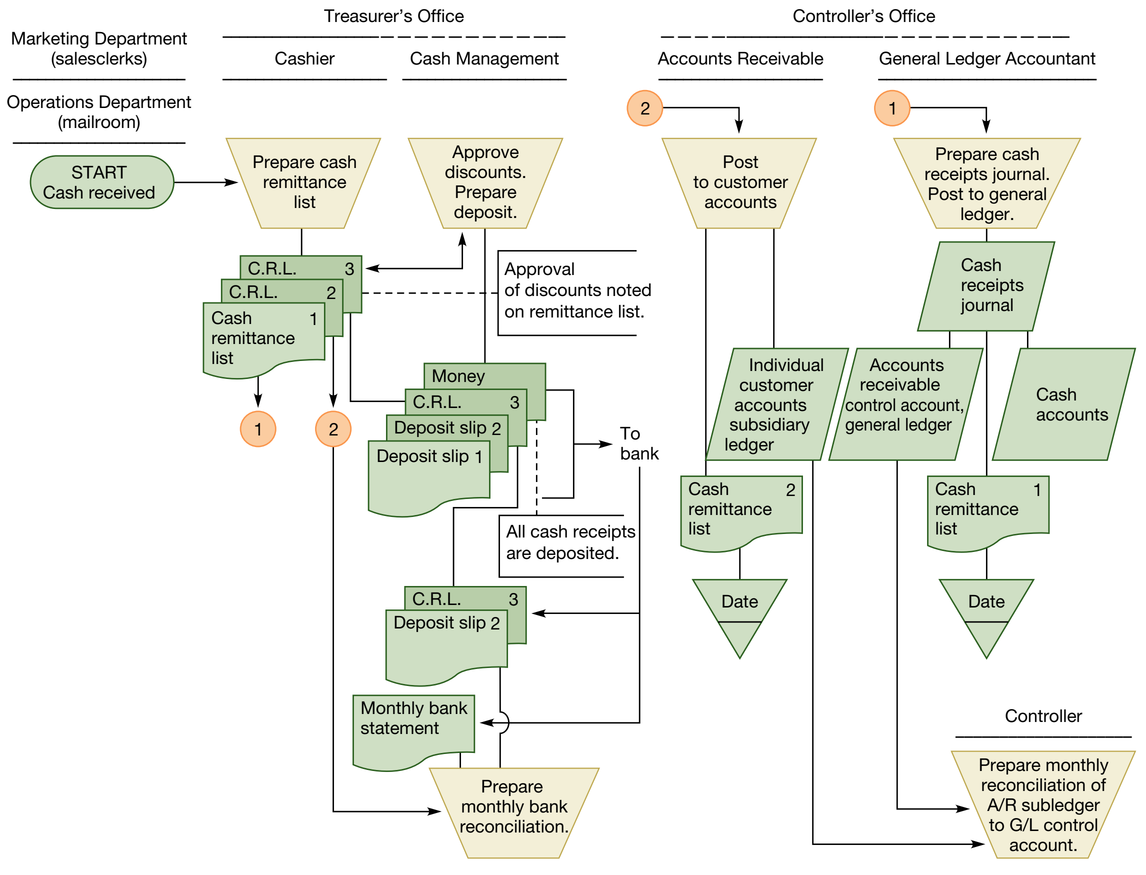
EXHIBIT 11B–2 **Cash Receipts Processing Flowchart Example: Manual System**



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Another systems documentation technique that can be used is an input/process/output table. As an example, the same cash receipts processing system shown in the flowchart in Exhibit 11B–2 is documented in an input/process/output table in Exhibit 11B-3.

EXHIBIT 11B–3 Cash Receipts Processing Input/Process/Output Table Example: Manual System

INPUT	ACTIVITY	PERFORMED BY	FREQUENCY	OUTPUT
Customer payment collected	List Cash receipts by customer and invoice #	Cashier	Daily	Cash remittance list
Cash remittance list	Approve any discounts taken	Cash Management	Daily	Approved Cash remittance list [3 copies]
Approved Cash remittance list [1]	Prepare deposit slip for bank	Cashier	Daily	Deposit slip
Bank deposit slip	Take cash and deposit slip to bank	Cash management	Daily	Bank-stamped deposit slip
Approved Cash remittance list [2]	Post to customer accounts	Account receivable clerk	Daily	Accounts receivable subledger update
Approved Cash remittance list [3]	Post to Cash receipts journal	General ledger accountant	Daily	Accounts receivable subledger update
Accounts receivable subledger update	Post total cash receipts to General ledger A/R control account	General ledger accountant	Daily	General ledger update
Accounts receivable reconciliation	Agree total A/R subledger balance to balance of A/R control account in G/L	Controller	Monthly	Reconciliation summary with documented support for all reconciling items
Bank reconciliation	Reconcile Cash balance per G/L to balance per bank statement	Cash management	Monthly	Reconciliation summary with documented support for all reconciling items

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CHAPTER 12

The Purchases, Payables, and Payments Process

This chapter summarizes the accounting cycle for business processes related to the acquisition of goods (inventory) and services (expenses); the acquisition of property, plant, and equipment (fixed assets); and the expenditure of cash (cash disbursements) to pay for purchases and acquisitions, as well as the related audit procedures. The chapter provides special notes on inventory observation, accounts payable completeness, and auditing property, plant, and equipment and intangible assets. An application case and analysis is given at the end of the chapter to demonstrate the performance of audit procedures in situations where errors or frauds might be discovered in the purchases, payables, and payments process.

EcoPak Inc.

EcoPak will perform a physical count of their inventory on December 31 to coincide with their year-end date. The count will take from 4 p.m. till approximately 11 p.m. This is a crucial, time-sensitive opportunity to collect audit evidence, so Donna takes the following steps to make sure it is done well. First, she discusses the inventory with various people at EcoPak to identify inventory risk factors and internal controls, including cutoff procedures. Next, she calls Nima and obtains EcoPak's inventory count instructions and its procedures for tying the count information into the accounting records to prepare the financial statements. She then develops a plan for M&G to attend the company's inventory count to observe the execution of the count, and to perform the necessary audit procedures, such as performing test counts. She also plans follow-up procedures that will allow the audit team to tie the count information into the final inventory listing that supports the valuation in the financial statements,

LEARNING OBJECTIVES

After completing this chapter, you will be able to do the following:

LO1 Describe the purchases, payables, and payments process, including typical risks, transactions, account balances, source documents, and controls.

LO2 Describe the auditor's control risk assessment and control tests for auditing control over the purchase of inventory, services, and fixed assets, and for the disbursement of cash.

LO3 Describe the typical substantive procedures used to respond to the assessed risk of material misstatement in the main account balance and transactions in the purchases, payables, and payments process.

LO4 Explain the importance of the completeness assertion for auditing the accounts payable liabilities, and the procedures used to search for unrecorded liabilities.

LO5 Identify audit considerations for observing the physical inventory count.

LO6 Explain the main auditing procedures used for property, plant, and equipment and intangible assets.

CHAPTER APPENDIX

Appendix 12A: Internal Control Questionnaires

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to allow them to reach a conclusion on whether it is fairly presented. Since it is M&G's first year auditing EcoPak, they assessed the inherent risks in inventory as high and decided to go with a totally substantive approach rather than testing controls. They will reconsider this approach for next year's audit, based on their greater experience with the company's inventory processes.

Donna notes some other key information about the count. The main raw materials items to count are processed biomass fibre, binding solutions, coatings, and ink. These will all be measured by volume, based on engineering specifications. There will also be a stock of finished products prepared for shipments in early January to fill outstanding orders. There are also quantities of a variety of products on hand for samples, prototypes, or for any urgent unplanned orders that might arise.

Donna was happy to hear EcoPak plans to complete all production and shut down the production lines on December 28 to allow for quarterly maintenance and cleaning of the equipment. This also will make the count easier, as there will be no work in progress (WIP) or movements of raw materials and finished goods. Experienced production workers will be performing the count under Mike's supervision. During the count, the workers will also count the supplies and moulds used in the production process, which are carried as separate inventory categories, and the plant and equipment, which are capitalized. Once the count has been completed, Nima will review the count information for completeness and any outstanding issues that will need to be addressed before the workers leave for the holidays. The plant and offices will be closed till January 3.

Donna has decided that Caleb will attend the EcoPak count to perform the required audit procedures. Even though he has never observed a count before, Donna feels confident that he understands what the audit team needs to achieve by observing the physical inventory and by doing the audit tests counts and other procedures at EcoPak's year-end. So, she has no hesitation in assigning Caleb to do the count on his own.

Donna also asks Caleb to get information for cutoff testing while he is at the count: last cheques issued and last deposits for cash, last shipments for the sales and accounts receivable, and last inventory receipts for the inventory and payables. And since this is a new audit, Caleb also should ask the factory manager to show him the various machines and equipment items that are listed in the plant equipment schedule.

Caleb is a bit nervous about attending the count on his own, but he realizes that the most important objective is for a person independent of EcoPak to be making observations, performing test counts, and inspecting the assets and related documents. He has seen EcoPak's operations and had a tour of the factory during their interim visits, so he feels he has a good knowledge of what he will need to do at the count. "So as long as I keep good notes of everything and follow the program, it should all be fine," he thinks to himself. Also, Donna has arranged to be available by cell phone in case he has any questions. Donna will not be going to the EcoPak count as she has been assigned to an inventory observation at another client that day, Jetstream Inc., a large jet turbine manufacturer, where she will need to supervise two assistants. Jetstream is a much more complex audit due to the high value and complicated technical design of its inventory, a large balance of WIP in various stages of completion, and very complex accounting processes. Also, Jetstream is a public company with some financial challenges, so that makes the engagement a lot riskier than EcoPak. Caleb realizes Donna will have a lot of challenges of her own on December 31! And as it turns out, Caleb is in for quite a complex learning experience himself, as he gets quite a surprise just as he is finishing up his day at the count.

When Caleb arrives at the count, the workers are receiving their instructions from Nima, and during the afternoon he observes them following these quite closely. He is provided with the schedules of plant equipment as well as copies of the count sheets the workers are now completing for the raw material, finished goods, and supplies counts. Caleb decides to do the cutoff work first and then turn to the test counts. While he was out on the loading dock noting the last receiving reports numbers for the last materials received, he notes a shipment of 10 crates of ink that the shipper/receiver, Karl, had signed for at 3:55 p.m., but that had no receiving report issued. Caleb goes and finds Karl, who explains that this order arrived just as he was going off to help with the count, so he was going to leave off entering that till after the holiday. Caleb points out that since the inventory is physically on hand, it should be counted and the paper work showing it was received should be processed into the accounts payable system. "Yes, I see your point. We are planning to add these items to our count, so I guess we need to set up the amount payable, too." Karl agrees, logs in to the system, and issues the appropriate document, Receiving Report #24-0909, and Caleb records this as the last receipt of

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inventory. "The gates are locked now, so even if another truck arrives they won't be able to drop anything off. That really will be the last of it for this year!" he tells Caleb.

As he is getting set to leave the dock, Caleb notices a small shipment of finished product sitting on the loading dock with shipping document #14-1546, dated December 30, for pickup by Kingston Transport attached. When he asks Karl about it, Karl takes a look at the document and says, "Looks like the truck didn't make it in to pick this up last night. Now the gates are closed, so that means this will the first shipment of next year—I'd better make sure accounting knows." So Caleb notes that #14-1545 was the last shipment, and #14-1546 should be the first of next year.

At this point, Mike comes looking for Caleb to tell him the production engineer is about to complete the measuring of the main vats of processing fibres. "Since that's most of our inventory, I thought it was something you would want to observe for sure!" Caleb heads on down to the storage vats area with Mike. On the way, he notices an unlocked room full of spare moulds with three workers busy counting them. Mike explains, "The moulds are really expensive and if one breaks it shuts down the line till we can replace it. So, we keep a good supply of spares in the locked storage. You will probably want to take some tests in there too, after we finish in the vat room. Quite a few bucks are tied up in there."

UNDERSTANDING THE PURCHASES, PAYABLES, AND PAYMENTS PROCESS

LO1 Describe the purchases, payables, and payments process, including typical risks, transactions, account balances, source documents, and controls.

Purchases of goods and services are a major part of cash outflow in most organizations. For this reason, they will be subject to a fairly high level of management planning and control. Purchases may result in the organization's acquiring assets; for example, inventory, fixed assets (such as property, plant, and equipment—"PPE"), or intangibles (copyrights and customer lists). Some purchases of goods, such as supplies, are expensed, and purchases of services are mainly expensed. Costs of purchasing goods and services may be deferred in some cases, if they relate to producing inventory (see Chapter 13) or internally developed assets, such as buildings and new products (deferred development costs).

Risk Assessment for Purchases, Payables, and Payments

To assess risks in the purchasing-related processes, the auditor focuses on purchasing and cash payment transaction streams and accounts payable balances. Important disclosures relating to purchases include asset capitalization and valuation policies, inventory cost flow assumption policies, contractual commitments, and related-party transactions. The auditors' understanding of the auditee's business and environment will point to specific business risks and the related financial misstatement risks that can arise from the auditee's purchasing, payables, and payments activities. Some examples of the risks at the assertion level are as follows.

Existence risks could involve inventory being overstated due to double counting or other errors in the year-end physical inventory count. Purchased assets may include improper capitalization of costs to increase reported profits (e.g., WorldCom). Improper cutoff can lead to overstating inventory on hand at period-end if shipments received after period-end are included.

Ownership risks can include inventory held on consignment being recorded as the company's own inventory, in error. In an owner-managed business, some personal expenses of the owner may be run through the company to avoid income taxes.

Completeness risks relate mainly to the possibility of unrecorded liabilities. Goods or services received but not yet paid for at year-end may not have been accrued. Provisions for future costs, such as warranties, may be missing or understated. Improper cutoff can also lead to incomplete recording of liabilities if purchased goods that are still in transit are not accounted for at period-end.

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Valuation risks can exist when purchases are denominated in foreign currency; if inventory or property values decline because of market conditions, obsolescence, or improper storage; or if intangible assets are improperly valued. Frauds relating to purchases and payables can arise from collusion between suppliers and employees to overstate purchase transactions payments, for example, via kickback schemes.

Presentation and disclosure risks include not properly presenting separate categories of inventory, PPE, or intangible assets; inadequate capitalization policy notes; and failure to disclose contractual commitments to make future purchases at fixed prices.

As you start to consider assertion-based risks more carefully, you will note that sometimes the same error or problem can affect more than one assertion. For example, if inventory held on consignment is included in the company's own inventory balance, this error affects both the existence and ownership assertions. The great value of the assertions concept to auditors is that it provides a wide net for catching all kinds of different things that could have gone wrong in a particular auditee's business to result in material misstatements in its financial statements.

This chapter outlines simple examples of processes for purchasing services, inventory, and fixed assets, as well as the related accounting cycle and control activities. The main risk in these processes is incomplete recognition of expenses and liabilities. Control tests in the purchasing processes and physical inspection of inventory and fixed assets address existence, completeness, and valuation assertions, and some substantive evidence for completeness is obtained from examining payments subsequent to year-end. It may be necessary to further inspect documents and use confirmations for more evidence in assessing the ownership assertion.

Purchases, Payables, and Payments Process: Typical Activities

Exhibit 12–1 presents a picture-style, skeleton overview of the typical activities and transactions involved in the purchases, payables, and payments process, and it also lists the accounts and records typically involved. The basic activities are (1) requesting purchases of goods and services, (2) receiving them, (3) recording costs and liabilities, and (4) paying the bills. The exhibit tracks the elements of the control structure described in the following sections. Further examples of controls related to the illustrated process are provided in Appendix 12A, Exhibit 12A–2.

The purchasing, payables, and payments process involves meeting various departments' identified requirements for goods and services, issuing purchase orders to suppliers, receiving the goods and services, and taking custody of goods received. Accounts payable to suppliers are recorded once the goods have been received or the services have been used, usually at the time the supplier invoice is received. The payables are recorded in a subledger by supplier name and in a control account in the general ledger. Payments involve a cash disbursement to the supplier, which relieves the liability in both the supplier subledger and the general ledger control account. Frequently, suppliers provide monthly statements of the amount owing, and these are reconciled to the subledger balance to ensure the correct amounts are being paid.

The company's control system will feature important types of control activities, including employee procedures relating to keeping custody of assets and records, authorizing purchases and payments, properly recording transactions and events, and performing reconciling procedures to check the completeness and integrity of the records by comparison to other summaries, reports, or the actual assets themselves. These control activities are described in more detail below.

Authorization

Purchases are requested (requisitioned) by people who know the needs of the organization. A purchasing department finds the best prices and quality, and issues a purchase order. Obtaining competitive bids is a good practice because, by involving several suppliers, it

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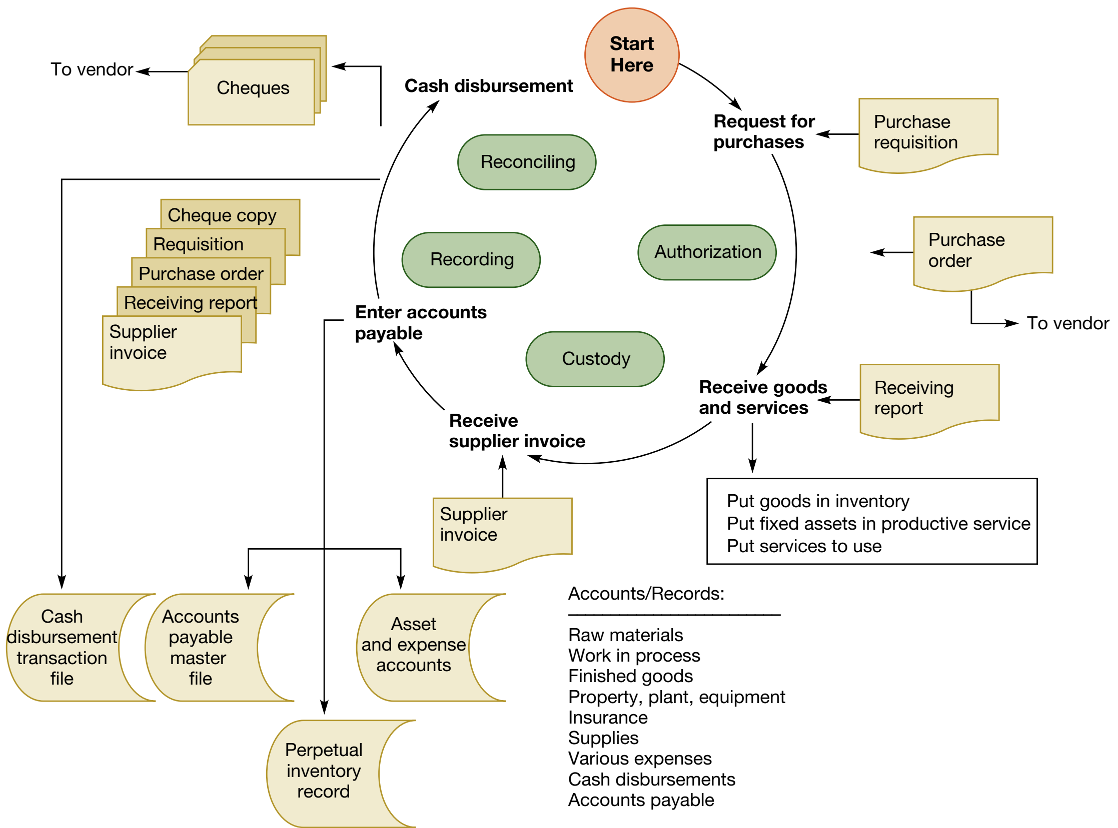
EXHIBIT 12–1 Purchases, Payables, and Payments Process: Overview Diagram of Typical Activities



tends to produce the best prices. It also reduces the risk of frauds involving collusion between suppliers and purchasing department employees, such as inflating purchases to increase sales commissions to the supplier, who then kicks back some of these commissions to the purchasing employee.

Cash disbursements are authorized by an accounts payable department matching purchase orders, supplier invoices, and internal receiving reports to show a valid obligation to pay. Accounts payable obligations usually are recorded when the purchaser receives the goods or services ordered. Cheques are signed by an authorized person. Companies may have a policy requiring two signatures on cheques over a certain amount. Also, a company may have electronic funds transfer (ETF) arrangements with some suppliers that allow it to transfer money directly from its own bank account to the supplier's account. Invoices should be marked "paid" or otherwise stamped to show that they have been processed completely, so that they will not be paid a second time (which would be an existence assertion error).

Custody

The receiving department is responsible for inspecting received goods for quantity and quality (producing a receiving report) and passing them on (i.e., to inventory warehousing, fixed asset installation). Services are accepted by the people responsible for them. Cash custody belongs to those authorized to sign cheques or transfer funds.

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Blank documents—such as purchase orders, receiving reports, and blank cheques—or access to a computerized purchase authorization program, are also custody issues. If unauthorized persons can access these or has authorization involving them, they can forge a purchase order to a fictitious supplier, forge a receiving report, send a false invoice from a fictitious supplier, and then prepare a company cheque in payment, which is embezzlement.

Recording

When the purchase order, supplier's invoice, and receiving report are matched, accountants enter the accounts payable with (1) debits to proper inventory, fixed asset, and expense accounts and (2) a credit to accounts payable. When cheques are prepared, entries are made to debit accounts payable and credit cash.

Periodic Reconciliation

A periodic reconciliation of existing assets to recorded amounts is not shown in Exhibit 12–1, but it occurs when (1) a physical inventory count compares inventory on hand with perpetual inventory records, (2) a bank account reconciliation compares book cash balances with bank cash balances, (3) an inspection compares fixed assets with detail fixed asset records, (4) preparation of an accounts payable trial balance compares the detail of accounts payable with the control account in the general ledger, and (5) accounts payable personnel compare suppliers' reports and monthly statements with recorded liabilities.

TOO MUCH TROUBLE

A trucking company self-insured claims of damage to goods in transit, processed claims reports, and paid customers from its own bank accounts. Several persons were authorized to sign cheques. One person thought it "too much trouble" to stamp the claims reports as PAID and said, "That's textbook stuff anyway." Numerous claims were recycled to other cheque signers, and $80,000 in claims was paid in duplicate before the problem was discovered.

REVIEW CHECKPOINTS

12-1 What is a purchase requisition?

12-2 What assertion is affected if duplicate payments are made from the same supporting documents? How can this type of error be prevented?

Audit Evidence in Management Reports

Computer processing of purchasing and payment transactions makes it possible for management to generate reports for control purposes, but they also can provide important audit evidence. Exhibit 12–2 shows how they might do this, and it is discussed in the following section.

Open Purchase Orders

Held in an open purchase order file, purchase orders are open from the time they are issued until the goods and services are received. Generally, no liability exists until the transactions are complete. However, auditors may find evidence of losses on purchase commitments in this file if market prices have fallen below the purchase order price.

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EXHIBIT 12–2 Management Control Reports Useful for Audit Evidence

MANAGEMENT REPORT	CONTROL PURPOSE	POTENTIAL AUDIT EVIDENCE
Open purchase orders	Completeness of accounts payable	Purchase commitments, valuation of inventory
Unmatched receiving reports	Validity of purchases recorded	Unaccrued liabilities for purchases
Unmatched supplier invoices	Validity of purchases recorded	Unaccrued liabilities for purchases
Accounts payable trial balance	Proper accounting cash flow management	Existence and completeness of payables
Purchases journal	Completeness and validity of inventory, purchases, and expenses	Analysis of inventory changes and expense reasonability
Inventory reports	Completeness, validity, and valuation of inventory	Analysis of inventory balances, valuation, selection of samples for test counts, and valuation tests
Fixed asset reports	Completeness, validity, and valuation of fixed assets, accumulated depreciation, and depreciation expense	Analysis of changes in fixed asset balances, selection of sample additions for vouching, and recalculation of depreciation expense
Cash disbursements report	Expenditure reviews by management for validity, authorization	Selection of sample for testing existence, authorization, and proper cutoff of payments

Unmatched Receiving Reports

Normally, liabilities should be recorded on the date the goods and services are received and accepted. Sometimes, however, supplier invoices arrive later and the accounts payable department holds the receiving reports, unmatched with invoices, until the information for recording an accounting entry arrives. Auditors can inspect the unmatched receiving report file to see if the company has material unrecorded liabilities on the financial statement date. The matching control procedures ensure purchases are valid as they verify the purchases are real and approved prior to processing the payment.

Unmatched Supplier Invoices

Supplier invoices may arrive in the accounts payable department before the receiving processing is complete. These invoices are held, unmatched with receiving reports, until there is information that the goods and services were actually received and accepted. Systems failures and human coding errors can cause unmatched invoices and receiving reports to sit around unnoticed when all the information is actually at hand. Auditors can inspect the unmatched invoice file and compare it with the unmatched receiving report file to determine whether liabilities are unrecorded.

Accounts Payable Trial Balance

This trial balance is a list of payable amounts by supplier, and the sum should agree with the accounts payable control account in the general ledger. (Some organizations record by individual invoices instead of by supplier names, so the trial balance is a list of unpaid invoices, which still should agree with the control account balance. This type of system is sometimes called an "open invoice system.") The ideal trial balance for audit purposes contains the names of all of an organization's suppliers, even if their balances are zero. The audit "search for unrecorded liabilities" should include the small and zero balances, especially for regular suppliers, because these may be the places where liabilities are unrecorded. Major suppliers will send regular statements of amounts outstanding. These statement amounts can be reconciled with accounts payable, and the details can be audited to detect any unrecorded liabilities. All paid and unpaid accounts payable should have supporting documents—purchase requisition (if any), purchase order (if any), supplier invoice, receiving report (if any), and cheque copy (or notation of cheque number, date, and amount), as shown in Exhibit 12–1. Similar records should be available for audit verification in a computerized accounts payable system.

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CLASSIFY THE DEBITS CORRECTLY

Invoices for expensive repairs were not clearly identified, so the accounts payable accountants entered the $125,000 as capitalized fixed assets instead of as repairs and maintenance expense. This initially understated expenses and overstated pretax income by $125,000 for one year, although the incorrectly capitalized expenses were written off as depreciation over the 10-year life of the assets. This spread the misstatement over many years, lowering its materiality.

THINKING AHEAD

Lone Moon Brewing purchased bulk aluminum sheets and manufactured its own cans. To ensure a source of raw materials, the company entered into a long-term purchase agreement for three million kilos of aluminum sheeting at 80 cents per kilo. At the end of this year, 1.5 million kilos have been purchased and used, but the market price had fallen to 64 cents per kilo. Lone Moon was on the hook for a $240,000 (1.5 million kilos × 16 cents) purchase commitment in excess of current market prices, so the auditors required management to disclose this commitment in the company's financial statements.

Purchases Journal

This listing of all purchases may exist only in a computer transaction file, not in print. In either event, it provides raw data for (1) computer-audit analysis of purchasing patterns, which may exhibit characteristics of errors or fraud, and (2) a sample selection of transactions for control tests of supporting documents for validity, authorization, accuracy, classification, accounting, and proper period recording. (A company may have already performed analyses of purchases, and auditors can use these for analytical evidence, provided the analyses are produced under reliable control conditions.)

Inventory Reports (Trial Balance)

A wide variety of inventory reports are useful for analytical evidence. An item-by-item trial balance should agree with a control account (if balances are kept in dollars). Auditors can use this trial balance (1) to scan for unusual conditions (e.g., negative item balances, overstocking, and valuation problems) and (2) as a population for sample selection for a physical inventory observation (audit procedures to obtain evidence about the existence of inventory included in the account). The scanning and sample selection may be computer-audit applications on a computerized inventory report file.

Fixed Asset Reports

These reports are similar to inventory reports because they show the details of fixed assets in control accounts, and they can be used for scanning and sample selection as well. A sample selection of fixed assets acquired can be verified against costs shown on purchase invoices. The information for depreciation calculation (cost, useful life, method, and salvage) can be audited by sampling, or a computer application could perform recalculations.

Cash Disbursements Report

The cash disbursements process produces a cash disbursements journal—sometimes printed, sometimes maintained only as a computer file. This journal should contain the date, cheque number, payee, amount, account debited for each cash disbursement, and a cross-reference to the supplier invoice number or other reason for the payment. A sample can be selected from the population of transactions in the cash disbursements journal for control tests of supporting documents for validity, authorization, accuracy, classification, accounting, and proper period recording of payments.

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THE SIGN OF THE CREDIT BALANCE

Auto Parts & Repair Inc. kept perpetual inventory records and fixed assets records on its computer system. Because of the size of the files (8000 parts in various locations and 1500 asset records), the company never printed reports for visual inspection. Auditors ran a computer audit "sign test" on inventory balances and fixed asset net book balances. The test called for a printed report for all balances less than zero. The auditors discovered 320 negative inventory balances caused by failure to record purchases and 125 negative net asset balances caused by depreciating assets more than their cost.

REVIEW CHECKPOINTS

12-3 Where could an auditor look to find evidence of losses on purchase commitments? on unrecorded liabilities to suppliers?

12-4 List the main supporting source documents used in a purchases, payables, and payments process.

12-5 List the management reports that can be used for audit evidence. What information in them can be useful to auditors?

CONTROL RISK ASSESSMENT

LO2 Describe the auditor's control risk assessment and control tests for auditing control over the purchase of inventory, services, and fixed assets, and for the disbursement of cash.

Control risk assessment is important because it governs the nature, timing, and extent of substantive audit procedures that will be applied in the audit of account balances in the purchases, payables, and payments process. These account balances include the following:

- Inventory
- Property, plant, and equipment (fixed assets), and intangible assets
- Depreciation and amortization expense
- Accumulated depreciation/amortization
- Accounts and notes payable
- Cash
- Expenses—administrative (supplies, legal fees, audit fees, taxes, insurance), selling (commissions, travel, delivery, advertising), manufacturing (maintenance, freight in, utilities), and so on.

General Control Considerations

Control procedures for proper segregation of responsibilities should be in place and operating. Exhibit 12–1 shows proper segregation to mean that people with authorization (requisitioning, purchase ordering) responsibilities do not have custody, recording, or reconciliation duties. Custody of inventory, fixed assets, and cash belongs with people who do not directly authorize purchases or cash payments, record the accounting entries, or reconcile physical assets and cash to recorded amounts. Recording (accounting) is done by people who do not authorize transactions, have custody of assets, or perform reconciliations. Periodic reconciliations are performed by people who do not have authorization, custody, or recording duties related to the same assets. Combinations of two or more of these responsibilities in a single person, office, or computer system may open the door for errors or frauds. An employee who has incompatible duties could make errors that go undetected, or even steal assets from the company and cover it up by making false accounting entries.

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PURCHASE ORDER SPLITTING

A school board's purchasing agent had authority to buy supplies in amounts of $1000 or less without being required to get competitive bids for the best price. The purchasing agent wanted to favour local businesses owned by her friends instead of large chain stores, so she broke up the year's $350,000 supplies order into numerous $900–$950 orders, paying about 12% more to local stores than would have been paid to the large chains. In return, the purchasing agent received very generous discounts and gifts from these local businesses. The auditors discovered this practice by scanning the purchases journal and investigating the frequent small amounts that were being paid to the same payee. They recommended to management that a regular supervisor review of the purchases journal may improve control over authorization of purchases.

In addition, internal controls should provide for detail-checking control procedures. For example, (1) all purchase requisitions and purchase orders are approved by authorized personnel, (2) purchase order master files changes are made by authorized persons only, (3) physical security for inventory warehouses and fixed asset locations (storerooms, fences, locks, etc.) is adequate, (4) accounts payable are recorded only when all the supporting documentation is in order (purchases and payables as of the date goods and services were received and cash disbursements on the date the cheques leave the organization's control), and (5) supplier invoices are compared with purchase orders and receiving reports to verify the price and that the quantity billed is the same as the quantity received. The following box offers an example of the consequences of weak management controls—in this case, when authorization controls for contract payments are inadequate in a government department.

Information gathering about the control structure often begins with an internal control questionnaire. Examples of questionnaires are provided in Appendix 12A. These questionnaires can be studied for details of desirable control policies and procedures as they are organized under headings that identify the important control objectives: environment, validity, completeness, authorization, accuracy, classification, accounting, and proper period recording.

WHERE TAX DOLLARS GO

The Auditor General of Canada had some harsh words for the federal government in an 83-page report released just days before an expected election call. The report criticized the way the government's departments and services spend money, and was particularly critical of the Human Resources Department (HRDC), pointing out its sloppy paperwork, careless spending, and vague job creation figures.

HRDC was at the centre of a scandal starting in January 2000 when an internal audit found massive mismanagement in its $1-billion jobs grants program. The AG's report confirms that finding and condemns poor accountability between the department and its programs, and within HRDC itself. The audit cites breaches of authority, improper payment practices, and limited monitoring of recipient projects' finances and activities. It also found an inadequate process to decide which projects should get money, including examples of some that were not eligible for funding but received it anyway.

The jobs program administered by the HRDC was designed to create long-term jobs in areas of high unemployment by giving money to companies to hire workers. But HRDC counted some jobs twice, making it impossible to determine how successful a project really was.

Auditor General Sheila Fraser said in a 2002 speech:

> "Our audit of HRDC grants and contributions showed what happens when there is no longer a balance between the insistence on performance and controls, and more emphasis is placed on one of these components.
>
> "Management's priorities were to implement strategic initiatives and improve service. We found that it had not placed enough emphasis on maintaining vital control while it reduced red tape and improved service."

This audit also pointed out the importance of internal audit as a fundamental tool for management. Internal audits at HRDC had previously identified many of the problems, but management took little action in response.

Here are some of the major findings reported by the Auditor General in recent years.

In 2004: "Our recent investigation of the contracts awarded to Groupaction (in the federal government's advertising and sponsorship program) is another high-profile example of failure to comply with the basic rules of contract management. As a result, it is impossible to say whether taxpayers received value for the money spent."

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Senior government officials running the federal government's advertising and sponsorship contracts in Quebec, as well as five Crown corporations—the RCMP, Via Rail, Canada Post, the Business Development Bank of Canada, and the Old Port of Montreal—wasted money and showed disregard for rules, mishandling millions of dollars since 1995.

More than $100 million was paid to various communications agencies in the form of fees and commissions. In most cases the agencies did little more than hand over the cheques. The sponsorship program was designed to generate commissions for private companies, while hiding the source of the funding, rather than providing any benefit for Canadians, Fraser said:

> "I think this is such a blatant misuse of public funds that it is shocking. I am actually appalled by what we've found. I am deeply disturbed that such practices were allowed to happen in the first place. I don't think anybody can take this lightly."

In 2006: A sampling of seven of the 88 information technology projects launched in the federal government since 2003, worth $7.1 billion, found rampant mismanagement. Many were far over budget and long past deadline. The former Liberal government misinformed Parliament about millions of dollars in expenses incurred by the gun registry.

In 2012, Auditor General Michael Ferguson released a scathing report over the government's planned purchase of new F-35 stealth fighter jets, which includes the stunning conclusion that the fighters could cost $10 billion more than the defence department has publicly acknowledged. It also finds that even though defence officials were getting regular updates about the delays and cost overruns with the Joint Strike Fighter (JSF) program, none of those concerns appear in briefing materials from 2006 to 2010 to warn "senior decision makers" about the potential problems. Ferguson revealed that defence officials lowballed the costs of the controversial F-35 fighter jet and kept Canadians in the dark about the risks of Canada's participation in a project beset by delays and cost overruns. As well, he concluded that federal officials oversold the potential benefits of the jet purchase to Canadian companies, which has been a sales pitch used by Conservative MPs to justify their choice of the stealth jet. Public Works Minister Rona Ambrose led the Conservatives' defence, saying the government will act on Ferguson's recommendation that defence officials refine their cost estimates for the jet to become more transparent. "We accept that. We will not purchase any new aircraft until the Department of National Defence has met that recommendation," Ambrose said.

Sources: CBC News, "Auditor General delivers stinging rebuke to Ottawa," October 22, 2000, at www.cbc.ca/stories/2000/10/17/auditor001014; Notes for an address by Sheila Fraser, FCA, Auditor General of Canada, to Canada Mortgage and Housing, June 11, 2002, Ottawa, Ontario, at wwww.oag-bvg.gc.ca/domino/other.nsf/html/02sp06_e.html; CBC News, Auditor General's Report 2004, February 11, 2004, at www.cbc.ca/news/background/auditorgeneral/report2004.html; www.cbc.ca/news/background/auditorgeneral; Bruce Campion-Smith and Les Whittington, "Auditor general slams Canada's plan to buy F-35 jets," *The Toronto Star*, Apr 03, 2012, at www.thestar.com/news/canada/politics/article/1155734--auditor-general-slams-canada-s-planned-f-35-purchase.

REVIEW CHECKPOINTS

12-6 What are the functions that should be segregated in the purchases, payables, and payments process?

12-7 What are some controls that might prevent the embezzling of cash by creation of fictitious supplier invoices?

12-8 How could an auditor determine if the purchasing agent had practised purchase order splitting?

Control Tests

An organization should have detail control procedures in place and operating to prevent or detect and correct accounting errors. You studied the general control objectives in Chapter 9 (validity, completeness, authorization, accuracy, classification, accounting, and proper period recording). Exhibit 12–3 demonstrates these in a purchasing activity situation, with examples related to specific purchasing objectives. Study this exhibit carefully.

Auditors can perform tests to determine whether controls said to be in place and operating actually are being performed properly by company personnel. Recall from Chapter 9 that a *control test* consists of (1) identification of the data population from which a sample of items will be selected for audit and (2) expression of the action that will produce relevant evidence. The actions involve vouching, tracing, observing, scanning, and recalculating—procedures for obtaining evidence used in a final control risk assessment. If control procedures are not well performed, auditors need to design substantive audit procedures to try to detect whether control failures have produced materially misleading account balances.

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EXHIBIT 12–3 Internal Control Objectives (Purchases)

GENERAL CONTROL OBJECTIVES	EXAMPLES OF SPECIFIC CONTROL OBJECTIVES
1. Recorded purchases are *valid* and documented.	Purchases of inventory (or fixed assets) are supported by supplier invoices, receiving reports, purchase orders, and requisitions (or approved capital budget).
2. Valid purchase transactions are *recorded* and none omitted.	Requisitions, purchase orders, and receiving reports are prenumbered and numerical sequence is checked. Overall comparisons of purchases are made periodically by statistical or product-line analysis.
3. Purchases are *authorized* according to company policy.	All purchase orders are supported by requisitions from proper persons (or approved capital budgets). Purchases are made from approved suppliers only after bids are received and evaluated.
4. Purchase orders are *accurately* prepared.	Completed purchase order quantities and descriptions are independently compared with requisitions and suppliers' catalogues.
5. Purchase transactions are properly *classified*.	Purchases from subsidiaries and affiliates are classified as intercompany purchases and payables. Purchase returns and allowances are properly classified. Purchases for repairs and maintenance are segregated from purchases of fixed assets.
6. Purchase transaction *accounting* is complete and proper.	Account distributions for invoices are appropriate and reviewed independent of preparation. Freight-in is included as part of purchase and added to inventory (or fixed-assets) costs.
7. Purchase transactions are recorded in the *proper period*.	Perpetual inventory and fixed asset records are updated as of date goods are received or title of ownership is transferred.

purchase cutoff: recording purchase transactions in the proper period, including accruals of payments not due until the following period

Proper timing is very important in the recording of the purchase transaction, and **purchase cutoff** tests provide assurance, as indicated in objective seven of Exhibit 12–3. In a perpetual inventory system, the inventory records are kept up-to-date continuously. In a periodic system, the inventory level is known only at the physical inventory count date. Even in perpetual systems, however, there should be an annual inventory count to reconcile records with actual inventory. The inventory count procedures are described in more detail later in this chapter. Thus, for both types of inventory systems, the inventory cutoff test date is the date the physical inventory is taken and accounting records are adjusted to distinguish between sales and purchases before the cutoff date and those after it.

cutoff error: when transactions are recorded in the wrong period, either by postponing to the next period or accelerating next period transactions into the current period

A **cutoff error** is a failure to assign a transaction to the proper period. For example, the shipping terms FOB destination and FOB shipping point indicate the date that legal title to the inventory is transferred to the purchaser: When goods are received, in the case of FOB destination, and when goods leave the seller's premises, in the case of FOB shipping point. Delivery time can thus have a major impact on proper recording of purchases, payables, inventory, sales, and receivables. The appropriate accounting depends on the shipping terms and whether the auditee is the buyer or seller in the transaction. These are major considerations in cutoff procedures related to inventory. Note that the auditee control system's ability to detect and correct cutoff errors justifies the auditor's decision to perform more or fewer cutoff procedures.

rollforward period: the period between the cutoff and year-end

The auditee may use a cutoff date other than the balance sheet date if controls are strong enough to ensure transactions between the cutoff and year-end are recorded accurately and completely. In this situation, the auditor verifies both the cutoff and the transactions in the **rollforward period**, the period between cutoff and year-end, to ensure the year-end balance is not misstated.

Exhibit 12–4 shows a selection of tests for controls over purchase, cash disbursement, and accounts payable transactions. The samples are usually attribute samples designed

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along the lines of those studied in Chapter 10. On the right, the exhibit shows the control objectives tested by the audit procedures shown on the left.

EXHIBIT 12–4 Control Tests for Purchases, Cash Disbursements, and Accounts Payable

	CONTROL OBJECTIVE
Consider the control environment	
Observe whether purchasing department personnel understand implement control activities assigned to them.	All control and objectives
A. Purchases	
1. Select a sample of receiving reports:	
a. Vouch to related purchase orders, and note missing receiving reports (missing numbers).	Authorization Completeness
b. Trace to inventory record posting of additions.	Completeness
B. Cash Disbursements and Other Expenses	
1. Select a sample of cash disbursement cheque numbers:	
a. Scan for missing documents (missing numbers).	Completeness
b. Vouch supporting documentation for evidence of accurate arithmetic, correct classification, proper approval, and proper date of entry.	Accuracy Classification Authorization Proper period
c. Trace disbursement debits to general and subsidiary ledger accounts.	Accounting
2. Select a sample of recorded expenses from various accounts and vouch them to (a) cancelled cheques, and (b) supporting documentation.	Validity Classification
C. Accounts Payable	
1. Select a sample of open accounts payable and vouch to supporting documents of purchase (purchase orders, suppliers' invoices).	Validity
2. Trace debits arising from accounts payable transactions for proper classification.	Classification
3. Select a sample of accounts payable entries recorded after the balance sheet date and vouch to supporting documents for evidence of proper cutoff—evidence that a liability should have been recorded as of the balance sheet date.	Proper period

Control Tests for Inventory Records

Many organizations have material investments in inventories. In some engagements, auditors need to determine whether they can rely on the accuracy of perpetual inventory records. For example, if inventory is to be physically counted at a date other than year-end, the controls need to be relied on to verify inventory changes in the rollforward period. Tests of controls over accuracy involve tests of the additions (purchases) to the inventory detail balances and tests of the reductions (issues) of the item balances.

Exhibit 12–5 pictures the dual direction of test audit samples. The source document samples (receiving reports, issue slips) meet the completeness direction requirement: Everything received was recorded as an addition and everything issued as a reduction of the balance. The sample from the perpetual inventory transaction records meets the validity direction requirement: Everything recorded as an addition or reduction is supported by receiving reports and issue documents.

Exhibit 12–6 contains a selection of tests for controls over perpetual inventory records similar to that of Exhibit 12–4. Note that some of these tests are dual purpose procedures as they also provide substantive evidence regarding the inventory balance. As before, the samples are usually attribute samples designed along the lines of those studied in Chapter 10. The control objectives tested are on the right side column.

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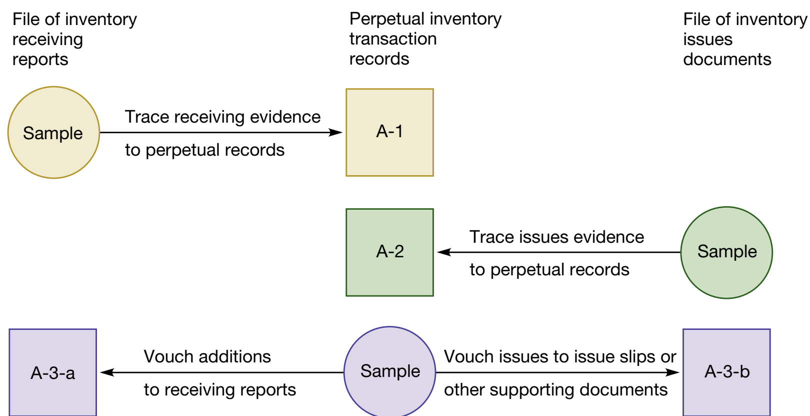
EXHIBIT 12–5 Dual Direction of Test Audit Samples



Note: The symbols A-1, A-2, A-3-a, and A-3-b are cross-references to the procedures in Exhibit 12–6.

EXHIBIT 12–6 Control Tests for Inventory Records

	CONTROL OBJECTIVE
Consider the control environment	
Observe whether inventory department personnel understand and implement control activities assigned to them.	All control objectives
A. Inventory Receipts and Issues	
1. Select a sample of receiving reports:	
a. Trace to perpetual inventory record entry of receipt.	Authorization Completeness
2. Select a sample of sales invoices, bills of lading or other shipping documents, or production requisitions:	
a. Trace to perpetual inventory record entry of issue.	Authorization Completeness
3. Select a sample of inventory item perpetual records:	
a. Vouch additions to receiving reports.	Validity
b. Vouch issues to invoices, bills of lading or other shipping documents, or production requisitions.	Validity
B. Cost of Sales	
1. With the sample of issues in A-2 above:	
a. Review the accounting summary of quantities and prices for mathematical accuracy.	Accuracy
b. Trace posting of amounts to general ledger.	Completeness
2. Obtain a sample of cost of goods sold entries in the general ledger and vouch to supporting summaries of finished goods issues.	Validity
3. Review (recalculate) the appropriateness of standard costs, if used, to price inventory issues and cost of goods sold. Review the disposition of variances from standard costs.	Accuracy

Summary: Control Risk Assessment

The audit manager or senior in charge on the audit evaluates the evidence obtained from an understanding of the internal controls and from the control test procedures. If the control risk is assessed very low, the substantive audit procedures on the account balances can be limited for efficiency. For example, the inventory observation test counts could be done prior to year-end and with a small sample size. On the other hand, if tests of controls reveal weaknesses, the substantive procedures will be needed to lower the risk of failing to

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detect material error in the account balances. For example, the inventory observation may need to be done on the year-end date and with a large number of test counts. Descriptions of major deficiencies, control weaknesses, and inefficiencies should be incorporated in a management letter to the auditee.

REVIEW CHECKPOINTS

12-9 Describe the two general characteristics of a control test.

12-10 How is the information from the shipping department, receiving department, and warehouse used to update perpetual inventory records?

12-11 In fixed asset management and accounting, which functional responsibilities should be delegated to separate departments or management levels?

SUBSTANTIVE AUDIT PROGRAMS FOR THE PURCHASES, PAYABLES, AND PAYMENTS PROCESS

LO3 Describe the typical substantive procedures used to respond to the assessed risk of material misstatement in the main account balances and transactions in the purchases, payables, and payments process.

This section provides examples of substantive procedures that may be considered for auditing the purchases, payables and payments process. These examples are concise lists of basic substantive procedures, along with the related assertions they address. As discussed in Chapter 11, the risk assessments and results of any control testing would be taken into account in selecting the nature, timing, and extent of further substantive procedures. Exhibit 12–7 shows selected substantive procedures for accounts payable and related accounts, such as accrued liabilities and deferred revenues. Exhibit 12–8 shows a generic program for inventory balance and the related expense, cost of sales. Exhibit 12–9 shows a program for property, plant, and equipment and intangible assets, and related depreciation and amortization accounting. The following section of the chapter presents special technical notes that go into more detail on some of the procedures related to assertions that tend to be higher risk in many audit situations, and typical procedures used to respond to these risks are discussed.

EXHIBIT 12–7 **Example of Substantive Audit Program Responding to Assessed Risks of Material Misstatement for Accounts Payable and Accrued Liabilities: Selected Substantive Procedures**

AUDIT PROGRAM				
AUDITEE: *ECOPACK INC.*	**FILE INDEX:** *BB-100*			
FINANCIAL STATEMENT PERIOD: *y/e DECEMBER 31, 20x1*				
ACCOUNT: *Accounts Payable and Accrued Liabilities*				
Substantive audit program in response to assessed risks at the assertion level:				
Consider risk assessment findingsand conclusion on residual detection risk to be reduced by performing substantive procedures. (Of the procedures listed below, perform those considered necessary to provide sufficient appropriate evidence to address the assessed risks and reduce risk of material misstatement to an acceptable level.)				*[Reference to relevant working papers]*
Substantive audit procedures:	Assertions evidence is related to [E,C,O,V,P]	Timing	Extent	Working paper reference
A. Accounts payable				
1. Obtain a trial balance of recorded accounts payable as of year-end.				
a. Recalculate its total and trace the total to the general ledger A/P control account.	E C			

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EXHIBIT 12–7 Continued

b. Vouch a sample of balances to suppliers' statements.	E C O			
c. Review the trial balance for unusual items, related-party payables or other items and follow up with management enquiries.	E C			
2. When concerned about the possibility of unrecorded payables, send confirmations to creditors, especially those with small or zero balances and those with whom the company has done significant business.	C			
3. Conduct a search for unrecorded liabilities by examining client reconciliations of suppliers' statements to accounts payable control account and cash payments made for a period after year-end, and by performing other procedures required to respond to assessed risk.	C			
4. Enquire about terms that justify classifying payables as long term instead of current.	V P			
5. Obtain written management representations about completeness of account payables, related-party payables, and pledges of assets as collateral for liabilities.	C O V P			
B. Accrued and other liabilities, deferred revenues				
1. Obtain a schedule of all accrued and other liabilities and deferred revenues. Agree each balance to the general ledger, and compare with prior period balances.	E C			
2. Determine basis for accrual/deferral, discuss the nature of each item with management, recalculate the recorded amounts, and determine whether each item is properly allocated to the current or a future accounting period and properly classified as current or long-term.	V P			
3. Obtain or prepare a continuity schedule showing all significant additions and subtractions from balances during the audited period, and vouch them to supporting documents, such as invoices, contracts, receipts, or calculations. Tie all expense items to revenue and expense audit working papers.	E C V			
4. In other audit work on revenues and expenses, be alert to items that should be considered deferred or accrued.	C P			
5. Scan the expense accounts in the trial balance, and compare with prior year. Investigate unusual differences that may indicate failure to account for a deferral or accrual item.	C P			
6. For estimated liabilities, such as warranties, determine and evaluate the basis of estimation, recalculate the estimate, and assess its reasonability. Ensure management's disclosure accounting policy is properly applied.	E C V			
7. Obtain written management representations about completeness and appropriate presentation of accrued and other liabilities and deferred revenue.	C O V P			
Misstatement summary: Summarize here all misstatements discovered in executing this program. Carry all forward for accumulation in the Summary of Accumulated Misstatements worksheet (Exhibit 16–1).				

AUDITOR'S CONCLUSIONS

[if the audit program is completed satisfactorily and the audit objectives are met, a conclusion such as the following would be recorded by the auditor performing the work]

Based on my professional judgment, the evidence obtained is sufficient and appropriate to conclude that the risk of material misstatement of the Accounts Payable, Accrued and Other Liabilities: Deferred Revenue is acceptably low.

Prepared by ______________________ Date ______________________

Reviewed by ______________________ Date ______________________

REVIEW CHECKPOINTS

12-12 In what situations would auditors send confirmation letters to creditors to audit accounts payable?

12-13 What information would be included in a continuity schedule for an accrued liability?

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EXHIBIT 12–8 **Example of Substantive Audit Program Responding to Assessed Risks of Material Misstatement for Inventory and Cost of Goods Sold: Selected Substantive Procedures**

AUDIT PROGRAM				
AUDITEE: *ECOPACK INC.*	**FILE INDEX**: *D-100*			
FINANCIAL STATEMENT PERIOD: *y/e DECEMBER 31, 20x1*				
ACCOUNT: *Inventory and Cost of Goods Sold*				
Substantive audit program in response to assessed risks:				
Consider risk assessment findingsand conclusion on residual detection risk to be reduced by performing substantive procedures. (Of the procedures listed below, perform those considered necessary to provide sufficient appropriate evidence to address the assessed risks and reduce risk of material misstatement to an acceptable level.)				*[Reference to relevant working papers]*
Substantive audit procedures:	Assertions evidence is related to [E,C,O,V,P]	Timing	Extent	Working paper Reference
A. Inventory Balance				
1. Obtain the auditee's final inventory compilation and tie into relevant general ledger accounts and supporting evidence from the observation of the company's physical inventory count, as follows:				
a. Trace the samples of inventory items audited at the physical inventory count observation to the final inventory compilation.	E C			
b. Select a further sample of items from the physical inventory listing and verify existence by finding them in the inventory.	E C			
c. Trace other information (items, quantities) recorded from the inventory listing at the count date to the final compilation.	E C			
d. Enquire about and make note of any damaged or scrap inventory, or inventory that appears slow moving or obsolete.	V			
2. Scan the inventory compilation for items added from sources other than the physical count and items that appear to be large round numbers or systematic fictitious additions.	E			
3. Select a sample of inventory items from the final compilation. Vouch unit prices to vendors' invoices or other cost records. Recalculate the multiplication of unit times price.	V			
4. Recalculate the extensions and totalling of the final inventory compilation for arithmetic accuracy.	V			
5. For selected inventory items and categories, determine the replacement cost and the applicability of lower-of-cost-or-market valuation.	V P			
6. Determine whether obsolete or damaged goods should be written down: *a*. Enquire about obsolete, damaged, unsalable, slow-moving items. *b*. Scan the perpetual records for slow-moving items. *c*. Ensure obsolete and damaged goods observed during the physical observation have been removed from the final inventory compilation. *d*. Compare the listing of obsolete, slow moving, damaged, or unsalable inventory from last year's audit to the current inventory compilation.	V			
7. At year-end (at physical inventory count observation) obtain the numbers of the last shipping and receiving documents for the year. Tie these into the sales, inventory/cost of sales, and accounts payable entries to verify proper cutoff. Note FOB terms in force, and ensure that goods-in-transit is correctly cut off.	E C			
8. Read bank confirmations, debt agreements, and minutes of the board, and make enquiries about pledge or assignment of inventory to secure debt.	O P			
9. Enquire about inventory out on consignment and about inventory on hand that is consigned in from suppliers.	E C O			
10. Confirm or inspect inventories held in public warehouses.	E C V			
11. Obtain written management representations concerning completeness of inventory, valuation accounting policies, and whether there are any pledges of inventory as collateral, intercompany sales, or other related-party transactions.	C O V P			

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EXHIBIT 12–8 Continued

B. Cost of Sales				
1. Select a sample of recorded cost of sales entries and vouch to supporting documentation.	E C			
2. Select a sample of basic transaction documents (such as sales invoices, production reports) and determine whether the related cost of goods sold was figured and recorded properly.	E C V			
3. Determine whether the accounting costing method used by the client (such as FIFO, average cost, standard cost) was applied properly.	V P			
4. Compute the gross margin rate and compare with prior years. Follow up with management on unusual fluctuations.	E C V			
5. Compute the ratio of cost elements (such as labour, material) to total cost of goods sold and compare with prior years. Follow up with management on unusual fluctuations.	E C			
Misstatement summary: Summarize here all misstatements discovered in executing this program. Carry all forward for accumulation in the Summary of Accumulated Misstatements worksheet (Exhibit 16–1).				

AUDITOR'S CONCLUSIONS

[if the audit program is completed satisfactorily and the audit objectives are met, a conclusion such as the following would be recorded by the auditor performing the work]

Based on my professional judgment, the evidence obtained is sufficient and appropriate to conclude that the risk of material misstatement of the Inventory and Cost of Sales is acceptably low.

Prepared by ______________________ Date ______________________

Reviewed by ______________________ Date ______________________

REVIEW CHECKPOINTS

12-14 List key substantive audit procedures used to address the inventory valuation assertion.

12-15 How is information collected during the auditor's attendance at the physical inventory count used in the audit of the inventory balance?

12-16 What cutoff misstatements can arise if the FOB terms for sales shipped are not properly accounted for? What about for inventory received?

EXHIBIT 12–9 Example of Substantive Audit Program Responding to Assessed Risks of Material Misstatement for Property, Plant and Equipment and Intangible Assets: Selected Substantive Procedures

AUDIT PROGRAM				
AUDITEE: *ECOPACK INC.*	**FILE INDEX**: *U-100*			
FINANCIAL STATEMENT PERIOD: *y/e DECEMBER 31, 20x1*				
ACCOUNT: *Property, Plant & Equipment and Intangible Assets: Depreciation and Amortization Expense*				
Substantive audit program in response to assessed risks at the assertion level:				
Consider risk assessment findingsand conclusion on residual detection risk to be reduced by performing substantive procedures. (Of the procedures listed below, perform those considered necessary to provide sufficient appropriate evidence to address the assessed risks and reduce risk of material misstatement to an acceptable level.)				*[Reference to relevant working papers]*
Substantive audit procedures:	Assertions evidence is related to [E,C,O,V,P]	Timing	Extent	Working paper Reference
A. Property, Plant, & Equipment (PPE) and Intangible Assets				
1. Summarize and recalculate detail PPE and intangible asset subsidiary records, and reconcile to general ledger control account(s).	E C			

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EXHIBIT 12–9 Continued

2. Select a sample of asset subsidiary records: *a*. Perform a physical observation (inspection) of the fixed assets recorded. *b*. Inspect title or other ownership legal documents, if any. *c*. Inspect supporting documentation, (i.e., invoices, contracts, purchase agreements) or obtain written confirmation of acquisition and ownership.	 E E O E O			
3. Obtain, or prepare, a continuity schedule of the balances, showing asset additions and disposals for the period: *a*. Vouch to disposals to documents, indicating proper approval. *b*. Vouch costs of additions to invoices, contracts, or other supporting documents. *c*. Determine whether all costs of shipment, installation, testing, and the like have been properly capitalized. *d*. Vouch proceeds (on dispositions) to cash receipts or other asset records. *e*. Recalculate gain or loss on dispositions. *f*. Agree amounts to detail fixed asset records and general ledger control account(s).	 C E V V V P V P E C V			
4. Observe a physical inventory taking of the fixed assets, and compare with detail assets records.	E C			
5. If any property is valued at fair value, examine and verify supporting valuation evidence, such as independent appraisals.	V			
6. Obtain written representations from management regarding ownership, completeness, and any pledging of assets as security for loans and leased assets.	C O V P			
B. Depreciation/Amortization				
1. Analyze amortization expense for overall reasonableness with reference to costs of assets (or fair values if used) and average depreciation rates.	V			
2. Obtain, or prepare, a continuity schedule of accumulated amortization showing beginning balance, current amortization, disposals, and ending balance. Trace to amortization expense and asset disposition analyses. Trace amounts to general ledger account(s).	E C P			
3. Recalculate amortization expense and trace to general ledger account(s).	E C P			
C. Related Accounts				
1. Analyze insurance for adequacy of coverage.	V P			
2. Analyze property taxes to determine whether taxes due on assets have been paid or accrued.	O (C for liability)			
3. Select a sample of rental expense entries. Vouch to rent/lease contracts to determine whether any leases qualify for capitalization.	V P			
4. Select a sample of repair and maintenance expense entries, and vouch them to supporting invoices for evidence of property that should be capitalized.	V			
Misstatement summary: Summarize here all misstatements discovered in executing this program. Carry all forward for accumulation in the Summary of Accumulated Misstatements worksheet (Exhibit 16–1).				

AUDITOR'S CONCLUSIONS

[if the audit program is completed satisfactorily and the audit objectives are met, a conclusion such as the following would be recorded by the auditor performing the work]

Based on my professional judgment, the evidence obtained is sufficient and appropriate to conclude that the risk of material misstatement of the Property Plant & Equipment and Intangible Assets, and Related Depreciation and Amortization Expense is acceptably low.

Prepared by ______________________________ Date ______________________________

Reviewed by ______________________________ Date ______________________________

The programs illustrated in Exhibits 12–7 to 12–9 are generic and, in practice, will need to be tailored to a specific audit engagement's risk assessments, to design an appropriate set of audit procedures linked to the assessed risks at the assertion level in each auditee's specific circumstances.

This section provides more detail on substantive procedures related to some of the key assertions to be audited in account balances and transactions related to the purchases, payables, and payments process, including completeness of liabilities, observation of the physical inventory count, and valuation of property, plant, and equipment. These are areas that often have high assessed risk, warranting a rigorous response.

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REVIEW CHECKPOINTS

12-17 What assertion(s) are addressed by a physical inspection of property, plant, and equipment?

12-18 What key items on the continuity schedule would be vouched to supporting documentation?

12-19 What is the main evidence used to audit depreciation expense?

SPECIAL NOTE: THE COMPLETENESS ASSERTION FOR LIABILITIES

LO4 Explain the importance of the completeness assertion for auditing the accounts payable liabilities, and the procedures used to search for unrecorded liabilities.

When considering assertions and obtaining evidence about accounts payable and other liabilities, auditors must emphasize the completeness assertion. (For asset accounts the emphasis is on the existence and ownership assertions.) This is necessary as companies are typically less concerned about timely recording of expenses and liabilities than they are about timely recording of revenues and assets. Also, management may have incentives to understate liabilities and expenses to show more favourable performance or financial position than is really the case. Of course, generally accepted accounting principles require timely accrual of liabilities and their associated expenses.

Evidence verifying the completeness assertion is more difficult to find than for the existence assertion. Auditors cannot rely entirely on a management assertion of completeness, even with a favourable assessment of control risk. Substantive procedures, tests of details, or analytical procedures should also provide corroborating evidence. The **search for unrecorded liabilities** is a set of procedures designed to yield audit evidence of liabilities that were not recorded in the reporting period. This search should normally be performed up to the audit report date in the period following the auditee's balance sheet date.

search for unrecorded liabilities: set of procedures designed to yield audit evidence of liabilities that were not recorded in the period following the audit client's balance sheet date

The following list of procedures is useful in the search for unrecorded liabilities. The audit objective is to search all the places where there might be evidence of them, and if none is revealed, it is reasonable to conclude that all material liabilities were recorded.

- Scan the open purchase order file at year-end for purchase commitments at fixed prices. From current prices, determine if any adjustments for loss and liability are needed.
- List the unmatched supplier invoices and, from the unmatched receiving report file and receiving reports prepared after year-end, determine when the goods were received. Determine which invoices, if any, should be recorded.
- Trace the unmatched receiving reports to accounts payable entries, and determine if any recorded in the next accounting period need to be reported in the current accounting period under audit.
- Vouch a sample of cash disbursements from the accounting period following the balance sheet date against supporting documents (invoice, receiving report) to determine if the related liabilities were recorded in the proper accounting period. Select the sample from the post-year-end cutoff bank statement to audit the cash balance (see Chapter 11).
- Trace liabilities reported by financial institutions to the accounts. (See the bank confirmation in Exhibit 11–8.) Since a bank may not report all auditee liabilities to auditors, other corroborating evidence for possible unrecorded debts should also be obtained.
- Canada Revenue Agency notices of assessment may contain evidence of income or other taxes in dispute that may need to be recorded as liabilities.
- Confirm accounts payable with suppliers, especially regular suppliers showing small or zero balances in the year-end accounts payable. (Suppliers' monthly statements controlled by the auditors also may be used.) Verify supplier addresses so confirmations will not be misdirected—perhaps deliberately.
- Study the accounts payable trial balance for dates showing fewer payables than are usually recorded near the year-end, evidence that invoices are not being recorded.

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- Review responses from auditee's lawyers to requests for information about pending or threatened litigation, and about unasserted claims and assessments. These may indicate a need for contingent liability accruals or disclosures. (As explained in Chapter 15, when the auditor assesses a risk of material misstatement due to litigation or claims, Canadian Auditing Standard [CAS] 501 requires that enquiry letters prepared by the auditee be sent to the auditee's lawyers. These letters request the lawyer to communicate directly with the auditor.)
- A checklist of accrued expenses will help determine whether the company has been conscientious in expense and liability accruals, including accruals for wages, interest, utilities, sales and excise taxes, payroll taxes, income taxes, real property taxes, rent, sales commissions, royalties and warranties, and guarantee expense.
- When auditing the details of sales revenue, the terms of sales will help determine if any amounts should be deferred as unearned revenue. (Initial information is gained by enquiries to management about terms of sale, such as customers' rights of cancellation or return.)
- A schedule of casualty insurance on fixed assets is used to determine the adequacy of insurance in relation to asset market values. Inadequate insurance and self-insurance create risks that should be disclosed in the notes to the financial statements.
- Confirm life insurance policies with insurance companies to ask whether the company has any loans against the cash value of the insurance. Also request the names of the beneficiaries of the policies. If a party other than the company benefits from the insurance, it may be a creditor on unrecorded loans. Enquire about the business purpose of making insurance proceeds payable to other parties.
- Review terms of any debt due within one year but classified long-term because the company plans to refinance it on a long-term basis. This cannot be based on management's intent; holders of the debt or financial institutions must have shown (preferably in writing) a willingness to refinance the debt before it can be classified as long-term.
- Apply analytical procedures appropriate in the circumstances. In general, accounts payable volume and period-end balances should increase when the company increases physical production volume or engages in inventory stockpiling. Some liabilities may be related to other activities; for example, sales taxes are functionally related to sales dollar totals, payroll taxes to payroll totals, excise taxes to sales dollars, or volume and income taxes to income.

REVIEW CHECKPOINTS

12-20 Describe the purpose of and give examples of audit procedures in the search for unrecorded liabilities.

12-21 Explain the difference in approach between confirmation of accounts receivable and confirmation of accounts payable.

12-22 In substantive auditing, why is the emphasis on the completeness assertion for liabilities instead of on the existence assertion as in the audit of assets?

SPECIAL NOTE: PHYSICAL INVENTORY OBSERVATION AND AUDIT OF INVENTORY AND COST OF SALES

LO5 Identify audit considerations for observing the physical inventory count.

The audit procedures for inventory and related cost of sales accounts can be extensive. A 96-page joint CICA–AICPA auditing technique study entitled *Audit of Inventories* describes many facets of inherent risk and control risk, and of the process of obtaining evidence about inventory financial statement assertions. The significance of inventories is acknowledged in the following statement:

> Generally, inventories reflect the characteristics of a business more than any other asset. Significant to manufacturing, wholesale, and retail organizations, inventories frequently are also material to the financial statements of service organizations. For some types of businesses, inventories constitute a significant percent of total assets and represent the largest current asset.

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A material misstatement in inventory has a pervasive effect on financial statements. It will cause misstatements in current assets, working capital, total assets, cost of sales, gross margin, and net income. While analytical procedures can help indicate inventory presentation problems, physical observation of the auditee's inventory count is the best opportunity to detect inventory misstatements. Auditing standards (CAS 501) require that auditors attend the physical inventory counting when inventory is material to the financial statements, to provide evidence of the existence and condition of inventory. While auditors rarely count the entire inventory, management's procedures for recording and controlling the count should be evaluated and observed, inventory inspected, and test counts performed. Later, the final inventory records should be tested to ensure they accurately reflect the evidence the auditor obtained at the physical counting.

STANDARDS CHECK

CAS 501

4. If inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:
   (a) Attendance at physical inventory counting, unless impracticable, to: (Ref: Para. A1–A3)
      (i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting; (Ref: Para. A4)
      (ii) Observe the performance of management's count procedures; (Ref: Para. A5)
      (iii) Inspect the inventory; and (Ref: Para. A6)
      (iv) Perform test counts. (Ref: Para. A7–A8)
   (b) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

Source: *CICA Handbook—Assurance*, 2012.

In some audits, obtaining evidence about an inventory's existence and valuation requires expert knowledge in a field other than accounting or auditing, as described in CAS 620. Often, experts employed by the auditee's management will provide tests and reports for this purpose. An auditee will likely have employees with the expertise required; for example, to assess the assembly stage of highly technical equipment held as work-in-progress inventory, or to calculate the quantity of raw material in containers or stockpiles based on measures of volume and density. Alternatively, if a high risk is assessed, an expert employed by the audit firm or an outside expert engaged by the audit firm to assist the team may be assigned to provide evidence that is considered more independent, and reliable, than that obtained from management's experts. In evaluating the need for an expert, the auditor first considers whether alternative sources of sufficient appropriate evidence are available and more cost effective. For example, an outside expert's report prepared for the auditee but for another purpose may also be relevant and reliable for the auditor's purposes.

STANDARDS CHECK

CAS 620

6. For purposes of the CASs, the following terms have the meanings attributed below:
   (a) Auditor's expert – An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert. (Ref: Para. A1–A3)
   (b) Expertise – Skills, knowledge and experience in a particular field.
   (c) Management's expert – An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

Nature, Timing, and Extent of Audit Procedures

8. The nature, timing, and extent of the auditor's procedures with respect to the requirements in paragraphs 9–13 of this CAS will vary depending on the circumstances. In determining the nature, timing and extent of those procedures, the auditor shall consider matters including: (Ref: Para. A10)
   (a) The nature of the matter to which that expert's work relates;

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(b) The risks of material misstatement in the matter to which that expert's work relates;
(c) The significance of that expert's work in the context of the audit;
(d) The auditor's knowledge of and experience with previous work performed by that expert; and
(e) Whether that expert is subject to the auditor's firm's quality control policies and procedures. (Ref: Para. A11–A13)

The Competence, Capabilities, and Objectivity of the Auditor's Expert

9. The auditor shall evaluate whether the auditor's expert has the necessary competence, capabilities, and objectivity for the auditor's purposes. In the case of an auditor's external expert, the evaluation of objectivity shall include inquiry regarding interests and relationships that may create a threat to that expert's objectivity. (Ref: Para. A14–A20)

Obtaining an Understanding of the Field of Expertise of the Auditor's Expert

10. The auditor shall obtain a sufficient understanding of the field of expertise of the auditor's expert to enable the auditor to: (Ref: Para. A21–A22)
   (a) Determine the nature, scope and objectives of that expert's work for the auditor's purposes; and
   (b) Evaluate the adequacy of that work for the auditor's purposes.

Source: *CICA Handbook—Assurance*, 2012.

Take note of the following details related to auditors' observation of physical inventory taking. The first task is to review the auditee's inventory-taking instructions. The instructions should include the following:

- Names of auditee personnel responsible for the count
- Dates, times, and locations of inventory taking
- Names of auditee personnel who will participate in the inventory taking
- Instructions for recording accurate descriptions of inventory items, for count and double count, and for measuring or translating physical quantities (such as counting by measures of litres, barrels, metres, dozens)
- Instructions for making notes of obsolete or worn items
- Instructions for the use of tags, cards, count sheets, or other media devices, and for their collection and control
- Plans for shutting down plant operations or for taking inventory after store closing hours, and plans for having goods in proper places (such as on store shelves instead of on the floor, or in a warehouse rather than in transit to a job)
- Plans for counting or controlling movement of goods in receiving and shipping areas if those operations are not shut down during the count
- Instructions for recording cutoff information, such as documents numbers and details relating to last shipments and last receipts of inventory at period-end
- Instructions for compilation of the count information (such as computer processing of scanned codes, or manual input of tags or count sheets) into final inventory listings or summaries
- Instructions for pricing the inventory items
- Instructions for review and approval of the inventory count and notations of obsolescence or other matters by supervisory personnel

These instructions characterize a well-planned counting operation. As the plan is carried out, the independent auditors should be present to hear the count instructions being given to the auditee's count teams and to observe the instructions being followed.

Many physical inventories are counted at year-end when the auditor is present to observe. The auditors can perform dual-direction testing by (1) selecting inventory items from a perpetual inventory master file and going to the location to obtain a test count, which produces evidence for the existence assertion; and (2) selecting inventory from locations on the warehouse floor, obtaining a test count, and tracing the count to the final inventory compilation, which produces evidence for the completeness assertion. If the company does not have perpetual records and a file to test for existence, the auditors must be careful to obtain a record of all the counts and to use it for the existence-direction tests.

However, other situations as described below frequently occur.

Physical Inventory Not on Period-End Date

Auditees sometimes count the inventory on a date other than the balance sheet date. The auditor observes this count, following the same procedures as for a period-end count. For

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the period between the count date and the balance sheet date, additional rollforward or rollback auditing procedures must be performed on inventory purchase (increasing) and issue (decreasing) transactions during that period. The inventory on the count date is reconciled to the period-end inventory by appropriate addition or subtraction of the receiving and issue transactions that have occurred in the rollforward or rollback period.

STANDARDS CHECK

CAS 501

5. If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures required by paragraph 4, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded. (Ref: Para. A9–A11)

A11. Relevant matters for consideration when designing audit procedures to obtain audit evidence about whether changes in inventory amounts between the count date, or dates, and the final inventory records are properly recorded include:
- Whether the perpetual inventory records are properly adjusted.
- Reliability of the entity's perpetual inventory records.
- Reasons for significant differences between the information obtained during the physical count and the perpetual inventory records.

Source: *CICA Handbook—Assurance*, 2012.

Cyclical Inventory Counting

Some companies count inventory on a cyclical basis or use a statistical counting plan but never take a complete count on a single date. Businesses that count inventory this way claim to have accurate perpetual records, and that they carry out the counting as a means of testing the records and maintaining their accuracy. In these cases, the auditors must understand management's counting plan and evaluate its appropriateness, and they should attend and perform tests whenever the value of inventory to be counted is material. They must be present during some counting operations to evaluate the counting plans and their execution. The procedures listed above for an annual count are used, test counts are made, and the audit team forms a conclusion concerning the accuracy (control) of perpetual records.

Auditors Not Present at Auditee's Inventory Count

It might happen on a first audit that the audit firm is appointed after the beginning inventory has already been counted. The auditors should still review the auditee's plan for the already completed count. Some test counts of current inventory should be made and traced to current records to form a conclusion about the reliability of perpetual records. If the actual count was recent, intervening transaction activity may be reconciled back to the beginning inventory.

However, it may be very difficult to reconcile more than a few months' transactions to an unobserved beginning inventory. Auditors may use the interrelationships between sales activity, physical volume, price variation, standard costs, and gross profit margins to form a conclusion about the reasonableness of the beginning inventory. This must be done very carefully, and, if the auditors cannot satisfy themselves as to the beginning inventory balance, a modification in the auditor's report is normally called for (CAS 501).

STANDARDS CHECK

CAS 510

6. If the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions.
7. If attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. If it is not possible to do so, the auditor shall modify the opinion in the auditor's report in accordance with CAS 705. (Ref: Para. A12–A14)

Source: *CICA Handbook—Assurance*, 2012.

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Inventories Located off the Auditee's Premises

The auditors must determine the locations and values of inventories that are located off the auditee's premises, perhaps in the custody of consignees or in public warehouses. If amounts are material and control is not exceptionally strong, the audit team may visit these locations and conduct onsite test counts. However, if amounts are not material or related evidence (periodic reports, cash receipts, receivables records, shipping records) is adequate and control risk is low, then direct confirmation with the inventory custodian may be sufficient appropriate evidence of existence (CAS 501).

INVENTORY COUNT AND MEASUREMENT CHALLENGES

EXAMPLES	CHALLENGES
Lumber	Identifying quality or grade
Piles of sugar, coal, scrap steel	Need geometric computations, aerial photos
Items weighed on scales	Accuracy of scales
Bulk materials (oil, grain, chemicals, liquids in storage tanks)	Dip measuring rods into tanks Sample for assay or chemical analysis
Diamonds, jewellery	Identification and quality determination Need an expert
Pulp wood	Quantity measurement estimation Need aerial photos
Livestock	Movement not controllable (count critter's legs and divide by four—two for chickens).

Source: Adapted from CICA, Audit of Inventories, *Auditing Procedure Study* (1986), p. 28.

Summary: Inventory Observation

The physical observation procedures are designed to audit for existence and completeness (physical quantities) and also to provide support for audit valuation procedures (e.g., recalculation of appropriate FIFO, weighted average, specific item, or other pricing at cost, and evaluation of lower-of-cost-or-net-realizable-value writedown of obsolete or damaged inventory). After the observation is complete, auditors should have sufficient appropriate evidence of physical quantities and valuations to ensure the inventory compilation includes goods (a) owned, on hand, and counted; (b) owned but not on hand (consigned out or stored in outside warehouses); and (c) in transit (purchased and recorded but not yet received, or shipped FOB destination but not yet delivered to customers). The inventory compilation should exclude goods (a) in the perpetual records but not owned; (b) on hand, already sold, but not yet delivered; and (c) on hand but not owned (consigned in).

REVIEW CHECKPOINTS

12-23 In the review of an auditee's inventory-taking instructions, what characteristics are the auditors looking for?

12-24 Explain dual-direction sampling in the context of inventory test counts.

12-25 What procedures are followed to audit inventory when the physical inventory is taken on a cyclical basis or on a statistical plan but never as a complete count on a single date?

SPECIAL NOTE: AUDIT OF PROPERTY, PLANT, AND EQUIPMENT AND INTANGIBLE ASSETS

LO6 Explain the main auditing procedures used for property, plant, and equipment and intangible assets.

Property, plant, and equipment assets (PPE) and intangible assets are the long-term assets used in an entity's operations. To be considered assets, they must be controlled by the entity and be expected to provide future economic benefits to it. PPE includes land, buildings, equipment,

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vehicles, computers, leasehold improvements, and other physical types of assets. PPE are also called "fixed assets." Intangible assets are identifiable non monetary assets that do not have a physical substance, such as patents, licences, copyrights, trademarks, application software, development costs, and customer lists. The risks, controls, and audit procedures required to respond to the risks in the assertions of PPE and intangible assets are outlined in this section.

Risks and Controls

Generally, the existence, completeness, and ownership assertions for PPE are likely to have a low assessed risk of misstatement and will be fairly straightforward to verify, since reliable evidence is usually available relevant to these assertions, as is introduced below. For intangible assets, the existence assertion tends to have a high risk, as it can be complex to determine whether a particular expenditure meets the definition of an intangible asset under generally accepted accounting principles (GAAP) (e.g. CICA 3064, or IAS 38).

Valuation can be a very high-risk assertion and challenging to verify, as there are many allocations and estimates involved. PPE and intangible assets with definite lives are initially recorded at their acquisition costs, and then amortized to expense over their expected useful lives. Intangible assets with indefinite lives are not amortized but are tested periodically for value impairment. Due to their long lives, a number of valuation changes can occur over time. Thus, there is a high degree of complexity involved in applying GAAP for subsequent measurement, amortization, and recording impairment losses. Recall that the valuation assertion mainly concerns whether the monetary amount included in financial statements complies with the applicable financial reporting principles. For example, under International Financial Reporting Standards (IFRS) (IAS 16 and IAS 38), management can choose the traditional cost model or a revaluation model based on fair value estimates, indicating the complexity of valuation for PPE and intangible assets. Also, if market conditions or production technologies change over time, an asset's value may become impaired requiring a writedown to be recorded. Overall, the accounting choices available within GAAP, and the subjective kinds of information used, can open the door for management bias in coming up with estimates. Also, the amounts invested in these long-lived operating assets can be quite large. These factors can often lead to the risk of material misstatement for the valuation assertion being high for PPE and intangible assets.

The main presentation issues are to ensure that management's accounting policies for PPE are appropriate and fully disclosed, and that the categories and appropriate monetary values of PPE elements are presented in the balance sheet and notes in accordance with the applicable financial reporting framework. Disclosures are required of the details and assumptions of the various valuation tests and models used. Auditors need to verify these are in accordance with GAAP, and more importantly, that these GAAP methods match what management actually used to come up with its numbers. Much of this information involves estimates, and Chapter 19 elaborates on the audit considerations related to obtaining reasonable assurance on accounting estimates, which can bear a high level of accounting risk. The box below provides examples of accounting policy disclosures for PPE and intangibles from various Canadian public companies' audited financial statements, to give you a sense of the complexity and estimations involved.

EXAMPLES OF PUBLIC COMPANIES' ACCOUNTING POLICY NOTES FOR PPE AND INTANGIBLE ASSETS
NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

2(g) Property, plant, and equipment

Production equipment, office equipment, computer software and equipment are stated at cost less accumulated depreciation and accumulated impairment losses. Depreciation of these assets, on the same basis as other property assets, commences when the assets are ready for their intended use.

Pre-production costs relating to installations of major new production equipment are expensed in the period in which occurred.

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Depreciation is recognized so as to write off the cost of assets less their residual values over their useful lives, using the straight-line method. The estimated useful lives, residual values and depreciation method are reviewed at each year end, with the effect of any changes in estimate accounted for on a prospective basis.

ASSET	BASIS	PERIOD
Buildings	Straight-line	20–40 years
Equipment	Straight-line	4–20 years
Production equipment	Straight-line	10–20 years
Office equipment	Straight-line	5 years
Computer software and equipment	Straight-line	3 years

Leasehold improvements are amortized on a straight-line basis over the lesser of the terms of the leases or their useful lives.

Effective January 1, 20X0, the Company revised the estimated useful life of its production equipment from 10 and 15 years to 20 years. The changes in estimates, which were applied prospectively, resulted in a reduction in depreciation of $2,126,000 ($2,017,000) for the year ended December 31, 20X1 (20X0).

When parts of an item of plant and equipment have different useful lives, they are accounted for as separate items (major components). The cost of replacing a component of an item of plant and equipment is recognized in the carrying amount of the item if it is probable that the future economic benefits of the item will occur and its cost can be measured reliably. The costs of day-to-day maintenance of plant and equipment are recognized directly in the statement of income.

An item of property, plant, and equipment is de-recognized upon disposal, or when no future economic benefits are expected to arise from the continued use of the asset. The gain or loss arising on the disposal or retirement of an item of property, plant, and equipment is determined as the difference between the sales proceeds and the carrying amount of the asset and is recognized in profit or loss.

When the Company has a legal right or constructive obligation to restore a site on which an asset is located either through make-good provisions in lease agreements or decommissioning of environmental risks, the present value of the estimated costs of dismantling and removing the asset and restoring the site are included in the carrying value of the asset with a corresponding increase to provisions. Borrowing costs directly attributable to the acquisition, construction, or production of qualifying property, plant and equipment that takes an extended period of time to be placed into service are added to the cost of the assets, until such time as the assets are substantially ready for their intended use.

2(h) Assets under finance lease

Assets held under finance leases are depreciated over their expected useful lives on the same basis as owned assets or, where shorter, the term of the relevant lease.

2(i) Impairment

At each reporting date, or sooner if there is an indication that an asset may be impaired, the Company reviews the carrying amounts of its assets to determine whether there is any indication that those assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss (if any).

The recoverable amount is the higher of fair value less costs to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pretax discount rate that reflects current market assessments of the time value of money and the risks specific to the assets for which the estimates of future cash flows have not been adjusted. If the recoverable amount of the assets is estimated to be less than their carrying amount, the carrying amount is reduced to the recoverable amount.

An impairment loss is recognized immediately in profit or loss.

Where an impairment loss subsequently reverses, the carrying amount of the assets is increased to the revised estimate of its recoverable amount, but such that the increased carrying amount does not exceed the carrying amount that would have been determined had no impairment loss been recognized for the asset in prior years. A reversal of an impairment loss is recognized immediately in profit or loss.

2(j) Grants and investment tax credits

Grants and investment tax credits are accounted for using the cost reduction method and are amortized to earnings as a reduction of depreciation, using the same rates as those used to depreciate the related property, plant and equipment.

2(k) Intangible assets

Intangible assets consist primarily of customer relationships and client lists, application software and favourable leases. They are recorded at cost less accumulated amortization and impairment losses and amortized on a straight-line basis, over the estimated useful lives as follows:

Patents	Between 2 and 17 years
Customer relationships and client lists	Between 2 and 30 years
Application software	Between 3 and 10 years
Favourable leases	Term of the lease
Other	Between 2 and 20 years

Expenditure on research activities is recognized as an expense in the period in which it is incurred.

The main financial controls of concern in this area relate to authorization of acquisitions, proper classification of assets and expenses, and accuracy of the depreciation calculations and recording, and application of appropriate revaluation or impairment testing procedures. In larger organizations with many different types of fixed assets, the information system will likely have a specialized subledger module for keeping the details and

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integrating the summary data with the general ledger system. In smaller entities, the details may be kept in a separate schedule, often a spreadsheet, which is used to update general ledger balances through manual journal entries. A further complication is that the tax values of assets can differ from their accounting values when companies choose depreciation accounting policies that differ from those prescribed for income tax purposes (i.e., capital cost allowance, or CCA). Such differences necessitate a separate tax-based schedules of assets values, and also give rise to deferred tax balances for accounting purposes in some financial reporting frameworks (which also need to be audited!).

Currently, most companies continue to use the cost basis for capital assets, and that will be the main focus of the following discussion. Generally, the assets are initially recorded at cost and then the cost is allocated by depreciation (or amortization) expense to periods of use over the life of the assets. Depreciation and amortization allocation approaches are designed to allocate costs systematically to the accounting periods in which their benefits are consumed, which results in a smoother income measure. While these allocations are estimates, approaches used have been well-accepted for many decades. Still, these are important and often material estimates, and like all management estimates, the risk of management bias must always be kept in mind by auditors. Be on the lookout for questionable changes to useful lives or depreciation methods, improper cost capitalization, idle assets still on the books, or estimates based on unreasonable assumptions. See, for example, item 2(g) in the box above; the auditors need to determine if this is a reasonable change.

Exhibit 12–10 shows a typical continuity schedule used to keep track of details underlying the valuation of PPE and intangible assets. Often, management will prepare this type of schedule for their own control purposes, and the auditors can use it as a working paper on which to summarize their verification work and conclusions.

Examples of the main audit procedures applied to PPE and intangible assets are set out in the audit program in Exhibit 12–9. Note that the analytical procedures involve study of industry trends, business strategy, changes in products or production methods, and changes in sales volumes, as these can have an impact on the recoverability of the company's investments in its long-term operating assets. Control tests generally are performed in the underlying purchases, payments, and payments cycle, though controls specific to these account balances may also be identified and considered for reliance, particularly when there are many different individual assets to be kept track of. Substantive procedures include physical inspection and inspection of documents, recalculation, and use of experts regarding valuation if it is complex and specialized. Enquiry is an important source of evidence for evaluating completeness, as well as aspects of valuation that may relate to management's intended use of various operating assets, but corroborating documentation-based evidence is also crucial.

Summary

The special note outlines some standard procedures used to obtain evidence about the existence, completeness, and ownership assertions, as well as the cost allocation aspect of the valuation assertions for PPE. The fair value aspect of valuation assertion risk relating to complexity of components; fair value option under IFRS IAS 16; and estimation bias, which is difficult to debate due to subjectivity of the allocations, are challenging issues the auditing profession is currently grappling with, as is further elaborated upon in Chapter 19.

REVIEW CHECKPOINTS

12-26 Explain why the valuation assertion often has a high risk of misstatement for PPE and intangible assets.

12-27 What is the purpose of a continuity schedule for PPE and intangibles in audit working papers?

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EXHIBIT 12–10 Example of Continuity Schedule Working Paper for Property, Plant, and Equipment and Intangible Assets

AUDITEE:	*EcoPak Inc.*
FINANCIAL STATEMENT PERIOD:	*y/e December 31, 20x1*

FILE INDEX:	*U-10*
Prepared by *C.S.*	Reviewed by *D.E.*
Date *Mar 11/x2*	Date *Mar 20/x2*

LONG-LIVED ASSETS CONTINUITY SCHEDULE

ASSET CATEGORY	W/P REF.	COST				ACCUMULATED DEPRECIATION/AMORTIZATION					NET BOOK VALUE	NET BOOK VALUE	
		BALANCE DEC 31, 20x0	ADDITIONS	DISPOSALS	BALANCE DEC 31, 20x1	BALANCE DEC 31, 20x0	DEPRECIATION/AMORTIZATION	DISPOSALS	IMPAIRMENT	BALANCE DEC 31, 20x1	DEC 31, 20x1	DEC 31, 20x0	
		[a] [b]	[e]	[f]	[c]	[a] [b]	[g] *	[f]	[h]	[d]	[d]	[a] [b]	
PROPERTY PLANT & EQUIPMENT													
LAND	*U-20*	250,650	0	0	250,650	0	0	0	0	0	250,650	250,650	[i]
BUILDING	*U-20*	760,321	0	0	760,321	608,257	30,413			638,670	121,651	152,064	[i]
PRODUCTION MACHINERY - LINE 1	*U-30*	2,950,550	0	500,563	2,449,987	1,475,275	244,999	250,282	579,995	2,049,987	400,000	1,475,275	[i]
PRODUCTION MACHINERY - LINE 2	*U-30*	148,808	2,980,311	0	3,129,119	0	312,912	0	0	312,912	2,816,207	148,808	[i]
COMPUTER EQUIPMENT	*U-30*	88,501	22,544	15,000	96,045	59,738	21,130	15,000	0	65,868	30,177	28,763	[i]
TOTALS		4,198,830	3,002,855	515,563	6,686,122	2,143,270	609,453	265,282	579,995	3,067,437	3,618,685	2,055,560	[i]
INTANGIBLE ASSETS													
PATENT	*V-10*	40,260	0	0	40,260	2,368	2,368	0	0	4,736	35,524	37,892	[i]
PRODUCTION SOFTWARE	*V-20*	0	165,892	0	165,892	0	16,178	0	0	16,178	149,714	0	[i]
CUSTOMER RELATED SOFTWARE	*V-20*	111,996	0	0	111,996	47,998	**190,393**	0	0	238,391	(126,395)	63,998	[i]
TOTALS		152,256	165,892	0	318,148	50,367	208,940	0	0	259,306	58,842	101,889	[i]
		[d]	[d]	[d]	[d]	[d]	[d]	[d]	[d]	[d]	[d]	[d]	

AUDIT VERIFICATION SUMMARY: Based on the Audit Programs filed at *U-100* and *V-100*

[a] Agreed to prior year's financial statement audit file.

[b] Agreed to prior year financial statements.

[c] Agreed to General Ledger account balance.

[d] Footed: Recalculated totals and cross totals - all are correct.

[e] Additions verified on *U-31* and *V-21* by vouching a sample of additions to valid supporting payments and proper account allocations.
- Conclusion is that amounts are valid, complete, accurate, authorized and properly classified.

[f] Disposals verified on *U-32*, by vouching amounts to documentation of sale or scrap, recalculation of cost and accumulated depreciation amounts removed from the accounts, and enquiries of management regarding reasons.
- Conclusion is disposal amounts are valid, complete, accurate, authorized and properly classified.

[g] Depreciation and amortization calculations verified on *U-40* and *V-30* by recalcuation, agreeing rates and methods to stated management accounting policies, and assessing reasonability based on asset types and industry practices.

* ***There is a misstatement in the amortization expense for the addition to production software. The bookkeeper recorded $17000 because the software was put into operation in November. However the CFO notes their usual policy is to record no amortization in first year of use. This $17000 overstatement carried forward to the Summary of Accumulated Misstatements for management decision on correcting J/E. See W/P#*335*.**
- Except for the error in amortization calculation, my conclusion is depreciation and amortization expense are reasonable.

[h] Impairment testing reviewed on *U-50* -The value-in-use of the old production line has declined and it is being phased out as the new line is more efficient. Impairment testing discussed with management. Only production line 1 found to be potentially impaired. Management's estimate methods and assumptions reviewed. Estimation method and assumptions discussed and assessed with G&M's valuation expert, P. Enge, and found to be reasonable.
- Conclusion is impairment value estimate appears to be within a reasonable range and is not materially misstated. No other assets found to be impaired.

[i] Audited balances carried forward to final financial statement and notes worksheet at *120*.

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APPLICATION CASE WITH ANALYSIS

Detecting Misstatements in the Purchases, Payables, and Payments Process

INTRODUCTION

In this application case, we will demonstrate tests of controls and substantive audit procedures in the evidence-gathering process related to purchases, payables, and payments. The case situation for each audit presented parallels the framework shown in Chapter 11's application case. It provides context for the auditing decisions, rather than presenting a list of detection procedures in the abstract. Lists of a selection of control tests are found in Appendix 12A, and selected detail substantive procedures for payables and payments processes are found in the examples of substantive audit programs provided in chapter learning objectives.

DISCUSSION CASE

As Jack told the new junior auditors his stories about revenue-related misstatements, Syed, one of the audit firm's senior partners, joined in the conversation: "You really have had an interesting first year, Jack! Most people don't see two frauds and a material cutoff error in their first year on the audit trail. Next year you will move on to auditing more complex areas, such as accounts payable and inventory. So, let me tell you some of the stories I have seen over many years in auditing. In some ways, fraud and other misstatements are even more likely in the purchases, payables, and payments process than in revenues. This is not only because there are complex accounts involved but also because the main business purpose of the auditee's purchasing process is to move cash out of the organization. That means errors often result in cash outflows. Also, it can be easier to subvert the process fraudulently, and harder for management controls and auditors to detect it. One thing you will notice early on is that well-managed organizations tend to have the strongest controls in this part of their accounting system. But here are four stories of misstatements that I or my colleagues have experienced in practice. The first one involves an employee fraud in the cash payment process, the second is a supplier overcharging situation, the third is an inventory valuation scam by employees, and the fourth is a misstatement due to management's misestimating forecasts used to calculate amortization expense."

AUDIT 12.1 Copying Money

CASE DESCRIPTION

Argus Productions Inc. (Argus) is a motion picture and commercial production company. Improper expenditures for copy services were charged to production costs by an employee, Welby, who had the power to perform incompatible functions in the purchasing, payables, and payments process. Because of his authority at Argus, over a period of five years, Welby was able to conduct a fraud that brought him $475,000 in false and inflated billings. (During this period, Argus's net income was understated a modest amount because copying costs were capitalized as part of production costs, then amortized over a two- to three year period.)

Argus management had assigned Welby authority and responsibility for obtaining copies of scripts used in production. Established procedures permitted Welby to arrange for outside script-copying services, receive the copies, and approve the bills for payment. In effect, Welby was both the purchasing department and the receiving department for this particular service. To a certain extent, Welby was also the accounting department because he approved the bills for payment and coded them for assignment to projects. Welby did not make the actual accounting entries or sign the cheques.

Welby set up a fictitious company under the registered name of Quickprint Company with himself as the incorporator and shareholder. The company had a post office box number, letterhead stationery, and nicely printed invoices, but no printing equipment. Copy services were subcontracted by Quickprint to real printing businesses, which billed Quickprint. Welby then wrote Quickprint invoices to Argus, billing the production company at the legitimate shop's rate, but for a few extra copies each time. Welby also submitted Quickprint bills to Argus for fictitious copying jobs on scripts for movies and commercials that never went into production. As the owner of Quickprint, Welby endorsed Argus's cheques and deposited the money in the copy company's bank account, paid the legitimate printing bills of the subcontractors, and took the rest for personal use.

Audit Trail

Argus's production cost files contained all the Quickprint bills, sorted under the names of the movie and commercial production projects. Welby even created files for proposed films that never went into full production and,

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thus, should not have had script copying costs. There were no copying service bills from any shop other than Quickprint.

AUDIT APPROACH ANALYSIS

Audit Objective

The auditors' objective was to obtain evidence of the valid existence (occurrence) and valuation of copying charges capitalized as film production costs.

Controls Relevant to the Purchasing Process

Authority to request copies and authority for purchasing should be assigned to different employees. The accounting, including the coding of cost assignments to production projects, also should be performed by someone else. A managerial review of production results might cause the excess costs to be noticed.

The request for a particular number of copies of a script should come from someone who would know the number needed. This person should act as the receiving department, signing off on the requested number of copies and the payment. This procedure would prevent waste and excess cost, especially if the requesting person were held responsible for the project's profitability.

Purchasing is always done by a company agent—Welby, in this case. Purchasing agents generally have authority to look for the best service at the best price, with or without bids from competitors. A requirement to obtain bids is usually a good idea, but legitimate purchasing often is done with sole-source suppliers, without bidding. The accounting department should be responsible for coding invoices to the projects, thus making it possible to detect costs charged to projects that are not actually in production. Someone with managerial responsibility should review project costs and the purchasing practices. However, this is an expensive use of executive time. It was not spent in the Argus case, with unfortunate results.

AUDIT PROCEDURES

Tests of Controls

While gaining their understanding of the control structure at Argus, auditors learned about all the trust and responsibility vested in Welby. The embezzlement was for about $95,000 per year, and total copying costs under Welby were around $1 million—inflating a cost by more than 10% might attract unwanted attention. (Note that the materiality concept even applies to the decisions of fraudsters!)

Company-level controls were very weak, especially in the combination of duties performed by Welby and in the lack of managerial review. For all practical purposes, there were no application controls to test, since the weak company-level controls meant they would not be effective anyway. A test of proper classification to see whether Welby had approved the copying cost invoices and coded them to active projects might have uncovered Welby's payments for copying scripts of movies that never went into production, had this been verified against the list of authorized projects. Unfortunately, Welby also produced an "authorized production listing" that included the fictitious projects, which the auditors accepted.

Dual-Purpose Procedures

Vouching costs charged to projects against supporting source documents for a sample of movie project files tests validity of capitalized costs. Tracing a sample of payments to the project cost records is a test of completeness and proper classification of capitalized costs and, if traced to the approved list of productions, it tests authorization. Since Welby had used convincing falsified documents, these audit procedures might not indicate any control exceptions. This case also illustrates the effect and limitations in audit effectiveness relating to materiality levels; Welby deliberately kept this fraud "below the radar screen."

Tests of Details of Balance

Substantive procedures are directed toward obtaining evidence about the existence of film projects, the completeness of the costs charged to them, the ownership of copyrights, the valuation of the capitalized project costs, and the proper allocation and disclosure of amortization methods. The most important procedures are the same as the test of controls procedures; thus, when performed at the year-end date on the capitalized cost balances, they are dual-purpose audit procedures.

Any of the procedures described as test of controls procedures should show evidence of projects that had never gone into production. (Auditors should be careful to obtain a list of actual projects before they begin the procedures.) Chances are high that the discovery of bad project codes with copying cost would reveal a pattern of Quickprint bills.

Knowing that controls over copying costs are weak, auditors could be tipped off to the possibility of a Welby-Quickprint connection. Efforts to locate Quickprint should be taken. Enquiry with the provincial Ministry of Commerce for names of the Quickprint incorporators would reveal Welby's connection. The audit findings could then be turned over to a trained investigator to arrange an interview and confrontation with Welby.

AUDIT RESULTS

In this case, the manager of production, who was worried about profitability, requested that the internal auditors review project costs. They performed the procedures described above on 100% of the transactions and, thus, noticed the dummy projects and the Quickprint bills, investigated the ownership of Quickprint, and discovered Welby's association. First efforts to locate Quickprint's shop by telephone, chamber of commerce, or other city

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directories failed. They were careful not to direct any mail to the post office box for fear of alerting the then-unknown parties involved. Through a ruse at the post office, a sly internal auditor had already learned that Welby had rented the box, but they did not know if anyone else was involved.

Alerted, the internal auditors gathered all the Quickprint bills and determined, with witnesses, the total charged for nonexistent projects. Welby was interviewed by Argus managers and readily confessed.

AUDIT 12.2 Receiving the Missing Oil

CASE DESCRIPTION

Johnson Chemical began a new contract with Madden Oil Distributors to supply fuel oil for the plant generators on a cost-plus contract. Madden delivered the oil weekly in a 20,000-litre-tank truck to Johnson's storage tanks. Because of short shipments by Madden, Johnson's fuel oil supplies inventory and fuel expense were inflated. During the first year, Madden shorted Johnson on quantity by 160,000 litres (loss = 160,000 × \$0.45 = \$72,000) and charged 5 cents per litre more than competitors (loss = 940,000 litres × \$0.05 = \$47,000) for a total overcharge of \$119,000—not to mention the inferior sludge mix occasionally delivered.

Johnson's receiving employees observed the pumping and recorded the quantity on a receiving report, which was forwarded to the accounts payable department and held pending arrival of Madden's invoice. The quantities received then were compared with the quantities billed by Madden, before the invoice was approved for payment and a cheque prepared for signature by the controller. Since it was a cost-plus contract, Madden's billing price was not checked against any standard price. The receiving employees were rather easily fooled by Madden's driver. He mixed sludge with the oil, but the receiving employees did not take samples to check for quality. He called out Johnson's storage tank content falsely at the beginning (e.g., 4000 litres on hand when 8000 were actually in the tank) and the receiving employees did not check the gauge themselves. The tank truck was not weighed at entry and exit to determine the amount delivered. During the winter months, when fuel oil use was high, Madden ran in extra trucks more than once a week, but pumped nothing when the receiving employees were not looking. Quantities "received" and paid during the first year of the contract were (in litres) as follows:

Jan.	124,000	May	72,000	Sept.	84,000
Feb.	112,000	June	56,000	Oct.	92,000
Mar.	92,000	July	60,000	Nov.	132,000
Apr.	76,000	Aug.	56,000	Dec.	144,000

Audit Trail

The receiving reports all agreed with the quantities billed by Madden. Each invoice had a receiving report attached in the Johnson accounts payable files. Even though Madden had many trucks, the same driver always came to the Johnson plant, as evidenced by his signature on the reports (along with the receiving employees' initials). At \$0.45 per litre, Madden charged \$495,000 for 1,100,000 litres of fuel for the year. The previous year, Johnson paid a total of \$360,000 for 900,000 litres, but nobody made a complete comparison with last year's quantity and cost.

AUDIT APPROACH ANALYSIS

Audit Objective

The auditors' objective was to obtain evidence that all fuel oil billed and paid was actually received in the quality expected, at a fair price.

Controls Relevant to the Process

Receiving employees should be given the tools and techniques they need to do a good job. Scales at the plant entrance could weigh the trucks in and out, determining the amount of fuel delivered. (Weight per litre is a well-known measure.) Sampling for simple chemical analysis would give evidence of the quality of the oil. Receiving employees should be instructed on the importance of their job, to encourage conscientiousness. They should have been instructed to read the storage tank gauges themselves instead of relying on Madden's driver. Lacking these tools and instructions, they were easy marks for the wily driver.

AUDIT PROCEDURES

Tests of Controls

The information from the "understanding the control structure" phase would need to be very detailed if it is to alert the auditors to the poor receiving practices. Procedures will include making enquiries with the receiving employees to learn about their practices and work habits. The control procedure supposedly in place was the receiving report on the oil delivered. A control test procedure would be to take a sample of Madden's bills, and compare quantities billed with quantities received while verifying the price billed against the contract. Because of the deception by Madden's driver, this would not have shown anything unusual, unless perhaps the auditor became suspicious of the fact that the same driver made all the deliveries.

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Tests of Details of Balance

The balances in question are the fuel oil supply inventory and the fuel expense. The inventory is easily audited by reading the tank storage gauge for the quantity. The price is found in Madden's invoices. However, a lower-of-cost-or-market test requires knowledge of market prices for the oil. Since Johnson Chemical apparently has no documentation of competing prices, the auditor will need to research with other oil distributors to get the prices. Presumably, the auditors would learn that the price is approximately $0.40 per litre. The expense balance can be audited like a cost-of-goods-sold amount. With knowledge of the beginning fuel inventory, the quantity "purchased," and the quantity in the ending inventory, the fuel oil expense quantity can be calculated. This expense quantity can be priced at Madden's price per litre.

Substantive Analytical Procedures

Analytical procedures applied to the expense revealed the larger quantities used and the unusual pattern of deliveries, leading to suspicions of Madden and the driver. Aware of the current year's higher expense and the evidence of a lower market price, the auditors obtained the fuel oil delivery records from the prior year. They are shown in the table below. (The numbers in parentheses are the additional litres delivered in the current year.)

AUDIT RESULTS

Having found a consistent pattern of greater "use" in the current year, with no operational explanation for it, the auditors took to the field. With the cooperation of the receiving employees, the auditors read the storage tank measure before the Madden driver arrived. They hid in an adjoining building to watch (and film) the driver call out an incorrect reading, pump the oil, sign the receiving report, and depart. Then they took samples. These observations were repeated for three weeks. They saw short deliveries, tested inferior products, and built a case against Madden and the driver. Johnson recovered the overcharges from Madden and, of course, immediately switched to a different fuel supplier!

Jan.	112,000 (12,000)	May	52,000 (20,000)	Sept.	60,000 (24,000)
Feb.	96,000 (16,000)	June	44,000 (12,000)	Oct.	80,000 (12,000)
Mar.	80,000 (12,000)	July	40,000 (20,000)	Nov.	112,000 (20,000)
Apr.	68,000 (8,000)	Aug.	36,000 (20,000)	Dec.	120,000 (24,000)

AUDIT 12.3 Retread Tires

CASE DESCRIPTION

Ritter Tire Wholesale Company had a high-volume truck and passenger car tire business in Hamilton, Ontario (area population 500,000). J. Lock, the chief accountant, was a long-time trusted employee who had supervisory responsibility over the purchasing agent as well as general accounting duties. Lock had worked several years as a purchasing agent before moving into the accounting job. Lock carried out a fraudulent scheme for three years, diverting tires that cost Ritter $2.5 million, which Lock then sold for $2.9 million. Inventory and income were overstated by Lock's substitution of the new-tire inventory with lower-quality retread tires, which he valued at new tire prices. (Lock's cost for retread tires was approximately $500,000.)

Lock often prepared the purchase orders, and the manufacturers were directed to deliver the tires to a warehouse in Milton (a town of 60,000, about 30 kilometres north of Hamilton). Ritter Tire received the manufacturers' invoices, which Lock approved for payment. Lock and an accomplice (his brother-in-law) sold the tires from the Milton warehouse and pocketed the money. At night, Lock moved cheaper retread tires into the Ritter warehouse so the space would not be empty. As chief accountant, Lock could override controls (e.g., approving invoices for payment without a receiving report), and T. Ritter (president) never knew the difference because the cheques presented for his signature were not accompanied by the supporting documents.

Audit Trail

Ritter Tire's files were well organized. Each cheque copy had supporting documents attached (invoice, receiving report, purchase order), except for the misdirected tire purchases, which had no receiving reports. These purchase orders were all signed by Lock, and the shipping destination on them was the Milton address. There were no purchase requisition documents because "requisitions" were in the form of verbal requests from salespeople. There was no paper evidence of the retread tires because Lock simply

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bought them elsewhere and moved them in at night when nobody was around.

AUDIT APPROACH ANALYSIS

Audit Objective

The auditors' objective was to obtain evidence of the existence and valuation of the inventory. (President Ritter engaged external auditors for the first time in the third year of Lock's scheme, after experiencing a severe cash squeeze.)

Controls Relevant to the Process

Competent personnel should perform the purchasing function. Lock and the other purchasing agents were competent and experienced. They prepared purchase orders, required by manufacturers for shipment, authorizing the purchase of tires. A receiving department prepared a receiving report, after counting and inspecting each shipment, by filling in the "quantity column" on a copy of the purchase order. (A common receiving report is a "blind" purchase order that has all the purchase information except the quantity, which the receiving department fills in after an independent inspection and count.) Receiving personnel made notes if the tires showed blemishes or damage. As chief accountant, Lock approved invoices from the manufacturers for payment after comparing the quantities with the receiving report and the prices with the purchase order. The cheques for payment were produced on the computerized accounting system when Lock entered the invoice payable in the system. The computer software did not void transactions without a receiving report reference because many expenses legitimately had no receiving reports. The key weaknesses in the control structure are that (1) no one on the accounting staff has the opportunity to notice missing receiving reports for invoices that should have had them, and (2) Ritter has no supporting documents when cheques are signed. Lock is a trusted employee.

AUDIT PROCEDURES

Tests of Controls

Because the control procedures for cross-checking the supporting documents were said to be in place, the external auditors could test those controls by the following procedure:

Select a sample of purchases (manufacturers' invoices payable entered in the computer system), and do the following:

1. Study the related purchase order for (a) valid manufacturer name and address; (b) date; (c) delivery address; (d) unit price, with reference to catalogue or price list; (e) correct arithmetic; and (f) approval signature.
2. Compare purchase order information with the manufacturers' invoice.
3. Compare the purchase order and invoice with the receiving report for (a) date, (b) quantity and condition, (c) approval signature, and (d) location.

Tests of Details of Balance

Ritter Tire did not maintain perpetual inventory records, so the inventory was a periodic system—an inventory figure calculated from the annual physical inventory count and costing compilation. The basic audit procedure was to observe the count by taking a sample from different locations on the warehouse floor, recounting the employees' count, controlling the count sheets, and inspecting the tires for quality and condition (related to proper valuation). The auditors kept their own copy of all the count sheets with their test count notes and notes identifying tires as "new" or "retread." (They took many test counts in the physical inventory sample as a result of the test of controls work, described following.)

AUDIT RESULTS

Forty manufacturers' invoices were selected at random for the test of controls procedure. The auditors were good. They had reviewed the business operations, and Ritter had said nothing about having operations or a warehouse in Milton, although a manufacturer might have been instructed to "drop-ship" tires to a customer there. The auditors noticed three missing receiving reports, all of them with purchase orders signed by Lock and requesting delivery to the same Milton address. They asked Lock about the missing receiving reports, and got this response: "It happens sometimes. I'll find them for you tomorrow." When Lock produced the receiving reports, the auditors noticed these were in a current numerical sequence (although dated much earlier), filled out with the same pen, and signed with an illegible scrawl not matching any of the other receiving reports they had seen.

The auditors knew the difference between new and retread tires when they saw them, and confirmed their observations with employees taking the physical inventory count. When Lock priced the inventory, new-tire prices were used, and the auditors knew the difference.

Ritter took the circumstantial evidence to a trained investigator who interviewed the manufacturers and obtained information about the Milton location. The case against Lock led to criminal theft charges and conviction.

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AUDIT 12.4 Amortize "the Drum" Slowly

CASE DESCRIPTION

Candid Production Company was a major producer of theatrical movies. The company usually had 15 to 20 films in release at theatres across the nation and in foreign countries. Movies also generated revenue through video/DVD licences and product sales (T-shirts, toys, etc.). Over a four-year period, Candid's net asset value (unamortized cost of films) was overstated through taking too little amortization expense: Candid Productions postponed recognition of a $20 million amortization expense, thus inflating assets and income. Movie production costs are capitalized as assets and then amortized to expense as revenue is received from theatre ticket and DVD sales, and from other sources of revenue. The amortization depends on the total revenue forecast and the current-year revenue amount. As the success or failure of a movie unfolds at the box office, revenue estimates are revised. (The accounting amortization is similar to depletion of a mineral resource, which depends on estimates of recoverable minerals and current production.)

Candid Production was not too candid: Its recent film, *Bang the Drum Slowly,* was forecast to produce $50 million total revenue over six years, while early box office returns showed only $10 million in the first eight months in the theatres. Revenue usually declines rapidly after initial openings, and DVD and other revenues depend on the box office success of a film. Accounting "control" with respect to film-cost amortization depends on the revenue forecasts, and the revision of them. In this case, these were overly optimistic, showing the expense recognition and overstating assets and income.

Audit Trail

Revenue forecasts are based on many factors, including facts and assumptions about number of theatres, ticket prices, receipt-sharing agreements, domestic and foreign reviews, and moviegoer tastes. Several publications track the box office records of movies. You can see them in entertainment websites, newspapers, and in the industry trade publications. Of course, the production companies themselves are the major source of the information, and company records do show the revenue realized from each movie. Revenue forecasts can be checked against actual results, and the company's history of forecasting accuracy can be determined by comparing actuals with forecasts over many films and many years.

AUDIT APPROACH ANALYSIS

Audit Objective

The auditors' objective was to obtain evidence determining if revenue forecasts provide a sufficient basis for calculating film-cost amortization and net asset value of films.

Controls Relevant to the Process

Revenue forecasts need to be prepared by a systematic and methodical process that documents both the facts and the underlying assumptions of the forecast. Forecasts should break down the revenue estimate by years, and the accounting system should produce comparable actual revenue data so that forecast accuracy can be assessed after the fact. Forecast revisions should be prepared with as much detail and documentation as original forecasts.

AUDIT PROCEDURES

Tests of Controls

The general procedures and methods used by personnel responsible for revenue forecasts should be studied (enquiries and review of documentation), including their sources of information—both internal and external. Procedures for review of mechanical aspects (arithmetic) should be tested by recalculating the final estimates for a sample of finished forecasts. Specific procedures for forecast revision should be studied in the same way. Reviewing the accuracy of the forecasts of other movies against actual revenues helps in a circumstantial way, but past accuracy on different film experiences may not be directly helpful to forecasting for a new, unique product.

Tests of Details of Balance

The audit of amortization expense concentrates on the content of the forecast itself. The forecasts used in the amortization calculation should be studied to distinguish underlying reasonable expectations from hypothetical assumptions. A hypothetical assumption states a condition that is not necessarily expected to occur, but it is nonetheless used to prepare an estimate—an if-then statement. For example, "*If Bang the Drum Slowly* sells 15 million tickets in the first 12 months of release, then domestic revenue and product sales will be $40 million, and foreign revenue can eventually reach $10 million." Auditors need to assess the reasonableness of the 15 million ticket assumption. It helps to have some early actual data from the film's release in hand before the financial statements need to be finished and distributed. For actual data, industry publications ought to be reviewed, with special attention paid to

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competing films and critics' reviews (yes, even movie reviews can be useful as audit evidence!).

AUDIT RESULTS

The auditors were not skeptical enough about the revenue forecasts, and they did not weigh unfavourable actual-to-forecast history comparisons heavily enough. Apparently, they let themselves be convinced by exuberant company executives that the movies were comparable with the blockbuster *Avatar* The audit of forecasts and estimates used in accounting determinations are very difficult to arrive at, especially when company personnel have incentives to hype the numbers, seemingly with conviction. The postponed amortization expense finally came home to roost in big writeoffs when the company management changed.

REVIEW CHECKPOINTS

12-28 Give some examples of receiving departments in the audit application cases above.

12-29 In Audits 12.1 and 12.3, frauds involving fictitious people, businesses, and locations occurred. Where can auditors obtain information showing whether people, businesses, and locations are real or not?

12-30 How can analysis be used for discovery of excess costs? (See Audit 12.2.)

12-31 How can analysis be used for discovery of understated expenses? (See Audit 12.4.)

12-32 Why must auditors understand the physical characteristics of inventoried assets?

12-33 Why is professional skepticism important for auditors? Give two case examples.

12-34 What evidence could the verbal enquiry audit procedure produce in Audits 12.1, 12.2, and 12.3?

SUMMARY

The learning objectives addressed in this chapter are summarized as follows:

- The purchases, payables, and payments process consists of purchase requisitioning, purchase ordering, receiving goods and services, recording suppliers' invoices, accounting for accounts payable, and making disbursements of cash. Companies reduce control risk by having a suitable separation of authorization, custody, recording, and periodic reconciliation duties. Error-checking procedures of comparing purchase orders and receiving reports with supplier invoices are important for recording proper amounts of accounts payable liabilities. Supervisory control is provided by separating the duties of preparing cash disbursement cheques and actually signing them. Otherwise, many things could go wrong, ranging from processing false purchase orders to failing to record liabilities for goods and services received.
- Auditors assess the auditee's controls over the purchases, payables, and payments process by evaluating whether the general and environmental controls and application controls effectively reduce the risk of material misstatement in purchasing transactions, accounts payable and other liability balances, and cash payments transactions. They test any key controls that they decide to rely on to reduce substantive testing.
- Substantive programs are developed by linking the auditor's risk assessments to the risks of material misstatements in purchasing transactions, accounts payable and other liability balances, and cash payments transactions. The chapter provided examples of typical substantive procedures that would be considered, depending on the risks assessed in each particular case.
- Three topics had special technical notes in the chapter covering some important assertion-based risks and audit approaches. The completeness assertion is very important in the audit of liabilities because misleading financial statements often contain unrecorded liabilities and expenses. The search for unrecorded liabilities is an important set of audit procedures. The physical inventory observation audit work was a special section

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because actual contact with inventories (and fixed assets, for that matter) provides auditors with direct eyewitness evidence of important tangible assets. The valuation assertion for PPE and intangible assets is often high risk due to the complexity and subjectivity of the estimates involved in accounting for long-lived assets over the years of use.

Cash disbursement is a critical point for asset control. Many cases of embezzlement occur in this process. Illustrative cases in the chapter told of some embezzlement schemes involving payment of fictitious charges to dummy companies set up by employees.

Analysis of Financial Statement Relationships

The audit of the purchases, payables, and payments processes results in verifying the balance of accounts payables/accrued liabilities and the two transaction streams that run through it—purchases/expenses and cash payments. In the balance sheet approach to auditing, we can analyze balance changes and the financial statement items related to them by preparing a continuity schedule. The accrued legal fees balance shown below is one example for the purchases, payables, and payments process. (The relationship between inventory purchases and balance sheet amounts will be analyzed in Chapter 13.)

AUDITED AMOUNT	FINANCIAL STATEMENT WHERE AMOUNT IS REPORTED
Opening balance of accrued liability for legal fees	Balance sheet(component of accrued liabilities in prior year comparative figures)
Add: New legal services expensed during the year	Income statement expense (e.g., legal services acquired)
Deduct: Cash paid against payables	Cash flow statement (direct method)
Ending balance of accrued liability for legal fees	Balance sheet(component of accrued liabilities in current year figures)

As these relationships illustrate, our procedures to audit the purchases, payables, and payments process allow us to assess whether all components of this system of related amounts are reported accurately in the financial statements. These relationships also indicate analytical procedures that can detect material misstatements. For example, the ratios that measure inventory turnover or expense-to-revenue ratios exploit these relationships and can indicate nonexistent inventory or misstatement in expense accounts and liabilities.

Misstatement Analysis

The financial statement relationships can also be used to analyze the kinds of misstatements that may be uncovered in the audit work. Consider the following situations.

Say, the auditors discover by their testing of the cash disbursements that a cutoff error has occurred. After the books were closed for the year-end on December 31, one additional cheque was issued that was not recorded. The auditors learned through enquiries that this happened when the CFO had to go see the company lawyer on a last-minute issue late on December 31 and asked the payables manager to issue a cheque to pay the lawyer's outstanding bill of $42,000, which had been set up in accounts payable when it was received earlier in the year. (A sharp auditor would also be sure to find out what the "last minute" legal issue was!) This cutoff error results in the cash payment amount deducted from the accrued liability balance being too small, making the accrued liability balance too big, that is, overstated. Since the cash part of the transaction was also unrecorded, the cash balance is overstated (this difference also will be picked up in the bank reconciliation audit). This misstatement will be carried forward to the accumulated misstatements worksheet in the audit file, as illustrated in Exhibit 16-1 of Chapter 16.

Consider another type of misstatement related to the expense accounts and accruals. The electricity company billed the company for December based on an estimate of its usage, and this bill was accrued at the year-end. However, on February 3, the electricity company sent a revised bill based on a meter reading, and the actual electricity charges were higher than the accrued amount by $3700. Since the new bill was received when the audit field work was being performed, it was noted by the auditors in their subsequent payments testing. Enquiries revealed that the

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company's electricity usage in December was much higher than in the past because it was an exceptionally cold month, and at one point, the loading dock door froze open over a weekend, causing a great deal of power to be wasted. The impact of the error is that too little was added to the accounts payable account, and too little was expensed, so liabilities are understated and net income is overstated. This misstatement will also be carried forward to the accumulated misstatements worksheet (see Exhibit 16–1) for evaluation at the final stage of the audit when the audit partner must assess whether the misstatements uncovered accumulate to a material amount.

KEY TERMS

cutoff error
purchase cutoff
rollforward period
search for unrecorded liabilities

EXERCISES AND PROBLEMS

EP 12-1 Liabilities: Authorization Control. LO1, LO2 The essential characteristic of the liabilities control system is to separate the authorization and approval to initiate a transaction from the responsibility for recordkeeping.

Required:
What would constitute the authorization for accounts payable recording? What documentary evidence could auditors examine as evidence of this authorization?

EP 12-2 Cash Disbursements: Completeness Control. LO1, LO2 The use of prenumbered documents is an important feature for control to ensure that all valid transactions are recorded and none are omitted.

Required:
How could auditors gather evidence that the control for completeness of cash disbursements was being used properly by a company?

EP 12-3 Automated Transactions: Authorization Control. LO1, LO2 Two "automatic transactions" can be produced in a computerized accounting system: (1) cheque printing and signature and (2) purchase order at a preprogrammed stock reorder point.

Required:
Assume management is uncomfortable with the computer creating transactions. How could management delay these transactions until they were "viewed" and authorized?

EP 12-4 Liabilities: Insurance Coverage. LO1

Required:
Why should auditors be concerned with the adequacy of casualty insurance coverage of an auditee's physical property?

EP 12-5 Inventory: Enquiry-based Evidence. LO3, LO5

Required:
What evidence regarding inventories and cost of sales can the auditor typically obtain from enquiry?

EP 12-6 Specific Assertions: Fixed Assets. LO6 Auditors plan their audit procedures to gather evidence about management's assertions in the financial statements. In addition to the broad assertions, such as existence and completeness, specific assertions are made for each major account area.

Required:
List 9 or 10 examples of such specific assertions for the fixed assets and related accounts.

EP 12-7 Repair and Maintenance Auditing. LO6

Required:
Why should the repairs and maintenance expense account be audited at the same time as the fixed asset accounts?

EP 12-8 Fixed Assets: Audit Procedures. LO6 Audit procedures may be classified as:

Recalculation/reperformance
Observation
Confirmation
Enquiry
Inspection of documents (vouching, tracing, scanning)
Inspection of physical assets
Analysis

Required:
Describe how each procedure may be used to gather evidence on fixed assets and which broad financial statement assertion(s) (existence, completeness, ownership [rights], valuation [allocation], and presentation and disclosure), are being addressed by the use of the procedure.

EP 12-9 Payable Internal Control Questionnaire Items: Control Objectives, Test of Controls Procedures, and Possible Errors or Fraud. LO1, LO2 Listed below is a selection of items from the internal control questionnaire on payables shown in Appendix 12A.

1. Are invoices, receiving reports, and purchase orders reviewed by the cheque signer?
2. Are cheques dated in the cheque register with the date of the cheque?
3. Are quantity and quality of goods received determined at time of receipt by receiving

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personnel independent of the purchasing department?

4. Are suppliers' invoices matched against purchase orders and receiving reports before a liability is recorded?

Required:

For each one:

a. Identify the control objective to which it applies.

b. Specify one test of controls audit procedure an auditor could use to determine whether the control was operating effectively.

c. Using your business experience, your logic, your imagination, or all three, give an example of an error or fraud that could occur if the control was absent or ineffective.

EP 12-10 Inventory Count, Measurement. LO1, LO5 Consider the following examples of inventories in various businesses:

1. Pharmaceuticals in a drug company
2. Fine chemical compounds in a biotechnology company
3. Software in an information technology development company
4. New condominium office units in a commercial real estate developer
5. Fine art works in an interior design business

Required:

For each item, indicate the challenges auditors would face in trying to count and measure the inventory, and suggest an approach to obtain sufficient audit evidence.

EP 12-11 Inventory, Analysis of Gross Margin. LO3 Li was assigned to work on the audit of A1 Clothing Ltd., because she has been auditing similar companies for three years and is considered to be knowledgeable about the clothing retailing industry in Canada. Her employer, Bing PAs, audited A1 in 20X5 for the first time and had difficulty verifying the opening inventory number. This year, in 20X6, Li has the audited ending balance from 20X5, so she does not expect any problems with the inventory account. However, while doing the preliminary work for the audit, she calculated the gross profit margin and was surprised by her findings. Li thinks the gross margin may indicate that the ending inventory for 20X0 may be incorrect.

	20X5	20X6
Sales of clothing	$10,000,000	$9,000,000
Cost of goods sold	7,000,000	5,500,000
Inventory	1,800,000	6,200,000

Required

Explain whether you agree with Li. Support your answer with at least three points.

(CGA-Canada adapted)

EP 12-12 Inventory, Impact of Cutoff Error. LO3 You are performing the audit of the CXX Limited (CXX) financial statements for its year ended September 30, 20X0. CXX is a private company and operates a grocery distribution business in the Greater Toronto Area. CXX's audited financial statements are used mainly by its bank, which has made a large operating loan to CXX. The bank requires CXX to maintain a quick ratio of at least 1.2, based on its year-end financial statements; otherwise, the bank can require CXX to repay the loan in full immediately.

CXX's accounting policy is to value its inventory based on the FIFO cost flow assumption. On September 30, 20X0, CXX had received a large truckload of pomegranate juice from California Fruit Inc. Since these goods were in CXX's warehouse at year-end, they were included in the year-end physical inventory count. During your audit you have discovered that the company's accountant did not record this purchase in the accounts payable balance until October 10, 20X0, when an invoice was received from the supplier, California Fruit, in the amount of $65,000.

Before correcting this error, CXX's draft financial statements show inventory of $900,000, total current assets of $1,500,000, accounts payable of $250,000, and total current liabilities of $450,000.

Required:

a. Explain how the accounts in the CXX September 30, 20X0, financial statements will be affected by this error. In your explanation identify the assertion(s) violated by this error.

b. Give one example of an audit procedure that would have discovered this error. Explain clearly how this procedure could discover the error.

c. What is the impact of this error on CXX's quick ratio? Show calculations.
(*Note:* Quick ratio = Current assets excluding inventory / Current liabilities)

d. Would you consider this error to be material? Justify your response.

EP 12-13 PPE audit evidence and assertions. LO3, LO6 Alvin is auditing Demure Fashions Inc., a chain of women's clothing stores. Demure operates six stores in shopping malls across the Toronto area and has been an audit client of Alvin's firm for several years. Alvin has been assigned the audit of Demure's store fixtures account. This year the audit partner has instructed Alvin that detection risk for the store fixtures account must reduced to a very low level, this is because Demure is negotiating new financing that will use the store fixtures as collateral.

Demure's chief accountant has given Alvin a detailed list of all the store fixtures (shelving, clothing display racks, and sales counters) included in Demure's general ledger account. The accounting policy is to record store fixtures at cost, with depreciation recognized using the straight-line method.

On the company's year-end date, January 2, 20X1, Alvin visited all six of the stores, looked at

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the fixtures in place, and compared them to the descriptions on the list. In eight cases he could not locate the listed fixture and asked the store manager where it was. In every case, the manager said the fixture unit had been placed in storage because it was broken and in need of repair. In one new store, Alvin found nine new clothing racks that were not included on the list. The store manager told him these racks had been purchased a few days before year-end.

Required:

a. Identify three types of audit evidence Alvin has obtained and explain which assertion(s) this evidence is relevant to.

b. Of the evidence Alvin obtained, which do you think is the most reliable? Why?

c. Describe one additional procedure Alvin should perform to get evidence regarding another assertion, and explain what assertion that evidence would be relevant to.

DISCUSSION CASES

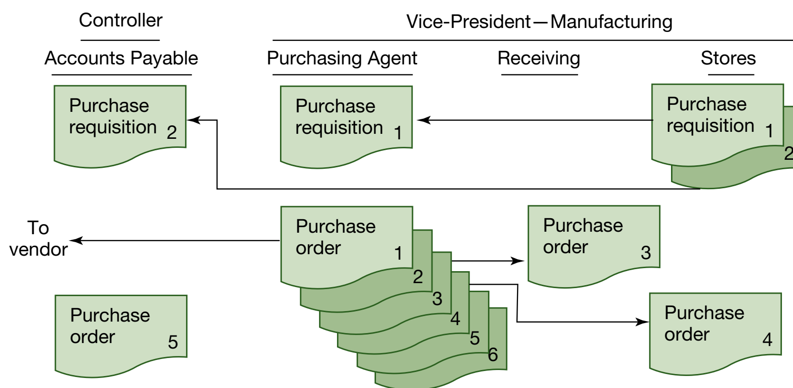
DC 12-1 Purchasing Control Procedures. LO1, LO2 Long, PA, has been engaged to examine and report on the financial statements of Maylou Corporation. During the review phase of the study of Maylou's system of internal control over purchases, Long was given the following document flowchart for purchases (see Exhibit DC12-1).

Required:

Identify the procedures relating to purchase requisitions and purchase orders that Long would expect to find if Maylou's system of internal control over purchases is effective. For example, purchase orders are prepared only after properly considering the time to order and quantity to order. Do not comment on the effectiveness of the flow of documents as presented in the flowchart or on separation of duties.

(AICPA adapted)

EXHIBIT DC12-1 Maylou Corporation—Document Flowchart for Purchases



DC 12-2 Control Tests for Cash Disbursements. LO1, LO2 The Runge Controls Corporation manufactures and markets electrical control systems: temperature controls, machine controls, burglar alarms, and the like. Electrical and semiconductor parts are acquired from outside vendors, and systems are assembled in Runge's plant. The company incurs other administrative and operating expenditures. Liabilities for goods and services purchased are entered in an accounts payable journal, at which time the debits are classified to the asset and expense accounts they apply to. The company has specified control procedures for approving vendor invoices for payment, for signing cheques, for keeping records, and for reconciling the chequing accounts.

The procedures appear to be well-specified and placed in operation. You are the senior auditor on the engagement, and you need to specify a program (list) of control tests to audit the effectiveness of the controls over cash disbursements.

Required:

Using the seven general internal control objectives discussed in Chapter 9, specify two or more control tests to audit the effectiveness of typical control procedures. (*Hint:* From one sample of recorded cash disbursements, you can specify control tests related to several objectives. See Exhibit 12–4 for examples of control test procedures over cash disbursements.) Organize your list according to the example shown below for the completeness objective.

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CONTROL OBJECTIVE	SPECIFIC CONTROL OBJECTIVE FOR CASH DISBURSEMENTS TRANSACTIONS	TEST OF CONTROLS PROGRAM
Completeness	All valid cash disbursements are recorded and none are omitted.	Determine the numerical sequence of cheques issued during the period and scan the sequence for missing numbers. (Scan the accounts payable records for amounts that appear to be too long outstanding, indicating liabilities for which payment may have been made but not recorded properly.)

DC 12-3 Unrecorded Liabilities Procedures. LO3, LO4 You were in the final stages of your audit of the financial statements of Ozine Corporation for the year ended December 31, 20X2, when you were consulted by the corporation's president. The president believes there is no point in your examining the 20X3 accounts payable records and testing data in support of 20X3 entries. He stated: (1) bills pertaining to 20X2 that were received too late to be included in the December accounts payable were recorded as of the year-end by the corporation by journal entry, (2) the internal auditor made tests after the year-end, and (3) he would furnish you with a letter certifying that there were no unrecorded liabilities.

Required:

a. Should your procedures for unrecorded liabilities be affected by the fact that the auditee made a journal entry to record 20X2 bills that were received later? Explain.

b. Should your test for unrecorded liabilities be affected by the fact that a letter is obtained in which a responsible management official certifies that to the best of his knowledge all liabilities have been recorded? Explain.

c. Should your test for unrecorded liabilities be eliminated or reduced because of the internal audit work? Explain.

d. What sources, in addition to the 20X3 accounts payable records, should you consider to locate possible unrecorded liabilities?

(AICPA adapted)

DC 12-4 Accounts Payable Confirmations. LO3, LO4 Clark and his partner, Kent, both PAs, are planning their audit program for the audit of accounts payable on the LeClair Corporation's annual audit. Saturday afternoon, they reviewed the thick file of last year's working papers, and both of them remembered all too well the six days they spent last year on accounts payable.

Last year, Clark had suggested that they mail confirmations to 100 of LeClair's suppliers. The company regularly purchases from about 1000 suppliers and these account payable balances fluctuate widely, depending on the volume of purchases and the terms LeClair's purchasing agent is able to negotiate. Clark's sample of 100 was designed to include accounts with large balances. In fact, the 100 accounts confirmed last year covered 80% of the total accounts payable.

Both Clark and Kent spent many hours tracking down minor differences reported in confirmation responses. Nonresponding accounts were investigated by comparing LeClair's balance with monthly statements received from suppliers.

Required:

a. Identify the accounts payable audit objectives that the auditors must consider in determining the audit procedures to be performed.

b. Identify situations when the auditors should use accounts payable confirmations, and discuss whether they are required to use them.

c. Discuss why the use of large dollar balances as the basis for selecting accounts payable for confirmation may not be the most efficient approach, and indicate a more efficient sample selection procedure that could be followed when choosing accounts payable for confirmation.

DC 12-5 Inventory Count Observation: Planning and Substantive Audit Procedures. LO3, LO5 Cindy Li is the partner in charge of the audit of Blue Distributing Corporation, a wholesaler that owns one warehouse containing 80% of its inventory. Cindy is reviewing the working papers that were prepared to support the firm's opinion on Blue's financial statements. Cindy wants to be certain that essential audit procedures are well documented in the working papers.

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Required:

a. What evidence should Cindy expect to find that the audit observation of the auditee's physical count of inventory was well planned and that assistants were properly supervised?

b. What substantive audit procedures should Cindy find in the working papers that document management's assertions about existence and completeness of inventory quantities at the end of the year? (Refer to Exhibit 12–8 for procedures.)

(AICPA adapted)

DC 12-6 Sales/Inventory Cutoff. LO3, LO5 Your auditee took a complete physical inventory count under your observation as of December 15 and adjusted the inventory control account (perpetual inventory method) to agree with the physical inventory. Based on the count adjustments as of December 15, and after review of the transactions recorded from December 16 to December 31, you are almost ready to accept the inventory balance as fairly stated.

However, your review of the sales cutoff as of December 15 and December 31 disclosed the following items not previously considered:

COST	SALES PRICE	SHIPPED	DATE BILLED	CREDITED TO INVENTORY CONTROL
$28,400	$36,900	12/14	12/16	12/16
39,100	50,200	12/10	12/19	12/10
18,900	21,300	1/2	12/31	12/31

Required:

What adjusting journal entries, if any, would you make for each of these items? Explain why each adjustment is necessary.

(AICPA adapted)

DC 12-7 Statistical Sampling Used to Estimate Inventory. LO3, LO5 Ace Corporation does not conduct a complete annual physical count of purchased parts and supplies in its principal warehouse but, instead, uses statistical sampling to estimate the year-end inventory. Ace maintains a perpetual inventory record of parts and supplies. Management believes that statistical sampling is highly effective in determining inventory values and is sufficiently reliable that a physical count of each item of inventory is unnecessary.

Required:

a. List at least 10 normal audit procedures that should be performed to verify physical quantities whenever an auditee conducts a periodic physical count of all or part of its inventory (see Exhibit 12–8 for procedures).

b. Identify the audit procedures you should use that change or are in addition to normal required audit procedures (in addition to those listed in your solution to part (*a*) when a auditee utilizes statistical sampling to determine inventory value and does not conduct a 100% annual physical count of inventory items.

(AICPA adapted)

DC 12-8 Inventory Procedures Using Generalized Audit Software. LO3, LO5 You are conducting an audit of the financial statements of a wholesale cosmetics distributor with an inventory consisting of thousands of individual items. The distributor keeps its inventory in its own distribution centre and in two public warehouses. A perpetual inventory database is maintained on a computer system and is updated at the end of each business day. Each individual record of the perpetual inventory database contains the following data:

- Item number
- Location of item
- Description of item
- Quantity on hand
- Cost per item
- Date of last purchase
- Date of last sale
- Quantity sold during year

You are planning to observe the distributor's physical count of inventories as of a given date. You will have available a computer file, provided by the auditee, of the above items taken from their database as of the date of the physical count. Your firm has a generalized audit software package that can upload and analyze the auditee's computer data files.

Required:

List the basic inventory auditing procedures and, for each, describe how the use of the general-purpose audit software package and the perpetual inventory database might be helpful to the auditor in performing such auditing procedures. (See Exhibit 12–8 for substantive audit procedures for inventory.) Organize your answer as follows:

Basic inventory auditing procedures	How general purpose audit software package and the inventory file data might be helpful

(AICPA adapted)

DC 12-9 Manufacturing Equipment and Accumulated Depreciation. LO3, LO6 In connection with a recurring examination of the financial statements of the Louis Manufacturing Company for the year ended December 31, you have been assigned the audit of the fixed assets accounts (Manufacturing Equipment, Manufacturing Equipment—Accumulated Depreciation, and Repairs to Manufacturing Equipment). Your review of Louis's policies and procedures has disclosed the following pertinent information:

1. The Manufacturing Equipment account includes the net invoice price plus related freight and installation costs for all of the equipment in Louis's manufacturing plant.
2. The Manufacturing Equipment—Accumulated Depreciation accounts are supported by a

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subsidiary ledger, which shows the cost and accumulated depreciation for each piece of equipment.

3. An annual budget for capital expenditures of $1000 or more is prepared by the executive committee and approved by the board of directors. Capital expenditures over $1000 that are not included in this budget must be approved by the board of directors, and variations of 20% or more must be explained to the board. Approval by the supervisor of production is required for capital expenditures under $1000.
4. Company employees handle installation, removal, repair, and rebuilding of the machinery. Work orders are prepared for these activities and are subject to the same budgetary control as other expenditures. Work orders are not required for external expenditures.

Required:

a. Prepare a list of the major specific objectives (assertions) for your audit of the Manufacturing Equipment, Manufacturing Equipment—Accumulated Depreciation, and Repairs of Manufacturing Equipment accounts. Do not include in this listing the auditing procedures designed to accomplish these objectives.

b. Prepare the portion of your audit program applicable to the review of current-year additions to the Manufacturing Equipment account.

(AICPA adapted)

DC 12-10 Peacock Company: Incomplete Flowchart of Inventory and Purchasing Control Procedures. LO1, LO2 Peacock Company is a wholesaler of soft goods. The inventory is composed of approximately 3500 different items. The company employs a computerized batch processing system to maintain its perpetual inventory records. The system is run each weekend so that inventory reports are available on Monday morning for management use. The system has been functioning satisfactorily for the past 10 years, providing the company with accurate records and timely reports.

The preparation of purchase orders has been automatic as a part of the inventory system to ensure that the company will maintain enough inventory to meet customer demand. When an item of inventory falls below a predetermined level, a record of the inventory items is written. This record is used in conjunction with the vendor file to prepare the purchase orders.

Exception reports are prepared during the update of the inventory and the preparation of the purchase orders. These reports list any errors or exceptions identified during the processing. In addition, the system provides for management approval of all purchase orders exceeding a specified amount. Any exceptions or items requiring management approval are handled by supplemental runs on Monday morning and are combined with the weekend results.

A system flowchart of Peacock Company's inventory and purchase order procedure is in Exhibit DC12-10.

Required:

a. The illustrated system flowchart (see Exhibit DC12-10) of Peacock Company's inventory and purchase order system was prepared, but several steps that are important to the successful operations of the system are omitted from the chart. Describe the steps that have been omitted and indicate where the omissions have occurred. The flowchart does not need to be redrawn.

b. In order for Peacock's inventory/purchase order system to function properly, control procedures should be included in the system. Describe the type of control procedures Peacock Company should use in its system to ensure proper functioning, and indicate where these procedures would be placed in the system.

(CMA adapted)

DC 12-11 Inventory Evidence and Long-Term Purchase Contracts. LO3 During the audit of Mason Company Inc., for the calendar year 20X2, you noticed that the company produces aluminum cans at the rate of about 40 million units annually. On the plant tour, you noticed a large stockpile of raw aluminum in storage. Your inventory observation and pricing procedures showed this stockpile to be the raw materials inventory of 400 tonnes valued at $240,000 (average cost). Enquiry with the production chief yielded the information that 400 tonnes was about a four-month supply of raw materials. Suppose you learn that Mason had executed a noncancellable long-term purchase contract with All Purpose Aluminum Company to purchase raw materials on the following schedule:

DELIVERY DATE	QUANTITY (TONS)	TOTAL PRICE
January 30, 20X3	500	$300,000
June 30, 20X3	700	420,000
December 30, 20X3	1,000	500,000

Because of recent economic conditions, principally a decline in the demand for raw aluminum and a consequent oversupply, the price stood at $400 per tonne (1 tonne = 2000 pounds) as of January 15, 20X3. Commodities experts predict that this low price will prevail for 12 to 15 months or until there is a general economic recovery.

Required:

a. Describe the procedures you would employ to gather evidence about this contract (including its initial discovery).

b. What facts recited in the case are ones that you would have to discover for yourself in an audit?

c. Discuss the effect this contract has on the financial statements.

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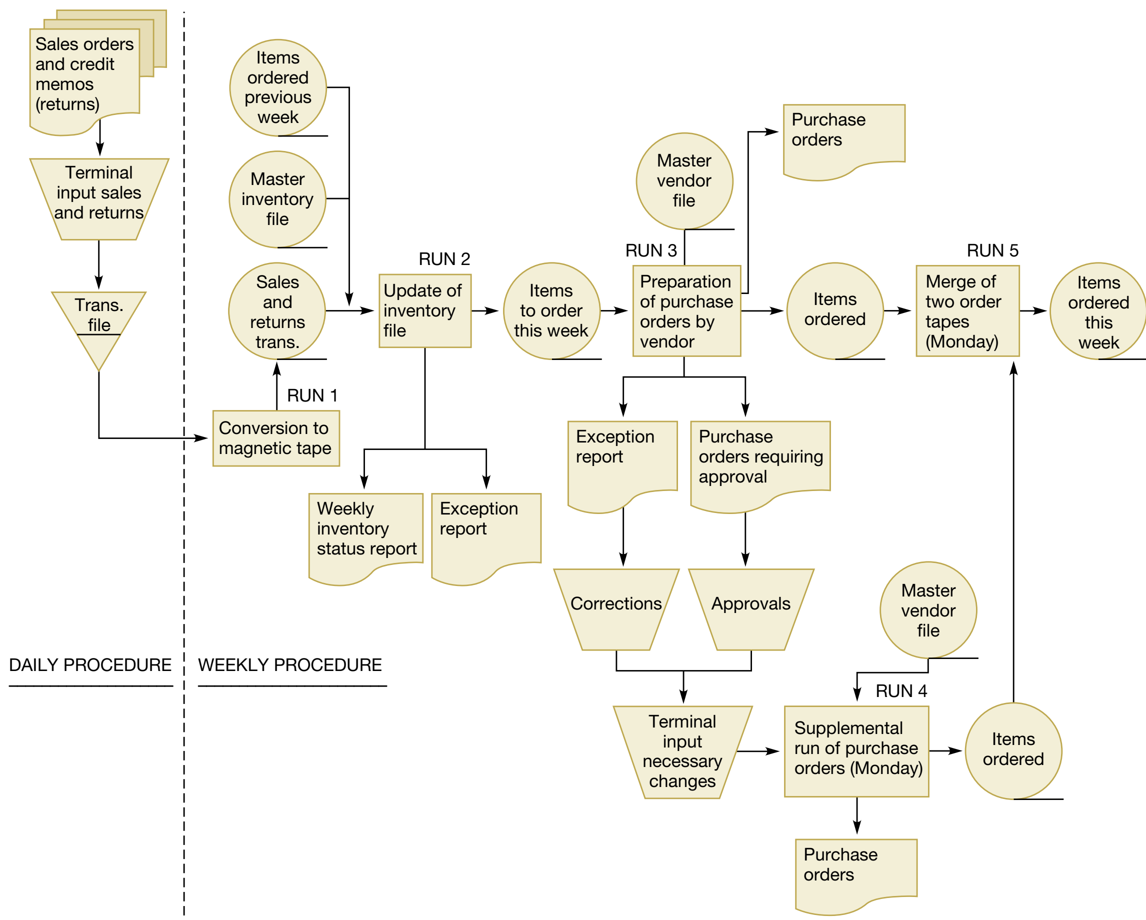
EXHIBIT DC12-10 **Peacock Company: Inventory and Purchase Order Procedure**



DC 12-12 Deake Corporation: Property Accounting System. LO1 Deake Corporation is a medium-sized, diversified manufacturing company. Recently, Jack Richards was promoted to manager of the property accounting section. Richards is having difficulty responding to some of the requests from individuals in other departments for information about the company's fixed assets. Some of the requests are as listed:

1. The controller has requested schedules of individual fixed assets to support the balances in the general ledger. Richards has furnished the necessary information, but it was not provided on a timely basis for the controller's financial reporting deadline. The manner in which the records are organized makes it difficult to obtain information easily.
2. The maintenance manager wishes to verify the existence of a punch press he thinks was repaired twice. He has asked Richards to confirm the asset number and location of the press.
3. The insurance department wants data on the cost and book values of assets to include in its review of current insurance coverage.
4. The tax department has requested data that can be used to calculate depreciation for tax purposes.
5. The company's internal auditors have spent a significant amount of time in the property accounting section recently, attempting to audit the annual depreciation expense.

The property account records consist of a set of manual books. These records show the date the asset was acquired, the account number for the asset, the dollar amount capitalized, and the estimated useful life of the asset for depreciation purposes.

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After many frustrations, Richards has realized that his records are inadequate and that he cannot supply data when requested. He has decided to discuss his problem with the controller, Jim Castle.

Richards: Jim, something has got to give. My people are working overtime and can't keep up. You worked in property accounting before you became controller. You know I can't tell the tax, insurance, and maintenance people everything they need to know from my records. Also, that internal auditing team is coming back to check my area in a couple of weeks, and last year my group spent at least a hundred hours creating data to answer their questions. That really slows down the work pace. The requests of these people are reasonable, and we should be able to answer these questions and provide the needed data. I think we need a computerized property accounting system. I would like to talk to the information systems people to see if they can help me.

Castle: Jack, I think you have a good idea, but be sure you are personally involved in the design of any system so that you get all the information you need.

Required:

a. Identify and justify four major objectives Deake Corporation's computerized property accounting system should meet to provide the data necessary to respond to requests for information by company personnel and auditors.

b. Identify the data that should be included in the computer record for each asset included in the property account.

(CMA adapted)

DC 12-13 Grover Manufacturing—Purchasing Defalcation. LO1, LO2, LO3 On January 11, at the beginning of your annual audit of the Grover Manufacturing Company's financial statements for the year just ended December 31, the company president confides to you that an employee is living on a scale in excess of that which his salary would support.

The employee has been a buyer in the purchasing department for six years and has charge of purchasing all general materials and supplies. He is authorized to sign purchase orders for amounts up to $2000. Purchase orders in excess of $2000 require the countersignature of the general purchasing agent.

The president understands that the usual audit of financial statements is not designed to disclose immaterial fraud or conflicts of interest, although such events may be discovered. The president authorizes you, however, to expand your regular audit procedures and to apply additional audit procedures to determine whether there is any evidence that the buyer has been misappropriating company funds or has been engaged in activities that are a conflict of interest.

Required:

List the audit procedures that you would apply to the company records and documents in an attempt to:

1. Discover evidence within the purchasing department of defalcations being committed by the buyer. Give the purpose of each audit procedure.
2. Provide leads about possible collusion between the buyer and suppliers. Give the purpose of each audit procedure.

DC 12-14 Inventory assertions, risk assessment and audit procedures. LO3, LO5 Refer to the case facts given in Chapter 11 and DC11–12, and answer the following questions:

Required:

a. What is your assessment the risk of material misstatement at the assertion level for the BSL inventory? Make reference to case facts to support your conclusions.

b. Describe the substantive procedures you would include in your audit program for verifying the quantity and the pricing of BSL's inventory. Explain how these procedures respond to the risks you have assessed in part a.

c. Identify three CAS that would apply to auditing BSL's inventory and outline the requirements that are relevant.

DC 12-15 Repairs Expense, Error Adjustment. LO3, LO6 You are the auditor of Bittern Inc. Bittern's long standing policy is to capitalize all repairs and maintenance payments that exceed $10,000, without assessing the nature of the expenditure. Many of Bittern's buildings and equipment are aging and repairs are becoming frequent and more expensive. You have concerns that a material amount of building repairs and maintenance expense is being capitalized, and undertake a detailed examination of all the building asset additions during the current year. Your analysis indicates that approximately $400,000 of repairs expense has been capitalized as buildings in the current year. Materiality for the audit is $500,000. In the prior year's audit, the staff noted approximately $100,000 of repairs expenses had been capitalized, but no adjustment was recorded. The estimated useful life of Bittern's buildings is 25 years, and the average remaining useful life of their buildings is approximately 8 years.

Required:

a. Describe the impact of the above error on the current year financial statements and the impact it will have on future periods' financial statements when the error reverses, if it is not adjusted.

b. Describe the impact the unadjusted error from the prior year will have on the current year's financial statements.

c. State whether you would require Bittern to adjust for this error, and support your conclusion. If you require an adjustment, provide the required journal entry.

d. What recommendation would you include in the management letter relating to the situation above?

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DC 12-16 Mining Properties, Using Work of Experts. LO3, LO6 White Ice Mines Inc. is a mining company. During 20X4, White Ice acquired a diamond mine located in the far north for $800 million from Albatross Inc. The purchase price is based on the mine's inventory of extracted diamonds, with an appraised value of $300 million, plus diamond reserves estimated in the range of $600 million to over $2 billion. White Ice raised $100 million of the funds to acquire the mine by issuing public shares on the Canadian Adventure Exchange, with the remainder being lent by a consortium of three major Canadian banks. Shortly after the IPO, a shareholder resolution was passed requiring White Ice to appoint new auditors from one of the large, national auditing firms. The previous auditor was a small firm that also was the auditor for Albatross for many years. The new auditor of White Ice is examining the existence, valuation, and ownership assertions for its mining assets for the year ended December 31, 20X4. White Ice informs the auditor that its mining specialists provided the appraisals for use in preparing the prospectus for their Initial Public Offering of shares, and to satisfy the due diligence enquiries of the three banks. The new auditor has determined that it will be necessary to rely on an independent expert to provide a valuation report to support the audit opinion.

Required:

a. Refer to CAS 620 (Using the Work of an Auditor's Expert) and develop an audit program for verifying White Ice's diamond mine investment.

b. White Ice's management is concerned that using another expert will drive up the audit cost. The managers (some of whom previously worked for a mining company called Bre-X) suggest it would be more efficient for the auditor to rely on the specialist reports already generated for the IPO and the bank financing. As the new auditor, how would you respond to this suggestion? You may want to refer to CAS 550 (Related Parties) for guidance.

DC 12-17 Audit Issues in Internet Business. LO1, LO3 TheShoppingMall.com (TSM) is an Internet business that provides a website with links to a variety of online shopping sites with which TSM has established "marketing partnerships." TSM also provides advertising, promotions, and discount coupons for its partner shopping sites. TSM was incorporated under the laws of Canada about 12 years ago. The original financing to start TSM came from its president, Mr. Fogg, and several outside venture capital investors. Mr. Fogg's plan is to issue common shares to the public after the business model has proven itself. The proceeds from this share issue will be used to repay the debt financing provided by Mr. Fogg and the venture capitalists. It is now late 20X2, and the financial results are being prepared for the year ended November 30, 20X2. Mr. Fogg believes that early 20X3 will be the right time to issue public shares.

The preliminary financial statements for the year ended November 30, 20X2, include the following items:

TSM contracted with three partners for $103.5 million to develop all their online shopping systems, including customer relation management and payment processing. The partners are name-brand product manufacturers that want to start direct online retailing. TSM has never completed this type of system before, but expects to complete it by the end of 20X4. TSM recorded $36.5 million of the $103.5 as revenues, deferring the rest to be reported when the work was completed.

TSM also provides an online auction service where individuals and businesses can list items for sale and interested purchasers can bid on them. TSM provides the auction service, arranges delivery, and processes payments for a fee of 8% of the selling price. TSM recognized the full selling price of these auction items as revenue and the net 92% paid to the seller as "product costs."

TSM provided an online travel agency, selling airline tickets and hotel rooms and car rentals. It recorded as revenue the entire fee paid by a customer for an airline ticket or hotel room. The amount TSM paid the airline or hotel chain that supplied the ticket or room was classified as "product costs." TSM reported that it earned $152 million in revenues, and its product costs came to $134 million, leaving $18 million of "gross profits." TSM's other costs, such as advertising and salaries, netted out to a loss of $102 million. While a traditional travel agency, which has a fixed commission, would show only the commission as revenue, Mr. Fogg believes it is appropriate to use the gross bookings amounts as revenue, because, unlike a traditional travel agency, TSM purchased the hotel room outright, so it assumed the full risk of ownership and could control the profit made on each sale.

To build awareness for its site, TSM purchased $1 million of advertising on several other companies' retailing websites. In exchange for advertising on these sites, TSM sold advertising worth $1million for these other companies on TSM's site. Mr. Fogg believes this bartering was an astute business move that ". . . saves us lots of cash and generates revenues at the same time."

TSM used promotions to bring people to its website. For example, customers who bought a pizza from a national pizza chain received a coupon for $10 off their next TSM purchase. TSM accounted for these costs as marketing expenses rather than recording them as a cost of goods sold. Mr. Fogg stated, "The gross profit line is very

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sensitive, so it is preferable to show these expenses below the gross profit line." Other expenses that TSM includes in "marketing expenses" are costs of warehousing, packaging, and shipping goods to customers.

Mr. Fogg and several top TSM executives have received options to purchase common shares of TSM at a fixed price of $1 per share.

Mr. Fogg realized the TSM financial statements must provide some disclosure of the accounting policies chosen. TSM's note on revenue recognition states, "Revenue is recognized when earned."

Required:

TSM plans to issue its Initial Public Offering of shares in early 20X4. It will require a set of audited financial statements. Assume the role of TSM's auditor. What is your position on the accounting matters listed above?

DC 12-18 Comprehensive Audit Case: Tour Business. LO1, LO3, LO5 On The Road Inc. (OTR) is a tour company owned by Joy Kerouak. OTR offers organized tours three weeks to six-months long, targeted to early retirees 55-years old and over. OTR is in its third year of operations. Joy is not actively involved in the business and has hired a team of skilled managers to run the business. OTR is a private Canadian corporation, with Joy owning 100% of its common shares. The managers receive a bonus of 30% of monthly pretax profits.

OTR's tours are guided road trips across North America. Tour groups travel in brightly painted camper vans and visit sites of historic events of the 1950s and 1960s. The packages are sold online and through travel agents, under the following terms:

- A deposit of 40% is required upon booking, which is refundable until 14 days before the start of the tour and nonrefundable after that point.
- The remaining 60% is due 14 days before the start of the tour. This is nonrefundable.
- If for some reason OTR is unable to offer the tour, 100% is refunded to the customer.

Online sales are paid by credit card. Travel agent sales are the same as those terms previously listed, except the agents receive payments from customers and forward these to OTR within seven days. Travel agents receive a commission of 10% of the tour selling price, which they deduct prior to forwarding the payments to OTR. During OTR's three years of operating, about half the tours have been sold through travel agents and the other half online, but the online portion has been increasing each year.

Economic conditions in the travel industry have been declining recently, and bankruptcies of travel agents are increasing. If travel agents that sell OTR tours go bankrupt, OTR would probably lose any customer payments the travel agents had not yet forwarded. Over its three-year history, the company's bad debts from travel agents have been about 5% of sales. To date, only one tour has had to be cancelled by OTR due to Hurricane Katrina flooding New Orleans. This refund made up about 2% of the total 20X5 revenues of OTR.

The main assets of OTR are a fleet of 50 camper vans that were purchased when the business started up. Since these are high-quality VW vans in classic designs, and management chose to depreciate the cost of the camper vans over 9.4 years. However, this winter, management informed Joy that at least 35 of the vans are in poor condition and will need to be replaced at a cost of $40,000 each before the spring tour season begins. Joy has contacted her banker, Nik Beat, to arrange to borrow the cost of replacing the camper vans. Currently, OTR is debt free. Mr. Beat requested audited financial statements prepared in accordance with generally accepted accounting principles for the first three years of OTR's operations. Since, to date, OTR has mainly prepared its financial statements for the purpose of computing the managers' monthly bonuses, Joy is not sure if these statements will meet Mr. Beat's requirements. Joy has hired you to advise her on accounting issues and on how to obtain the audit that her banker is requesting.

Required:

Assume the role of an advisor to Joy and answer the following questions:

a. Identify the main users of OTR's financial statements and the kinds of decisions/evaluations that each user will make based on these financial statements.

b. What are the main objectives of OTR's management that may affect the accounting choices it makes in preparing OTR's financial statements?

c. Describe four or more possible revenue and expense recognition points for OTR's tour business, indicating the most appropriate method, in your judgment. Provide the reasons that support your judgment.

d. Outline the key issues that would need to be addressed by a prospective auditor in order to decide whether to accept the engagement.

e. Prepare a report to Joy describing in detail a preliminary audit plan for OTR. Include explanations for each component you include in the preliminary plan that will help Joy understand the audit objectives and procedures.

DC 12-19 Cash Payments Fraud: Medical Benefits Claims. LO1, LO2, LO3 This case is modelled on the Application Case and analysis in the chapter.

Case Description Beta Magnetic, a large company, experienced a fraud in the cash payments processed for employees' supplementary medical benefit claims. Fictitious benefit claims were paid by the company, which self-insured up to $50,000 per

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employee for supplementary benefits costs (such as physiotherapy and acupuncture) not covered by other medical and benefits coverage plans. The expense account that included legitimate and false charges was "employee supplementary medical benefits."

As manager of the claims payment department, Martha Lee was considered one of Beta Magnetic's best employees. She never missed a day of work in 10 years, and her department had one of the company's best efficiency ratings. Controls were considered good, including the verification by a claims processor that (1) the patient was a Beta employee, (2) treatments were covered by the company-sponsored plan, (3) the charges were within approved guidelines and not covered by another plan, (4) the cumulative claims for the employee did not exceed $50,000 (if over $50,000, a claim was submitted to an insurance company), and (5) the calculation for payment was correct. After verification processing, claims were sent to the claims payment department to pay the medical practitioner directly. No payments ever went directly to employees. Martha Lee prepared false claims on real employees, forging the signature of various claims processors, adding her own review approval, naming bogus medical practitioners who would be paid by the payment department. The payments were mailed to various post office box addresses and to her husband's business address.

Nobody ever verified claims information with the employee. The employees received no reports of medical benefits paid on their behalf. While the department had performance reports by claims processors, these reports did not show claim-by-claim details. No one verified the credentials of the medical practitioners. Over the last seven years, Martha Lee and her husband stole $3.5 million, and, until the last, no one noticed anything unusual about the total amount of claims paid.

Audit Trail The falsified claim forms were in Beta's files, containing all the fictitious data on employee names, processor signatures, medical practitioners' bills, and phony medical practitioners addresses. The cancelled cheques, "endorsed" by the doctors, were returned by the bank and kept in Beta's files. Martha Lee and her husband were somewhat clever: They deposited the cheques in various banks in accounts opened in the names and identification of the "medical practitioners."

Martha Lee did not make any mistakes in covering the paper trail. She drew the attention of an auditor who saw her take her 24 claims-processing employees out to an annual staff appreciation luncheon in a fleet of stretch limousines.

Audit Approach Analysis The auditor's objective is to obtain evidence determining whether employee medical benefits "existed" in the sense of being valid claims paid to valid medical practitioners.

Controls relevant to the process are good as far as they go. The claims processors used internal data in their work—employee files for identification, treatment descriptions submitted by medical practitioners with comparisons to plan provisions and mathematical calculations. This work amounted to all the approval necessary for the claims payment department to prepare a cheque. There were no controls that connected the claims data with outside sources, such as employee acknowledgment or investigation of medical practitioners.

Required:

Describe in detail the audit procedures you would perform in this case. Consider tests of control and substantive tests, such as dual-purpose tests of transactions and/or tests of details of balance. Which tests do you consider likely to detect Martha Lee's theft? Why?

DC 12-20 Analysis of Purchasing Process and Controls. LO1, LO2 Integrated Measurement Systems Inc. (IMS) is a Canadian public company that manufactures high-end measuring devices used primarily in the oil and natural gas industries. In 20X3, it had sales of $100 million and earnings before income tax of $5 million. The company has a December 31 year-end.

Ted Pollock, IMS's CEO, is a proponent of strong corporate governance. He has spent the last year strengthening IMS's internal control environment. He believes that organizations that demonstrate good corporate governance practices will be perceived favourably by the markets. Ted wants to make a presentation to IMS's audit committee supporting the position that throughout the year the company's internal controls functioned in accordance with the company's control objectives. Depending on the reaction of the audit committee, Ted would like to make the presentation an annual occurrence. IMS has hired your professional services firm to assist Ted in preparing the content of his presentation.

Your firm is currently assessing the purchasing process. Accordingly, IMS has provided you with relevant material and access to the company's resources (Exhibit 12-20–1). As part of the analysis of this process, IMS has asked you to:

1. Identify the existing key internal controls within the purchasing process.
2. Describe the procedures that IMS could use to test the controls.
3. Identify the internal control weakness within the purchasing process and recommend improvements.

It is now the first week of March 20X4. The partner responsible for the IMS audit engagement

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provides you with her notes from a meeting with Ted Pollock (Exhibit 12-20–2). You have been asked by the partner to prepare the analysis of IMS's purchasing process, addressing the three requirements, and to identify any additional issues and make any observations that would be relevant to the engagement.

Required:

Prepare an analysis of IMS's purchasing process, addressing the three requirements requested by the IMS CEO, in a report format suitable for the CEO's use.

(CICA adapted)

EXHIBIT DC12-20–1 Purchasing Process Documentation Updated November 20X3

The purchasing process has four major components, namely:

1. Vendor prequalification
2. Purchase of goods and/or services
3. Receipt of goods
4. Settlement

Process description

The purchasing process begins when there is a requirement for goods or services. A manually completed purchase request form is sent from the operating department (e.g., Sales Marketing, Manufacturing, etc.) to the purchasing department. The purchasing clerk numbers these documents and reviews each purchase request form to verify that a signature is present.

Purchase request forms must be authorized by the signature of a person with the appropriate level of authority. The amount of the expenditure determines the level of authority required, and the expenditure authorization levels are organized in tiers. Because there are so many possible combinations of departments and authorization levels, the operating departments are responsible for ensuring that their purchase request forms are signed by individuals with the appropriate level of authority. This requirement eliminates the need for the purchasing clerk to check the specifics of their signatures.

The purchasing clerk sends the purchase requests to the purchasing manager for review and approval.

The approved purchase request is then sent to the buyer who sources the purchase. If the amount is below $5000, selection of the vendor is left up to the buyer. For purchases in excess of $5000 but less than $25,000, a vendor from the Prequalification Listing is selected, again at the discretion of the buyer. For purchases in excess of $25,000, a formal bidding process is performed. However, at the discretion of the buyer, the bid process can be waived if deemed to be cost inefficient.

Upon selection of the vendor, the buyer inputs the purchase request information into a purchase order form. The purchase order is forwarded to the purchasing manager for review, and a photocopy is made and filed, in numerical order, with the appropriate photocopy of the purchase request. The original purchase order is then sent back to the buyer who delivers it to the vendor.

All goods are received in the warehouse. All employees have access to the warehouse. The goods are checked against the packaging slip and are examined for damage, and so on. If the goods are acceptable, the bill of lading is signed off by the receiver. A copy of the signed bill of lading is then forwarded to the purchasing clerk who matches it to the file copy of the purchase request and purchase order. If there are differences in the details (over/under shipment, wrong product, etc.), the bill of lading is forwarded to the buyer for resolution with the vendor. If no problems are noted, copies of the three documents are sent to the payables group for settlement.

The receiver, John Smith (who was hired six months ago), sends the goods to the user department that made the original purchase request along with a photocopy of the bill of lading. The user department agrees the quantities noted by the receiver and files the bill of lading. User departments have noted that, recently, there have been an increasing number of manual adjustments to the quantities shipped versus received.

Any unmatched purchase requests and purchase orders that remain outstanding for over 90 days are returned by the purchasing clerk to the user department that originally ordered the goods on the assumption that the goods have been received. It is then the responsibility of the user department to follow up and forward the paperwork to the payables group for settlement.

If a signed bill of lading is forwarded to the purchasing clerk for which there is no source documentation (i.e., no purchase request or purchase order exists), the purchasing clerk follows up with the buyer to understand the nature of the receipt. At the same time, a copy of the bill of lading is also sent to the payables group.

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EXHIBIT DC12-20–2 Meeting Notes Received from Partner

I met today with the CEO of IMS, Ted Pollock, for the purpose of discussing his needs. He provided the following information:

— IMS's corporate governance framework

— IMS has adopted an approach to establishing a strong corporate governance framework that includes:
  1. Documentation of the existing processes and controls
  2. Identification of the key controls in the process
  3. Evaluation and testing of the internal controls and implementation of improvements

— Control objectives that relate to the purchasing process
  1. Proper approval of all transactions
  2. Safeguarding of company assets
  3. Prevention and detection of errors and irregularities
  4. Accuracy and completeness of books and records
  5. Appropriate use of information

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APPENDIX 12A

Internal Control Questionnaires

EXHIBIT 12A–1 Internal Control Questionnaires Purchases, Payables, and Payments Process

This exhibit provides an example of the type form that could be used to guide the auditor's assessment of the effectiveness of application controls in the main classes of transactions and the main account balances related to the purchases/payables/payments process. Note that, in practice, forms like this can provide only a general starting point, and the actual audit work must always be tailored to the specifics of each engagement.

INTERNAL CONTROL QUESTIONNAIRE FOR PURCHASES, PAYABLES, AND PAYMENTS PROCESS	Auditor Responses	Audit File References
auditee:__________ f/s period:__________		
OVERALL COMPANY-LEVEL CONTROL AND CONTROL ACTIVITIES ASSESSMENT (Refer to responses recorded for questions in Exhibit 9A in Appendix 9A)		
1. Are company-level and general control activities adequate as they apply to the revenues, receivables, and receipts components of the information system? • Consider the impact of any weakness in company-level and general control activities on planned audit approach and procedures. • Assess the potential for weaknesses to result in a material misstatement of the financial information generated from this accounting cycle. If a significant risk of misstatement is assessed, perform procedures to determine extent of any misstatement. 2. Consider adequacy of the following general controls in place in the revenue, receivables, and receipts process to: — Prevent unauthorized access or changes to programs and data — Ensure the security and privacy of data — Control and maintain key systems — Protect assets susceptible to misappropriation — Ensure completeness, accuracy, and authorization of data and processing — Ensure that adequate management trails exist		
APPLICATION CONTROL ASSESSMENTS		
PURCHASING AND ACCOUNTS PAYABLE APPLICATION CONTROLS **Environment and general controls relevant to this application**: 1. Is the purchasing department independent of the accounting department, receiving department, and shipping department? 2. Are receiving report copies transmitted to inventory custodians? to purchasing? to the accounting department? **Application Control Assessments**: Consider whether the auditee has appropriate policies and procedures in place to meet the following control objectives: *Validity objective:* 3. Are suppliers' invoices matched against purchase orders and receiving reports before a liability is recorded? *Completeness objective:* 4. Are the purchase order forms prenumbered, and is the numerical sequence checked for missing documents? 5. Are receiving report forms prenumbered, and is the numerical sequence checked for missing documents? 6. Is the accounts payable department notified of goods returned to vendors? 7. Are suppliers' invoices listed immediately upon receipt? 8. Are unmatched receiving reports reviewed frequently and investigated for proper recording? *Authorization objective:* 9. Are competitive bids received and reviewed for certain items?		

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EXHIBIT 12A–1 Continued

10. Are all purchases made only on the basis of approved purchase requisitions? 11. Are purchases made for employees authorized through the regular purchases procedures? 12. Are purchase prices approved by a responsible purchasing officer? 13. Are all purchases, whether for inventory or expense, routed through the purchasing department for approval? 14. Are shipping documents authorized and prepared for goods returned to vendors? 15. Are invoices approved for payment by a responsible officer? *Accuracy objective:* 16. Are quantity and quality of goods received determined at the time of receipt by receiving personnel independent of the purchasing department? 17. Are suppliers' monthly statements reconciled with individual accounts payable accounts? 18. In the accounts payable department, are invoices checked against purchase orders and receiving reports for quantities, prices, and terms? *Classification objective:* 19. Does the chart of accounts and accounting manual give instructions for classifying debit entries when purchases are recorded? 20. Are account distributions recorded on supplier invoices and independently verified prior to being entered in the accounts payable system? *Accounting objective:* 21. Is the accounts payable detail ledger balanced periodically with the general ledger control account? *Proper period objective:* 22. Does the accounting manual give instructions to date purchase/payable entries on the date of receipt of goods?		
CASH DISBURSEMENTS PROCESSING APPLICATION CONTROLS **Environment and general controls relevant to this application**: 1. Are persons with cash custody or cheque-signing authority denied access to accounting journals, ledgers, and bank reconciliations? 2. Is access to blank cheques denied to unauthorized persons? 3. Are all disbursements except petty cash made by cheque? 4. Are cheque signers prohibited from drawing cheques to cash? 5. Is signing blank cheques prohibited? 6. Are voided cheques mutilated and retained for inspection? **Application Control Assessments**: Consider whether the auditee has appropriate policies and procedures in place to meet the following control objectives: *Validity objective:* 7. Are invoices, receiving reports, and purchase orders reviewed by the cheque signer? 8. Are the supporting documents stamped "paid" (to prevent duplicate payment) before being returned to accounts payable for filing? 9. Are cheques mailed directly by the signer and not returned to accounts payable department for mailing? *Completeness objective:* 10. Are blank cheques prenumbered and is the numerical sequence checked for missing documents? *Authorization objective:* 11. Do cheques require two signatures? Is there dual control over machine signature plates? *Accuracy objective:* 12. Are bank accounts reconciled by personnel independent of cash custody or recordkeeping? *Classification objective:* 13. Do the chart of accounts and accounting manual give instructions for determining debit classifications of disbursements not charged to accounts payable? 14. Is the distribution of charges double-checked periodically by an official? Is the budget used to check on gross misclassification errors? 15. Are special disbursements (e.g., payroll and dividends) made from separate bank accounts? *Accounting objective:* 16. Is the bank reconciliation reviewed by an accounting official with no conflicting cash receipts, cash disbursements or recordkeeping responsibilities? 17. Do internal auditors periodically conduct a surprise audit of bank reconciliations? *Proper period objective:* 18. Are cheques dated in the cash disbursements journal with the date of the cheque?		

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EXHIBIT 12A–1 Continued

INVENTORY TRANSACTION PROCESSING CONTROLS **Environment and general controls relevant to this application**: 1. Are perpetual inventory records kept for raw materials? supplies? work in process? finished goods? 2. Are perpetual records subsidiary to general ledger control accounts? 3. Do the perpetual records show quantities only? quantities and prices? 4. Are inventory records maintained by someone other than the inventory stores custodian? 5. Is merchandise or materials on consignment-in (not the property of the company) physically segregated from goods owned by the company? **Application Control Evaluation**: *Validity objective:* 6. Are additions to inventory quantity records made only on receipt of a receiving report copy? 7. Do inventory custodians notify the records department of additions to inventory? *Completeness objective:* 8. Are reductions of inventory record quantities made only on receipt of inventory issuance documents? 9. Do inventory custodians notify inventory records of reductions of inventory? *Authorization objective:* Refer to question 6 above (additions). Refer to question 8 above (reductions). *Accuracy objective:* 10. If standard costs have been used for inventory pricing, have they been reviewed for current applicability? *Classification objective:* 11. Are periodic counts of physical inventory made to correct errors in the individual perpetual records? *Accounting objective:* 12. Is there a periodic review for overstocked, slow-moving, or obsolete inventory? Have any adjustments been made during the year? 13. Are perpetual inventory records kept in dollars periodically reconciled to general ledger control accounts? *Proper period objective:* 14. Does the accounting manual give instructions to record inventory additions on the date of the receiving report? 15. Does the accounting manual give instructions to record inventory issues on the issuance date?		
PROPERTY, PLANT, AND EQUIPMENT ASSETS AND RELATED TRANSACTIONS PROCESSING APPLICATION CONTROLS **Environment and general controls relevant to this application**: 1. Are detailed property records maintained for the various fixed assets? **Application Control Assessments**: Consider whether the auditee has appropriate policies and procedures in place to meet the following control objectives: *Validity objective:* 2. Is the accounting department notified of actions of disposal, dismantling, or idling of a productive asset? for terminating a lease or rental? 3. Are fixed assets inspected periodically and physically counted? *Completeness objective:* 4. Is casualty insurance carried? Is the coverage analyzed periodically? When was the last analysis? 5. Are property tax assessments periodically analyzed? When was the last analysis? *Authorization objective:* 6. Are capital expenditure and leasing proposals prepared for review and approval by the board of directors or by responsible officers? 7. When actual expenditures exceed authorized amounts, is the excess approved? *Accuracy objective:* 8. Is there a uniform policy for assigning depreciation rates, useful lives, and salvage values? 9. Are depreciation calculations checked by internal auditors or other officials? *Classification objective:* 10. Does the accounting manual contain policies for capitalization of assets and for expensing repair and maintenance? 11. Are subsidiary fixed assets records periodically reconciled to the general ledger accounts? 12. Are memorandum records of leased assets maintained?		

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Proper period objective: 13. Does the accounting manual give instructions for recording fixed asset additions on a proper date of acquisition?		
Auditor's conclusion on the effectiveness of application controls in the purchases/payables/payments process: ____________________________ ____________________________	Prepared by ____________	Date ____________

Exhibit 12A–2 provides few examples of the types of controls one expects to find in a typical system such as the one illustrated in Exhibit 12–1 of the chapter.

EXHIBIT 12A–2 Examples of Purchases and Payables Controls Relating to Exhibit 12–1

- Each terminal performs only designated functions. For example, the receiving clerk's terminal cannot accept a purchase order entry.
- An identification number and password (used on an individual basis) is required to enter the nonautomatic purchase orders, vendors' invoices, and the receiving report information. Further, certain passwords have "read only" authorization. These are issued to personnel authorized to determine the status of various records, such as an open voucher, but not authorized to enter data.
- All input immediately is logged to provide restart processing should any terminal become inoperative during the processing.
- The transaction codes call up a full-screen "form" on the terminals that appears to the operators in the same format as the original paper documents. Each clerk must enter the information correctly (online input validation) or the computer will not accept the data.
- All printed documents are computer numbered and the number is stored as part of the record. Further, all records in the open databases have the vendor's number as the primary search and matching field key. Of course, status searches could be made by another field. For example, the inventory number can be the search key to determine the status of a purchase of an item in short supply.
- A daily search of the open databases is made. Purchases outstanding for more than 10 days and the missing "document" records are printed out on a report for investigation of the delay.
- The cheque signature is printed, using a signature plate that is installed on the computer printer only when cheques are printed. A designated person in the treasurer's office maintains custody of this signature plate and must take it to the computer room to be installed when cheques are printed. This person also has the combination to the separate document storage room where the blank cheque stock is kept and is present at all cheque printing runs. The printed cheques are taken immediately from the computer room for mailing.

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CHAPTER 13

Production and Payroll Processes

This chapter offers an overview of the production and payroll process where materials, labour, and overhead are converted into finished goods and services. Our coverage separates this process into two distinct parts: Part I, which is the production process, including inventory valuation, amortization, and cost of goods sold; and Part 2, which covers the payroll process, including labour cost accounting. Application cases demonstrate the application of audit procedures in situations where errors or frauds might be discovered.

EcoPak Inc.

Caleb's evening at the EcoPak inventory count is going well. By 6 p.m. he has inspected 100% of the items on the PPE schedule. Caleb learns from Nima that the moulds installed in the machines are considered part of the production equipment, whereas the spare moulds are included in inventory. He makes note of this in the file so that he can follow up at the next team meeting on whether this accounting policy results in a fair presentation of these assets. By 8 p.m. he has completed fairly extensive tests (floor-to-list and list-to-floor counts) of the finished goods and spare moulds inventories. He also checked a number of the workers' counts and recorded additional information from their final count sheets for follow-up later.

He closely observed the measurement process for the vats of raw materials and was able to verify the readings and measures that the engineers used in their volume calculations. The raw material inventory consists of large vats of processed fibre, a goopy substance that is mixed with binding agent solutions, left to cure for several days, then aerated and sprayed into moulds that shape the material into coffee cups, cutlery, and so on. The aerating spray process is EcoPak's own patented technology. Based on review of Nima's preliminary inventory balances, he notes that while the volume

LEARNING OBJECTIVES

After completing this chapter, you will be able to do the following:

LO1 Explain the key risks of misstatement in production and payroll processes.

LO2 Outline the production process: typical transactions, account balances, source documents, and controls.

LO3 Give examples of control tests for auditing control over conversion of materials and labour in the production process.

LO4 Give examples of the typical substantive procedures used to address the assessed risk of material misstatement in the main accounts in the production process.

LO5 Outline the payroll process: typical transactions, account balances, source documents, and controls.

LO6 Give examples of control tests for auditing control over hiring, firing, and payment of employees in the payroll process.

LO7 Give examples of the typical substantive procedures used to address the assessed risk of material misstatement in the main accounts in the payroll process.

CHAPTER APPENDICES

Appendix 13A: Internal Control Questionnaires

Appendix 13B: Just-in-Time Manufacturing and Supply Chain Management *(online)*

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of the raw material is very large, its dollar value is actually considerably less than materiality. So, he decides he has done enough on that balance.

The spare moulds, however, reflect a balance that is several times materiality, so he makes sure he has a lot of reliable evidence about their quantities and condition. He notes a number of moulds at the back of the storage area that are very dusty and is told by the production manager that they are for a product that EcoPak never gets orders for anymore. “But that item was once used by one of our best customers, so we should keep them on hand in case they ever decide to go back to that type of package.” Caleb makes a note to discuss the valuation of this part of the spare moulds inventory with Donna.

At about 9 p.m., it looked like Caleb was close to being finished (and in good time to ring in the New Year with his friends). Just as he was getting to the very back of the plant for a look at the last area, he became aware of a lot of vibration and noise from the back production line—it was running a job! But Nima had told them the production would be shut down. Mike confirms to Caleb that it was not possible to keep the lines completely shut down—an urgent order that needed to be completed by January 3 came in the night before, and they had to get it going right away. Mike comments, “I guess this kind of messed up Nima’s nice neat plan for the count, and I am sorry about that. But business comes first. Kam’s been working on this account for two years, and now they are finally giving us a chance! If we meet this deadline, this could turn into a huge new account that will increase our sales by a good 30% and allow us to expand our new cutlery line production line, which currently is underutilized. That will make us the industry leader in biodegradable disposable cutlery. This could be the big breakthrough for EcoPak!”

When Nima finds out, she’s furious but quickly agrees that the order is too important to the company’s success to turn down just to make the accounting job easier. “Still, Mike,” she says, “you could have told me sooner—you know I need to know what’s going on!” She gives Caleb a quick estimate of the dollar value likely to be involved—about 50% of their performance materiality.

Caleb is really unsure about what to do, so he calls Donna. Donna is having some issues of her own at the turbine work-in-process (WIP) inventory count but explains how to assess the situation. “Get a copy of the bill of materials for the job being processed. Then, ask the production manager for a timetable that we can use to assess the percentage of completion at year-end. Have him show you where they are in the process right now, and make lots of notes. It’s good you could get a handle on the expected dollar amount likely to be involved; that will help a lot.”

At around 10 p.m., Mike and Nima are satisfied with the count information the workers have provided. As Nima brings out some ginger ale and cake to celebrate with them, Mike also hands each worker a $500 cash bonus. “I got a cheque for $5000 made out to ‘Cash’ from Nima yesterday, so I could give my guys and gals a nice reward for handling the count today.” Mike explains. Caleb had noted this as one of the last cheques of the year to follow-up for cutoff, so now he knows what it was for—payroll. As he makes a note to see how it got accounted for, Mike calls out, “Hey Caleb, I guess I should have gotten a cash bonus to give you, too? After all, you found a couple of errors and helped us get the count done successfully!” Caleb explains that he is just doing his job and it would not be appropriate to take that kind of payment, since it might look like he lacks independence. Nima smiles, “I know . . . it’s kind of too bad, but that’s the right answer, Caleb!” At 10:30 p.m., Caleb enters 6.5 hours in the inventory on his time sheet for the week and heads out for a well-deserved couple of days off.

RISK ASSESSMENT FOR THE PRODUCTION AND PAYROLL PROCESSES

LO1 Describe the key risks of misstatement in production and payroll processes.

For auditors, it is important to understand the production process of any businesses involved in manufacturing. Similarly, the payroll process is significant in virtually every business that has employees. Risk considerations are explained for each of these processes.

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Production Process

The main function of inventory accounting within a manufacturing business is the allocation of material, labour, and overhead costs to inventory items being produced. Businesses produce many different types of tangible assets for sale or internal use, and all will have similar production accounting cycles that capture relevant costs and allocate them to asset accounts. Service businesses, on the other hand, bill customers for performing a specific job, such as a haircut or snowplowing, when the service is completed. Therefore, their productive activities are not inventoried. Professional service firms, such as lawyers and accountants, usually earn revenues based on the time spent on the assigned work; it could be hours, days, or weeks. For billing the customer, they have accounting systems that track hours spent on each job, giving them an intangible "inventory" of work in progress showing hours worked that have not yet been billed.

The production accounting process discussed in this chapter generates important information for management decisions on setting product selling prices, product-line profitability, whether to produce or contract production out, and production volume decisions. The process also generates the reported balance sheet value of inventory or other assets. The flexibility and judgment involved in these costing processes leads to a risk of misstatement that the auditor has to assess. The inherent risk in this process also tends to be high because the information is complex and the transaction volumes involved can be large. This text focuses mainly on manufacturing businesses, while other types of production businesses have the same basic accounting requirements but with differing specific activities and costs.

Transaction streams in the production process are allocations from various material and overhead purchases, using accounts discussed in Chapter 12. Allocations are also made for labour costs, a payroll expenditure discussed later in this chapter. The main balances are finished inventory and WIP. **Cost of goods sold** expense is calculated from the changes in inventory, purchases, and other allocated costs, and from adjustments that result from reconciling booked quantities to a physical count of the inventory. The main disclosure is the inventory valuation policy, including lower-of-cost-or-market policy.

cost of goods sold: includes costs such as materials, labour, overheads, freight, and so on, that are necessary to get goods to the stage when they can be sold; calculated as the beginning inventory, plus costs added during the period, less the ending inventory; offset against sales revenues, it indicates the gross profit or gross margin on sales on which analytical expectations can be based

The risks for inventory relate to two components: physical quantities and valuation (or pricing). If the production process is the business's main activity, management should have strong controls over existence and completeness related to inventory quantities. Physical counts and reconciliation to booked quantities are very effective control procedures that auditors test substantively. Existence and completeness risks in inventory as well as related accounts receivable and payable balances are affected by cutoff errors. The valuation risk is affected by controls over pricing procedures for purchases and other manufacturing costs, and by the possibility that market values can fall below cost. Analytical procedures, often using detailed management reports, are useful for assessing risks related to the existence, completeness, and valuation assertions. Ownership risks relate to transfer of title to inventory, as it may not happen at the same time as the physical transfer. Ownership is assessed by enquiries, and by examining documents and inventory movements subsequent to year-end. Presentation risks include disclosure of inventory pledged as collateral, descriptions of accounting policies, details of writedowns and reversals, as illustrated in the following box.

EXAMPLE OF MANUFACTURING COMPANY INVENTORY FINANCIAL STATEMENT DISCLOSURES

Note 3 Significant Accounting Policies

(i) Inventories:

Inventories are stated at the lower of cost and net realizable value. The cost of inventories is based on the first-in, first-out principle and includes expenditures incurred in acquiring the inventories and bringing them to their existing location and condition. In the case of manufactured inventories, cost includes an appropriate share of variable and fixed overheads based on normal operating capacity. Any excess, unallocated, fixed overhead costs are expensed as incurred. Net realizable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion and selling expenses.

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13. Inventories:

	20X1	20X0	20X9
Raw materials	122,584	124,138	123,570
Work-in-process	13,753	12,266	9,619
Finished goods	137,367	135,757	133,230
Spare parts	4,314	3,914	3,393
	278,018	276,075	269,812

During 20X1, the Company recorded, within cost of sales, inventory writedowns for slow-moving and obsolete inventory of $16,080 (20X0 – $21,539) and reversals of previously written-down items of $5688 (20X0 – $11,366).

Payroll Process

Payroll is the payments to hourly wage workers and salaried employees. Payments to employees involved in production are usually transferred to the cost of inventory (or self-constructed assets, etc.). Other wages and salaries will be expensed in the current period. Payments to employees are the main transaction stream in the payroll process, and the main balances related to the process are relatively small year-end accruals for payroll liabilities. Ownership is the key assertion at risk here; the process involves small cash payments to individuals, so it is vulnerable to employee fraud. The major control risks are payments to fictitious employees (sometimes called "ghosts" on the payroll) and for more hours than are actually worked.

The assessment of payroll system control has to consider that the many transactions in this cycle add up to a large dollar amount, even though they result in small balance sheet account amounts at year-end. Because of this, reviews of control effectiveness and dual-purpose tests of controls and transaction details are used in many audit engagements, and the substantive audit procedures devoted to auditing the payroll-related, year-end balances can be more limited.

Risk assessment involves ensuring that payroll processing duties are well segregated and that independent reviews and approvals are effective. Substantive evidence is available from reconciling to government income tax reports.

REVIEW CHECKPOINT

13-1 List the main risks auditors will be concerned with in assessing risk in the production and payroll processes of a typical manufacturing business.

PART I: UNDERSTANDING THE PRODUCTION PROCESS

LO2 Describe the production process: typical transactions, account balances, source documents, and controls.

Exhibit 13–1 is a picture-style skeleton diagram showing the activities and accounting involved in a production process. These begin with production planning, including inventory planning and management. Production planning can involve use of a sophisticated, computerized long-range plan with just-in-time (JIT) inventory management, or it can be done by a simple ad hoc method ("Hey, Joe, we got an order today. Go make 10 units!"). Most businesses try to estimate or forecast sales levels and seasonal effects, and they plan facilities and production schedules to meet forecast customer demand. As shown in Exhibit 13–1, the production cycle interacts with the purchasing process (see Chapter 12) and the payroll process (later in this chapter) for the acquisition of fixed assets, materials, supplies, overhead, and labour.

The physical output of a production process is the inventory (from raw materials to WIP to finished goods). Inventory auditing and physical inventory taking were explained in Chapter 12, and in Exhibit 11–1 (page 437) showed the connection of inventory to the revenue process in terms of orders and deliveries.

Most of the transactions in a production cycle are cost accounting allocations, unit cost determinations, and standard cost calculations. These are internal transactions, produced entirely within the company's accounting system. Exhibit 13–1 shows the elements of depreciation cost calculation, cost of goods sold determination, and job cost analysis as examples.

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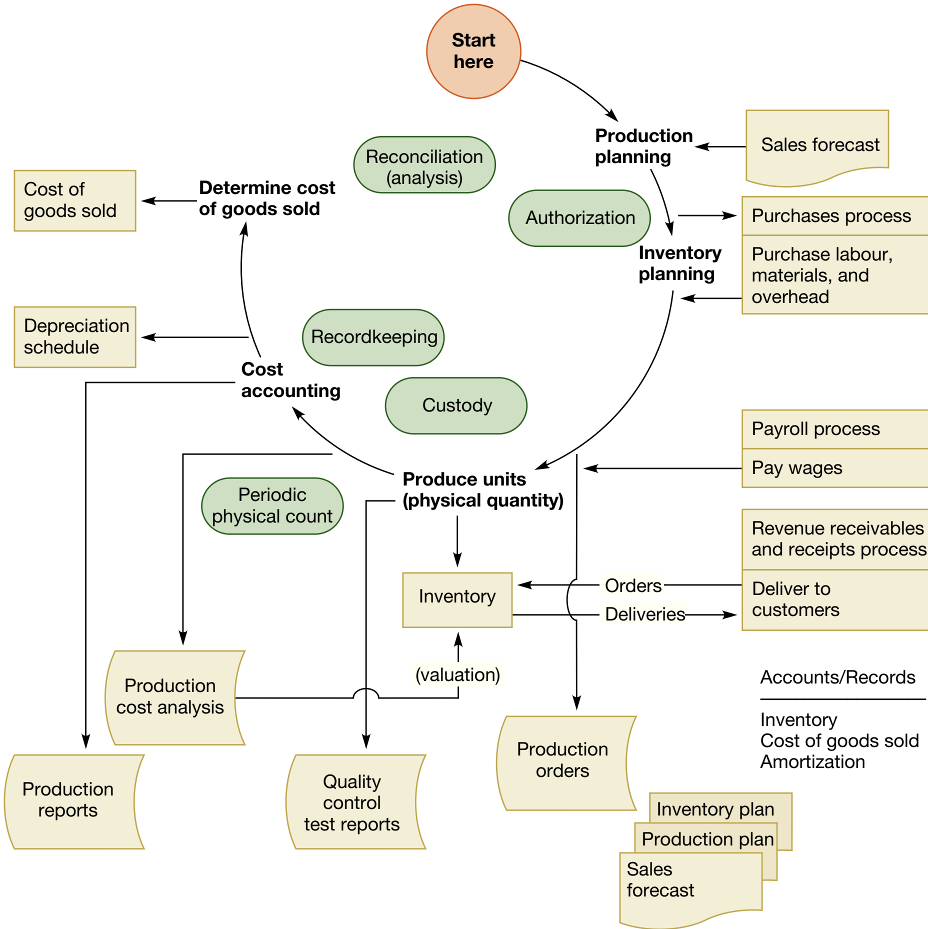
EXHIBIT 13–1 Production Process



The audit of inventory consists of two phases: verifying the physical units and testing the unit costs. Physically observing the inventory count, including any equivalent units calculations for work in process, is the main procedure for verifying physical units. The unit costing of inventory (also referred to as *price tests*) for purchased inventory, such as the inventory of retailers, was partly covered in Chapter 12. In the cost-testing procedures for produced or manufactured inventory, the cost allocations and computations are much more complex (as you may have noticed in your management accounting courses). For example, in process costing the following formula is used:

$$\text{Unit Cost of Production} = \frac{\text{Production Costs}}{\text{(Equivalent Units of Production)}}$$

Once the unit costs of production are known, the total inventory production costs for reporting purposes are unit cost times number of units. The total inventory production cost must be allocated between cost of sales (on the income statement) and inventory (on the balance sheet). This allocation of costs between inventory and cost of goods sold includes proper allocation of any cost variances. This is necessary because a budget system is a control system, and for external reporting purposes the actual costs, not the standard or budgeted costs, must be disclosed. This allocation will affect the cost amounts the auditor uses in inventory valuation tests that assess

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whether recorded inventory costs are lower than market-based net realizable values. The box below shows how errors can arise in allocating standard overhead costs to inventory.

OVERHEAD ALLOCATION ANALYSIS

The cost accounting department at Pointed Publications Inc. routinely allocated overhead to book printing runs at the standard rate of 40% of materials and labour cost. The debit was initially to the finished books inventory, while the credit went to an "overhead allocated" account that was offset against other entries in the cost of goods sold calculation, which included all the actual overhead incurred. During the year, 10 million books were produced and $40 million of overhead was allocated to them. The auditors noticed that actual overhead expenditures were $32 million, and three million books remained in the ending inventory.

This finding resulted in the conclusion that the inventory was overstated by $2.4 million, and the cost of goods sold was understated by $2.4 million.

	COMPANY ALLOCATION (USING STANDARD OVERHEAD RATE)	AUDITOR ANALYSIS (USING ACTUAL OVERHEAD)
Books produced	10.00 million	10.00 million
Labour and material cost	$100.00 million	$100.00 million
Overhead allocated	$ 40.00 million	$ 32.00 million
Cost per book	$ 14.00 million	$ 13.20 million
Cost of goods sold		
Labour and materials cost	$100 million	$100.0 million
Overhead allocated to books	40 million	
Overhead incurred	32 million	32.0 million
Overhead credited to cost	(40 million)	
Ending inventory	(42 million)	(39.6 million)
Total cost of goods sold	$ 90 million	$ 92.4 million
Cost of goods sold per company		$ 90.0 million
Difference (understated)		$ 2.4 million

Audit Conclusion: Cost of sales is understated by $ 2.4 million. Difference is carried forward to accumulated misstatements summary worksheet in audit file documentation.

Valuation of manufactured inventory, manufactured cost of goods sold, and any self-constructed property, plant, and equipment assets are based on these internal cost allocations. Therefore, the appropriateness of such cost allocations is a critical part of the audit of the valuation assertion of inventory and fixed assets.

As you follow Exhibit 13–1, you can track the elements of the control structure below.

Authorization

Production authorization starts with production planning, which usually is based on a sales forecast. Production planning interacts with inventory planning to generate production orders. These production orders specify the materials and labour required, as well as the timing for the start and end of production. Managers in the sales/marketing and production departments usually sign off their approval on plans and production orders. Since sales volume and inventory requirements change with economic conditions and company success or failure, these plans and approvals are dynamic; they are amended according to changing needs. Authorization also can include plans and approvals for subcontracting work to other companies. The process of taking bids and executing contracts can be a part of the planning-authorization system.

The production order usually includes a *bill of materials* (a specification of the materials authorized for the production). The materials requisitions are prepared based on the authorization of the bill of materials, and these requisitions become the authorization for the inventory custodian to release raw materials and supplies to the production personnel. They then become the inventory recordkeeper's authorizations to update the raw materials inventory files to record reductions in the raw materials inventory.

Later, when production is complete, the production reports, the physical units, and the quality control test reports for them are the authorizations for the finished goods inventory custodian to place the units in the finished goods inventory. These same documents are the inventory recordkeeper's authorization to update the inventory record files with the additions.

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Custody

Supervisors and workers have physical custody of materials, equipment, and labour while production work is performed. They requisition materials from the raw materials inventory, assign people to jobs, and control the pace of work. In a sense, they have custody of a moving inventory. The "work in process" (an inventory category) is literally "moving" and changing form in the process of being transformed from raw materials into finished goods.

Control over this custody is more difficult than control over a closed warehouse full of raw materials or finished goods. It can be exercised by holding supervisors and workers accountable for the use of materials specified in the production orders, the timely completion of production, and the quality of the finished goods. This accountability can be achieved with good cost accounting, cost analysis, and quality control testing.

Recordkeeping (Cost Accounting)

When production is completed, production orders and the related records of material and labour used are forwarded to the cost accounting department. Since these accounting documents may come from the production personnel, the effective separation depends on its receiving independent notices from other places, especially notifications of materials issued from the inventory custodian and of the labour costs assigned by the payroll department.

The cost accounting department calculates the cost per unit, standard cost, and variances. It also may determine the allocation of overhead to production in general, to production orders, and to finished units. Depending on the design of the company's accounting system, these costs are used in inventory valuation and, ultimately, in determining the cost of goods sold. Often, this department is responsible for calculating the depreciation of production assets and the amortization of intangibles.

Periodic Reconciliation

Periodic reconciliation compares actual assets and liabilities with amounts recorded in the company accounts (e.g., the physical count of inventory with the perpetual inventory records, vendors' monthly statements with the recorded accounts payable). Exhibit 13–1 shows the periodic reconciliation of physical inventory to recorded amounts. The features and audit considerations of this reconciliation were covered in Chapter 12. The WIP inventory also can be observed, although the "count" of partially completed units is subjective. It can be costed based on the labour, materials, and overhead used at its stage of completion.

Most other periodic reconciliations in the production cycle are analyses of internal information. After all, other than physical inventory, no external transactions or physical units are unique to production and cost accounting. The analyses include costing the production orders, comparing the cost with prior experience or with standard costs, and determining **lower-of-cost-or-net-realizable-value (LCNRV)** valuations. In a sense, the LCNRV calculations are a reconciliation of product cost to the external market price of product units.

lower-of-cost-or-net-realizable-value (LCNRV): an accounting rule that requires inventory to be reported at its cost, or, if the amount that could be obtained by selling it net of any selling costs is less than its cost, at that lower amount; the lower amount is achieved by recording a writedown

REVIEW CHECKPOINTS

13-2 What are the functions normally associated with the production process? Why is an understanding of the production process, including the related data processing and cost accounting, important to auditors evaluating the control structure as part of their assessment of control risk?

13-3 Describe a walk-through of a production transaction from production orders to entry in the finished goods perpetual inventory records. What document copies would be collected? what controls noted? what duties separated?

13-4 Describe how the separation of (1) authorization of production transactions, (2) recording of these transactions, and (3) physical custody of inventories can be specified among the production, inventory, and cost accounting departments.

13-5 What features of the cost accounting system would be expected to prevent the omission of recording materials used in production?

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Audit Evidence in Management Reports and Files

Most production accounting systems produce timely reports that managers use to supervise and control production. Auditors use them as supporting evidence for assertions about WIP and finished goods inventories and about cost of goods sold.

Sales Forecast

Several aspects of business planning, notably the planning of production and inventory levels, are based on management's sales forecasts. If the auditors want to use the forecast for substantive audit decisions, assurance about its reasonableness needs to be obtained, particularly about assumptions built into it. In addition, the mechanical accuracy of the forecast should be verified.

As much of the year under audit will have passed when the audit work begins, the forecasts can help the auditor to understand the nature and volume of production orders and the level of materials inventory on hand. Forecasts for the following year are used in valuing the inventory (e.g., lower-of-cost-or-net-realizable-value if forecast indicates slow-moving and potentially obsolete inventory). If a writedown from cost to market value is required, this increases the amount of cost of goods sold that is shown in the financial statements. Special care must be taken when using forecasts with inventory valuation, because an overly optimistic forecast can lead to a failure to write down inventory.

THE SALY FORECAST

The auditors were reviewing the inventory items that had not been issued for 30 days or more, to assess whether any items need to be written down because their market values were lower than cost. The production manager showed them the SALY forecast that indicated a continuing need for the materials in products that were expected to have reasonable demand. The auditors agreed that the forecasts supported the prediction of future sales of products at prices that would cover the cost of the slow-moving material items.

Unfortunately, they neglected to ask the meaning of SALY in the designation of the forecast. They did not learn that it means "same as last year." It is not a forecast at all. The products did not sell at the prices expected, and the company experienced losses the following year that should have been charged to cost of goods sold earlier.

Production Plans and Reports

Management's plan for the amount and timing of production provides general information to the auditors, but the production orders and inventory plan associated with it are even more important. These carry the information about requirements for raw materials, labour, and overhead, including the requisitions for purchase and use of materials and labour. These documents are the initial authorizations for control of the inventory and production.

Production reports record the completion of production quantities. When coupled with the related cost accounting reports, they are the company's record of the cost of goods placed in the finished goods inventory. In most cases, auditors will audit the cost reports as part of determining the cost valuation of inventory and cost of goods sold.

Amortization Schedule

The cost accounting department may prepare the schedule of the depreciation (amortization) of production assets. Company accountants may prepare similar schedules for the company's other (nonproduction) fixed assets. These are often long and complicated, involving large dollar amounts of asset cost and calculated depreciation expense. An abbreviated illustration of a production asset and amortization schedule follows.

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PRODUCTION ASSETS AND DEPRECIATION								
	ASSET COST (000s)				ACCUMULATED DEPRECIATION (000s)			
DESCRIPTION	BEGINNING BALANCE	ADDITIONS	DISPOSALS	ENDING BALANCE	BEGINNING BALANCE	ADDITIONS	DISPOSALS	ENDING BALANCE
Land	10,000			10,000				
Building 1	30,000			30,000	6,857	857		7,714
Building 2		42,000		42,000		800		800
Computer A	5,000			0	3,750	208	3,958	0
Computer B		3,500	5,000	3,500		583		583
Press	1,500			1,500	300	150		450
Machine 1	15		15	0	15		15	0
Machine 2		22		22		2		2
Total	46,515	45,522	5,015	87,022	10,922	2,600	3,973	9,549

REVIEW CHECKPOINTS

13-6 When auditors want to use an auditee's sales forecast for general familiarity with the production process or for evaluation of slow-moving inventory, what kind of work should be done on the forecast?

13-7 If the actual sales for the year are substantially lower than the sales forecast at the beginning of the year, what potential valuation problems may arise in the production cycle accounts?

13-8 What production documentation supports the valuation of manufactured finished goods inventory?

13-9 What items in an auditee's production asset and amortization schedule can auditors use for designing audit procedures? Describe these audit procedures.

The depreciation schedule is audited by using the company's methods to recalculate the depreciation expense, estimates of useful life, and estimates of residual value, and by verifying the additions and disposals recorded. When the schedule covers hundreds of assets and numerous additions and disposals, auditors can (a) use computer auditing methods to recalculate the depreciation expense and (b) use sampling to choose additions and disposals for test of controls and substantive audits. The beginning balances of assets and accumulated amortization should be traced to the prior-year audit's working papers. This schedule can be made into an audit working paper and placed in the auditor's files for future reference, as was illustrated in Exhibit 12–10 (see page 515).

CONTROL RISK ASSESSMENT

LO3 Describe control tests for auditing control over conversion of materials and labour in the production process.

Control risk assessment is important because it governs the nature, timing, and extent of substantive audit procedures that will be applied in the audit of account balances in the production accounting process. These account balances include the following:

- Inventory—raw materials, work-in-process, finished goods
- Cost of goods sold
- Depreciation—depreciation expense, accumulated depreciation

Several aspects of auditing purchased inventories and physical quantities are covered in Chapter 12. With respect to inventory valuation, this chapter points out the cost accounting function and its role in determining the cost valuation of manufactured finished goods.

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General Control Considerations

Control procedures for proper segregation of responsibilities should be in place and operating. From Exhibit 13–1, you can see that proper segregation involves authorization (production planning and inventory planning) by those who do not have custody, recording, or cost accounting and reconciliation duties. Custody of inventories (raw materials, WIP, and finished goods) is in the hands of people who do not (a) authorize the amount or timing of production or the purchase of materials and labour, (b) perform the cost accounting recordkeeping, or (c) prepare cost analyses (reconciliations). Cost accounting (a recording function) is performed by those who do not authorize production or have custody of assets in the process of production. However, you usually will find that the cost accountants prepare various analyses and reconciliations directly related to production activities. Combinations of two or more of the duties of authorization, custody, or cost accounting in one person, one office, or one computerized system may open the door for errors or fraud.

In addition, the control structure includes the following detail-checking procedures:

1. Production orders contain a list of materials and their quantities, and they are approved by a production planner/scheduler.
2. Materials requisitions are (a) compared, in the cost accounting department, with the list of materials on the production order and (b) approved by the production operator and the materials inventory stock keeper.
3. Job labour time records are signed by production supervisors, and the cost accounting department reconciles the amounts with the labour report from the payroll department.
4. Production reports of finished units are signed by the production supervisor and finished goods inventory custodian and then forwarded to cost accounting.

These control operations track the raw materials and labour through the production process. With each internal transaction, the responsibility and accountability for assets are passed to the next person or location.

Many companies have complex systems for managing production and material flows. These information systems are customized as production processes vary considerably for different products and factories. Even within the same company, different information systems may be used to manage different products or different locations. Some parts of the production process and accounting may be done manually, while others are automated. Paper source documents and authorization signatures may not exist for automated functions. Even though the information system and technology may be complex and specific to the entity, auditors should ensure the basic management and control functions of ensuring the flow of labour and materials to production and controlling waste are in place.

Internal Control Questionnaire

Information about the production process control structure often is gathered initially by completing an internal control questionnaire (ICQ). Exhibit 13A–1 in Appendix 13A (page 582) is an example of an ICQ, and it can be studied for details of desirable control policies and procedures. The ICQ lists control activities found in the manual aspects of a production cost accounting system. The automated aspects that have no paper trail must be assessed to see whether each control objective is met through application controls or other verification procedures, for example, input/output checks.

Production Management: JIT

Just-in-time (JIT) manufacturing and supply chain management systems have expanded in many companies with the availability of electronic data interchange (EDI) and other information technologies. Auditors need to be familiar with the components and functions of these systems and their implications for auditing. Appendix 13B on Connect provides further details on auditor's risk assessments related to JIT manufacturing and supply chain management.

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Control Tests

An organization should have functioning control activities that prevent, detect, and correct accounting errors. You studied the general control objectives in Chapter 9 (validity, completeness, authorization, accuracy, classification, accounting, and proper period recording). Exhibit 13–2 puts these in the perspective of production activity, with examples of specific control objectives. Study this exhibit carefully as it expresses the control objectives in examples specific to production.

EXHIBIT 13–2 Control Objectives (Production Process)

GENERAL OBJECTIVES	EXAMPLES OF SPECIFIC CONTROL ACTIVITIES
1. Recorded production transactions are *valid* and documented.	Cost accounting separated from production, payroll, and inventory control Material use reports compared with raw material stores issue slips Labour use reports compared with job time tickets
2. Valid production transactions are *recorded completely* and none omitted.	All documents prenumbered and numerical sequence reviewed
3. Production transactions are *authorized*.	Material use and labour use prepared by foreman and approved by production supervisor
4. Production job cost transactions computations contain *accurate* figures.	Job cost sheet entries reviewed by person independent of preparation Costs of inventory used and labour used reviewed periodically
5. Labour and materials are *classified* correctly as direct or indirect.	Production supervisor required to account for all material and labour used as direct or indirect
6. Production *accounting* is complete.	Open job cost sheets periodically reconciled to the work-in-process inventory accounts
7. Production transactions are recorded in the *proper period*.	Production reports of material and labour used prepared weekly and transmitted to cost accounting Job cost sheets posted weekly and summary journal entries of work-in-process and work completed prepared monthly

Auditors perform control tests to determine whether controls said to be in place and operating actually are being performed properly by company personnel. Recall that a control test consists of (1) identification of the data population from which a sample of items will be selected for audit and (2) an expression of the action that will be taken to produce relevant evidence, such as vouching, tracing, observing, scanning, and recalculating.

Exhibit 13–3 contains a selection of control tests for auditing controls over the accumulation of costs for WIP inventory. This is the "inventory" of things in the production process. Upon completion, the accumulated costs become the cost valuation of the finished goods inventory. The exhibit presumes that there are production cost reports, which are updated as production takes place, labour reports assigning labour cost to the job, reports of materials used and materials requisitions charging raw materials to the production order, and overhead allocation calculations. Some or all of these documents may be in the form of computer records. The samples are usually attribute samples designed along the lines studied in Chapter 10. On the right-hand side, Exhibit 13–3 shows the control objectives tested by the audit procedures listed.

EXHIBIT 13–3 Control Tests for Work-in-Process Inventory

	CONTROL OBJECTIVE
1. Reconcile the open production cost reports to the work-in-process inventory control account.	Completeness
2. Select a sample of open and closed production cost reports:	
a. Recalculate all costs entered.	Accuracy
b. Vouch labour costs to labour reports.	Validity
c. Compare labour reports with summary of payroll.	Accounting
d. Vouch material costs to issue slips and materials-used reports.	Validity
e. Vouch overhead charges to overhead analysis schedules.	Accuracy
f. Trace selected overhead amounts from analysis schedules to cost allocations and to invoices or accounts payable vouchers.	Validity

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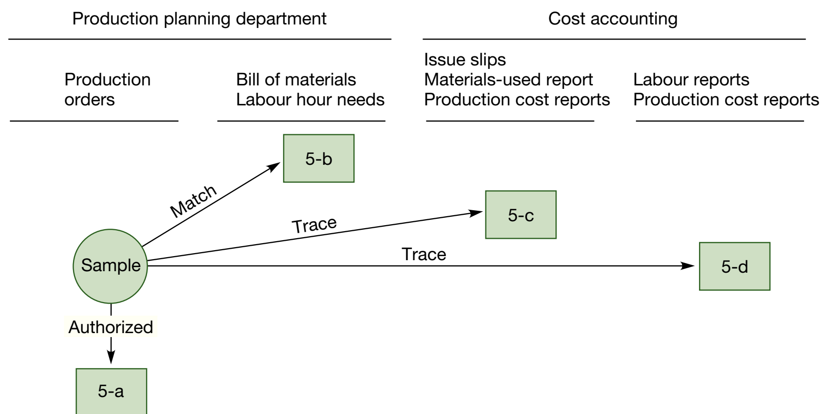
EXHIBIT 13–3 Continued

	CONTROL OBJECTIVE
3. Select a sample of issue slips from the raw materials stores file:	
a. Determine if a matching requisition is available for every issue slip.	Completeness
b. Trace materials-used reports into production cost reports.	Completeness
4. Select a sample of clock timecards from the payroll file. Trace to job time tickets, labour reports, and production cost reports.	Completeness
5. Select a sample of production orders:	
a. Determine whether production order was authorized.	Authorization
b. Match to bill of materials and labour hour needs.	Completeness
c. Trace bill of materials to material requisitions, material issue slips, materials-used reports, and production cost reports.	Completeness
d. Trace labour hour needs to labour reports and production cost reports.	Completeness

Dual Direction of the Test of Controls Procedures

The procedures listed in Exhibit 13–3 are designed to test the production accounting in two directions, the first being the completeness direction, testing whether all production ordered to be started is recorded. Exhibit 13–4 shows that the sample for this testing direction is taken from the population of production orders found in the production planning department. The cost accumulation is traced forward into the production cost reports in the cost accounting department. The procedures keyed in the boxes (5-a, -b, -c, -d) are cross-references to the procedures in Exhibit 13–3. Potentially, these procedures will find any scheduled production that has been cancelled because of technical or quality problems, which means there should be some writing off or scrapping of partially completed production units.

EXHIBIT 13–4 Test of Production Cost Controls: Completeness Direction



Note: The 5–a, etc., codes refer to control tests listed in Exhibi 13–3.

The other direction of the test is validity, which is concerned with the proper recording of work in process and finished goods in the general ledger. Exhibit 13–5, which is a sample for this test, is from the production reports (quantity and cost) recorded in the inventory accounts. This sample references to production cost reports filed in the cost accounting department. From these basic records, the recorded costs can be recalculated, vouched to labour reports, compared with the payroll, and vouched to records of material used and overhead incurred. The procedures keyed in the boxes (2-a, -b, -c, -d, -e, -f) are cross-references to the procedures in Exhibit 13–3. These procedures might reveal that there is improper valuation of the recorded inventory cost.

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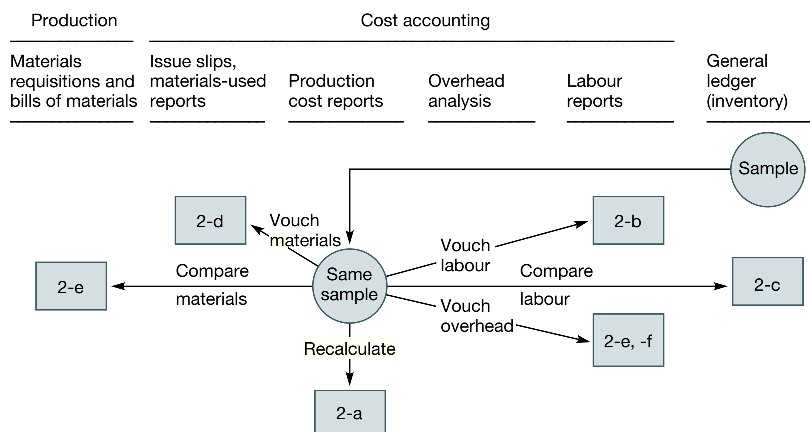
EXHIBIT 13–5 Test of Production Cost Controls: Validity Direction



Note: The 2–a, etc., codes refer to control tests listed in Exhibi 13–3.

Summary: Control Risk Assessment

The audit manager or senior in charge of the audit should evaluate the evidence obtained from an understanding of the internal control structure and from the test of controls audit procedures. If the control risk is assessed very low, the substantive audit procedures on the account balances can be limited in cost-saving ways. For example, the inventory valuation substantive tests can be limited in scope (i.e., smaller sample sizes), and there can be more confidence that the overall analytical procedures will be able to detect material misstatements not otherwise evident in the accounting details.

On the other hand, if tests of controls reveal weaknesses, amortization calculation errors, and cost accumulation errors, the substantive procedures must be designed to lower the risk of failing to detect material error in the inventory and cost of goods sold account balances. For example, the amortization cost might be completely recalculated and reviewed again by the auditors, valuation calculations may need to be performed for a large number of the inventoried production reports, and contract terms related to cost overruns may need to be investigated to determine if they should be carried as assets (e.g., as inventory or unbilled receivables) or written off. Descriptions of major control deficiencies, control weaknesses, and inefficiencies may need to be communicated to the auditee management and those charged with governance.

Since inventory production accounting often involves processing high volumes of transactions and keeping track of items in different locations, computer assisted audit testing can be efficient. Computerized components of the production information system may range from simple batch systems, which automate the data processing, to transaction-driven integrated systems, which capture the production progress electronically from devices on the production line. Computer audit techniques, such as test data, may be used to audit controls in such systems. For tests of details of transactions and balances, auditor-created or tested software for verifying all (or a sample) of the inventory transaction processing can include (a) selecting items for test counting based on auditor-determined criteria, (b) sorting inventory items by location to facilitate observations, (c) recalculating extensions on inventory quantities and pricing, and (d) comparing inventory test counts with perpetual records. Audit software can also perform analytical review procedures; for example, identify unusual fluctuations in current and prior inventory quantities in comparison with details of purchases and sales transactions, spot negative or unreasonably large inventory quantities, and summarize inventory turnover statistics for obsolescence analysis.

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IMPROPER PRODUCTION LOSS DEFERRALS

Alton Corporation incurred cost overruns on its shipbuilding contracts. By classifying the cost overruns as an asset for financial reporting purposes, Alton postponed writing off an $18 million cost overrun. If it had been written off in the proper period, the company would have reported a large loss instead of a net income of $500,000 for the year. Alton wrote off the $18 million two years later by restating its financial statements.

****

International Technologies Corporation (ITC) experienced cost overruns on fixed price contracts, claims for price escalation, and kickback arrangements with suppliers. ITC recorded and reported these costs as "unbilled receivables," using the account to misrepresent the cost overruns as escalation payments due from the customer, while the contract did not provide for any such payment. ITC used the unbilled receivables account as a hiding place for improper and questionable payments on the contracts so it could show them as legitimate reimbursable contract costs in order to avoid (a) writing them off as expense and (b) showing the true nature of the items. ITC also buried uncollectible contract costs, which indicated losses on fixed price contracts, in other unrelated contracts that were still profitable. When ITC's auditor uncovered the materially overstated assets, it required a writedown. This revealed that ITC was insolvent, and it was acquired by another technology company that quickly fired ITC's management.

REVIEW CHECKPOINTS

13-10 What are the primary functions that should be segregated in the production process?

13-11 How does the production order document or record provide a control over the quantity of materials used in production?

13-12 Where might an auditor find accounting records of cost overruns on contracts? improper charges? improperly capitalized inventory?

13-13 Evaluate the following statement made by an auditing student: "I do not understand cost accounting; therefore, I want to get a job with an auditing firm where I will only have to know financial accounting."

13-14 Which population of documents or records would an auditor sample to determine whether (a) all authorized production was completed and placed in inventory or written off as scrap? and (b) finished goods inventory were actually produced and properly costed?

SUBSTANTIVE AUDIT PROGRAM FOR THE PRODUCTION PROCESS

LO4 Describe the typical substantive procedures used to address the assessed risk of material misstatement in the main accounts in the production process.

Exhibit 13–6 shows a list of typical substantive procedures used to obtain evidence related to production transactions, and their impact on the financial statements. It provides a template substantive audit program for the production process. As always, the auditor's risk assessments are used to adapt the template to respond to the risks present in a particular audit engagement.

EXHIBIT 13–6 Example of Substantive Audit Program Responding to Assessed Risk of Material Misstatement for Production Costing: Selected Procedures

SUBSTANTIVE AUDIT PROGRAM				
AUDITEE: *ECOPACK INC.*		**FILE INDEX:** *7.20*		
FINANCIAL STATEMENT PERIOD: *y/e DECEMBER 31, 20x1*				
PROCESS: Inventory production costing				
Substantive audit program in response to assessed risks at the assertion level:				
Consider risk assessment findings and conclusion on residual detection risk to be reduced by performing substantive procedures. (Of the procedures listed below, perform those considered necessary to provide sufficient appropriate evidence to address the assessed risks and reduce risk of material misstatement to an acceptable level.)				*[Reference to relevant working papers]*

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EXHIBIT 13–6 Continued

Substantive audit procedures	Assertions evidence is related to [E,C,O,V,P]	Timing	Extent	Working paper reference
Analytical procedures 1. Perform the following analysis and obtain satisfactory explanations from management for relationships observed: *a.* Compare gross profit margin (i.e., as a percentage of sales) by product and compare with prior periods. *b.* Compare gross profit margin by product with the standard markup. *c.* Compare gross profit margin by month for the last two fiscal periods. Note any differences in the gross profit margin in the months before and after the period-end.				
Tests of details of transactions and balances 1. Select the significant items contained in the inventory balance and perform the following procedures: *a.* Raw material Agree cost to suppliers' invoices, shipping charges, and customs brokers' charges. *b.* WIP and finished goods Review cost elements and costing calculations by product for accuracy and reasonableness. Compare labour rates used with the payroll records. *c.* Overhead applied to inventory Assess the reasonableness of overhead rates used by comparing amounts applied with actual overhead in the accounting records.				
2. Ensure inventory costs in a foreign currency have been translated at the period-end exchange rate.				
3. Assess reasonability of accounting policies chosen by the entity in relation to common practice in the industry, consistency with previous periods, and impact on net income.				
4. Obtain evidence of current market prices of raw materials and finished goods, and expected costs of selling these, to determine whether net realizable value exceeds their carry costs. If not, a write down to NRV is required for fair presentation.				
Misstatement summary: Summarize here all misstatements discovered in executing this program. Carry all forward for accumulation in the Summary of Accumulated Misstatements worksheet (see Exhibit 16–1)				

AUDITOR'S CONCLUSIONS

[if the audit program is completed satisfactorily and the audit objectives are met, a conclusion such as the following would be recorded by the auditor performing the work] *Based on my professional judgment, the evidence obtained is sufficient and appropriate to conclude that the risk of material misstatement of the Inventory Production Costing is acceptably low.*

Prepared by __________ Date __________

Reviewed by __________ Date __________

REVIEW CHECKPOINTS

13-15 Explain how the auditor's risk assessment affects the design of the substantive audit program.

13-16 In the audit of inventory, what is the purpose of the analytical procedure that compares gross profit margin by month for the last two fiscal periods?

13-17 What substantive tests of details of transactions and balances are used to verify the pricing of manufactured inventory items? Which assertion do these procedures mainly address?

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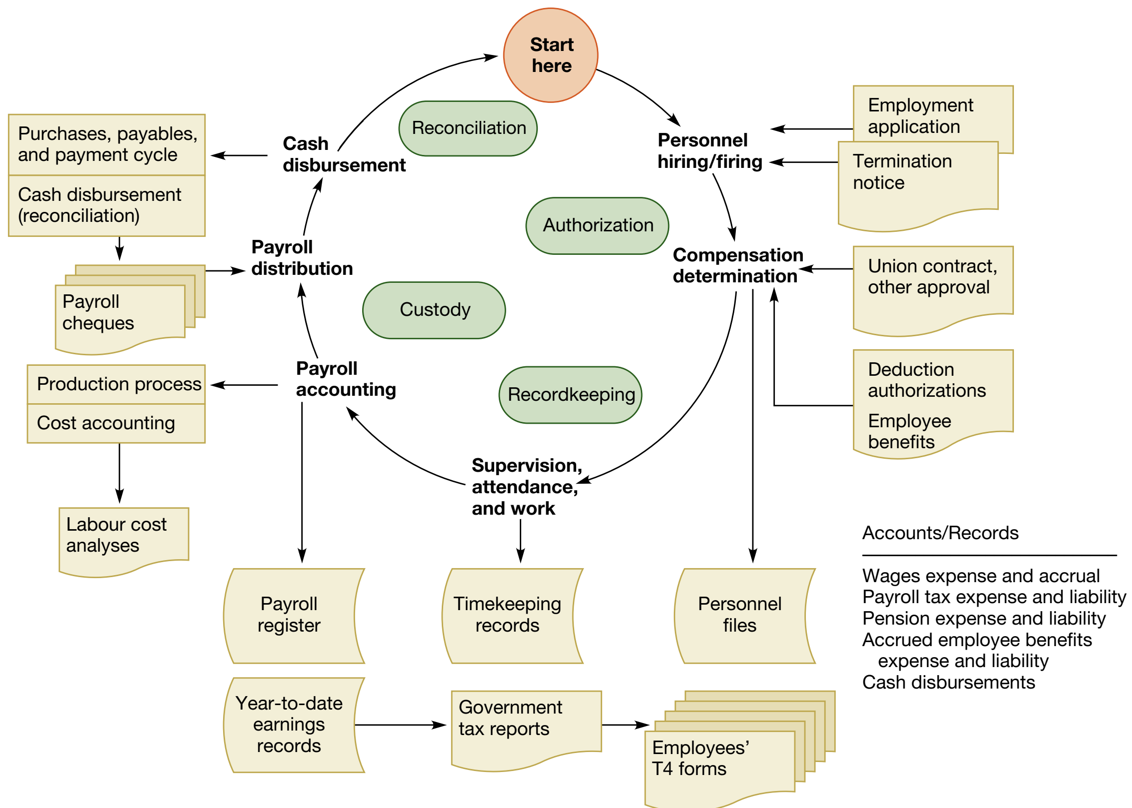
PART II: UNDERSTANDING THE PAYROLL PROCESS

LO5 Describe the payroll process: typical transactions, account balances, source documents, and controls.

Every company has a payroll process. It may include payrolls for manufacturing labour, research scientists, administrative personnel, or for all of these. Subsidiary operations, partnerships, and joint ventures may call their payroll *management fees* charged by a parent company or general partner. Payroll can take different forms. Personnel management and the payroll accounting cycle includes transactions affecting the wage and salary accounts as well as those affecting pension benefits, deferred compensation contracts, stock option plans, employee benefits (such as health insurance), payroll taxes, and related liabilities for these costs. It is very important that auditors verify the payroll system's compliance with local, provincial, and federal laws regarding deductions, overtime rules (e.g., after 8 hours in a day or 40 hours in a week), and minimum wage rates, and so on. Failures to comply can lead to large liabilities. Many companies find it cost effective to use an outside payroll service organization to process and distribute payroll directly to employees' bank accounts because income taxes, rates, and calculations change frequently, and service organizations are better able to keep up to date with these changes.

Exhibit 13–7 is a picture-style skeleton diagram of a payroll process. It starts with hiring (and firing) people, determining employee wage rates and deductions, recording attendance and work (timekeeping), payment of wages and salaries, and then ends with preparation of governmental (tax) and internal reports. One of these internal reports is a report of labour cost to the cost accounting department, which links the payroll cycle with cost accounting in the production cycle.

EXHIBIT 13–7 Payroll Process



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Five functional responsibilities should be performed by separate people or departments. They are as follows:

1. Human Resources/Personnel Management —hiring and firing
2. Supervision—approval of work time
3. Timekeeping and Cost Accounting—payroll preparation and cost accounting
4. Payroll Accounting—cheque preparation and related payroll reports
5. Payroll Distribution—actual custody of cheques and distribution to employees by cash, cheque, or direct bank deposit

The elements that follow are part of the payroll control structure.

Authorization

A human resources department with authority to add new employees to the payroll, delete terminated employees, obtain authorizations for deductions (i.e., insurance, charitable donations, withholding-tax exemptions), and transmit authority for pay rate changes to the payroll department should be independent of the other functions. The supervision function should include authorization power. All pay base data (hours, job number, absences, time off allowed for emergencies, and the like) should be approved by an employee's immediate supervisor. Authorization is also a feature of the timekeeping and cost accounting functions. The data that pay is based on (i.e., hours, piece-rate volume, and incentives) should be accumulated independent of other functions. Many of the functional duties and responsibilities described relate primarily to non-salaried (hourly) employees. For salaried employees, no timekeeping data are collected.

Custody

The main custody item in the payroll cycle is possession of the paycheques, cash, or electronic transfer codes used to pay people. (Electronic transfer codes refer to the practice of transferring pay directly into employees' bank accounts.) A payroll distribution function should control the delivery of pay to employees so that unclaimed cheques, cash, or incomplete electronic transfers are not returned to persons involved in any of the other functions.

There are elements of custody of important documents in the supervision and timekeeping functions. Supervisors usually have access to time cards or time sheets that provide the basis for payment to hourly workers. Likewise, the timekeeping devices (e.g., time clocks, supervisory approval of time cards or time sheets, electronic punch-in systems) have a type of custody of employees' time-base for payroll calculations.

APPROVAL OF FICTITIOUS OVERTIME

A supervisor at Austin Stoneworks discovered that she could approve overtime hours even though an employee had not worked 40 regular-time hours. She made a deal with several employees to alter their work time cards and split the extra payments. Over a 12-year period, the supervisor and her accomplices embezzled $107,000 in excess payments.

The employees' time cards were not reviewed after being approved by the supervisor. The company's payroll computer program did not have a valid data combination test that paid overtime only after 40 regular-time hours were paid.

Recordkeeping

The *payroll accounting* function prepares individual paycheques, pay envelopes, or electronic transfers using rate and deduction information supplied by the human resources function and base data supplied by the timekeeping-supervision function. Those in charge of the authorization and custody functions should not also prepare the payroll, as they might be tempted to pay fictitious employees.

Payroll accounting maintains individual year-to-date earnings records and prepares the provincial and federal tax reports (income tax and Canada or Quebec Pension Plan withholding, employment insurance reports, and annual T4 forms). The payroll tax returns

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(e.g., the federal T4 summary reporting income taxes, employment insurance, and pension withholdings from employees for the year) are useful records for audit recalculation and overall testing (analytical) procedures. They should correspond to company records and financial statement amounts. When an outside payroll processing service is used, it usually will provide the detailed journal entries to record each payroll as well as the year-end T4 forms and summaries.

Periodic Reconciliation

The payroll bank account can be reconciled as any other bank account, and the transactions can also be reconciled to recorded wage cost and expense. Some companies send each supervisor a copy of the payroll register showing the employees paid under their authority and responsibility. The supervisor gets a chance to re-approve the payroll after it is completed. This provides an opportunity to notice whether any persons not approved have been paid and charged to the supervisor's accountability.

The payroll report sent to cost accounting can be reconciled to the labour records charging labour cost to production. The cost accounting function should determine whether the labour paid is the same as the labour cost used in the cost accounting calculations.

NOT ENOUGH CONTROL, NO FEEDBACK, BYE-BYE MONEY

Homer had been in payroll accounting for a long time. He knew it was not uncommon to pay a terminated employee severance benefits and partial pay after termination; Homer received the termination notices and the data for the final paycheques. But Homer also knew how to keep the terminated employee on the payroll for another week, pay a full week's compensation, change the electronic transfer code, and take the money for himself. The only things he could not change were the personnel department's copy of the termination notices, the payroll register, and the individual employee pay records used for withholding tax.

Fortunately for Homer, nobody reconciled the cost accounting labour charges to the payroll. The supervisors did not get a copy of the payroll register for postpayment approval, so they did not have any opportunity to notice the extra week. Nobody ever reviewed the payroll with reference to the termination notices. Former employees never complained about more pay and withholding reported on their T4s.

Homer and his wife, Marge, retired comfortably to a villa in Spain on a nest egg that had grown to $450,000. After Homer retired, the company experienced an unexpected decrease in labour costs and higher profits.

REVIEW CHECKPOINTS

13-18 What functional responsibilities are associated with the payroll process?

13-19 Describe a walk-through of the payroll transaction flow from hiring authorization to payroll cheque disbursement. What document copies would be collected?

13-20 In a payroll system, which duties should be separated?

13-21 What features of a payroll system can be expected to prevent or detect (a) payment to a fictitious employee? (b) omission of payment to an employee?

Audit Evidence in Management Reports and Files

Payroll systems produce numerous reports. Some are internal reports and bookkeeping records. Others are government tax reports.

Personnel Files

The human resources department keeps individual employee files. The contents usually include an employment application, background investigation report, notice of hiring, job classification with pay rate authorization, and authorizations for deductions (e.g., health benefits, life insurance, retirement contribution, union dues, and income tax exemptions). When employees retire, quit, or are otherwise terminated, appropriate notices of termination

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are filed. These files contain the raw data for important pension and post-retirement benefit accounting involving an employee's age, tenure with the company, wage record, and other information used in actuarial calculations.

A personnel file should establish the reality of a person's existence and employment. The background investigation report (prior employment, references, social insurance number validity check, credentials investigation, and perhaps a private investigator's report) is important for employees in sensitive positions such as accounting, finance, and asset custody. Capable personnel are a primary system control. Errors and frauds perpetrated by people who falsify their credentials (identification, education, prior experience, criminal record, and the like) abound. A fidelity bond for employees through an insurance company offers some protection from this risk.

Timekeeping Records

For employees paid by the hour or on various incentive systems, records of time, production, piecework, or other measures are the basis of their pay. These records are collected in a variety of ways. Old-fashioned time clocks still accept employee time cards and imprint the time when work started and ended. More sophisticated systems use card readers to perform the same function. Production employees may clock in for various jobs or production processes in a system that assigns labour costs to various stages of production.

Timekeeping records should be approved by supervisors to show that employees actually worked the hours (or produced the output) reported to the payroll department. A supervisor's signature or initials should be on the documents used by the payroll department as the basis for periodic pay. In computerized payroll systems, this approval comes in the form of the supervisory passwords used to input data.

WHERE DID HE COME FROM?

The controller defrauded the company for several million dollars. As it turned out, he was no controller at all. He did not know a debit from a credit. The fraudster had been fired from five previous jobs where money had gone missing. He was discovered one evening when the president showed up unexpectedly at the company and found a stranger in the office with the controller. The stranger was doing all of the accounting for the bogus controller.

Source: "Auditing for Fraud," training course © 2006 Association of Certified Fraud Examiners.

Payroll Register

The payroll register typically contains a record for each employee, showing the gross regular pay, gross overtime pay, income tax withheld, Employment Insurance (EI) and Canada Pension Plan (CPP) or Quebec Pension Plan (QPP) withheld, other deductions, and net pay. The net pay amount usually is transferred from the general bank account to a special imprest payroll bank account. To illustrate the details of payroll bookkeeping, the journal entry for the transfer of net payroll, for example, is as follows:

Account	Debit	Credit
Payroll Bank Account	25,774	
General Bank Account		25,774

When a payroll processing service is used, a cheque for the net payroll is usually issued to the payroll organization for distribution to employees' bank accounts; a separate payroll bank account is not required. The payroll amounts are accumulated to create the payroll posting to the general ledger, as in this example:

Account	Debit	Credit
Wages clearing account	40,265	
Employee income taxes payable account		7,982
Employee Canada Pension plan account		3,080
Employment Insurance premium payable account		2,100
Life insurance premium payable account		1,329
Payroll bank account		25,774

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The payroll register is the primary original record for payroll accounting. It contains the implicit assertions that the employees are real company personnel (existence assertion), that they worked the time or production they were paid for (rights/ownership assertion), that the amount of the pay is calculated properly (valuation assertion), and that all the employees were paid (completeness assertion). The presentation and disclosure assertion depends on the labour cost analysis explained below.

Payroll department records also include the cancelled cheques (or a similar electronic-deposit record) containing the employees' endorsements.

Labour Cost Analysis

The cost accounting department can receive its information in more than one way. Systems may independently report time and production work data from the production floor directly to the cost accounting department. Cost accounting departments may receive labour cost data from the payroll department. When the information is received independently, it can be reconciled in quantity (time) or amount (dollars) with a report from the payroll department. This reconciliation makes sure that the cost accounting department is using actual payroll data and that the payroll department is paying only for work performed.

The cost accounting department (or a similar accounting function) is responsible for the cost distribution—the most important part of the payroll presentation and disclosure assertion. The cost distribution assigns payroll to the accounts where it belongs for internal and external reporting. As an illustration of the accounting, using its input data, the cost accounting department may make a distribution entry, such as the following:

Production job A	14,364	
Production job B	3,999	
Production process A	10,338	
Selling expense	8,961	
General and administrative expense	2,603	
Wages clearing account		40,265

Payroll data flow from the hiring process, through the timekeeping function, into the payroll department, to the cost accounting department, and, finally, to the accounting entries that record the payroll for inventory cost determination and financial statement presentation. The same data are used for various governmental and tax reports.

Government and Tax Reports

Provincial and federal income and pension plan laws introduce complications into payroll systems. Several reports are produced that auditors can use in tests of controls and substantive tests of the balances produced by accumulating payroll transactions in year-to-date (YTD) records.

Year-to-Date Earnings Records

The YTD earnings records are the cumulative subsidiary records of each employee's gross pay, deductions, and net pay. Each time a periodic payroll is produced, the YTD earnings records are updated for the new information. The YTD earnings records are a subsidiary ledger of the wages and salaries cost and expense in the financial statements. Theoretically, like any subsidiary and control account relationship, their sum (e.g., the gross pay amounts) should be equal to the costs and expenses in the financial statements. The trouble with this reconciliation idea is that there are usually many payroll cost/expense accounts in a company's chart of accounts. The production wages may be scattered in several different accounts, such as inventory (WIP and finished goods), selling, general, and administrative expenses.

The YTD records do, however, provide the data for periodic governmental and tax forms. They usually can be reconciled to the tax reports. Companies in financial difficulty have been known to try to postpone payment of employee taxes, EI, and CPP or QPP withheld. However, the consequences can be serious. The Canada Revenue Agency can and will padlock the business and seize the assets for nonpayment. After all, the withheld taxes belong to the employee's accounts with the government, and the employers are obligated to pay over the amounts withheld from employees along with a matching share for the CPP.

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Employee Income Tax Reports

In Canada, the T4 slip is the annual report of gross salaries and wages as well as the income tax, pension plan, and employment insurance withheld. Copies are filed with the CPP or QPP and the Canada Revenue Agency, and copies are sent to employees for preparing their income tax returns. The T4 contains the YTD accumulations for the employee, along with their address and social insurance number. In certain procedures (described later), auditors can use the name, address, social insurance number, and dollar amounts to obtain evidence about the existence of employees. The T4 can be reconciled to the payroll tax reports.

BEWARE THE "CLEARING ACCOUNT"

Clearing accounts are temporary storage places for transactions awaiting final accounting. Like the wages clearing account illustrated in the entries above, all clearing accounts should have zero balances after the accounting is completed.

A balance in a clearing account means that some amounts have not been classified properly in the accounting records. If the wages clearing account has a debit balance, some labour cost has not been properly classified in the expense accounts or cost accounting classifications. If the wages clearing account has a credit balance, the cost accountant has assigned more labour cost to expense accounts and cost accounting classifications than the amount actually paid.

REVIEW CHECKPOINTS

13-22 What important information can be found in employees' personnel files?

13-23 What is important about background checks using the employment applications submitted by prospective employees?

13-24 What payroll documentation supports the validity and accuracy of payroll transactions?

13-25 Which government tax returns can be reconciled in total with employees' year-to-date earnings records? reconciled in total but not in detail?

13-26 What is the purpose of examining endorsements on the back of payroll cheques?

CONTROL RISK ASSESSMENT

LO6 Describe control tests for auditing control over hiring, firing, and payment of employees in the payroll process.

The major risks in the payroll process are as follows:

- Paying fictitious "employees" (employees that do not exist, invalid transactions)
- Overpaying for time or production (inaccurate transactions, improper valuation)
- Accounting for costs and expenses incorrectly (incorrect classification, improper or inconsistent presentation and disclosure)

The assessment of payroll system control risk is significant because there are so many transactions in this process, yet they result in small amounts in balance sheet accounts at year-end. Therefore, auditors often decide to use a combined audit approach, testing controls and transaction details using dual-purpose tests to lower assessed control risk so that less substantive testing is required.

General Control Considerations

Control procedures for proper segregation of responsibilities should be in place and operating. From Exhibit 13–7, you can see that proper segregation involves authorization (human resources department hiring and firing, pay rate, and deduction authorizations) by persons who do not have payroll preparation, paycheque distribution, or reconciliation duties. Payroll distribution (custody) is in the hands of those who neither authorize employees' pay rates or time, nor prepare the payroll cheques. Recordkeeping is performed by payroll and cost accounting personnel who do not make authorizations or distribute pay. Combinations of two or more of the duties of authorization, payroll preparation and recordkeeping, and payroll distribution in one person, office, or computerized system may open the door for errors and fraud.

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In addition, the control structure should provide for detail-checking procedures: (1) periodic comparison of the payroll register with the human resources department files to check for hiring authorizations and terminated employees not deleted, (2) periodic rechecking of wage rate and deduction authorizations, (3) reconciliation of time and production paid to cost accounting calculations, (4) reconciliation of YTD earnings records with tax returns, and (5) payroll bank account reconciliation.

Many companies have IT-based systems to gather payroll data, calculate payroll amounts, print cheques, and transfer electronic deposits. Their complexity varies, however, from simply writing payroll cheques to an integrated system preparing management reports and cost analyses based on payroll and cost distribution inputs. Payroll accounting is frequently contracted out to specialized service organizations. Regardless of the technology, the basic management and control functions of ensuring a flow of data to the payroll department should be in place. Computer audit techniques, such as test data, can be used to audit general controls that may be embedded in a computerized payroll system, and penetration tests can be used to verify effectiveness of general controls over security and authorized access.

Internal Control Questionnaire

Information about the payroll process control structure often is gathered initially through an ICQ. Exhibit 13A–2 in Appendix 13A shows details of desirable policies and procedures for the control environment and the important control objectives—validity, completeness, authorization, accuracy, classification, accounting, and proper period recording.

Control Tests

An organization should have detail control procedures in place and operating to prevent, detect, and correct accounting errors. The general control objectives were covered in Chapter 9. Exhibit 13–8 puts these in the perspective of the payroll functions with examples of specific objectives.

EXHIBIT 13–8 Control Objectives (Payroll Process)

GENERAL OBJECTIVES	EXAMPLES OF SPECIFIC CONTROL ACTIVITIES
1. Recorded payroll transactions are *valid* and documented.	Payroll accounting separated from personnel and timekeeping Time cards approved by supervisor Payroll files compared with personnel files periodically
2. Valid payroll transactions are *recorded completely* and none are omitted.	Employees' complaints about paycheques investigated and resolved (written records maintained and reviewed by internal auditors)
3. Payroll names, rates, hours, and deductions are *authorized*.	Names of new hires or terminations reported immediately in writing to payroll by the personnel department Authorization for deductions kept on file Rate authorized by union contract, agreement, or written policy and approved by personnel officer
4. Payroll computations contain *accurate* gross pay, deductions, and net pay.	Payroll computations checked by person independent of preparation Totals of payroll register reconciled to totals of payroll distribution by cost accounting
5. Payroll transactions are *classified* correctly as direct or indirect labour or other expenses.	Employee classification reviewed periodically Overall charges to indirect labour compared with direct labour and total product costs periodically
6. Payroll transaction *accounting* is complete.	Details of employee withholding reconciled periodically to liability control accounts and tax returns Employee tax expense and liabilities prepared in conjunction with payroll
7. Payroll costs and expenses are recorded in the *proper period*.	Month-end accruals reviewed by internal auditors Payroll computed, paid, and booked in timely manner

Auditors can perform control tests to determine whether controls that are said to be in place and operating actually are being performed properly by company personnel. Exhibit 13–9 contains a selection of procedures for testing controls over payroll, together with the control objective each tests. The samples are usually attribute samples designed along the lines you studied in Chapter 10.

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EXHIBIT 13–9 Control Tests for Payroll

	CONTROL OBJECTIVE
A. Personnel Files and Compensation Documents	
1. Select a sample of personnel files:	
a. Review personnel files for complete information on employment date, authority to add to payroll, job classification, wage rate, and authorized deductions.	Authorization Classification Authorization
b. Trace pay rate to union or other contracts or other rate authorization. Trace salaries to directors' minutes for authorization.	Authorization
c. Trace pay rate and deduction information to payroll department files used in payroll preparation.	Completeness
2. Obtain copies of pension plans, stock options, profit sharing, and bonus plans. Review and extract relevant portions that relate to payroll deductions, fringe benefit expenses, accrued liabilities, and financial statement disclosure.	Validity Completeness
3. Trace management compensation schemes to minutes to verify board of directors' approval.	Authorization Accuracy Accounting
B. Payroll	
1. Select a sample of payroll register entries:	
a. Vouch employee identification, pay rate, and deductions to personnel files or other authorizations.	Authorization
b. Vouch hours worked to time clock records and supervisor's approval.	Validity Authorization
c. Recalculate gross pay, deductions, net pay.	Accuracy
d. Recalculate a selection of periodic payrolls.	Accuracy
e. Vouch to cancelled payroll cheque. Examine employees' endorsement or payroll distribution report details.	Accuracy Validity
2. Select a sample of time-clock entries. Note supervisor's approval and trace to periodic payroll registers.	Authorization Completeness
3. Vouch a sample of periodic payroll totals to payroll bank account transfer vouchers and vouch payroll bank account deposit slip for cash transfer.	Accounting
4. Trace a sample of employees' payroll entries to individual payroll records maintained for tax reporting purposes. Reconcile total of employees' payroll records with payrolls paid for the year.	Completeness Accuracy
5. Review computer-printed error messages for evidence of the use of check digits, valid codes, limit tests, and other input, processing, and output application controls. Investigate correction and resolution of errors.	Accuracy
6. Trace payroll information to management reports and to general ledger account postings.	Accounting
7. Obtain control of a periodic payroll and conduct a surprise distribution of paycheques.	Validity
C. Cost Distribution Reports	
1. Select a sample of cost accounting analyses of payroll:	
a. Reconcile periodic totals with payroll payments for the same periods.	Completeness
b. Vouch to time records.	Validity
2. Trace cost accounting labour cost distributions to management reports and postings in general ledger and subsidiary account(s).	Accounting Classification
3. Select a sample of labour cost items in (a) ledger accounts and/or (b) management reports. Vouch to supporting cost accounting analyses.	Validity

COVERT SURVEILLANCE

This sounds like spy work, and it, indeed, includes certain elements of that.

Auditors can test controls over employees' clocking in for work shifts by making personal observations of the process—observing whether anybody clocks in with two time cards or with two or more electronic entries, or leaves the premises after clocking in.

The auditors need to be careful not to make themselves obvious. Standing around in a manufacturing plant at 6 a.m. in blue pinstripe suit is as good as printing "Beware of Auditor" on your forehead. People then will be on their best behaviour, and you will observe nothing unusual.

Find an unobtrusive observation post. Stay out of sight. Keep detailed records of what you see; even take a video, if permitted. Get a knowledgeable office employee to accompany you to interpret various activities. Perform an observation that has a chance of producing evidence of improper behaviour.

Dual Direction of Control Tests

The control tests in Exhibit 13–9 are designed to test the payroll accounting in two directions. One is the completeness direction, which matches personnel file content to payroll department files and the payroll register. The procedures trace the human resources department authorizations to the payroll department files—procedure A-1-*c* in Exhibits 13–9 and 13–10. The other direction of the test is validity. The control performance of interest here

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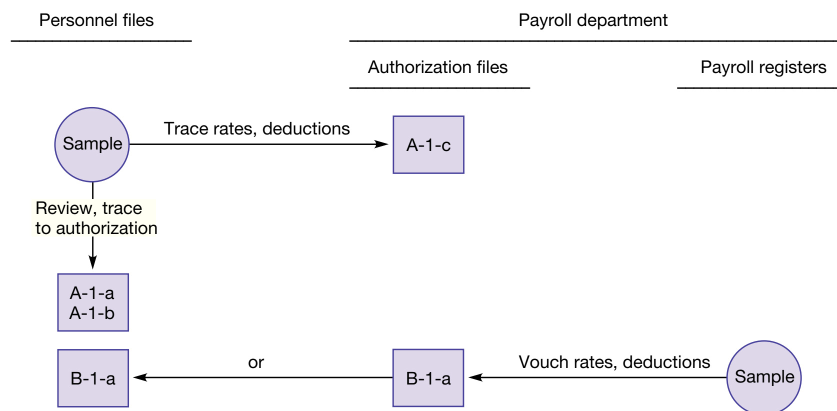
is the preparation of the payroll register. Exhibit 13–10 shows that the sample for this test is from the completed payroll registers. The individual payroll calculations are vouched to the personnel files (procedure B-1–*a*).

Generalized audit software can be used to test controls in the payroll process. Files are matched (e.g., personnel Generalized audit software can be used to test controls in the payroll process. Files are matched (e.g., personnel master file and payroll master file), and unmatched records and differences in common fields can be printed out. Statistical samples of files can be printed for vouching to union contracts or other authorizations. Statistical samples can be selected for recalculation by the software or be printed out as working papers for tracing and vouching, using the procedures in Exhibit 13–9.

In both manual and computerized systems, the test of controls and transaction details are evidence of the reliability of internal management reports and analyses. In turn, reliance on these reports and analyses, along with other analytical relationships, is a major portion of the substantive audit of payroll, compensation costs, and labour costs assigned to inventory and costs of goods sold.

EXHIBIT 13–10 Dual-Direction Test of Payroll Controls



Note: The A–1–a, etc., codes refer to control tests listed in Exhibit 13–9.

The test of controls procedures are designed to produce evidence of the following items:

- Adequacy of personnel files, especially the authorizations of pay rate and deductions used in calculating pay.
- Accuracy of the periodic payrolls recorded in accounts and in employees' cumulative wage records; the procedures tend to centre on the periodic payroll registers.
- Accuracy of cost accounting distributions and management reports. (The cost accounting for labour costs must be reasonably accurate because good management reports contribute to cost control. The auditor who relies on the cost accounting system must determine whether it contains and transmits accurate information.)

OVERT SURVEILLANCE

Surprise Payroll Distribution

In organizations that distribute paycheques by hand, auditors may perform a surprise observation of a payroll distribution in connection with tests for overstatement. This involves taking control of paycheques and accompanying a company representative as the distribution takes place. The auditor ensures that each employee is identified and that only one cheque is given to each individual. Unclaimed cheques are controlled, and in this manner the auditor hopes to detect any fictitious persons on the payroll. Auditors need to be extremely careful to notice any duplication of employee identification or instance of one person attempting to pick up two or more cheques.

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Summary: Control Risk Assessment

The audit manager or senior accountant in charge of the audit should evaluate the evidence obtained from an understanding of the internal control structure and from the test of controls audit procedures. If the control risk is assessed very low, the substantive audit procedures on the account balances can be limited. For example, it may be appropriate to rely on management reports generated by the payroll system.

On the other hand, if tests of controls reveal weaknesses, improper segregation of duties, inaccurate cost reports, inaccurate tax returns, or lax human resources policies, then substantive procedures will need to be designed to lower the risk of failing to detect material error in the financial statements. However, the irregularities of paying fictitious employees and overpaying for fraudulent time records do not normally misstate the financial statements, as long as the improper payments are expensed. (The losses are expensed, as they should be!) The misstatement is failing to distinguish and disclose "payroll fraud losses" from legitimate wages expense and cost of goods sold, but such losses would probably be immaterial in a single year's financial statements, anyway. While it is not a central part of their work of detecting material misstatements in financial statements, auditors nevertheless do perform procedures that may find payroll fraud.

REVIEW CHECKPOINTS

13-27 What are common errors and fraud in the payroll process? Which control characteristics are auditors looking for to prevent or detect these errors and fraud?

13-28 Why is it unwise for an auditor to stand by the plant gate and time clock to observe employees checking in for work shifts?

13-29 How can an auditor determine whether the amount of labour cost charged to production was actually paid to employees?

13-30 Why might an auditor conduct a surprise observation of a payroll distribution? What should be observed?

13-31 Describe a control test using generalized audit software that can be performed in a computerized payroll system.

SUBTANTIVE AUDIT PROGRAM FOR PAYROLL

LO7 Give examples of the typical substantive procedures used to address the assessed risk of material misstatement in the main accounts in the payroll process.

Exhibit 13-11 provides a template audit program for obtaining substantive evidence in relation to payroll expenses and balances. The program that outlines the substantive procedures typically used to audit the payroll process. Analytical procedures are often a key source of evidence. Substantive evidence is obtained through examination of transactions and resulting account balances.

EXHIBIT 13–11 Example of Substantive Audit Program Responding to Assessed Risk of Material Misstatement for Payroll Expenses and Balances: Selected Substantive Procedures

SUBSTANTIVE AUDIT PROGRAM				
AUDITEE: *ECOPACK INC.*		FILE INDEX: *730*		
FINANCIAL STATEMENT PERIOD: *y/e DECEMBER 31, 20x1*				
ACCOUNT: *Payroll expenses and balances*				
Substantive audit program in response to assessed risks:				
Consider risk assessment findings and conclusion on residual detection risk to be reduced by performing substantive procedures. (Of the procedures listed below, perform those considered necessary to provide sufficient appropriate evidence to address the assessed risks and reduce risk of material misstatement to an acceptable level.)				*[Reference to relevant working papers]*

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EXHIBIT 13–11 Continued

Substantive audit procedures	Assertions evidence is related to [E,C,O,V,P]	Timing	Extent	Working paper reference
Analytical procedures 1. Develop expectations for payroll expenses based on understanding the entity, including production volumes, new product lines, labour union agreements, prior period's payroll expenses, industry changes, etc.				
2. Perform the following analysis and obtain satisfactory explanations from management for relationships observed: *a.* Significant changes or trends in payroll expenses compared with prior period(s) and/or budgets in total and as a percentage of sales *b.* Payroll expenses compared with related accrued liabilities *c.* Average annual wage in comparison with work force, minimum wage rates, etc. *d.* Payroll expenses compared with nonfinancial information such as production volume, facility size, manufacturing process times, product-line changes *e.* Analyze payroll and benefits by employee type or class by comparing with prior period and budgets (e.g., benefits as a percentage of total payroll, average salary per employee, etc.). *f.* Calculate and assess the reasonableness of average hourly rates and average salary per employee when compared with normal rates or salary classes.				
3. Consider management responses to enquiries about: *a.* Changes to payroll policies and procedures, noting any changes from prior periods *b.* Any salary or rate increases, significant increases in staffing, and/or changes to the benefit plan or regulations And conclude whether these are consistent with the payroll expenses and balances reported for the current period.				
Tests of details of transactions and balances For payroll and benefits: *a.* Scan the payroll journal for the period for large and unusual items and ascertain propriety of such items. *b.* Ask responsible payroll personnel about any instances of fictitious employees, employees with unusual contract terms or conditions, or unrecorded transactions.				
For high assessed risk of misstatement of payroll and benefits Select a sample of employee payroll payments from the payroll journal and perform the following: *a.* Trace employee's name, job category, and employee number to authorized personnel records. *b.* Agree pay rate to authorized wage, union contract, or other authorized record. *c.* Agree hours worked to clock card or other time record. *d.* Enquire of employee's supervisor regarding the person's job description and assess reasonability of their pay rate. *e.* Agree hours worked to labour cost allocated to inventory cost accounting records. *f.* Recalculate gross and net pay using employee TD-1 and current tax withholding tables for income tax withheld, Canada Pension Plan and Employment Insurance deduction rates, and by examining authorization forms for other payroll deductions such as company pension plan or group insurance. *g.* If the period-end is close to the calendar year-end, compare the total payroll costs to the T4 summary. Investigate and document any significant differences. *h.* Examine paid and endorsed payroll cheques, or payroll bank account debit entry details, of selected employees and trace to data in the payroll journal.				
Misstatement summary: Summarize here all misstatements discovered in executing this program. Carry all forward for accumulation in the Summary of Accumulated Misstatements worksheet (Exhibit 16–1)				

AUDITOR'S CONCLUSIONS

[if the audit program is completed satisfactorily and the audit objectives are met, a conclusion such as the following would be recorded by the auditor performing the work] *Based on my professional judgment, the evidence obtained is sufficient and appropriate to conclude that the risk of material misstatement of the* PAYROLL EXPENSES AND BALANCES *is acceptably low.*

Prepared by ________ Date ________

Reviewed by ________ Date ________

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REVIEW CHECKPOINTS

13-32 Describe analytical procedures that can be used for payroll transactions and balances.

13-33 Explain how government forms and reports can be used in the audit of payroll transactions and balances.

APPLICATION CASE WITH ANALYSIS

Detecting Misstatements in Production and Payroll Processes

INTRODUCTION

In this application case, we will demonstrate tests of controls and substantive audit procedures in the evidence gathering process related to the production and payroll processes. The case situation for each audit presented parallels the framework shown in Chapter 11's application case. The case situation provides context for the auditing decisions, rather than presenting a list of detection procedures in the abstract. Lists of detailed procedures, a selection of control tests, and detailed substantive procedures for production and payroll are found in the chapter discussions above.

DISCUSSION CASE

In his second year as an auditor, Jack is assigned to audit the payroll and inventory in Kromax Inc., a large manufacturing company. After the initial audit team meeting and his review of the prior years' audit files, Jack is starting to design his detailed audit programs for this year. Kromax is publicly traded and has been experiencing very poor profit results this year. Jack wants to make sure his procedures will address the risks of material misstatement, which may be higher this year than in the past, but he finds that many aspects of the payroll and manufacturing production processes are unfamiliar. Jack gets an opportunity to meet over lunch with Syed, one of his firm's senior partners. He knows Syed is always willing to help out less-experienced auditors by sharing stories about interesting audit situations. When Jack asks him specifically about audits where the auditors detected misstatements due to errors or frauds in payroll or production, Syed relates the following audit stories showing errors in cost of sales recording and payroll embezzlement through payment of fictitious employees.

AUDIT 13.1 Unbundled Before Its Time

CASE DESCRIPTION

Western Corporation assembled and sold computer systems. A systems production order consisted of hardware and peripheral equipment specifications, and software specifications with associated performance criteria. Western brought in new auditors who discovered that items in production were being treated as finished goods "sold" before actual completion, which caused understated inventory, overstated cost of goods sold, overstated revenue, and overstated income. Western was routinely recording the hardware component of contracts too soon, recognizing revenue and cost of goods sold that should have been postponed until later when the customer accepted the entire system. In the last three years, the resulting income overstatement amounted to 12%, 15%, and 19% of the reported operating income before taxes.

Customer contracts always required that the unit be assembled to specifications, with hardware installation and testing as well as software installation and testing, before accepting the finished installation and paying for the entire package. Order completion usually took three to eight months. For internal accounting purposes, Western "unbundled" production orders into the hardware and software components of the customer orders so that production processing and cost accounting were performed as if the two were independent orders. When the hardware was installed and tested (with or without customer acceptance), Western recorded part of the contract price as sales revenue and the related cost of goods sold. The amount "due from customers" was carried in an asset account entitled

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"unbilled contract revenue," and no billing statement was sent to the customer at that time.

When the software component was completed, installed, tested, and accepted, the remainder of the contract price was recorded as revenue, the cost of the software was recorded as cost of goods sold, and a billing statement was sent to the customer. The "unbilled contract revenue," which now matched the customer's obligation, was moved to accounts receivable. While the two order components were in process (prior to installation at the customer's location), accumulated costs were carried in a work-in-process inventory account.

Audit Trail

Customer orders and contracts contained all the terms relating to technical specifications, acceptance testing, and the timing of the customer's obligation to pay. Copies of the technical specification sections of the contracts were attached to both the hardware and software production orders prepared and authorized in the production planning department. During production, installation, and testing, each of these orders was the basis of the production cost accumulation and subsidiary record of the work-in-process inventory. At the end, the production reports along with the accumulated costs became the production cost report and supporting documentation for the cost of goods sold entry.

AUDIT APPROACH ANALYSIS

Audit Objective

The auditors' objective is to obtain evidence of the actual occurrence of cost of goods sold transactions, thereby yielding evidence of the completeness of recorded inventory.

Controls Relevant to the Process

The major control lies in the production planning department approval of orders identifying a total unit of production (in this case, the hardware and software components combined). Nothing is wrong with approving separate orders for efficiency of production, but they should be cross-referenced so that both production personnel and the cost accounting department see them as separate components of the same order unit.

AUDIT PROCEDURES

Tests of Controls

Even though the company generated a large amount of revenue, it had relatively few production orders (200–250 charged to cost of goods sold during each year). A sample of completed production orders should be taken and vouched to the customer orders and contracts. This is done to determine the validity of the production orders in relation to customer orders and whether the cost of goods sold was recorded in the proper period. (Audit of accuracy and completeness of the cost accumulation can also be carried out on this sample, making it a dual-purpose test as further described below.)

Even though the auditors can read the customer contracts, enquiries should be made about the company's standard procedures for the timing of revenue and cost of goods sold recognition to determine what is actually being done in practice.

Tests of Details of Balance

The sample of completed production orders can also be used in a dual-purpose test of the cost of goods sold balance. For the balance audit, the primary points are the existence and completeness of the dollar amounts accumulated as cost of the contracts and the proper cutoff for recording the cost. The existence of the "unbilled contract revenue" asset account in the general ledger should raise a red flag. Such an account always means that management has estimated a revenue amount that has not been determined according to contract or billed to the customer according to contract terms. Even though the revenue is "unbilled," the related cost of goods sold still should be in the cost of goods sold account. While accounting theory and practice permit recognizing unbilled revenue in certain cases (e.g., percentage of completion for construction contracts), there have been abuses.

AUDIT RESULTS

When the company decided to issue shares to the public, a new audit firm was engaged. The new auditor team performed the dual-purpose procedures already outlined, made the suggested enquiries, and investigated the unbilled contract revenue account. They learned about management's unbundling policy and insisted that it be changed so that revenue was recognized only when all the terms of the contract were met. (The investigation yielded the information about prior years' overstatements of revenue, cost of goods sold, and income.) Part of the reason for insisting on the change of policy was the finding that Western did not have a very good record of quality control and customer acceptance of software installation. Customer acceptance was often delayed several months while systems engineers debugged software. On several occasions Western solved the problems by purchasing complete software packages from other developers.

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AUDIT 13.2 Ghosts on the Payroll

CASE DESCRIPTION

Maybelle had responsibility for preparing personnel files for new hires, approving wages, verifying time cards, and distributing payroll cheques for the BlueBonnet Company. She embezzled funds by "hiring" fictitious employees, faking their records, and issuing cheques to them through the payroll system. She deposited some cheques in several personal bank accounts and cashed others, endorsing all of them with the names of the fictitious employees as well as her own. Maybelle stole $160,000 by creating these "ghosts," usually three to five of 112 people on the payroll, and paying them an average of $456 per week for three years. Sometimes, the ghosts quit and were later replaced by others. But she stole "only" about 2% of the payroll funds during the period.

Audit Trail

Payroll creates a large paper trail with individual earnings records, T4 tax forms, payroll deductions for taxes, insurance and pension plans, and payroll tax reports. Maybelle mailed all the T4 forms to the same post office box.

AUDIT APPROACH ANALYSIS

Audit Objective

The auditor's objective is to obtain evidence of the existence and validity of payroll transactions.

Controls Relevant to the Process

Different people should be responsible for hiring (preparing personnel files), approving wages, and distributing payroll cheques. These controls relate to the authorization and ownership objectives. "Thinking like a crook" in their fraud risk assessment led the audit team to suspect that Maybelle could put people on the payroll and obtain their cheques.

AUDIT PROCEDURES

Tests of Controls

Audit for transaction authorization and validity. Random sampling may not work because of the small number of ghosts. Look for the obvious. Select several weeks' cheque blocks, account for numerical sequence (to see whether any cheques have been removed), and examine cancelled cheques for two endorsements.

Tests of Details of Balance

There may be no "balance" to audit other than the accumulated total of payroll transactions, and the total may not appear out of line with history because the fraud is small in relation to total payroll and has been going on for years. Scan cancelled payroll cheque endorsement details and trace these to personnel files. Observe a payroll distribution on a surprise basis, noting any employees who do not collect their cheques and follow up by examining prior cancelled cheques for these missing employees. Scan personnel files for common addresses.

AUDIT RESULTS

Both the surprise distribution observation and the scan for common addresses provided the names of two to three exceptions. These led to prior cancelled cheques (which Maybelle had not removed and the bank reconciler had not noticed) that carried Maybelle's own name as endorser. When confronted, she confessed.

REVIEW CHECKPOINTS

13-34 In a production situation similar to the Audit 13.1 case, what substantive audit work should be done on a sample of completed production orders (cost reports) recorded as cost of goods sold?

13-35 Is there anything wrong with auditors helping auditees obtain bank loans to pay their accounting firm's fees?

13-36 How can an auditor find out whether payroll control procedures were followed by company personnel?

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SUMMARY

The learning objectives addressed in this chapter are summarized as follows:

- The production and payroll processes produce information about costs of manufactured inventory and employee salaries. These tend to be highly automated processes where transaction volumes are high. Risks in the production process arise mainly related to the valuation of inventory, for example, if there are errors in allocating material, labour, and overhead costs to production. The main risk in the payroll process relates to making unauthorized payments. Well-designed information systems and controls are very important to control risks in both these processes. Production and payroll information systems produce many internal documents, reports, and files that are sources of audit information. These systems mostly involve evidence made up of internal documentation, with relatively little external documentary evidence. Aside from physical inventory, the accounts in the production and payroll process are intangible: They cannot be observed, inspected, touched, or counted in any meaningful way.
- The production process involves production planning; inventory planning; acquisition of labour, materials, and overhead (purchases, payables, and payment process); custody of assets while work is in process and when finished products are stored in inventory; and cost accounting. Payroll is also an important part of the production process for manufacturing businesses where management and control of labour costs are important. Companies reduce control risk in the production process by separating authorization, custody, recording, and periodic reconciliation duties. Error-checking procedures of analyzing production orders and finished production cost reports are important for proper determination of inventory values and proper valuation of cost of goods sold. Without these procedures, many things could go wrong, ranging from overvaluing the inventory to understating costs of production by deferring costs that should be expensed.
- Most audit procedures for the production process are analytical and dual-purpose procedures related to inventory and costs of sales, testing both the company's control procedures and the existence, valuation, and completeness assertions made by accumulating the results of numerous labour and overhead transactions.
- The extent and nature of further substantive testing depends on the auditor's risk assessment. Typical substantive procedures in the production process relate to testing the underlying costing of the period-end inventory balance, and the transactions underlying the costs of sales expense for the period. An example of an audit program for a production process showing a selection of typical substantive procedures was provided.
- The payroll process consists of hiring, rate authorization, attendance and work supervision, payroll processing, and paycheque distribution. Key controls in the payroll process are the segregation of approval and payments functions, proper documentation and recording of payroll transactions, and periodic reconciliations of total payroll amounts.
- Auditors often use analysis and dual-purpose testing to provide evidence about control effectiveness and substantive evidence about the existence, completeness, valuation, and ownership assertions related to payroll.
- The extent and nature of further substantive testing depends on the auditor's risk assessment. Typical substantive procedures in the payroll process relate to vouching payments to supporting documents, such as time cards and approved pay rates, and verifying payments were received by legitimate employees. An example of an audit program for a payroll process showing a selection of typical substantive procedures was provided.

Cost accounting is a central feature of the production process and reports can be manipulated. Payroll accounting is critical to expenditure control as embezzlement often occurs during this process as well. Chapter application cases provided examples of these along with procedures for detecting them.

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Analysis of Financial Statement Relationships

The audit of the production and payroll processes verifies the balances of inventory, various payroll liabilities, cost of goods sold, and wages/salary expense. In the balance sheet approach to auditing, we can analyze balance changes and the financial statement items related to them by preparing a continuity schedule. The finished goods inventory balance is used as an example for the production process:

AUDITED AMOUNT	FINANCIAL STATEMENT WHERE AMOUNT IS REPORTED
Opening balance of finished goods inventory	Balance sheet (prior year comparative figure)
Add: Purchases of materials during the year Labour costs allocated Overhead costs allocated	Cash flow statement (direct method)
Deduct: Costs allocated to inventory work-in-process	Balance sheet (current year balance of work-in-process inventory, usually in inventory detail note)
Deduct: Cost of goods sold	Income statement expense
Ending balance of finished goods inventory	Balance sheet (current year figure)

Analytical procedures that use these relationships include inventory turnover ratios and gross margin analyses. Misstatements in the existence, completeness, and valuation assertions for inventory may result in unexplained fluctuations in these relationships.

Misstatement Analysis

Consider the following two misstatements that might be discovered in an audit. First, the auditor of a machine parts manufacturer made note of a quantity of inventory that appeared to be slow moving at the end of the prior year. At that time, management asserted that the inventory was a special part that was occasionally needed by some customers, so eventually it would be sold. Accordingly, the auditors accepted that a writedown was not needed at that time. At the end of the current year, however, this same inventory of parts is still on hand and still has not been written down. When the auditors dig further and interview the sales manager, she informs them that the last customer that would have used this part had changed its process earlier in the year, so there was no market at all for this type of part anymore. The cost recorded for the inventory is $21,000 and the auditor concludes that this cost is not recoverable and should be written off through cost of sales. Note that in the analysis above, this error understates cost of sales amount deducted, leaving the inventory balance too high (overstated). Second, the auditors examined the payroll process and learn that the company payroll had been paid up to December 30 prior to its year-end of December 31. Since the company shut down for December 31, the payroll accountant decided that it was not necessary to accrue the last day's payroll, which amounts to $2500. The auditors did not agree; whether the offices were closed is not relevant because the employees were still being paid for that day, and the financial statements are dated December 31. This error means the accrued payroll liability and the payroll expense for the year are both understated. (The account analysis for this accrued liability will follow the same format as the one given for legal expenses and accrual at the end of Chapter 12.) Both these misstatements will be carried forward to the summary of accumulated misstatements (see Exhibit 17–1) for evaluation in forming the audit opinion at the end of the audit.

KEY TERMS

cost of goods sold

lower-of-cost-or-net-realizable-value (LCNRV)

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EXERCISES AND PROBLEMS

PRODUCTION PROCESS

EP 13-1 ICQ Items: Possible Error Due to Weakness. LO2, LO3

Required:
Refer to the internal control questionnaire (Appendix 13A, Exhibit 13A–1), and assume the answer to each question is "no." Prepare a table matching questions to errors that could occur because of the absence of the control. Your column headings should be:

Question	Possible Error or Fraud Due to Weakness

EP 13-2 Control Tests Related to Controls and Objectives. LO1, LO2, LO3 Each of the following control test procedures may be performed during the audit of the controls in the production process.

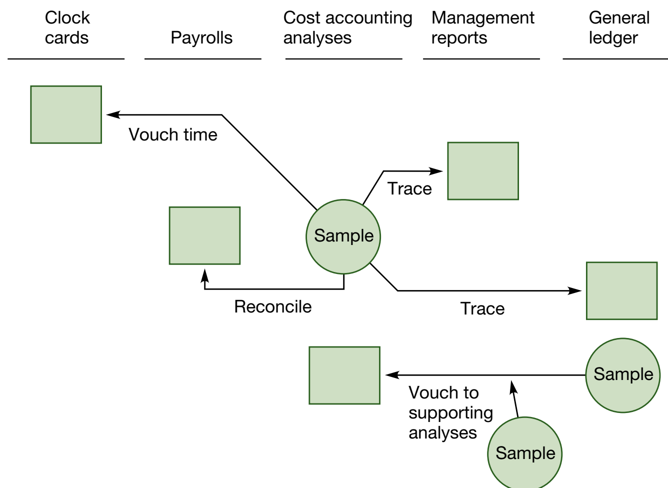
Required:
For each procedure (a) identify the internal control procedure (strength) being tested, and (b) identify the internal control objective(s) being addressed.

1. Balance and reconcile detail production cost sheets to the work-in-process inventory control account.
2. Scan closed production cost sheets for missing numbers in the sequence.
3. Vouch a sample of open and closed production cost sheet entries to (a) labour reports and (b) issue slips and materials-used reports.
4. Locate the material issue forms. Are they prenumbered? kept in a secure location? available to unauthorized persons?
5. Select several summary journal entries in the work-in-process inventory: (a) vouch to weekly labour and material reports and to production cost sheets, and (b) trace to control account.
6. Select a sample of the material issue slips in the production department file. Examine for the following:
   a. Issue date/materials-used report date
   b. Production order number
   c. Supervisor's signature or initials
   d. Name and number of material
   e. Raw material stores clerk's signature or initials
   f. Matching material requisition in raw material stores file, noting date of requisition
7. Determine by enquiry and inspection if cost clerks review dates on report of units completed for accounting in the proper period.

EP 13-3 Cost Accounting Test of Controls. LO1, LO2 The diagram in Exhibit EP13-3 describes several cost accounting test of control procedures. It shows the direction of the tests, leading from samples of cost accounting analyses, management reports, and the general ledger to blank squares.

Required:
For each blank square in Exhibit EP13-3, write a cost accounting test of controls procedure and describe the evidence it can produce. (*Hint:* Refer to Exhibit 13–3.)

EXHIBIT EP13-3 Diagram of Cost Accounting Test of Controls



EP 13-4 Work-in-Process Inventory, Tests of Control. LO2 Assume an auditor finds the following errors while performing tests of controls for work-in-process inventory in a custom machinery manufacturing business.

Required:
For each finding, state which control objective is affected, what control deficiency is indicated, and what further investigation (if any) should be undertaken by the auditor.

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a. Budgeted labour hours are 30% lower than actual labour costs and production cost reports.
b. Of 20 time-clock entries examined for July 14, three do not appear on the daily labour report or production cost report for that day.
c. Weekly labour cost reports do not agree with the weekly payroll summary.
d. The open production report used to cost work-in-process inventory contains costs of materials for which no matching amount and description are found on the material used reports and no material issue slip is on file in the material storage department.

EP 13-5 **Auditor Independence.** LO4

Required:
Give some examples of payroll control omissions that would make it easy to "think like a crook" and see opportunities for errors and frauds.

EP 13-6 **Strengths and weaknesses of inventory production controls.** LO2 Peterson Electronics manufactures radio equipment. Its manufacturing plant and warehouse are located in the same building. When parts are received at the warehouse, the receiver compares the type of goods and quantity to a copy of the purchase order available online. If the quantity received differs from the quantity on the purchase order, the receiver adjusts the purchase order amount online. When the goods are checked by the receiver, she sends an e-mail to the accounting department, recording the type of goods, quantity, and date received. The accounting department uses the e-mail to create a receiver's report, and the purchase order is then printed and filed in the accounting department. The online system allows the company to reduce paper, as a hard copy is not needed until the goods are actually received. The company's' order-entry and tracking system automatically assigns the next number in a series to the purchase order just before printing.

After the receipt of inventory has been recorded, the parts are physically moved to the warehousing area, which is located in a locked-up area at the end of the plant. There is a stores department in a separate area for supplies, such as gloves, wire, and adhesives, all of which are used in significant quantities on a regular basis. When an assembly line worker requires supplies, the supervisor fills out a serially pre-numbered requisition card, signs it, and gives it to the worker, who then takes it to the stores department to obtain the needed items. Each supervisor has a stock of requisition cards. When the supplier's invoice is received by the purchasing department, one of the purchasing department staff sends an e-mail to the accounting department, noting the invoice amount, supplier name, date of shipment, and type of goods. The accounting department then matches these items to the purchase order and receiving report, and prepares a cheque for the controller to sign.

The controller does not sign the cheque until she also receives an e-mail from the accounting staff indicating that the purchase order, receiving report, and invoice have been matched.

Required
a. List four internal controls that appear to be effective in Peterson's system.
b. List three examples of weak internal controls in Peterson's system. Explain why each of your examples would be a weak control; i.e., explain what can go wrong because of the weakness.

(CGA-Canada adapted)

PAYROLL PROCESS

EP 13-7 **ICQ Items: Misstatements That Could Occur from Control Weaknesses.** LO5, LO6 Refer to the internal control questionnaire on a payroll system (Exhibit 13A–2 in Appendix 13A) and assume the answer to each question is "no."

Required:
Prepare a table matching each question to an error or fraud that could occur because of the absence of the control. Your column headings should be:

Question	Possible Error or Fraud Due to Weakness

EP 13-8 **ICQ Items: Control Objectives, Control Tests, and Possible Misstatements.** LO1, LO5, LO6 Listed below is a selection of items from the payroll processing internal control questionnaire in Exhibit 13A–2.

1. Are names of terminated employees reported in writing to the payroll department?
2. Are authorizations for deductions, signed by the employees, on file?
3. Is the timekeeping department (function) independent of the payroll department?
4. Are timekeeping and cost accounting records (such as hours, dollars) reconciled with payroll department calculations of wage and salaries?

Required:
For each question:
a. Identify the control objective to which the question applies.
b. Specify one test of controls audit procedure an auditor could use to determine whether the control was operating effectively (see Exhibit 13–9 for procedures).
c. Using your business experience, your logic, and/or your imagination, and give an example of a misstatement caused by error or fraud that could occur if the control was absent or ineffective.

EP 13-9 **Major Risks in Payroll Process.** LO5, LO6

Required:
Prepare a schedule of the major risks in the payroll process. Identify the control objectives and financial statement assertions related to each. Lay out a three-column schedule as follows:

Payroll Process Risk	Control Objective	Assertion

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EP 13-10 Payroll Processed by a Service Organization. LO6 Assume that you are the audit senior conducting a review of the payroll system of a new auditee. While you are in the process of interviewing the payroll department manager, she makes the following statement: "We don't need many controls since our payroll is done outside the company by Automated Data Processing, a service organization."

Required:

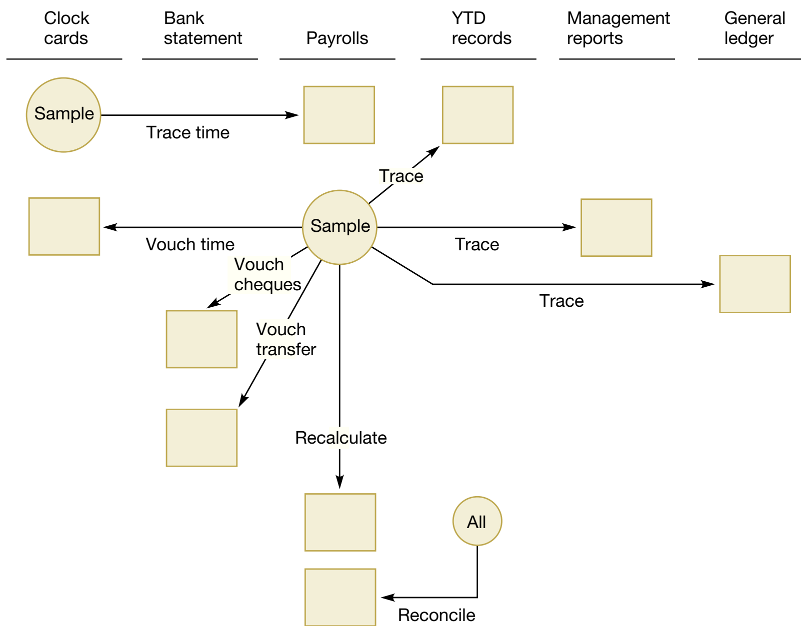
Evaluate the payroll department manager's statement and describe how a service organization affects an auditors' review of controls. You may want to refer to Chapter 9.

EP 13-11 Payroll Tests of Controls. LO5, LO6 The diagram in Exhibit EP13-11 describes several payroll test of control procedures. It shows the direction of the tests, leading from samples of time cards, payrolls, and cumulative year-to-date earnings records to blank squares.

Required:

For each blank square in Exhibit EP13-11, write a payroll test of controls procedure and describe the evidence it can produce. (*Hint:* Refer to Exhibit 13–9.)

EXHIBIT EP13-11 Diagram of Payroll Test of Controls



DISCUSSION CASES

PRODUCTION PROCESS

DC 13-1 Control over Departmental Labour Cost in a Job-Cost System. LO1, LO2, LO3 The Brown Printing Company accounts for the services it performs on a job-cost basis. Most jobs take a week or less to complete and involve two or more of Brown's five operating departments. Actual costs are accumulated by job. To ensure timely billing, however, the company prepares sales invoices based on cost estimates.

Recently, several printing jobs have incurred losses. To avoid future losses, management has decided to focus on cost control at the department level. Since labour is a major element of cost, management proposes a department labour cost report.

This report will originate in the payroll department as part of the biweekly payroll and then go to an accounting clerk for comparison with total labour cost estimates by department. If the actual total department labour costs in a payroll are not much more than the estimated total departmental labour cost during that period, the accounting clerk will send the report to the department foreman. If the accounting clerk concludes that a significant variance exists, the report will be sent to the assistant controller. The assistant controller will investigate the cause when time is available, and recommend corrective action to the production manager.

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Required:

Evaluate the proposal:

a. Give at least three common aspects of control the department labour cost report proposal complies with. Give an example from the case to support each aspect cited.

b. Give at least three common aspects of control the departmental labour cost report proposal does not comply with. Give an example from the case to support each aspect cited.

(CIA adapted)

DC 13-2 Audit of Manufacturing PPE and Depreciation Allocated to Inventory. LO4 Bart's Company has prepared the fixed asset and depreciation schedule shown in Exhibit DC13-2. The following information is available:

- The land was purchased eight years ago when Building 1 was erected. The location was then remote but now is bordered by a major freeway. The appraised value is $35 million.
- Building 1 has an estimated useful life of 35 years and no residual value.
- Building 2 was built by a local contractor this year. It also has an estimated useful life of 35 years and no residual value. The company occupied it on May 1 this year.
- The Equipment A was purchased January 1 six years ago, when the estimated useful life was eight years with no residual value. It was sold on May 1 for $500,000.
- The Computer system was placed in operation as soon as the Equipment A was sold. It is estimated to be in use for six years with no residual value at the end.
- The company estimated the useful life of the press at 20 years with no residual value.
- Truck 1 was sold during the year for $1,000.
- Truck 2 was purchased on July 1. The company expects to use it five years and then sell it for $2000.
- All amortization is calculated on the straight-line method using months of service.

Required:

a. Audit the depreciation calculations. Are there any errors? Put the errors in the form of an adjusting journal entry, assuming 90% of the depreciation on the buildings and the press has been charged to cost of goods sold and 10% is still capitalized in the inventory, and the other depreciation expense is classified as general and administrative expense.

b. List two audit procedures for auditing the fixed asset additions.

c. What will an auditor expect to find in the "gain and loss on sale of assets" account? What amount of cash flow from investing activities will be in the statement of cash flows?

EXHIBIT DC13-2

	PPE ASSETS AND DEPRECIATION							
	ASSET COST (000s)				ACCUMULATED DEPRECIATION (000s)			
DESCRIPTION	BEGINNING BALANCE	ADDED	SOLD	ENDING BALANCE	BEGINNING BALANCE	ADDED	SOLD	ENDING BALANCE
Land	10,000			10,000				
Building 1	30,000			30,000	6,857	857		7,714
Building 2		42,000		42,000		800		800
Equipment	5,000		5,000	0	3,750	208	3,958	0
Computer system		3,500		3,500	583			583
Press	1,500			1,500	300	150		450
Truck 1	15		15	0	15		15	0
Truck 2		22		22		2		2
Total	46,515	45,522	5,015	87,022	10,922	2,600	3,973	9,549

DC 13-3 Inventory Costing Errors, Standard Manufacturing Costs. LO1, LO2, LO3, LO4 Thermox Inc. manufactures heating elements and devices. One of its main raw material components is steel tubing. During the current year, Thermox's new raw material buyer began purchasing steel tubing from a U.S. supplier. The buyer found this supplier's prices to be considerably lower than the previous Canadian suppliers.

Thermox's cost accounting department uses standard manufacturing costs to determine its inventory cost and cost of goods sold. In her audit of the reasonability of the standard costs, the audit senior is vouching the raw materials components list to supplier invoices and supporting documents. She notes several steel tubing purchases in March that were invoiced in U.S. dollars (a U.S. dollar at this time was worth about $1.25 Canadian). However, the U.S. dollar amount, not the Canadian dollar amount, is used in the standard costing formula. Steel tubing comprises 70% of Thermox's standard manufacturing cost. The audit senior extends her vouching and discovers that all steel tubing purchases from March to the December year-end were from the same U.S. supplier and were invoiced in U.S. dollars.

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The audit senior then examines the U.S. supplier's monthly statements of account and discovers that Thermox's accounts payable department has been paying the U.S. steel tubing invoices in Canadian dollars. Thus Thermox has been short-paying the U.S. supplier by about 25%. Because of this related error, no significant cost variances appeared for raw materials, which would have alerted Thermox management to the problem.

Required:

a. What impact will this error have on Thermox's year-end inventory balance and its cost of sales if standard costs are used and no variances are adjusted? What impact will this error have on accounts payable? State any assumptions you make.

b. What records will the audit senior need to examine and what tests and analyses will she need to perform to assess the magnitude of the error in inventory, cost of goods sold, and accounts payable?

c. What control deficiency would allow this type of error to occur, and what kind of control procedure(s) could be implemented to prevent this type of error?

DC 13-4 Audit of Electronics Inventory. LO1, LO2 During his examination of the inventories and related accounts of Consumer Electronics Inc., a manufacturer and distributor of small appliances, an auditor encountered the following:

a. Several trucks loaded with finished goods were parked at the shipping dock. The contents of the trucks were excluded from the physical inventory.

b. The finished goods inventory included high volumes of several products, and many of their cartons were old and covered with dust. In response to the auditor's questions, the plant manager stated that there was no problem as "all of these goods will eventually be sold although some price incentives may be necessary."

c. While reviewing the complex calculations used to develop the unit production costs of items in finished goods, the auditor noted that the costs of the company's electrical engineering department had been treated as period expenses in previous years but were included in manufacturing overhead in the current year.

d. The company installed a new perpetual inventory system during the year. The auditor noted that numerous of the company's recorded year-end quantities differed from the actual physical inventory counts. Partly because of these problems, the company took a complete physical inventory at year-end.

Required:

Describe the additional audit procedures (if any) that the auditor should perform to obtain sufficient appropriate evidence in each of the preceding situations.

(CGA-Canada adapted)

DC 13-5 Audit of Real Estate Inventory. LO1, LO2, LO3, LO4 Desai Developments Limited (DDL) is in the business of buying undeveloped land in the regions outside of Calgary and holding it until it has development permits and market conditions are favourable for development. DDL began operations 12 years ago. Once a property is ready for development, DDL contracts with various construction companies to build the houses. DDL handles all the promotions and sales of the houses once they are completed.

Because of recent changes in environmental laws and zoning restrictions, some of the sites DDL originally purchased for subdivisions can no longer be used for this purpose. However, golf courses are still permissible on these sites because they preserve wetlands and forests. DDL is, therefore, now undertaking a new business model that involves developing and operating golf courses. DDL will also sell off the outer edges of the golf course properties as building lots for large "estate lot" homes, which are still permitted because they have a low impact on the environment.

The president of DDL, Mira Desai, owns 51% of the DDL common shares. Her relatives hold the remainder. DDL also has financed its operation by bank mortgages on the land. Mira Desai now wants to issue preferred shares in DDL to private investors, and use the proceeds to pay back the bank mortgages and fund the golf course developments. The plan is for the preferred shares to be nonvoting, to pay a 6% noncumulative dividend per year, and to provide the preferred shareholder with a life-long membership in one of the golf courses. She has found several investors who are interested in the preferred shares, but DDL will need to provide prospective investors with DDL's 20X5 financial statements prepared in accordance with generally accepted accounting principles (GAAP).

Mira Desai is considering engaging your audit firm to provide an audit opinion on DDL's GAAP financial statements. Up until now DDL has only prepared unaudited financial statements primarily for tax purposes, and has always used accounting methods that result in paying the minimum amount of tax. In discussions with Mira Desai, and from reviewing DDL's most recent annual financial statements (for the year ended December 31, 20X5), you learn the following:

1. DDL currently owns four properties that have been approved for golf course development. It has finalized the plans and will start development in the spring of 20X6. DDL owns five other properties that may be suitable for future golf course developments.
2. DDL owns another eight properties approved for residential subdivisions. Recently DDL received an offer from another property development company, Atim Corp., to purchase all eight of

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these properties for $50 million. The mortgages on these properties are $45 million. Mira Desai is interested in exiting from the subdivision development to allow DDL to focus on the golf course business. She is considering making a counter-offer in which DDL would form a 50:50 joint venture with Atim Corp. DDL would contribute the properties to this joint venture entity and Atim would contribute the cash and management skills to construct and sell the subdivision homes.

3. DDL has capitalized the purchase price of the land, legal fees relating to the purchase, and land transfer taxes. All other costs related to the properties, such as property taxes, interest, earth-moving costs, and fees for architectural and landscaping plans, have all been expensed to maximize tax deductions.
4. DDL's net income from the subdivision business has varied widely over the years, with profits in years when housing developments are completed and sold, and losses in other years. Revenue is recognized when each house is sold. The average subdivision development takes about 18 months to complete. A golf course development will take about two years because of the extensive landscaping and planting required.
5. The golf course development costs can be partly financed by selling the estate lots around the golf course site to the custom home builders. As part of its agreement with these construction companies, DDL will handle the sales promotions and marketing of the houses for a 10% commission on selling prices.
6. To date, DDL has completed five housing subdivision developments. The first development, completed about 10 years ago, has recently been in the news because methane and other noxious gases have been seeping into basements. Environmental assessments have determined that the subdivision was built on what was a landfill site in the 1950s. It was never properly sealed off prior to redevelopment and is now releasing gases that are dangerous to people. Environmental consultants estimate it will cost up to $2 million to remediate the properties so the houses will be safe to live in. The current owners of these homes have started legal action against DDL. DDL's lawyers believe that the company that sold DDL the land had fraudulently withheld relevant information about the prior use of the land, so that DDL will not be liable for the remediation costs.
7. DDL received a government loan of $6 million in early 20X5, under a program aimed at helping developers cope with the impact of the changes in environmental regulations. The entire loan is forgivable if DDL produces a commercially viable golf course by the end of 20X7. Half of the government loan amount was recorded as revenue in 20X5 since, in DDL management's view, the golf course development is 50% complete.
8. Late in 20X5, DLL rented earth-moving equipment to start the golf course development work. The equipment lease agreement has a 10-year term and required a $200,000 payment at the start of the term, with payments of $200,000 thereafter at the start of each of the next nine years. The equipment could have been purchased for $1,265,650 in cash and has an expected useful life of 10 years. The relevant borrowing rate for assessing this lease is 12% per year.

Required:

a. Prepare a report outlining the considerations your firm would have to make before accepting the audit of DDL.
b. Assuming your firm accepts the engagement, prepare a detailed and complete audit plan that addresses the accounting and other information items noted previously. Also, suggest any other information that you would want for planning the audit.

PAYROLL PROCESS

DC 13-6 Control Tests, Evaluation of Possible Diversion of Payroll Funds. LO5, LO6, LO7 The Generous Loan Company has 100 branch loan offices. Each office has a manager and four or five subordinates who are employed by the manager. Branch managers prepare the weekly payroll, including their own salaries, and pay employees from cash on hand. Employees sign the payroll sheet signifying receipt of their salary. Hours worked by hourly personnel are inserted in the payroll register sheet from time cards prepared by the employees and approved by the manager.

The weekly payroll register sheets are sent to the head office along with other accounting statements and reports. The head office compiles employee earnings records and prepares all federal and provincial salary reports from the weekly payroll sheets.

Salaries are established by head office job-evaluation schedules. Salary adjustments, promotions, and transfers of full-time employees are approved by a head office salary committee based on the recommendations of branch managers and area supervisors. Branch managers advise the salary committee of new full-time employees and terminated employees. Part-time and temporary employees are hired without advising the salary committee.

Required:

a. Prepare a payroll audit program to be used in the head office to audit the branch office payrolls of the Generous Loan Company. See Exhibit 13–9 for sample audit procedures.
b. Based on your review of the payroll system, how might funds for payroll be diverted fraudulently?

(AICPA adapted)

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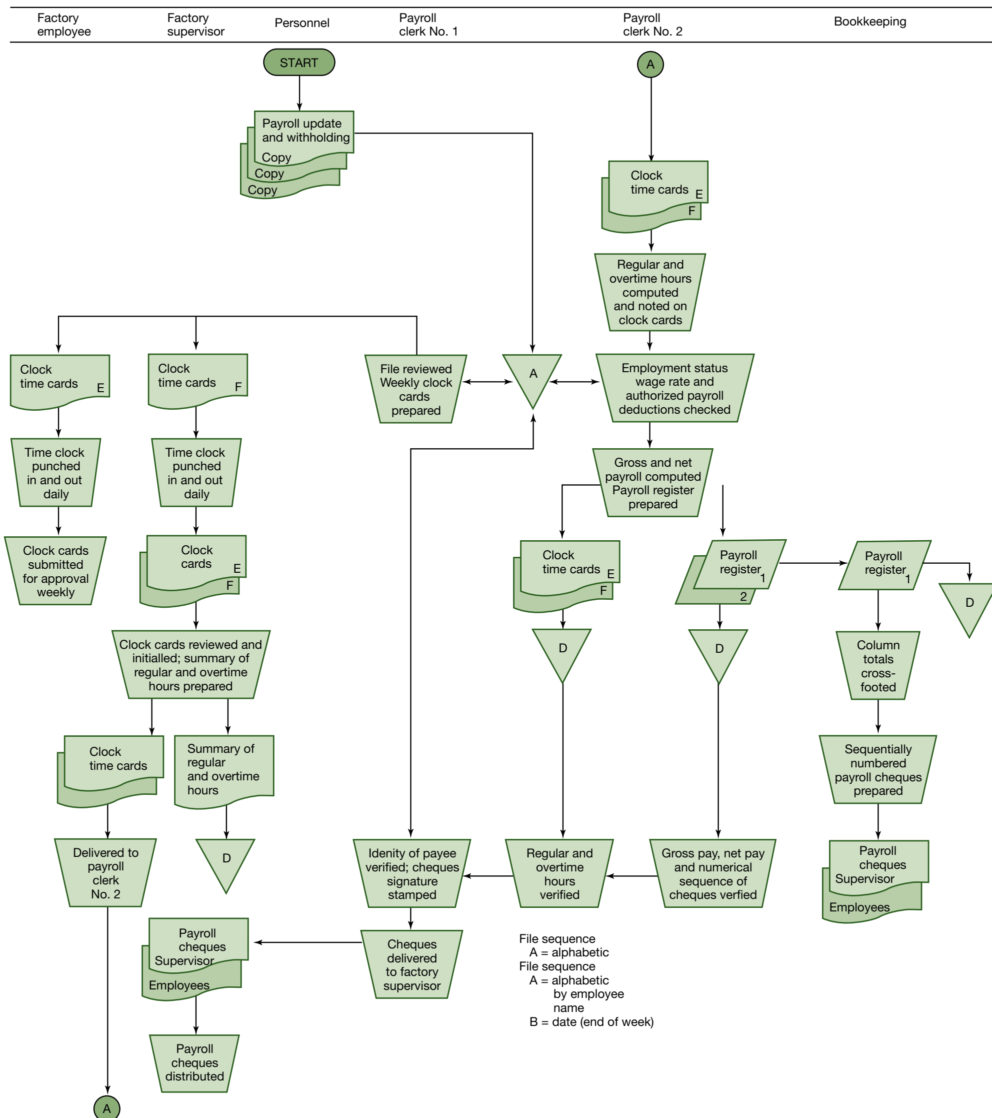
DC 13-7 **Croyden Factory Inc.: Evaluation of Flowchart for Payroll Control Weaknesses.** **LO5, LO6** A PA's audit working papers contain a narrative description of a segment of the Croyden Factory Inc. payroll system and an accompanying flow chart (Exhibit DC13-7) as follows:

The internal control system, with respect to the personnel department, is well functioning and is not included in the accompanying flowchart.

At the beginning of each workweek, payroll clerk No. 1 reviews the payroll department files to determine the employment status of factory employees. Clerk No. 1 then prepares time cards and distributes them as each individual arrives at work. This payroll clerk, who also is responsible for custody of the cheque signature stamp machine, verifies the identity of each payee before delivering signed cheques to the supervisor.

At the end of each workweek, the supervisor distributes payroll cheques for the preceding workweek. Concurrent with this activity, the supervisor reviews the current week's employee time cards, notes the regular and overtime hours worked on a summary form, and initials the time cards. The supervisor then delivers all time cards and unclaimed payroll cheques to payroll clerk No. 2.

EXHIBIT DC13-7 Croyden Inc. Factory Payroll System



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Required:

a. Based on the narrative and accompanying flowchart, what are the weaknesses in the system of internal control?

b. Based on the narrative and accompanying flowchart, what enquiries should be made with respect to clarifying the existence of possible additional weaknesses in the system of internal control?

Note: Do not discuss the internal control system of the personnel department.

(AICPA adapted)

DC 13-8 Vane Corporation: Control Weaknesses in Computerized Payroll System. LO6 The Vane Corporation is a manufacturing concern that has been in business for the past 18 years. During this period, the company has grown from a very small family-owned operation to a medium-sized company with several departments. Despite this growth, many procedures employed by Vane have been in effect since the business was started.

Vane's current payroll process is semi-automated. The payroll operation involves each worker picking up a weekly time card on Monday morning and writing in his or her name and identification number. These blank cards are kept near the factory entrance. Workers fill in their daily arrival and departure times each day on the card. Each Monday, the factory supervisor collects the time cards for the previous week and sends them to data processing.

In data processing, the time cards are entered into the computerized payroll system. The system updates the payroll records and prints out the paycheques. The cheques are written on the regular chequing account, imprinted by a signature plate with the treasurer's signature, and sent to the factory supervisors who distribute them to the workers or hold them for absent workers to pick up later. Supervisors notify data processing of new employees, terminations, changes in hourly pay rates, or any other changes affecting payroll.

The workers also complete a job time ticket for each individual job they work on each day. These are collected daily and sent to cost accounting, where they are used to prepare a cost distribution analysis.

Further analysis of the payroll function reveals the following:

1. A worker's gross wages never exceed $600 per week.
2. Raises never exceed 55 cents per hour for the factory workers.
3. No more than 20 hours of overtime are allowed each week.
4. The factory employs 150 workers in 10 departments.

The payroll function had not been operating smoothly for some time, but even more problems have surfaced since the payroll was computerized. The factory supervisors would like a weekly report indicating worker tardiness, absenteeism, and idle time so that they can determine the amount of productive time lost and the reasons for the lost time. The following errors and inconsistencies have been encountered the past few pay periods:

1. A worker's paycheque was not processed properly because he had transposed two digits in his identification number on his time card.
2. A worker was issued a cheque for $4531.80 when it should have been $453.18.
3. One worker's paycheque was not written, and this error was not detected until the paycheques for that department were distributed by the supervisor.
4. Some of the payroll register records were accidentally erased from the system when a data processing clerk tried to reorganize and rename the files in the hard drive. Data processing attempted to re-establish the destroyed portion from original source documents and other records.
5. One worker received a much larger paycheque than he should have. A clerk had keyed 84 instead of 48 for hours worked.
6. Several paycheques issued were not included in the totals posted to the payroll journal entry to the general ledger accounts. This was not detected for several pay periods.
7. In processing non-routine changes, a data processing clerk included a pay rate increase for one of his friends in the factory. By chance, this was discovered by another employee.

Required:

Identify the control weaknesses in Vane's payroll procedures and in the computer processing as it is now conducted. Recommend the necessary changes to correct the system. Arrange your answer in the following columnar format:

Control Weaknesses	Recommendations
1.	1.

DC 13-9 Risk Assessments and responses for Manufacturing inventory. LO4 Sun-house Solar Inc. (SHS) is a medium-sized private company that is develops solar energy systems for sale and installation in private residences. It is privately owned, with the majority of the shares held by the company's president, Yong Shu. SHS started up five years ago. Its first two years were mostly involved in research and development. Over the past three years, SHS has been very successful and its customer sales and installations have grown continuously. SHS's main raw material is silicone, which it purchases on the world market so that it can keep a one-year supply on hand at its factory in Woodbridge, NS. It also has some purchase commitments for silicone at prices far above the current spot price, which it would only use if there was a huge increase in the price of silicone on the world market.

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Ms. Shu has engaged your audit firm to do the current year's audit because she plans obtain $20 million in financing to allow further commercialization of the SHS systems. The plan is to turn SHS into a public company and issue shares on the Toronto Stock Exchange. Your firm has accepted the engagement and assigned you to prepare the audit plan. You have obtained the preliminary general ledger trial balance from the SHS chief financial officer. The CFO is a qualified professional accountant with 15-years experience as a financial officer in various public companies before joining SHS two years ago.

The following is a summary of the accounts that appear in this trial balance as at year-end:

ACCOUNT	BALANCE DR/(CR)
Cash	$101,209
Accounts receivable	85,019
Allowance for bad debts	(15,000)
Inventory, finished goods	100,550
Inventory, work-in-progress	44,666
Inventory, unassembled solar panels	67,890
Inventory, raw materials	834,445
Property, plant and equipment	3,700,990
Accumulated amortization, PPE	(901,108)
Patents, at cost	1,010,000
Accounts payable	(198,009)
Warranty provision	(30,000)
Shareholder loan, non–interest–bearing	(5,400,000)
Share capital, common shares	1,000
Retained earnings	1,261,558
Revenue	(4,812,202)
Cost of goods sold	1,666,502
General and administration expenses	802,500
Research and development expenses	190,000
Other expenses	1,489,990

Required:

a. Identify three factors your audit firm would have had to consider in order to decide to accept the SHS audit engagement for the current year, and explain how each factor affects the acceptance decision.

b. What ***materiality levels*** would you use for planning this audit? Show your calculations and justify your decisions.

You can assume your audit firm has the following policy for setting performance materiality: Performance materiality should be 70% of the materiality level for financial statements as a whole, unless specific information indicates a different value should be used.

c. What ***audit risk level*** would you want to achieve for this engagement? Describe your choice in terms of one of these levels: highest, medium, or lowest. Explain the factors that support your decision.

d. Identify and explain three ***business risk factors*** in SHS that you would need to understand in order to assess the risk of material misstatement in its financial statements.

e. Based on the business risk analysis for SHS, your audit manager is concerned the SHS finished goods inventory account balance has high risks of material misstatement. Your manager has asked you to *assess the risk of material misstatement* (RMM) at the *assertion level* for this account. Use the levels high, medium, or low to describe your assessments. Explain the factors that support your assessments.

f. Outline a substantive audit program that responds to the risks at the assertion level that you have assessed, above, for SHS's inventory.

DC 13-10 Payroll Process: False Claims for Hours Worked. LO1, LO5, LO6, LO7 This case is modelled on the Application Case and Analysis in the chapter.

Case Description The case involves overpayment of wages to employees making false claims for hours worked. A temporary personnel agency assigned Nurse Jane to work at Municipal Hospital. The personnel agency paid Nurse Jane, then billed Municipal Hospital for the wages and benefits. Supporting documents were submitted with the personnel agency's bills.

Nurse Jane claimed payroll hours on agency time cards, which showed approval signatures of a hospital nursing shift supervisor. This shift supervisor had been terminated by the hospital several months prior to the periods covered by the time cards in question. Nurse Jane worked one or two days per week but submitted time cards for a full 40-hour work week.

Nurse Jane's wages and benefits were billed to the hospital at $22 per hour. False time cards charging about 24 extra hours per week cost the hospital $528 per week. Nurse Jane was assigned to Municipal Hospital for 15 weeks during the year, so she caused overcharges of about $7900. However, she told three of her crooked friends about the procedure, and they overcharged the hospital another $24,000.

Audit Trail Each hospital work station keeps ward shift logs, which are sign-in sheets showing nurses on duty at all times. Nurses sign in and sign out when going on and off duty. Municipal Hospital maintains personnel records showing, among other things, the period of employment of its own nurses, supervisors, and other employees.

AUDIT APPROACH ANALYSIS

Audit Objective The auditor's objective is to obtain evidence determining whether wages were paid to valid employees for actual time worked at the authorized pay rate.

Controls Relevant to the Process Control procedures in the payroll process should include a hiring authorization for putting employees on the payroll. For temporary employees, this authorization includes contracts for nursing time, conditions of employment, and terms, including the contract reimbursement rate. Control records of attendance and work should be

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kept (ward shift log). Supervisors should approve time cards or other records used by the payroll department to prepare paycheques.

In this case, the contract with the personnel agency provided that approved time cards had to be submitted as supporting documentation for the agency billings.

Required:

Describe in detail the audit procedures you would perform in this case. Consider tests of control, and substantive tests, such as dual-purpose tests of transactions and/or tests of details of balance. Which tests do you consider likely to detect the overpayment of hourly wages? Why?

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APPENDIX 13A

Internal Control Questionnaires

Exhibit 13A–1 provides an example of the type form that could be used to guide the auditor's assessment of the effectiveness of application controls in the main classes of transactions and the main account balances related to the production and the payroll processes. Note that in practice, forms like this can provide only a general starting point, and the actual audit work must always be tailored to the specifics of each engagement.

EXHIBIT 13A–1 Internal Control Questionnaire: Production and Payroll Processes

INTERNAL CONTROL QUESTIONNAIRE FOR PRODUCTION PROCESS **AUDITEE:** ____________ **FINANCIAL STATEMENT PERIOD:** ____________		**FILE INDEX** *V-551*
PROCESS: Inventory production costing		
OVERALL COMPANY-LEVEL CONTROL AND CONTROL ACTIVITIES ASSESSMENT (Refer to responses recorded for questions in Exhibit 9A–1 in Appendix 9A)	Auditor Responses	Audit File References
APPLICATION CONTROL ASSESSMENTS		
PRODUCTION APPLICATION CONTROLS **Environment and general controls relevant to this application:** 1. Are access controls properly designed to restrict access to production initiation documents and functions to authorized personnel? Consider production system user identity assignments, access to blank production order forms, materials and labour requisitions forms, and finished goods inventory issue forms. 2. Are physical access controls in place to ensure only authorized personnel have custody of materials, work in progress, and finished goods? 3. Is production cost accounting segregated from factory production functions? **Application Control Assessments:** Consider whether the auditee has appropriate policies and procedures in place to meet the following control objectives: *Validity objective:* 4. Are material requisitions and job time tickets reviewed by the production supervisor after factory personnel prepares them? 5. Are the weekly direct labour and materials-used reports reviewed by the production supervisor after factory personnel prepares them? *Completeness objective:* 6. Are production orders, materials and labour requisitions, job time tickets and inventory issue slips prenumbered and the numerical sequence checked for missing documents? *Authorization objective:* 7. Are authorizations of production orders and materials and labour requisitions independently verified? *Accuracy objective:* 8. Are differences between inventory issue slips and materials-used reports recorded and reported to the cost accounting supervisor? 9. Are differences between job time tickets and the labour report recorded and reported to the cost accounting supervisor? 10. Are standard costs used? If so, are they reviewed and revised periodically? 11. Are differences between reports of units completed and finished goods entries recorded and reported to the cost accounting supervisor? *Classification objective:* 12. Does the accounting manual give instructions for proper classification of cost accounting transactions? *Accounting objective:* 13. Are summary journal entries reviewed and approved by an accounting supervisor? *Proper period objective:* 14. Does the accounting manual give instructions to date cost entries on the date of use? Does an accounting supervisor review monthly, quarterly, and year-end cost accruals?		
Auditor's conclusion on the effectiveness of application controls in the production process: ____________ ____________ Prepared by ________ Date ________		

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EXHIBIT 13A–2 Payroll Application

INTERNAL CONTROL QUESTIONNAIRE FOR PRODUCTION PROCESS **AUDITEE:** ______________________________ **FINANCIAL STATEMENT PERIOD:** ______________________________		**FILE INDEX** V -555
PROCESS: Inventory production costing		
OVERALL COMPANY-LEVEL CONTROL AND CONTROL ACTIVITIES ASSESSMENT (Refer to responses recorded for questions in Exhibit 9A–1 in Appendix 9A)	Auditor Responses	Audit File References
APPLICATION CONTROL ASSESSMENTS		

PAYROLL APPLICATION CONTROLS

Environment and general controls relevant to this application:

1. Are all employees paid by cheque or direct deposit to their bank accounts?
2. If a special payroll bank account is used, is the payroll bank account reconciled by someone who does not prepare, sign, or deliver paycheques?
3. Are payroll cheques signed by persons who neither prepare cheques nor keep cash funds or accounting records?
4. If an outside payroll processing service is used, is the list of employees paid by the service reviewed by the employees' supervisor or someone else who cannot add or make changes to the employee payroll list submitted to the processing service?
5. Are payroll department personnel rotated in their duties? required to take vacations? bonded?
6. Is there a timekeeping department (function) independent of the payroll department?

Application Control Assessments:

Consider whether the auditee has appropriate policies and procedures in place to meet the following control objectives:

Validity objective:

7. Are names of terminated employees reported in writing to the payroll department?
8. Is the payroll compared with personnel files periodically?
9. Are cheques distributed by someone other than the employee's immediate supervisor?
10. Are unclaimed wages controlled by a responsible officer?
11. Do internal auditors conduct occasional surprise distributions of paycheques?

Completeness objective:

12. Are names of newly hired employees reported in writing to the payroll department?
13. Are blank payroll cheques prenumbered and the numerical sequence checked for missing documents?

Authorization objective:

14. Are all wage rates determined by contract or approved by a personnel officer?
15. Are authorizations for deductions, signed by the employees, on file?
16. Are time cards or piecework reports prepared by the employee approved by his or her supervisor?
17. Is a time clock or other secure time recording system used to record hours worked by each employee?
18. Is the payroll register sheet signed by the employee preparing it and approved prior to payment?

Accuracy objective:

19. Are timekeeping and cost accounting records (such as hours, dollars) reconciled with payroll department calculations of hours and wages?
20. Are payrolls audited periodically by internal auditors?

Classification objective:

21. Do payroll accounting personnel have instructions for classifying payroll debit entries?

Accounting objective:

22. Are payroll records reconciled with government tax reports (e.g., T4 summary)?

Proper period objective:

23. Are monthly, quarterly, and annual wage accruals reviewed by an accounting officer?

Auditor's conclusion on the effectiveness of application controls in the production process:
____
____

Prepared by __________ Date __________

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CHAPTER 14

The Finance and Investment Process

In essence, the finance and investment process is the manner in which a company plans for capital requirements and raises the money by borrowing, selling shares, and entering into acquisitions and joint ventures. Dividend, interest, and income tax payments are part of the related accounting cycle. This cycle also includes the accounting for investments in marketable securities, joint ventures and partnerships, and subsidiaries. The finance portion of the process deals with acquiring money to fund the company's activities. The investment portion deals with investing money in revenue-generating assets and other long-term investments. The process has become much more complex through the use of sophisticated financial engineering that used to manage client financial and business risk. Auditors have to make sure that these complex risks are properly disclosed in financial reporting.

EcoPak Inc.

The EcoPak audit team is reaching the final days of its field work. Today, Donna is auditing EcoPak's long-term debt and shareholders' equity balances and transactions. She has started by reviewing the draft financial statements and the minutes of the board of directors meetings to identify important items that need to appear in the financial statements and notes. She notices that a new $2 million operating line of credit was arranged with EcoPak's bank to finance the purchase of new production equipment in April. This line is secured by the new equipment and bears interest at the prime rate plus 2.5%. The previous credit line of $1 million is still in place as well; it is secured by the inventory and accounts receivable, and bears interest of prime plus 1%. Donna reviews the legal documents to ensure the details of these liabilities will be correctly presented and disclosed in the notes to the financial statement. She also notes the minutes recording the board's approval of the loan increase. She ensures she has read all the minutes for all the meetings held up to today, to make sure there are no other new debts or other items approved that are not recorded in the financial statements.

LEARNING OBJECTIVES

After completing this chapter, you will be able to do the following:

LO1 Describe the finance and investment process: risk assessment, typical transactions, source documents, controls, and account balances.

LO2 Outline control tests for auditing control over debt, owner's equity, and investment transactions.

LO3 Describe the typical substantive procedures used to respond to the assessed risk of material misstatement in the main account balance, and in transactions in the finance and investment process.

LO4 Describe the most common fraud problems in the finance and investment process.

CHAPTER APPENDICES

Appendix 14A: Derivative Securities—An Example of Risks that Management and Auditors Face *(online)*

Appendix 14B: GAAP for Private Enterprises *(online)*

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To verify the interest expense, Donna applies an analytical procedure—taking the monthly average loan balances from the bank statements and applying the applicable average interest charge for each month, she develops an expectation of that is within $400 of the amount that is recorded in the draft financial statements, so she concludes that the interest expense amount is reasonable.

Turning to the shareholders' equity, Donna notes there are no changes in the number of common shares outstanding during the year. Kam, Mike, and Nima each hold 100 common shares. Inspection of the minutes of the December 15 board meeting shows the approval of a common share dividend of $300,000 to be distributed on January 15 of the next year to the shareholders of record on December 15. The same meeting also shows board approval of the issue of 30 new common shares to Zhang upon conversion of 10% of her convertible preferred share holding, with effect on January 15 of the next year.

Donna knows that Nima has not yet finished drafting the financial statement notes but is not sure why the dividend payable does not appear in the draft balance sheet. She meets with Nima first thing the next day to discuss the dividend payable and also the disclosure of the issuing of new common shares.

"The dividend payable is included in accrued liabilities for now. It's the first dividend we've ever paid, and I didn't have another account set up for it yet in the general ledger, so I just stuck it in there to save time. When you review the rest of my final journal entries you will see that one—it's GJ #12-15-1, making a debit to retained earnings and a credit to accrued liabilities. But you are right that it needs to go on a separate line, and I will make sure it is presented that way in the next draft of the statements. And yes, absolutely, the new common shares that were issued to Zhang after year-end ought to be disclosed in the notes as a subsequent event. I hope to finish drafting up those notes by tomorrow and will email them to you in draft form as soon as I'm done. Thanks for pointing these issues out, Donna. Are you getting near the end of the field work by now?"

"Pretty near," Donna replies, "We should be able to finish the last few procedures tomorrow or next day at the latest. Then you can have your boardroom back!"

UNDERSTANDING THE FINANCE AND INVESTMENT PROCESS

LO1 Describe the finance and investment process: risk assessment, typical transactions, source documents, controls, and account balances.

The finance and investment process involves the client company's legal structure, how it raises capital from shareholders and creditors, its intercorporate investments, and related parties. Each entity will have its own mix of these components. Understanding these important aspects of the corporate structure and their implications for financial statement misstatement risks requires the input of the most experienced audit team members. The corporate governance controls introduced in Chapter 9 are relevant to this risk assessment and are discussed in more detail in this chapter.

The account balances in the finance and investments process include those for financial instruments, such as long-term investments and debt, share capital, and contributed surplus. Dividend and interest payments are regular transactions. Disclosure requirements in the finance and investment process are extensive and include accounting policies for intercorporate investments; valuation bases of financial instruments; continuity of financial instrument balances and share capital; detailed terms, interest rates, and repayment dates of debt; and details of any contingent liabilities.

The estimates that fair value accounting of financial instruments require have been blamed for helping cause the global credit crisis, as shown in the Chapter 1 box titled "Accounting Blamed for Global Credit Crisis." That article indicates how increasingly crucial the finance and investment process is to both individual auditees and the entire economy.

Paul Krugman, the 2008 winner of the Nobel Prize in economics, attributes the 2008/2009 economic crisis to widespread fraud on Wall Street: frauds carried out through the finance and investment process and based on risky gambles using other peoples' money. The following box contains what Krugman had to say shortly after he accepted the Nobel Prize.

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THE MADOFF ECONOMY

The revelation that Bernard Madoff—brilliant investor (or so almost everyone thought), philanthropist, pillar of the community—was a phony has shocked the world, and understandably so. The scale of his alleged $50 billion Ponzi scheme is hard to comprehend.

Yet surely I'm not the only person to ask the obvious question: How different, really, is Mr. Madoff's tale from the story of the investment industry as a whole?

The financial services industry has claimed an ever-growing share of the nation's income over the past generation, making the people who run the industry incredibly rich. Yet, at this point, it looks as if much of the industry has been destroying value, not creating it. And it's not just a matter of money: the vast riches achieved by those who managed other people's money have had a corrupting effect on our society as a whole.

Let's start with those pay checks. Last year, the average salary of employees in "securities, commodity contracts, and investments" was more than four times the average salary in the rest of the economy. Earning a million dollars was nothing special and even incomes of $20 million or more were fairly common. The incomes of the richest Americans have exploded over the past generation, even as wages of ordinary workers have stagnated; high pay on Wall Street was a major cause of that divergence.

But surely those financial superstars must have been earning their millions, right? No, not necessarily. The pay system on Wall Street lavishly rewards the appearance of profit, even if that appearance later turns out to have been an illusion.

Consider the hypothetical example of a money manager who leverages up his clients' money with lots of debt, then invests the bulked-up total in high-yielding but risky assets, such as dubious mortgage-backed securities. For a while—say, as long as a housing bubble continues to inflate—he (it's almost always a he) will make big profits and receive big bonuses. Then, when the bubble bursts and his investments turn into toxic waste, his investors will lose big—but he'll keep those bonuses.

O.K., maybe my example wasn't hypothetical after all.

So, how different is what Wall Street in general did from the Madoff affair? Well, Mr. Madoff allegedly skipped a few steps, simply stealing his clients' money rather than collecting big fees while exposing investors to risks they didn't understand. And, while Mr. Madoff was apparently a self-conscious fraud, many people on Wall Street believed their own hype. Still, the end result was the same (except for the house arrest): the money managers got rich; the investors saw their money disappear.

We're talking about a lot of money here. In recent years the finance sector accounted for 8% of America's GDP, up from less than 5% a generation earlier. If that extra 3% was money for nothing—and it probably was—we're talking about $400 billion a year in waste, fraud, and abuse.

But the costs of America's Ponzi era surely went beyond the direct waste of dollars and cents.

Meanwhile, how much has our nation's future been damaged by the magnetic pull of quick personal wealth, which for years has drawn many of our best and brightest young people into investment banking, at the expense of science, public service, and just about everything else?

Most of all, the vast riches being earned—or maybe that should be "earned"—in our bloated financial industry undermined our sense of reality and degraded our judgment.

Think of the way almost everyone important missed the warning signs of an impending crisis. How was that possible? How, for example, could Alan Greenspan have declared, just a few years ago, that "the financial system as a whole has become more resilient"—thanks to derivatives, no less? The answer, I believe, is that there's an innate tendency on the part of even the elite to idolize men who are making a lot of money, and to assume that they know what they're doing.

After all, that's why so many people trusted Mr. Madoff.

Now, as we survey the wreckage and try to understand how things can have gone so wrong, so fast, the answer is actually quite simple: What we're looking at now are the consequences of a world gone Madoff.

Source: Paul Krugman. Op-Ed Columnist, "The Madoff economy," *The New York Times*, Editorial Section. Dec. 19, 2008, page A45, Op-Ed Columnist.

We discuss the Madoff fraud and Ponzi schemes via financial reporting in more detail in Chapter 21 (available on Connect). For now, we note that Krugman's view is consistent with PCAOB's observation, as early as 2005, that "Financial engineering, in general, involves structuring a transaction to achieve a desired accounting that is not consistent with the economics of the transaction." The PCAOB, thus, seems to view financial engineering via derivatives and other financial instruments of the finance and investment process as primarily a tool to create deceptive accounting.[1]

The credit crisis that started on Wall Street in 2007 spread globally and to the broader capital markets. Throughout 2007–2009, there was a cascading series of failures of financial institutions and government intervention, with secondary effects on markets and individual corporations, which eventually impacted the global economy. The events led to calls for accounting and auditing changes. Many came to question why those "fake profits" were so widespread and why auditing and accounting practices had allowed them to exist.

1 Public Company Accounting Oversight Board (PCAOB), *Review of Existing Standards—Principles of Reporting,* Background Paper: Standards Advisory Group Meeting, October 5–6, 2005, p. 7 (www.pcaobus.org).

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This brief summary of recent events illustrates why reporting of the finance and investment process is becoming increasingly important, and why this process is more and more regarded as a risky part of the audit of financial statements. With this background, we begin the detailed study of this process.

The International Financial Reporting Standards (IFRS) apply to accounts within the finance and investment process: measurement and recognition of financial instruments and derivatives at fair values, comprehensive income reporting, and consolidation of variable interest enterprises. There are differences between the risks in public companies and those "without public accountability." In particular, the latter group in Canada has the option to use Accounting Standards for Private Enterprises (ASPE), which means they can use simpler accounting principles, such as cost basis for financial assets or taxes-payable basis for income taxes. (See Appendix 14B.) Like Canada, other countries that have adopted IRFS for public companies allow similar exceptions for smaller, private entities.

Risk Assessment for the Finance and Investment Process

At the assertion level, the main risks are completeness of debt, valuation of financial instruments, disclosures of risks relating to financial instruments and derivatives, and presentation and disclosure of intercorporate investments. Controls in the finance and investment process involve the highest level of management, and auditors usually use substantive procedures to assess presentation and verify changes and balances. Since these are long-term (financing/investing) or permanent (shares issued) items in the financial statements, it is important to include copies of all legal documents relating to loans, partnerships, leases, joint venture (JV) investments, and other long-term legal arrangements in audit documentation. These legal documents must be retained in permanent audit files so auditors can check that the contracts are properly accounted for and disclosed in future audits. The same goes for **articles of incorporation** (which set out authorized classes of shares, their features, shareholder rights, etc.) and records of issuing shares approved by the board of directors in the minutes.

articles of incorporation: a corporation's legal documents that set out its purpose, classes of shares that can be issued, etc.

It is also important for auditors to document management's rationale and procedures for accounting estimates and the audit procedures used to verify them, both to help future auditors assess the methods and apply them consistently if there is no reason to change them. Note that changing economic and business conditions are risk factors and may indicate that estimation methods should be changed as well.

Finance and Investment Process—Typical Activities

The finance and investment process relates to a large number of accounts and records: assets that are either tangible or intangible, liabilities, deferred credits, shareholders' equity, gains and losses, expenses, and related taxes such as income tax, goods and services tax (GST) or harmonized sales tax (HST), and provincial sales tax (PST). The major accounts and records are listed in Exhibit 14–1 and include some of the more complicated topics in accounting: equity method accounting for investments, consolidation accounting, goodwill, income taxes, and financial instruments, to name a few. We will not explain the accounting for these balances and transactions, but instead concentrate on a few important aspects of auditing them. Exhibit 14–1 shows a skeleton outline of the finance and investment process, the main functions of which are (1) financial planning and raising capital; (2) interacting with the processes of (i) purchases, payables, and payments; (ii) production and payroll; (iii) revenues, receivables, and receipts; and (3) entering into mergers, acquisitions, and other investments.

Good Corporate Governance: A Key Control for the Finance and Investment Process

According to the "Guidance for Directors on Governance Processes for Control" of the Canadian Institute of Chartered Accountants (CICA), the responsibilities of boards of

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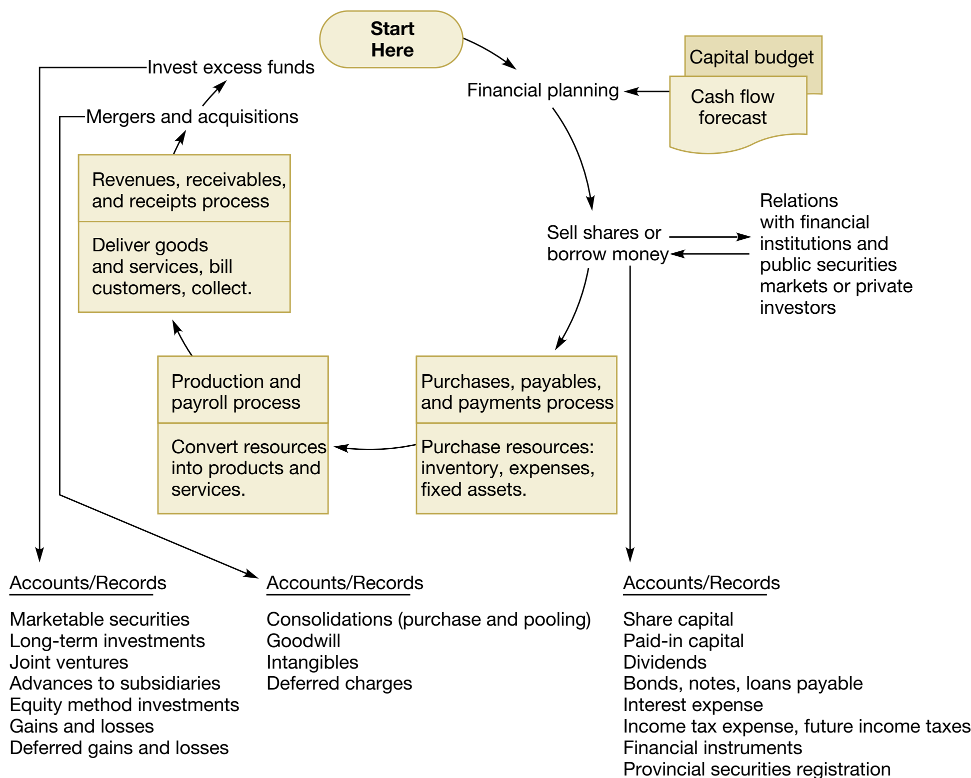
EXHIBIT 14–1 Finance and Investment Process



directors are determined by the organization's legal and administrative framework.[2] This view considers the directors to be stewards of the organization and, as such, to have responsibility to oversee the conduct of the business and to monitor management, while giving all major issues affecting the business and affairs of the organization proper consideration. The contributions by the board of directors to internal control are given as follows:

- *Approving and monitoring mission, vision, and strategy.* Endeavouring to see that the organization has the right approach in order to both add to shareholder and/or stakeholder value and improve its chances of viability and success.
- *Approving and monitoring the organization's ethical values.* Acting as guardian of the organization's values, and as its conscience.
- *Monitoring management control.* Overview of the systems whereby the chief executive officer and senior management exercise their power and influence over the rest of the organization.
- *Evaluating senior management.* Evaluation of the competence and integrity of the chief executive officer and other members of senior management, as it is primarily through them that the board exercises its power and influence.
- *Overseeing external communications.* Responsibility for the organization's communication of information to and from external parties.
- *Assessing the board's effectiveness.* Evaluation of how well it discharges its roles and responsibilities as part of the organization's overall control.

2 CICA, Toronto, Canada, 1996.

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These make up a comprehensive, idealized role for the board, one which might not be fully realized in practice. Nevertheless, this guideline is an authoritative source on good corporate governance practices with respect to control of management activities, especially as they relate to the finance and investment process. These elements of board control, especially the last four, are a useful benchmark in auditor evaluation of internal controls in this cycle.

Debt and Shareholder Equity Capital

Transactions in debt and shareholder equity capital are typically few in number but large in monetary amount. They are handled by the highest levels of management, and the control-related duties and responsibilities reflect this high-level attention.

Authorization

Financial planning starts with the chief financial officer's (CFO's) cash flow forecast. It informs the board of directors and management of the business plans, the prospects for cash inflows, and the needs for cash outflows. The forecast usually is integrated with the capital budget, which contains the plans for asset purchases and business acquisitions. A capital budget approved by the board of directors is the authorization for major asset acquisitions and investments.

Sales of share capital and debt financing transactions usually are authorized by the board of directors. All the directors must sign registration documents for public securities offerings. However, the CFO usually has authority to complete transactions, such as periodic renewals of notes payable and other ordinary types of financing transactions, without specific board approval of each transaction. Auditors should expect to find the authorizing signatures of the chief executive officer (CEO), the CFO, the of the board of directors, and perhaps other high-ranking officers on financing documents.

Many financing transactions are **off the balance sheet.** Companies can enter into obligations and commitments that are not required to be recorded in the accounts. Examples include various business and financing options such as leases, endorsements on discounted notes or on other companies' obligations, letters of credit, guarantees, repurchase or remarketing agreements, commitments to purchase at fixed prices, commitments to sell at fixed prices, and certain kinds of stock options. Many of these were discussed in previous chapters as part of the assessment of the risk of material misstatement related to the disclosure assertion.

off the balance sheet: refers to how certain obligations and commitments do not have to be reported on the balance sheet, such as purchase commitments and operating leases

Custody

In large companies, banks and trust companies serve as registrars and transfer agents of share certificates. A registrar keeps the shareholder list and, from time to time, determines the shareholders eligible to receive dividends (shareholders of record on a dividend record date) and those entitled to vote at the annual meeting. A transfer agent handles the exchange of shares, cancelling the shares surrendered by sellers, and issuing new certificates to buyers. The same bank or trust company might provide both services.

Small companies often keep their own shareholder records. A share certificate book looks like a chequebook, with perforated stubs for recording the number of shares, the owner's name and other identification, and the date of issue. Actual unissued share certificates are attached to the stubs, like unused cheques in a chequebook. The missing certificates have been sent to the share owners. Custody of the share certificate book is important because the unissued certificates are like money or collateral. Share certificates can be improperly sold to buyers who think they are genuinely issued or can be used as collateral with unsuspecting lenders.

Lenders have custody of **debt instruments** (e.g., leases, bonds, notes, and loans payable). A CFO may have copies, but they are just records. However, when a company repurchases its debt instruments, these become within the custody of trustees or company officials, usually the CFO. Until they are cancelled and destroyed, they can be misused by improperly reselling them to unsuspecting investors.

debt instruments: legally documented obligations between a borrower and a lender, such as a bond payable, lease, or mortgage payable

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Recordkeeping

The accounting department and the CFO or controller keep records of notes, loans, and bonds payable. Recordkeeping procedures are similar to those used to account for vendor accounts payable: payment notices from lenders are compared with the accounting records, due dates are monitored, interest payments are set up for payment on due dates, and accruals for unpaid interest are made on financial reporting dates. If the company has only a few debt instruments outstanding, no subsidiary records of these are needed. All the information is in the general ledger accounts. (Companies with a large number of bonds, loans, and notes may keep control and subsidiary accounts, as is done for accounts receivable.) As all or some of the notes become due, the CFO and the controller have the necessary information for properly classifying current and long-term amounts.

The functions of authorization, custody, and reconciliation for another class of credit balances, calculated liabilities, and credits are not easy to describe. These include lease obligations, future income taxes, pension and post-retirement benefit liabilities, and foreign currency translation gains and losses, to name a few. They are accounting creations, calculated according to accounting rules and using basic data from company plans and operations, and management usually enjoys considerable discretion in structuring them. These accounting calculations often involve significant accounting estimates by management. Auditors should consider whether company accountants have been realistic in these calculated liabilities and are following generally accepted accounting principles, and pay careful attention to how these estimates may affect decisions of financial statement users.

Periodic Reconciliation

The share certificate book should be periodically inspected to ensure that only certificates in the possession of *bona fide* owners are outstanding. If necessary, company officials can confirm this with the holders of record. Reports with similar information can be obtained from registrars and transfer agents to verify that the numbers of outstanding shares agree. (Without this reconciliation, counterfeit shares handled by the transfer agent and recorded by the registrar might go unnoticed.)

A trustee with duties and responsibilities similar to those of registrars and transfer agents can handle ownership of bonds. Confirmations and reports from bond trustees can be reconciled to the company's records.

Investments and Intangibles

A company may have many or only a few investments and these may include a large variety or a limited set of investments types. Intangible assets may be in the form of purchased assets (e.g., patents, trademarks) or of accounting allocations (e.g., goodwill, deferred costs). A manufacturing or service company is the context for the sections following, and investments and intangibles may be fairly incidental in these businesses. Financial institutions (banks, trust companies), investment companies, mutual funds, insurance companies, and the like have more elaborate systems for managing their investments and intangibles.

An important new type of investment is the financial instrument, which IFRS (IAS 32) defines as "any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity." The definition encompasses a wide range of financial instruments from simple loans and deposits to complex derivatives, structured products, and some commodity contracts. Financial instruments can vary greatly in terms of their complexity, due to the high volume of individual cash flows and complex formulas for determining cash flows which arise from the uncertainty or variability of future cash flows. The main reason for using financial instruments is to reduce exposures to business risks, for example, changes in exchange rates, interest rates and commodity prices, or a combination of those risks. On the other hand, the inherent complexities of some financial instruments also may result in increased risk. Thus, the extent of an entity's use of financial instruments and the degree of complexity of the instruments are important determinants

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of the necessary level of sophistication of the entity's internal control. For example, smaller entities may use less structured products and simple processes and procedures to achieve their objectives.

Authorization

All investment policies and major individual investment transactions should be approved by the board of directors, executive committee, or its investment committee. However, there is a great deal of variety between companies in the nature and amount of transactions that must have specific high-level approval. Often, it is the role of those charged with governance to set the tone regarding and approve and oversee the extent of use of financial instruments, while it is management's role to manage and monitor the entity's exposures to those risks. The board of directors is always closely involved in major acquisitions, mergers, and share buy-back plans.

THE LITTLE LEASE THAT COULD

The Quick-Fly commuter airline was struggling. According to its existing debt covenants, it could not incur any more long-term liabilities. The company needed a new airplane to expand its services, so it "rented" one. The CFO pointed out that the deal for the $12 million airplane was a noncancellable operating lease because (1) Quick-Fly does not automatically own the plane at the end of the lease; (2) the purchase option of $1,500,000 is no bargain; (3) the lease term of 133 months is 74%, not 75%, of the plane's estimated 15-year economic life; and (4) the present value of the lease payments of $154,330 per month, discounted at the company's latest borrowing rate of 14%, is $10.4 million, which is less than the 90% of fair value (0.90 × $12 million = $10.8 million) criterion in the *CICA Handbook* in paragraph 3065.06.

The CFO did not record a long-term lease obligation (liability). Do you agree with this accounting conclusion?

Custody

Custody of investments and other intangible assets varies. Some investments, such as shares and bonds, are represented by actual negotiable certificates that may be kept in a brokerage account in a "house name" (the brokerage company). In that case, custody rests with the company official who is authorized to order the buy, sell, and delivery transactions. They also may be in the possession of the owner (client company), in which case they should be in a safe or a bank safety deposit box. Only high-ranking officers (e.g., CFO, CEO, president, chairman of the board) should have combinations and keys.

Other kinds of investments, such as joint ventures and partnerships, do not have formal negotiable certificates, and custody may instead take the form of management responsibility. The venture and partnership agreements that are evidence of these investments are usually merely filed with other important documents as they are not readily negotiable. Management's supervision and monitoring of the operations is the true custody.

AUTHORIZATION: HERE TODAY, GONE TOMORROW

The treasurer of Travum County had many responsibilities as a chief financial officer. She invested several million dollars of county funds with a California-based investment money manager. Soon thereafter, news stories of the money manager's expensive personal lifestyle and questionable handling of client's funds began to circulate, indicating that clients could lose much of their investments. At the same time, news stories about the treasurer's own credit card spending habits were published locally, indicating that she had obtained a personal credit card by using the county's name.

Although no county funds were lost and no improper credit card bills were paid, the county commissioners temporarily suspended the treasurer's authority to choose investment vehicles for county funds.

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Having custody of most intangibles is like trying to keep Jell-O in your pocket—good in theory but messy in practice. There are legal documents and contracts for financial instrument transactions, patents, trademarks, copyrights, and similar legal intangibles. These seldom are negotiable and are usually kept in ordinary company files. Company managers may be assigned responsibility to protect exclusive rights granted by various intangibles. Accounts like goodwill, deferred charges, and pension obligations are intangibles created by accountants' estimates and calculations. They have no physical substance, but they are "in the custody" of the accountants who calculate them.

Recordkeeping

Purchases of share and bond investments require authorization by the board of directors or other responsible officials. Because a higher level of approval is required for these, the cheque for the investment is signed by a higher ranking finance officer, such as the CFO or treasurer, as well. If the company has few investments, no subsidiary records are maintained and all information is kept in the general ledger accounts. If the company has many investments, a control account and subsidiary ledger may be maintained.

The recordkeeping for the maintenance of some investment and intangible accounts over time can be complicated. This is the place where complex accounting standards for equity method accounting, consolidations, goodwill, intangibles amortization and valuation, deferred costs, future income taxes, pension and post-retirement benefit liabilities, and various financial instruments enter the picture. High-level accountants who prepare financial statements get involved with the accounting rules and management estimates required. The accounting for these balances is influenced by management plans and estimates of future events and interpretations of the accounting standards. These decisions are risk areas for overstatement of assets, understatement of liabilities, and understatement of expenses because managers can exercise considerable discretion and auditors seldom have hard evidence confirming or refuting these management assessments.

Periodic Reconciliation

Inspection and count of negotiable securities certificates is the most significant reconciliation opportunity in the investments and intangibles accounts. Certificates on hand are inventoried, inspected, and compared with the information recorded in the accounts. (Written confirmations are requested for securities held by brokerage firms.)

REVIEW CHECKPOINTS

14-1 When a management carefully crafts a lease agreement to barely fail the tests for lease capitalization and liability recognition, should the auditor insist on capitalization anyway?

14-2 What would constitute the authorization for loans payable? What documentation is evidence of this authorization?

14-3 Give five examples of off-balance-sheet information. Why should auditors be concerned with such items?

14-4 What features of a client's share capital are important in the audit?

14-5 What information about share capital could be confirmed with outside parties? How could auditors corroborate this information?

14-6 How can auditors verify the names of the issuers, the number of shares held, certificate numbers, maturity value, and interest and dividend rates in an audit of investment securities?

14-7 Describe the procedures and documentation of a controlled count of client's investment securities.

14-8 What information should be included in a working paper for the audit of investment securities?

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A securities "inventory count" should include a record of the name of the company represented by the certificate, the interest rate for bonds, the dividend rate for preferred shares, the due date for bonds, the serial numbers on the certificates, the face value of bonds, the number or face amount of bonds and shares, and notes on the name of the owner shown on the face of the certificate or on the endorsements on the back (should be the client company). This reconciliation should happen reasonably often and not wait until the independent auditors' annual visit. A securities count in a financial institution holding thousands of shares in multimillion-dollar asset accounts is a major undertaking.

The auditors should record the same information in the audit working papers when performing the securities inspection and count. If a security certificate has been pledged as collateral for a loan and is in the hands of a creditor, it can be confirmed or inspected only through a visit to the creditor. The fact that it has been pledged as collateral may be an important disclosure note. A securities count and reconciliation is important because companies do sometimes try to substitute others' securities for missing ones. If securities have been sold and replaced without any accounting entries, the serial numbers will show that the certificates recorded in the accounts are not the same as the ones on hand.

CONTROL RISK ASSESSMENT

LO2 Outline control tests for auditing control over debt, owner equity, and investment transactions.

In the finance and investment process, auditors enquire about and look for control procedures, such as authorization, custody, recordkeeping, and periodic reconciliation. They especially look for information about the level of management involved in these functions. Samples of transactions are not normally part of the control risk assessment work, as they can be in the other operations processes covered in Chapters 11 to 13. Because finance and investment transactions are usually individually material, each transaction is audited in detail. The extent of substantive audit work on finance and investment cycle accounts is not reduced by relying on controls, but lack of controls can mean significant amounts of extended procedures as the risk of material misstatement from improper financing and investing transactions is high.

General Control Considerations

There should be control procedures for handling of responsibilities. Policies on this will vary greatly between companies, but the discussion related to Exhibit 14–1 indicates that these responsibilities are basically in the hands of senior management officials.

Segregation of incompatible duties does not really apply in the financing and investing functions. It is hard to have a strict segregation of functional responsibilities when the same principal officers authorize, execute, and control finance and investment activities. It is not realistic for a CEO to authorize investments but not have access to shareholder records, securities certificates, and the like. Real segregation of duties is found in middle management and lower ranks but is hard to create and enforce in upper-level management. A company should have compensating control procedures in place.

One compensating control could be involvement of two or more people in each important functional responsibility. Or, alternatively, oversight or review can be substituted. For example, if the board of directors authorized the purchase of securities or creation of a partnership, the CFO or the CEO could carry out the transactions, have custody of certificates and agreements, manage the partnership or the portfolio of securities, oversee the recordkeeping, and make the decisions about valuations and accounting (authorizing the journal entries). These are rather normal management activities, and they combine several responsibilities. The compensating control could be periodic reports to the board of directors, oversight by the investment committee of the board, and a periodic reconciliation of securities certificates in a portfolio with the amounts and descriptions recorded in the accounts by internal auditors.

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Control over Accounting Estimates

An accounting estimate amount shows the approximate effect of past business transactions or events on the present status of an asset or liability. Accounting estimates are common in financial statement reporting. Examples include such items as allowance for doubtful receivables, loss provisions, and valuation of stock options using a mathematical model. Accounting estimates can have a significant or pervasive effect on reported results, either individually or when considered in the aggregate.[3] They are included in basic financial statements because (1) the measurement of some values is uncertain, usually depending upon the outcome of future events, or (2) relevant data cannot be accumulated on a timely, cost-effective basis. Some examples of accounting estimates in the finance and investment process are shown in the following box.

FINANCE AND INVESTMENT PROCESS ESTIMATES

Financial instruments: valuation of securities, classification into trading versus investment portfolios, probability of a correlated hedge, sales of securities with puts and calls

Accruals: compensation in stock option plans, actuarial assumptions in pension costs

Leases: initial direct costs, executory costs, residual values, capitalization interest rate

Rates: imputed interest rates on receivables and payables

Other: losses and net realizable value on segment disposal and business restructuring, fair values in nonmonetary exchanges

Management is responsible for making estimates and should have a process and control structure designed to reduce the likelihood of their material misstatement. The following are some items that this control structure should involve:

- Management communication of the need for proper accounting estimates
- Accumulation of relevant, sufficient, and reliable data for estimates
- Preparation of estimates by qualified personnel
- Adequate review and approval by appropriate levels of authority
- Comparison of estimates with subsequent results to assess the reliability of the estimation
- Assessment by management of the consistency between accounting estimates and company operational plans

Auditors' test of controls of estimation procedures involves enquires about the process. They might ask who prepares estimates, when they are prepared, what data are used, who reviews and approves the estimates, and if the estimates are being compared with subsequent actual events. Auditors will also study data documentation, comparisons of prior estimates with subsequent actual experience, and inter-company correspondence concerning estimates and operational plans. Much of the audit test of controls of estimates has a bearing on the substantive quality of the estimation process and on the estimate itself. Further substantive audit procedures include recalculating the mathematical estimate, developing an auditor's own independent estimate based on reasonable alternative assumptions, and comparing the estimate to subsequent events, to the extent they are known before the end of the field work.

Canadian Auditing Standard (CAS) 540 adopts a risk-based approach to the audit of accounting estimates, including fair value accounting estimates. It addresses matters such as the auditor's evaluation of the effect of estimation uncertainty on risk assessments, management's estimation methods, the reasonableness of management assumptions, and the adequacy of disclosures. CAS 540 defines an accounting estimate as an approximation of a monetary amount in the absence of a precise means of measurement. Estimation uncertainty is the likelihood that the accounting estimates and related disclosures are not accurate.

3 CAS 540.

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Accounting estimates will have relatively high estimation uncertainty when they are based on significant assumptions and subjective judgment. Examples include fair value accounting estimates for derivative financial instruments not publicly traded, and fair value accounting estimates based on a highly specialized client-developed model, or for which there are assumptions or inputs that cannot be observed in the market place. When accounting estimates give rise to significant risks, the auditor should also evaluate how adequately the estimation uncertainty is disclosed in the financial statements. In some cases, the estimation uncertainty may be so great that the recognition criteria in the applicable financial reporting framework are not met and the accounting estimate cannot be made. In such situations, critical thinking involving integration of accounting and auditing theories is used to come up with appropriate reporting solutions. Conceivably, such reporting situations may also present new opportunities for management fraud. The earlier "Madoff Economy" feature illustrates the extent to which estimation uncertainties have spread to the financial services sector. The importance of estimation uncertainties has grown enormously in financial reporting over the past few decades. For this reason, Chapter 19 (available on Connect) discusses in more detail the audit issues associated with increased estimation uncertainties in financial reporting.

Control Risk Assessment for Notes and Loans Payable

From the preceding discussion, you can tell that test of controls audit procedures take a variety of forms—enquiries, observations, study of documentation, comparison with related data (such as tax returns), and detail audit of some transactions. The detail audit of transactions, however, is a small part of the test of controls because finance and investment transactions are generally few in number while their amounts are large. However, some companies have numerous debt financing transactions, and in such cases a more detailed control risk assessment can be done that includes selecting a sample of transactions for control risk assessment evidence.

An internal control questionnaire for notes and loans payable is found in Exhibit 14–2. It illustrates typical questions about the control objectives. These enquiries give auditors insights into the review and approval procedures for major financing transactions, the accounting system for them, and the error-checking review procedures.

Auditors can select a sample of notes payable transactions for detail test of controls, provided that the population of notes is large enough to justify it. Exhibit 14–3 lists a selection of these procedures, with the relevant control objectives noted on the right.

EXHIBIT 14–2 Internal Control Questionnaire: Notes and Loans Payable Application

Environment and general controls relevant to this application

1. Are records kept by someone who cannot sign notes or cheques?

Application Control Assessment

Validity objective:

2. Are paid notes cancelled and stamped "paid" and filed?

Completeness objective:

3. Is all borrowing authorization by the directors checked to determine whether all notes payable are recorded?

Authorization objective:

4. Are direct borrowings on notes payable authorized by the directors, the treasurer, or by the chief financial officer?
5. Are two or more authorized signatures required on notes?

Accuracy objective:

6. Are bank due notices compared with records of unpaid liabilities?

Classification objective:

7. Is sufficient information available in the accounts to enable financial statement preparers to classify current and long-term debt properly?

Accounting objective:

8. Is the subsidiary ledger of notes payable periodically reconciled with the general ledger control account(s)?

Proper period objective:

9. Are interest payments and accruals monitored for due dates and financial statement dates?

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EXHIBIT 14–3 Control Tests for Notes and Loans Payable

	CONTROL OBJECTIVE
1. Read directors' and finance committee's minutes for authorization of financing transactions (such as short-term notes payable, bond offerings).	Authorization
2. Select a sample of paid notes: *a*. Recalculate interest expense for the period under audit. *b*. Trace interest expense to the general ledger account. *c*. Vouch payment to cancelled cheques.	Accuracy Completeness Validity
3. Select a sample of notes payable: *a*. Vouch to authorization by directors or finance committee. *b*. Vouch cash receipt to bank statement.	Authorization Validity

Control Risk Assessment for Derivatives and Related Financial Instruments

Derivative financial instruments can have a significant impact on audit procedures because they are becoming more complex and more commonplace. Accounting standards also increasingly require that they be accounted for at fair value and that other information about them is in financial statement notes.

In many cases, derivative financial instruments can reduce a company's exposures to risks, such as changes in exchange rates, interest rates, and commodity prices. On the other hand, the nature of activities involving derivative financial instruments, and derivative financial instruments themselves, also may result in increased business risk in some companies. This both increases and presents new inherent risk factors for the auditor to consider in terms of the values of derivative financial instruments. Their values are volatile and large, and unexpected decreases in their fair values can result in large losses to report in the income statement. The complexity of derivative activities increases the risk that management may not fully understand how to manage them, thus exposing the company to the risk of large losses.

The CICA AuG-39 describes derivatives and the relevant accounting standards that apply as guidance for auditors of companies where derivative financial instruments are used. It sets out managements' and auditors' responsibilities, and describes the risks and audit risk assessment in detail. AuG-39, paragraphs 24 and 40, describe internal control considerations specific to derivatives activities, including the control environment and control systems required to meet the control objectives. The following control objectives relate specifically to derivative financial instruments:

- Transactions are executed in accordance with approved policies.
- Information, including fair value information, is recorded on a timely basis, is complete and accurate, and has been properly classified, described, and disclosed.
- Misstatements in the processing of accounting information are prevented or detected in a timely manner.
- Activities are monitored on an ongoing basis to recognize and measure events affecting related financial statement assertions.
- Changes in the fair value are appropriately accounted for and disclosed to the right people from both an operational and a control viewpoint. Valuation may be a part of ongoing monitoring activities.
- Control systems for those designated as hedges should assure that these meet the criteria for hedge accounting, both at the inception and on an ongoing basis.

AuG-39 also deals with transaction records used for derivative financial instruments (database, register, or subsidiary ledger) and suggests the audit procedures of checking the transaction records for accuracy and independently confirming the derivative transactions

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with counterparties. The auditor needs to assess whether there are appropriate controls over input, processing, and maintenance of the transaction records because these often will be used to provide accounting information for disclosures in the financial statements and other risk management uses, such as exposure reports for comparison with company risk policy limits. Further detailed guidance in AuG-39 covers control testing, obtaining management representations, and communicating with those charged with governance relating to derivatives positions and trading.

Audit of derivative financial instruments is also covered in IAPN 1000 (International) and SAS No. 92 (American Institute of Certified Public Accountants [AICPA]). These list the following as its key control procedures for derivatives:

- Derivatives activities are monitored by independent control staff.
- Approval (oral, at least) from members of senior management who are independent of derivatives activities is obtained by derivatives personnel prior to exceeding limits.
- Limit excesses and divergences from approved derivatives strategies are properly addressed by senior management.
- Accurate transmittals of derivatives positions are made to the risk measurement systems.
- Reconciliations are performed to ensure data integrity across a full range of derivatives.
- Constraints are designed and activities are monitored, identifying excesses justified by traders, risk managers, and senior management.
- Regular review of the identifying controls and financial results of the derivatives activities are performed by senior management, an independent group, or an individual that management designates, to determine whether controls are being effectively implemented in the entity's business objectives and strategies are being achieved.
- Limits are reviewed in the context of changes and strategy, risk tolerance of the entity, conditions.

RISK FACTORS OF DERIVATIVES

The following are examples of unique, inherent risk factors associated with derivatives:

- Many derivatives are not recognized in the financial statements. As a result, there is an increased risk that derivatives and related fees, premiums, commissions, receivables, and payables will not be captured and recorded by control systems.
- Because derivatives are financial instruments whose values are derived from underlying market rates or indexes, their values change as those rates or indexes change. Increase in the volatility of interest rates, commodity prices, and foreign currency rates may cause wide fluctuations in the values of derivatives.
- Entities use derivatives to (a) manage risk (that is, to hedge) and (b) to speculate. Derivatives used for hedging purposes must be accounted for differently from those used to speculate.

Audit Considerations for Derivatives

The following are steps that the auditor might consider taking when auditing an entity involved with derivative financial instruments.

- Obtain an understanding of the nature and extent of the use of derivatives to determine whether they may have a significant effect on the audit or on the financial statements.
- Make preliminary decisions on the materiality of derivatives and the level of inherent risk during the planning stage of the audit.
- Ensure that audit staff who will be performing audit procedures on derivatives have an appropriate level of knowledge and experience.
- Consider whether it is necessary to use the work of an specialist (see "Using the work of auditor's expert," CAS 620 of the *CICA Handbook* for guidance).
- Consider the extent to which it is appropriate to use the work of internal audit (see CAS 610, Using the work of internal auditors).
- Obtain an understanding of the control-environment factors affecting derivative activities (see IAPN 1000 and CAS 315 Appendix 2 of the *CICA Handbook* for examples).

Source: "Auditing derivative financial instruments, studies and standards alert," *CA Magazine*, January/February 1995, p. 66.

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When applicable, auditors design tests of the preceding controls for derivatives to determine the extent of substantive tests needed. Key substantive procedures for derivatives include confirmations with issuers, brokers, or counterparties; physical inspection of derivatives contracts; inspection of underlying agreements and other supporting documentation in paper or electronic form; review of minutes of the board of directors' meetings; and confirmation of quoted prices from broker dealers or from derivatives exchanges. For more background on the unique risks represented by derivatives activities, see Sample Letter on page 607, which illustrates the important substantive procedure of a confirmation request detailing outstanding derivative instruments for a client.

Summary: Control Risk Assessment

The audit manager or senior accountant in charge of the audit should evaluate the evidence gathered through understanding the internal control structure and from test of controls procedures. These procedures can take many forms because management systems for finance and investment accounts vary between clients. Control risk assessment is tailored to each company's situation where senior officials are involved in the relatively small number of high-dollar transactions. The complexity of financing and investment transactions varies from one company to another as well.

AN ESTIMATED VALUATION BASED ON FUTURE DEVELOPMENT

Gulf & Western Industries (G&W) sold 450,000 shares of Pan American stock from its investment portfolio to Resorts International (Resorts). Resorts paid $8 million plus 250,000 shares of its unregistered common stock. G&W recorded the sale proceeds as $14,167,500, valuing the unregistered Resorts shares at $6,167,500, which was approximately 67% of the market price of Resorts shares at the time ($36.82 per share). G&W reported a gain of $3,365,000 on the sale.

Four years later, Resorts shares fell to $2.63. G&W sold its 250,000 shares back to Resorts in exchange for 1100 acres of undeveloped land on Grand Bahamas Island. For its records, Resorts got a broker-dealer's opinion that its 250,000 shares were worth $460,000. For property tax assessment purposes, the Bahamian government valued the undeveloped land at $525,000.

G&W valued the land on its books at $6,167,500, which was the previous valuation of the Resorts shares. The justification was an appraisal of $6,300,000 based on the estimated value of the 1100 acres when ultimately developed (i.e., built into an operating resort and residential community). However, G&W also reported a loss of $5,527,000 in its tax return (effectively valuing the land at $640,500). The Securities and Exchange Commission (SEC) accused G&W of failing to report a loss of $5.7 million in its financial statements. Do you think the loss should have appeared in the G&W income statement?

Source: I. Kellog, *How to Find Negligence and Misrepresentation in Financial Statements* (New York: Shepard's/McGraw-Hill, 1983), p. 279.

Some control considerations can be generalized. There are common features characterizing control over management's production of accounting estimates. Detail testing through samples of transactions can produce evidence about compliance with control policies and procedures as well; for instance, when there are numerous notes payable transactions.

In general, substantive audit procedures on finance and investment accounts are not limited in extent. It is very common for auditors to perform substantive audit procedures on 100% of these transactions and balances, as there are not many transactions and the audit cost for complete coverage is not high. But control deficiencies and unusual or complicated transactions might cause auditors to adjust the nature and timing of audit procedures. Complicated financial instruments, pension plans, exotic equity securities, related-party transactions, and nonmonetary exchanges of investment assets call for procedures designed to find evidence of error and fraud. The next section deals with some of the finance and investment process assertions, and it has some cases for your review.

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REVIEW CHECKPOINTS

14-9 What is a compensating control for the finance and investment process? Give some examples for finance and investment accounts.

14-10 What are some of the specific, relevant aspects of management's control over the production of accounting estimates? What are some enquiries auditors can make?

14-11 When a company has produced an estimate of an investment valuation based on a nonmonetary exchange, what source of comparative information can an auditor use?

14-12 If a company does not monitor notes and loans payable for due dates and interest payment dates in relation to financial statement dates, what misstatements can appear in the financial statements?

14-13 Generally, how much emphasis is placed on adequate internal control in the audit of each of long-term debt, share capital, contributed surplus, and retained earnings?

SUBSTANTIVE AUDIT PROGRAMS FOR THE FINANCE AND INVESTMENT PROCESS

Assertions, Substantive Procedures, and Audit Cases for Finance and Investment Accounts

LO3 Describe the typical substantive procedures used to respond to the assessed risk of material misstatement in the main account balance, and in transactions in the finance and investment process.

As discussed above, the main control over financial reporting of the auditee's financing and investing activities comes from the highest level of management and those charged with governance. Also, there often are few, but quite sizable, transactions and balances in the financing and investing process. Consequently, auditors tend to seek out reliable substantive evidence for any transactions, supplementing the important management representations they obtain regarding these accounts. The long-term debt and owners' equity balances in this part of the balance sheet mainly report the financial position of the equity and debt holders of the firm. Since these are the main users of the entity's financial statements, it is important that this information be perfectly accurate, and that fully informative disclosures of the details of the investors' and creditors' positions vis-à-vis the company are provided.

Exhibits 14-4 and 14-5 provide examples of working papers for substantive audit programs that would be used in a typical company for the account balances, transactions, and disclosures in the financing and investing process. These include the owners' equity accounts, loans and long-term debts payable, and investments of various types, such as short-term holdings of debt or shares, investments in other companies for significant influence, and investments in controlled subsidiaries. After the working papers, there is a discussion of the audit logic behind each program.

Substantive Audit Programs—Exhibits of Working Papers

Owners' Equity

Management makes assertions about the existence, completeness, rights and obligations, valuation and presentation, and disclosure of owners' equity. Typical specific assertions include the following:

1. The number of shares shown as issued is, in fact, issued.
2. No other shares (including options, warrants, and the like) have been issued and not recorded or reflected in the accounts and disclosures.
3. The accounting is proper for options, warrants, and other share issue plans, and related disclosures are adequate.
4. The valuation of shares issued for noncash consideration is proper, in conformity with accounting principles.
5. All owners' equity transactions have been authorized by the board of directors.

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EXHIBIT 14–4 Example of Substantive Audit Program for Owners' Equity Account Responding to Assessed Risk of Material Misstatement: Selected Substantive Procedures

SUBSTANTIVE AUDIT PROGRAM				
AUDITEE: *ECOPACK INC.*	**FILE INDEX:** *UU-100*			
FINANCIAL STATEMENT PERIOD: *y/e DECEMBER 31, 20x1*				
ACCOUNT: *Owners' Equity*				
Substantive audit program in response to assessed risks at the assertion level:				
Consider risk assessment findings and conclusion on residual risk of material misstatement to be reduced by performing substantive procedures. (Of the procedures listed below, perform those considered necessary to provide sufficient appropriate evidence to address the assessed risks and reduce risk of material misstatement to an acceptable level.)				*[Reference to relevant working papers]*
Substantive audit procedures	Assertions evidence is related to [E,C,O,V,P]	Timing	Extent	Working paper reference
1. Obtain an analysis of owners' equity transactions. Trace additions and reductions to the general ledger. *a*. Vouch additions to directors' minutes and cash receipts. *b*. Vouch reductions to directors' minutes and other supporting documents.	E CV			
2. Read the directors' minutes for owners' equity authorization. Trace to entries in the accounts. Determine whether related disclosures are adequate.	ECOP			
3. Confirm outstanding common and preferred shares with share registrar agent.	ECO			
4. Vouch stock option and profit-sharing plan disclosures to contracts and plan documents.	P			
5. Vouch treasury stock transactions to cash receipts and cash disbursement records and to directors' authorization. Inspect treasury stock certificates.	P			
6. When the company keeps its own share records: *a*. Inspect the share record stubs for certificate numbers and number of shares. *b*. Inspect the unissued certificates. c. Obtain written client representations about the number of shares issued and outstanding.	ECOV			

AUDITOR'S CONCLUSIONS:
Based on my professional judgment, the evidence obtained is sufficient and appropriate to conclude that the risk of material misstatement of the Owners' Equity is acceptably low.

Prepared by ________ Date ________

Reviewed by ________ Date ________

An illustrative program of substantive audit procedures for owners' equity can be found in Exhibit 14–4 above. Some key substantive procedures are discussed below.

Inspection of Documentation Owners' equity transactions usually are well documented in board of directors meeting minutes, proxy statements, and securities offering registration statements. Transactions can be vouched to these documents, and the cash proceeds can be traced to the bank accounts.

Confirmation Share capital may be subject to confirmation when independent registrars and transfer agents are employed. Agents are responsible for knowing the number of shares authorized and issued and for keeping lists of shareholders' names. The basic information about share capital—such as number of shares, classes of shares, preferred dividend rates, conversion terms, dividend payments, shares held in the company name, expiration dates and terms of warrants, and share dividends and splits—can be confirmed with them. Auditors corroborate many of these things by inspection and reading of share certificates,

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EXHIBIT 14–5 Example of Substantive Audit Program for Notes and Loans Payable and Long-Term Debt Account Responding to Assessed Risk of Material Misstatement: Selected Substantive Procedures

SUBSTANTIVE AUDIT PROGRAM				
AUDITEE: *ECOPACK INC.*	**FILE INDEX:** *KK-100*			
FINANCIAL STATEMENT PERIOD: *y/e DECEMBER 31, 20x1*				
ACCOUNT: *Notes and Loans Payable and Long-Term Debt*				
Substantive audit program in response to assessed risks at the assertion level:				
Consider risk assessment findings and conclusion on residual risk of material misstatement to be reduced by performing substantive procedures. (Of the procedures listed below, perform those considered necessary to provide sufficient appropriate evidence to address the assessed risks and reduce risk of material misstatement to an acceptable level.)				*[Reference to relevant working papers]*
Substantive audit procedures	Assertions evidence is related to [E,C,O,V,P]	Timing	Extent	Working paper reference
1. Obtain a schedule of notes payable and other long-term debt (including capitalized lease obligations) showing beginning balances, new notes, repayments, and ending balances. Trace to general ledger accounts.	ECV			
2. Confirm liabilities with creditor: amount, interest rate, due date, collateral, and other terms. Some of these confirmations may be standard bank confirmations.	ECOVP			
3. Review the standard bank confirmation for evidence of assets pledged as collateral and for unrecorded obligations.	CP			
4. Read loan agreements for terms and conditions that need to be disclosed and for pledge of assets as collateral.	CVP			
5. Recalculate the current portion of long-term debt and trace to the trial balance, classified as a current liability.	VP			
6. Study lease agreements for indications of need to capitalize leases. Recalculate the capital and operating lease amounts for required disclosures.	ECOVP			
7. Recalculate interest expense on debts and trace to the interest expense and accrued interest accounts.	ECOVP			
8. Obtain written representations from management concerning notes payable, collateral agreements, and restrictive covenants.	CP			

AUDITOR'S CONCLUSIONS:
Based on my professional judgment, the evidence obtained is sufficient and appropriate to conclude that the risk of material misstatement of the Notes and Loans Payable and Long-Term Debt is acceptably low.

Prepared by _________ Date _________

Reviewed by _________ Date _________

charter authorizations, directors' minutes, and registration statements. However, when there are no independent agents, most audit evidence is gathered by vouching share record documents (such as certificate book stubs). When circumstances call for extended procedures, information on outstanding shares is confirmed directly with the holders.

Long-Term Liabilities and Related Accounts

Exhibit 14-5 above shows an example of a substantive program for long-term liabilities. The primary audit concern with the verification of long-term liabilities is that all liabilities are recorded and that the interest expense is properly paid or accrued. This makes the completeness assertion paramount. During procedures in all areas, auditors are alert to the possibility of unrecorded liabilities. For example, when fixed assets are acquired during the year under audit, auditors should enquire about the source of funds for financing the new asset.

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EXHIBIT 14–6 Audit Program for Owners' Equity

1. Obtain an analysis of owners' equity transactions. Trace additions and reductions to the general ledger. *a*. Vouch additions to directors' minutes and cash receipts. *b*. Vouch reductions to directors' minutes and other supporting documents.
2. Read the directors' minutes for owners' equity authorization. Trace to entries in the accounts. Determine whether related disclosures are adequate.
3. Confirm outstanding common and preferred shares with share registrar agent.
4. Vouch stock option and profit-sharing plan disclosures to contracts and plan documents.
5. Vouch treasury stock transactions to cash receipts and cash disbursement records and to directors' authorization. Inspect treasury stock certificates.
6. When the company keeps its own share records, perform the following: *a*. Inspect the share record stubs for certificate numbers and number of shares. *b*. Inspect the unissued certificates. *c*. Obtain written client representations about the number of shares issued and outstanding.

Management makes assertions about existence, completeness, rights and obligations, valuation and presentation, and disclosure. Typical specific assertions relating to long-term liabilities include the following:

1. All material long-term liabilities are recorded.
2. Liabilities are properly classified according to their current or long-term status. The current portion of long-term debt is properly valued and classified.
3. New long-term liabilities and debt extinguishments are properly authorized.
4. Terms, conditions, and restrictions relating to noncurrent debt are adequately disclosed.
5. Disclosures of maturities for the next five years and the capital and operating lease disclosures are accurate and adequate.
6. All important contingencies are either accrued in the accounts or disclosed in footnotes.

Exhibit 14–7 illustrates some substantive audit procedures for notes and loans payable and for long-term debt.

EXHIBIT 14–7 Audit Program for Notes and Loans Payable and Long-Term Debt

1. Obtain a schedule of notes payable and other long-term debt (including capitalized lease obligations) showing beginning balances, new notes, repayments, and ending balances. Trace to general ledger accounts.
2. Confirm liabilities with creditor: amount, interest rate, due date, collateral, and other terms. Some of these confirmations may be standard bank confirmations.
3. Review the standard bank confirmation for evidence of assets pledged as collateral and for unrecorded obligations.
4. Read loan agreements for terms and conditions that need to be disclosed and for pledge of assets as collateral.
5. Recalculate the current portion of long-term debt and trace to the trial balance, classified as a current liability.
6. Study lease agreements for indications of need to capitalize leases. Recalculate the capital and operating lease amounts for required disclosures.
7. Recalculate interest expense on debts and trace to the interest expense and accrued interest accounts.
8. Obtain written representations from management concerning notes payable, collateral agreements, and restrictive covenants.

Below are some key audit procedures.

Confirmation When auditing long-term liabilities, auditors usually obtain independent written confirmations for notes, loans, and bonds payable. In the case of loans payable to banks, the standard bank confirmation may be used. The amount and terms of bonds payable, mortgages payable, and other formal debt instruments can be confirmed by requests to holders or a trustee. The confirmation request should include questions not only of

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amount, interest rate, and due date but also about collateral, restrictive covenants, and other items of agreement between lender and borrower. Confirmation requests should be sent to lenders the company has done business with in the recent past, even if no liability balance is shown at the confirmation date. This is part of the search for unrecorded liabilities. (Chapter 12 has more on this search.)

Many of the auditor's procedures for financial instruments can be used to address a number of assertions. For example, procedures to address the existence of an account balance at period end will also address the occurrence of a class of transactions, and may also assist in establishing proper cutoff. This is because financial instruments arise from legal contracts and, by verifying the accuracy of the recording of the transaction, the auditor can also verify its existence, and obtain evidence to support the occurrence and rights and obligations assertions at the same time, and confirm that transactions are recorded in the correct accounting period.

For financial instruments, there should be external confirmation of trades, bank accounts, and custodian payments. This can be done by direct confirmation with the counterparty (including the use of bank confirmations), where a reply is sent directly to the auditor. Alternatively, this information may be obtained from the counterparty's systems through a data feed. Where this is done, controls to prevent tampering with the computer systems through which the information is transmitted may be considered by the auditor in evaluating the reliability of the evidence from the confirmation. If confirmations are not received, the auditor may be able to obtain evidence by reviewing contracts and testing relevant controls. External confirmations, however, often do not provide adequate audit evidence with respect to the valuation assertion though they may assist in identifying any side agreements (International Auditing Practice Note [IAPN] 1000).

Off-Balance-Sheet Financing

Confirmation and enquiry procedures are used to obtain responses on a class of items loosely termed *off-balance-sheet information*. These items include terms of loan agreements, leases, endorsements, guarantees, and insurance policies (whether issued by a client insurance company or owned by the client). Among these items is the difficult-to-define set of "commitments and contingencies" that often poses evidence-gathering problems. Some common types of commitments are shown in Exhibit 14–8.

Footnote disclosure should be considered for the types of commitments shown this exhibit. Some of them can be estimated and valued, allowing them to be recorded in the accounts and shown in the financial statements themselves (e.g., fixed-price purchase commitments and losses on fixed-price sales commitments).

EXHIBIT 14–8 Off–Balance-Sheet Commitments

TYPE OF COMMITMENT	TYPICAL PROCEDURES AND SOURCES OF EVIDENCE	ASSERTION
1. Repurchase or remarketing agreements	1. Vouching of contracts, confirmation by customer, enquiry of client management	1. Existence
2. Commitments to purchase at fixed prices	2. Vouching of open purchase orders, enquiry of purchasing personnel, confirmation by supplier	2. Existence/occurrence
3. Commitments to sell at fixed prices	3. Vouching of sales contracts, enquiry of sales personnel, confirmation by customer	3. Existence/valuation
4. Loan commitments	4. Vouching of open commitment file, enquiry of loan officers	4. Existence/valuation
5. Lease commitments	5. Vouching of lease agreement, confirmation with lessor or lessee	5. Existence/valuation/ownership

Analytical relationships are used to help verify interest expense, which generally is related item by item to interest-bearing liabilities. Interest expense amounts can be recalculated for long-term liability transactions (including those that have been retired during the year). The amount of debt, the interest rate, and the time period are used to determine whether the interest expense and accrued interest are properly recorded. The audit results are compared with the recorded interest expense and accrued interest accounts to detect (1) greater expense than audit calculations show, indicating some interest paid on an

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unknown debt, possibly an unrecorded liability; (2) lesser expense than audit calculations show, indicating misclassification, failure to accrue interest, or an interest payment default; or (3) interest expense equal to audit calculations. The first two possibilities raise questions for further study, while the third shows a correct correlation between debt and debt-related expense.

A current controversy involving use of off-balance-sheet debt concerns the ongoing litigation (as of May 12, 2012) against the bankrupt Lehman Brothers investment bank (whose failure was the catalyst for the 2008 financial crisis) and its auditors. The basic fact issues of this case are outlined in the box below. The box illustrates the huge (and potentially misleading) financial statement impact that off-balance-sheet accounting rules can have. The rules that have since been modified, indicating that there should be better, broader principles underlying the detailed rules. The Lehman case is further explored in the exercises at the end of this chapter.

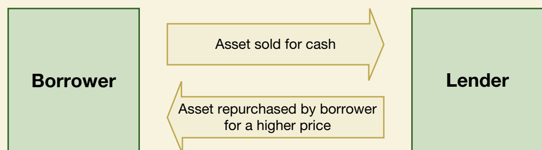
LEHMAN BROTHERS: CAUSES OF BANKRUPTCY

Prior to its collapse in 2008, Lehman Brothers employed a typical investment banking strategy of a high-risk, high-leverage model. Lehman's balance sheet at the time showed approximately $700 billion in longer-term assets, with only $25 billion in short-term liabilities. In order to stay afloat, Lehman was borrowing hundreds of millions of dollars per day. Investor confidence is key to the success of this strategy.

At the same time, since 2007 Lehman was also heavily invested in the subprime real estate market, thinking that they could "buy low and sell high."

However, when Bear Sterns collapsed in March of 2008, investor confidence began to erode. Lehman incurred a $2.8 billion loss in the second quarter of 2008 due to large asset writedowns. In the face of the changing financial climate, Lehman attempted to show a positive liquidity position despite their decreasing profitability. Lehman claimed to have significantly reduced their net leverage ratio to below 12.5. How? By engaging in the accounting policy of "Repo 105."

An ordinary repurchase (REPO) transaction is designed to facilitate short-term financing over the span of a few days. In 2007, there was $12 trillion worth of these loans in the market at any given time. Shown below is this transaction of which the goal is to reduce leverage (debt) on the balance sheet.



Under IAS 39 / FASB No. 125, the accounting treatment for REPO is as follows:

- Balance Sheet – The asset stays on the books of the borrower as this is NOT a sale. A corresponding liability is created.
- Income Statement – The spread ("repo interest") is treated as payment of interest.

Lehman engaged in REPO deals just before quarter-end, where they ensured that the fair market value of the asset was 105% greater than the amount of cash received. This allowed Lehman to recognize the transactions as a sale rather than as a liability, despite the fact that they bought the asset back within 7 to 10 days. Using the REPO 105 loophole allowed Lehman to record the transactions as shown on the right, rather than as a conventional REPO transaction, at left.

Regular REPO Journal Entry	REPO 105 Journal Entry
Dr. Cash	Dr. Cash
Cr. Liability	Cr. Sales

The impact on Lehman's financial statements was that tens of billions of dollars were borrowed without recording a liability. Cash from these transactions was used to pay down other liabilities, which in turn reduced the total liabilities, total assets, and leveraging ratios. Lehman then borrowed from other sources to pay back this debt after quarter-end. Through this process, Lehman was able to hide $50 billion of liabilities from investors, and reduced their leverage ratio by 14% (from 13.9 to 12.1) in the second quarter of 2008.

Deferred Credits: Calculated Balances

Existence and valuation of several types of deferred credits are calculated. Examples include (1) deferred profit on instalment sales involving the gross margin and the sale amount; (2) future income taxes and investment credits involving tax-book timing differences, tax rates, and amortization methods; and (3) deferred contract revenue involving contract provisions for prepayment, percentage-of-completion revenue recognition methods, or other terms unique to a contract. Auditors can check the calculations for accuracy.

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Investments and Intangibles

There is a wide variety of investments and relationships a company might have with affiliates. Investment accounting for these may be on the cost or equity method, either without consolidation or with full consolidation, depending on the size and influence represented by the investment. Purchase method consolidations usually create problems of accounting for the fair value of acquired assets and the related goodwill. There are specific assertions typical of a variety of investment account balances:

1. Investment securities are on hand or are held in safekeeping by a trustee (existence).
2. Investment cost does not exceed market value (valuation).
3. Significant influence investments are accounted for by the equity method (valuation).
4. Purchased goodwill is properly valued (valuation).
5. Capitalized intangible costs relate to intangibles acquired in exchange transactions (valuation).
6. Research and development costs are properly classified (presentation).
7. Amortization is properly calculated (valuation).
8. Investment income has been received and recorded (completeness).
9. Investments are adequately classified and described in the balance sheet (presentation).

A program of substantive audit procedures for investments, intangibles, and related accounts is shown in Exhibit 14–9.

EXHIBIT 14–9 **Example of Substantive Audit Program for Investments and Related Accounts Responding to Assessed Risk of Material Misstatement: Selected Substantive Procedures**

SUBSTANTIVE AUDIT PROGRAM				
AUDITEE: *ECOPACK INC.*	**FILE INDEX:** *B-100*			
FINANCIAL STATEMENT PERIOD: *y/e DECEMBER 31, 20x1*				
ACCOUNT: *Investments and related accounts*				
Substantive audit program in response to assessed risks at the assertion level:				
Consider risk assessment findings and conclusion on residual risk of material misstatement to be reduced by performing substantive procedures. (Of the procedures listed below, perform those considered necessary to provide sufficient appropriate evidence to address the assessed risks and reduce risk of material misstatement to an acceptable level.)				*[Reference to relevant working papers]*
Substantive audit procedures	Assertions evidence is related to [E,C,O,V,P]	Timing	Extent	Working paper reference
1. Obtain a schedule of all investments, including purchase and disposition information for the period. Reconcile with investment accounts in the general ledger.	EC			
2. Inspect or confirm with a trustee or broker the name, number, identification, interest rate, and face amount (if applicable) of securities held as investments.	ECOVP			
3. Vouch the cost of recorded investments to brokers' reports, contracts, cancelled cheques, and other supporting documentation.	V			
4. Vouch recorded sales to brokers' reports and bank deposit slips, and recalculate gain or loss on disposition.	ECV			
5. Recalculate interest income and look up dividend income in a dividend reporting service (such as Moody's or Standard & Poor's annual dividend record).	ECV			

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EXHIBIT 14–9 Continued

6. Obtain market values of investments and determine appropriate valuation method has been applied as required by the auditee's financial reporting framework. Determine whether any writedown or write off is necessary. Scan transactions soon after the client's year-end to see if any investments were sold at a loss. Recalculate the unrealized gains and losses required for marketable equity securities disclosures.	V			
7. Read loan agreements and minutes of the board, and enquire of management about pledge of investments as security for loans.	P			
8. Obtain written representations from the client concerning pledge of investment assets as collateral.	P			
9. Obtain audited financial statements of joint ventures, investee companies (equity method of accounting), subsidiary companies, and other entities in which an investment interest is held. Evaluate indications of significant controlling influence. Determine proper balance sheet classification. Determine appropriate consolidation policy in conformity with accounting principles.	ECOVP			
10. Review acquisition documents for proper calculation of purchased goodwill.	ECV			
11. Enquire of management about legal status of patents, leases, copyrights, and other intangibles.	ECV			
12. Review documentation of new patents, copyrights, leaseholds, and franchise agreements	ECO			
13. Vouch recorded costs of intangibles to supporting documentation and cancelled cheque(s).	V			
14. Select a sample of recorded R&D expenses. Vouch to supporting documents for evidence of proper classification.	P			
15. Recalculate amortization of copyrights, patents, and other intangibles.	ECV			

AUDITOR'S CONCLUSIONS

Based on my professional judgment, the evidence obtained is sufficient and appropriate to conclude that the risk of material misstatement of the Investments and Related Accounts is acceptably low.

Prepared by _________ Date _________

Reviewed by _________ Date _________

Unlike the current assets accounts, which typically include many small transactions, the noncurrent investment accounts usually consist of a few large entries. This difference has internal control and substantive audit procedure implications, and auditors will concentrate on the authorization of transactions, since each transaction is likely to be material in itself and the authorization will give significant information about the proper classification and accounting method. The controls usually are not reviewed, tested, or evaluated at an interim date but are included in year-end procedures when the transactions and their authorizations are audited. The following box shows a few of the trouble spots in audits of investments and intangibles.

TROUBLE SPOTS IN AUDITS OF INVESTMENTS AND INTANGIBLES

- Valuation of investments at cost or market and classification as held-to-maturity or financial assets held for trading or available for sale
- Determination of significant influence relationship for equity method investments
- Proper determination of goodwill in consolidations
- Capitalization and continuing valuation of intangibles
- Realistic distinctions of research, feasibility, and production milestones for capitalization of development costs
- Adequate disclosure of restrictions, pledges, or liens related to investment assets

Confirmation Written confirmation obtained from outside parties is fairly limited for investments, intangibles, and related income and expense accounts. Securities held by

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trustees or brokers should be confirmed, and the confirmation should request the same descriptive information the auditor looks for in the physical count (described earlier in this chapter). The CICA recommends that the sample letter below be used for confirming information related to derivative instruments.

Request for Statement Detailing Outstanding Derivative Instruments
[Auditee letterhead]

[Date]

[Financial institution official responsible for account]
[Financial institution name]
[Financial institution address]

Dear [financial institution official responsible for account]:

In connection with their audit of our financial statements for the year ended March 31, 20X9, our auditors, PA & Co., have requested a statement summarizing all derivative financial instruments entered into by the company and outstanding at March 11, 20X9. Derivative financial instruments include futures, foreign exchange contracts, forward rate agreements, interest rate swaps, and options contracts, or other financial instruments with similar characteristics.

In your response, please include the following information for each instrument:

1. The principal, stated, face, or other similar amount (sometimes also referred to as the notional amount) on which future payments are based
2. The date of maturity, expiration, or execution
3. Any early settlement options, including the period in which, or date at which, the options may be exercised and the exercise price or range of prices
4. Any options to convert the instrument into, or exchange it for, another financial instrument or some other asset or liability, including the period in which, or date at which, the options may be exercised, and the conversion or exchange ratio(s)
5. The amount and timing of scheduled future cash receipts or payments of the principal amount of the instrument, including instalment repayments and any sinking fund or similar requirements
6. The stated rate or amount of interest, dividend, or other periodic return on principal and the timing of payments
7. Any collateral held or pledged
8. The currency of the cash flows if these are other than Canadian funds
9. Where the instrument provides for an exchange, information noted in 1 to 8 above for the instrument to be acquired in the exchange
10. Any condition of the instrument or an associated covenant that, if contravened, would significantly alter any of the other terms

Please mail the above noted information directly to our auditors in the enclosed addressed envelope. Should you wish to discuss any details of this confirmation request with our auditors, please contact (name of audit staff member) at (111) 222-3333, or by fax at (111) 222-3334.

Yours truly,

[Authorized signatory of the auditee company management]

Enquiries about Intangibles Auditors query company counsel about any lawsuits or defects relating to patents, copyrights, trademarks, or trade names as a specific request in the enquiry letter to the law firm. (Chapter 15 contains more information about this enquiry letter.)

Income from Intangibles Royalty income from patent licences received are confirmed. These income amounts are usually audited by examining licence agreements and vouching the licensee's reports and related cash payment.

Inspection Investment property is inspected as the fixed assets are. The principal goal is to determine actual existence and condition of the property. Official documents of patents, copyrights, and trademark rights can be inspected to see that they are, in fact, in the name of the client.

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Documentation Vouching Investment costs should be vouched to brokers' reports, monthly statements, or other documentary evidence of cost. At the same time, the amounts of sales are traced to gain or loss accounts, and the amounts of sales prices and proceeds are vouched to the brokers' statements. Auditors should determine what method of cost-out assignment was used (i.e., FIFO, specific identification, or average cost) and whether it is consistent with prior-years' transactions. The cost of real and personal property likewise can be vouched to invoices or other documents of purchase, and title documents (such as on land, buildings) may be inspected.

Market valuation of securities may be required. Depending on the financial reporting framework it uses and the nature of the items, a company may need to record financial assets and liabilities at their fair values at year end. The auditor will need to obtain evidence of market values or recent sales of investments to verify these fair values. The most reliable data for valuation of a financial instrument is the market value in an actively traded, liquid, competitive market. A less-reliable estimate of the value of a financial instrument is to use a discounted cash flow model. Auditors must use the fair value hierarchies specified by the applicable GAAP, with level 1 of the IFRS hierarchy for fair value estimates representing the least level of estimation uncertainty and levels 2 and 3 representing increasing levels of measurement uncertainty. In CAS 540 what are referred to as *estimation uncertainties* are synonymous with what IFRS refers to as measurement uncertainties.

Models can be used when price cannot be directly observed in a market. Judgment is needed to decide if a market is inactive. Models should reflect the assumptions of market participants, including assumptions about risk. Management is expected to document its valuation policies and model used to value a particular financial instrument, including the rationale for the model(s) used, the selection of assumptions in the valuation methodology, and the entity's consideration of whether adjustments for measurement uncertainty are necessary. These aspects of dealing with estimates are considered an advanced audit topic and are covered in more detail in Chapter 19 (available on Connect).

Most entities use third-party pricing sources when valuing securities either as a primary source or as a source of corroboration for their own valuations. These third-party pricing sources generally fall into two categories:

- Pricing services, including consensus pricing services
- Brokers providing broker quotes

The reliability of this evidence depends very much on the source, and this has proven to be a major problem area in audits, according to recent Canadian Public Accountability Board (CPAB) reports. For example, some third-party pricing sources make more information available about their process, such as methodology, assumptions, and data at the asset level. In contrast, most brokers provide only limited information about inputs and assumptions used in developing a quote. Some third-party pricing sources have more experience in only certain types of financial instruments. A quoted price from the broker who sold the financial instrument to the entity or from one having a close relationship with the entity being audited may not be reliable. Auditors must consider the reliability of the estimates in these different situations.

Obtaining prices from multiple third-party pricing services may provide useful information about measurement uncertainty for financial instruments. A wide range of prices may indicate higher measurement uncertainty and may suggest that the financial instrument is sensitive to small changes in data and assumptions. A narrow range may suggest lower measurement uncertainty and less sensitivity to changes in data and assumptions. An auditor may feel that he or she is unable to get an understanding of the process used to generate the price, including controls over the reliability of the process, or the auditor may not have access to the model, assumptions, and other inputs used. In such cases, the auditor may decide to undertake development of a point estimate or a range to evaluate management's point estimate in responding to assessed risk. Further consideration of these

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issues is an advanced topic, covered in Chapter 19 (available on Connect), which discusses the concepts and principles auditors should consider in developing and using point estimates or ranges of estimates for financial reporting.

Valuation in the areas of research and development (R&D) and deferred development costs is done by extensive vouching. Evidence should determine whether costs are properly classified as assets or as R&D expense. A sample of recorded amounts is selected, and the purchase orders, receiving reports, payroll records, authorization notices, and management reports are compared with them. Some R&D costs may resemble non-R&D costs (such as supplies, payroll costs), so auditors must be alert for costs that appear to relate to other operations.

External Documentation Auditors use quoted market values of securities to calculate market values. If quoted market values are not available, financial statements for investments are analyzed for evidence of basic value. If the financial statements are unaudited, the evidence indicated by them is considered to be extremely weak.

Income amounts can be verified by consulting published dividend records for dividends actually declared and paid during a period (e.g., Moody's, and Standard & Poor's dividend records). Since auditors know the holding period of securities, dividend income can be calculated and compared with the amount in the account. Any difference could indicate a cutoff error, misclassification, defalcation, or failure to record a dividend receivable. Applying interest rates to bond or note investments produces a calculated interest income figure (making allowance for amortization of premium or discount, if applicable).

Equity Method Investments

When equity method accounting is used for investments, auditors need the audited financial statements of the investee company. Inability to obtain these from a closely held investee may indicate that the auditee investor does not have the significant influence over the investee company, which is required for use of equity method accounting. These statements are used in recalculating the auditee's share of income to recognize in the accounts and to audit the disclosure of investees' assets, liabilities, and income disclosed in notes (a disclosure recommended when investments accounted for by the equity method are material).

Depreciation and Amortization Recalculation Depreciation or amortization expense owes its existence to a calculation, and recalculation based on audited costs and rates is sufficient audit evidence. The term "depreciation" is commonly used when reference is to amortization of tangible (fixed) assets.

The appraisals, judgments, and allocations within merger and acquisition transactions that are used to assign portions of the purchase price to tangible assets, intangible assets, liabilities, and goodwill should be reviewed. Inspection of transaction documentation is ideal, but verbal enquiries may help auditors to understand the circumstances of a merger.

Questions about lawsuits challenging patents, copyrights, or trade names may indicate problem areas for further investigation. Likewise, questions about research and development successes and failures may alert the audit team to problems of valuation of intangible assets and related amortization expense. Responses to questions about licensing of patents can be used in the audit of related royalty revenue accounts.

Enquiries about Management Intentions Enquiries should deal with the nature of investments and the reasons for holding them. Management's expressed intention that a marketable security investment be considered a long-term investment may be the only evidence for classifying it as long-term and not as a current asset. That classification will affect the accounting treatment of market values and the unrealized gains and losses on investments.

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REVIEW CHECKPOINTS

14-14 What are some of the typical assertions found in owners' equity descriptions and account balances?

14-15 How can confirmations be used in auditing shareholder capital accounts? auditing notes payable? loans and bonds payable?

14-16 What are some of the typical assertions found in long-term liability accounts?

14-17 What procedures do auditors employ to obtain evidence of the cost of investments? investment gains and losses? investment income?

14-18 Why are auditors interested in substantial investment losses occurring early in the period following year-end?

14-19 What is the concept of "substance versus form" in relation to financing and investment transactions and balances? (Refer to the off-balance-sheet and application cases in the chapter.)

14-20 What are some of the trouble spots for auditors in the audits of investments and intangibles?

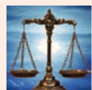
APPLICATION CASE WITH ANALYSIS

Detecting Misstatements in Finance and Investment Processes

INTRODUCTION

At the point in the chapter, we present an application case that contains specific examples of tests of controls and substantive audit procedures used to gather evidence in the finance and investment process. The case situation for each audit presented parallels the framework shown in Chapter 11's application case. Each case situation provides context for the auditing decisions, rather than presenting a list of detection procedures in the abstract. If you would like to review lists of detailed procedures, a selection of control tests and detail substantive procedures for cash and accounts receivable is found in Exhibits 11C–1 and 11C–2 of Appendix 11C.

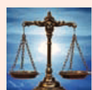
DISCUSSION CASE



While preparing to audit the investments and financing process of one of the firm's larger clients, Jack does some research work to become more knowledgeable about the risks in these areas. He finds news stories about four audits where misstatements occurred. These cases involved improper issue of securities, misstatement of tax loss carryforwards, misuse of related-party transactions to keep liabilities off the balance sheet, and an example of non-consolidation of a controlled company to conceal losses.

AUDIT 14.1 Unregistered Sale of Securities

CASE DESCRIPTION



The Bliss Solar Heating Company (Bliss) sold investment contracts to the public in the form of limited partnership interests. These "securities" sales should have been under a public registration filing with the provincial securities regulator, but they were not. Under the terms of the deal, these investors purchased solar hot water heating systems for residential and commercial use from Bliss and then entered into arrangements to lease the equipment to Nationwide Corporation, which, in turn, rented the equipment to end users. The limited partnerships were, in effect, financing conduits for obtaining investors' money to pay for Bliss's equipment. The investors' return of capital and profit depended on Nationwide's business success and ability to pay under the lease terms. The amounts involved are not known, but all the money put up by the limited partnership investors was at risk and largely not disclosed to the investors.

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Audit Trail

Bliss published false and misleading financial statements, which used a non-GAAP revenue recognition method and failed to disclose cost of goods sold. Bliss overstated Nationwide's record of equipment installation and failed to disclose that Nationwide had little cash flow from end users (resulting from rent-free periods and other inducements). Bliss knew, but failed to disclose to prospective investors, that a number of previous investors had filed petitions with the federal tax court to contest Canada Revenue Agency's disallowance of the tax credits and benefits claimed in connection with their investments in Bliss's tax-sheltered equipment lease partnerships.

AUDIT APPROACH ANALYSIS

Audit Objective

The auditor's objective is to obtain evidence determining whether capital fundraising methods comply with provincial securities laws and whether financial statements and other disclosures are misleading.

Controls Relevant to the Process

Management should employ experts—lawyers, underwriters, and accountants—who can determine whether securities and investment contract sales require registration.

AUDIT PROCEDURES

Tests of Controls

Auditors should learn about the business backgrounds and securities-industry expertise of the senior managers. Study the authorization of the fundraising method in the minutes of the board of directors meetings. Obtain and study opinions of lawyers and underwriters about the legality of the fundraising methods. Enquire about management's interaction with the provincial securities regulator in any presale clearance. (The securities regulator will give advice about the necessity for registration.)

Tests of Details of Balance

Auditors should study the offering documents and literature used in the sale of securities to determine whether financial information is being used properly. In this case, the close relationship with Nationwide and the experience of earlier partnerships give reasons for extended procedures to obtain evidence about the representations concerning Nationwide's business success (in this case, lack of success).

AUDIT RESULTS

The auditors gave unqualified reports on Bliss's materially misstated financial statements. They apparently did not question the legality of the sales of the limited partnership interests as a means of raising capital, nor did they perform procedures to verify representations made concerning Bliss or Nationwide finances. Two partners in the audit firm were enjoined for violations of the securities laws. They resigned from practice before the provincial securities regulator and were ordered not to perform any assurance services for companies making filings with the securities regulator. They later were expelled from the Institute of Chartered Accountants of Ontario (ICAO) for failure to cooperate with the disciplinary committee in its investigation of alleged professional ethics violations.

AUDIT 14.2 Tax Loss Carryforwards

CASE DESCRIPTION

Aetna Life & Casualty Insurance Company had losses in its taxable income operations in 2001 and 2002. Confident that future taxable income would absorb the losses, the company booked and reported a future income tax asset for the tax loss carryforward. The provincial securities regulator maintained that the company understated its tax expense and overstated its assets. Utilization of the loss carryforward was not "more likely than not to be realized," as required by *CICA Handbook,* paragraph 3465.24.

Aetna forecast several more years of taxable losses (aside from its nontaxable income from tax-exempt investments) followed by years of taxable income, which would eventually offset the losses and allow the company to utilize the benefit of the losses carried forward to offset against future taxable income. The company maintained there was no reasonable doubt that the forecasts would be achieved.

At first, the carryforward tax benefit was $25 million, soon growing to over $200 million, then forecast to become an estimated $1 billion before the losses would be reversed and absorbed by the forecast future taxable income. In 2003, the first full year in which these forecasts had an impact, Aetna's net income was 35% lower than it had been in 2001, instead of just 6% lower, as a result of the carryforward benefit recognized.

Audit Trail

The amounts of tax loss were clearly evident in the accounts and Aetna made no attempt to hide the facts. The portfolio of taxable investments and all sources of taxable income and deductions were well known to the company accountants, management, and independent auditors.

AUDIT APPROACH ANALYSIS

Audit Objective

The auditor's objective is to obtain evidence determining whether realization of the benefits of the tax loss carryforward are "more likely than not to be realized."

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Controls Relevant to the Process

The relevant control in this case concerns the assumptions and mathematics underlying the forecasts that justify recording the tax loss carryforward benefit. These forecasts are the basis for an accounting estimate of "more likely than not."

AUDIT PROCEDURES

Tests of Controls

Auditors should make enquiries and determine the following. Who prepared the forecasts? When were they prepared? What data were used? Who reviewed and approved the forecast? Is there any way to test the accuracy of the forecast with actual experience?

Tests of Details of Balance

Aside from audit of the assumptions underlying the forecasts and recalculations of the compilation, the test of balances amounted to careful consideration of whether the forecast, or any forecast, could meet the test required by accounting standards. The decision was a judgment of whether the test of "more likely than not to be realized" was met.

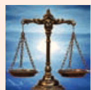
The auditors should obtain information about other situations in which recognition of tax loss carryforward benefits were allowed in financial statements. Other companies have booked and reported such benefits when gains from sales of property were realized before the financial statement was issued and when the loss was from discontinuing a business line, leaving these businesses with long profit histories.

AUDIT RESULTS

The provincial securities regulator was tipped off to Aetna's accounting recognition of the tax loss carryforward benefit by a story in *Financial Post* magazine, which described the accounting treatment. Aetna's defence was based on the forecasts. The securities regulator countered that the forecasts did not provide assurance beyond any reasonable doubt that future taxable income would be (1) sufficient to offset the loss carryforward and (2) earned during the prescribed carryforward period, as prescribed by paragraph 3465.28 of the *CICA Handbook*. For this reason, the securities regulator concluded that the "virtually certain realization" was not established. The securities regulator won the argument. Aetna revised its previously issued quarterly financial statements, and the company abandoned the attempt to report the tax benefit.

AUDIT 14.3 Off-Balance-Sheet Inventory Financing

CASE DESCRIPTION



Verity Distillery Company used the "product repurchase" ploy to convert its inventory to cash, failing to disclose the obligation to repurchase it later. Related-party transactions were not disclosed. To do this, Verity's president formed Veritas Corporation, making himself and two other Verity officers the sole shareholders. The president arranged to sell $40 million of Verity's inventory of whiskey, still in the aging process, to Veritas, showing no gain or loss on the transaction. The officers negotiated a 36-month loan with a major bank to get the money Veritas needed for the purchase, pledging the inventory as collateral. Verity pledged to repurchase the inventory for $54.4 million, which amounted to the original $40 million plus 12% interest for three years.

The $40 million purchased 40% of Verity's normal inventory, and the company's cash balance was increased by 50%. While the current asset total was not changed, the inventory ratios (e.g., inventory turnover, day's sales in inventory) were materially altered. Long-term liabilities were understated by not recording the liability. The ploy was actually a secured loan with inventory pledged as collateral, but this reality was neither recorded nor disclosed. The total effect would be to keep debt off the books, avoid recording interest expense, and record inventory later at a higher cost. Subsequent sale of the whiskey at market prices would not affect the ultimate income results, but the unrecorded interest expense would be buried in the cost of goods sold. The net income in the year the "sale" was made was not changed, but the normal relationship of gross margin to sales was distorted by the zero-profit transaction.

Audit Trail

The contract of sale was in the files, specifying the name of the purchasing company, the $40 million amount, and the cash consideration. Nothing mentioned the relationship between Veritas and the officers. Nothing mentioned the repurchase obligation. However, the sale amount was unusually large.

AUDIT APPROACH ANALYSIS

Audit Objective

The auditors' objective is to obtain evidence determining whether all liabilities are recorded. Be alert to undisclosed related-party transactions.

Controls Relevant to the Process

The relevant control in this case would rest with the integrity and accounting knowledge of the senior officials who arranged the transaction. Authorization in the board minutes might detail the arrangements, but, if they wanted to hide it from the auditors, they also would suppress the telltale information in the board minutes.

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	BEFORE TRANSACTION	RECORDED TRANSACTION	SHOULD HAVE RECORDED
Assets	$530	$530	$570
Liabilities	390	390	430
Shareholder Equity	140	140	140
Debt/Equity ratio	2.79	2.79	3.07

AUDIT PROCEDURES

Tests of Controls

Enquiries should be made about large and unusual financing transactions, although this may not elicit a response because the event is a sales transaction, according to Verity. Other audit work on controls in the revenues, receivables, and receipts process may turn up the large sale. Fortunately, this one stands out.

Tests of Details of Balance

Analytical procedures to compare monthly or seasonal sales probably will identify the sale as large and unusual, which should lead to an examination of the sales contract. Auditors should discuss the business purpose of the transaction with knowledgeable officials. If being this close to discovery does not bring out an admission of the loan and repurchase arrangement, the auditors nevertheless should investigate further. Even if the "customer" name is not a giveaway, a quick enquiry for corporation records at the relevant provincial ministry (online in some databases) will show the names of the officers, exposing the nature of the deal. Veritas's financial statements should be requested.

AUDIT RESULTS

The auditors found the related-party relationship between the officers and Veritas. Confronted, the president admitted the attempt to make the cash position and the debt-equity ratio look better than it was. The financial statements were adjusted to reflect the "should have recorded" set of figures shown previously.

AUDIT 14.4 A Consolidation by Any Other Name

CASE DESCRIPTION

Digilog Inc. formed a company named DBS International (DBSI) and controlled it but did not consolidate its financial position and results of operations in the Digilog financial statements. Digilog income was overstated, and assets and liabilities were understated.

Digilog formed DBSI to market Digilog's computer equipment but kept it separate to avoid the adverse impact of reporting expected startup losses in Digilog's financial statements. Instead of owning shares in DBSI, Digilog financed the company with loans convertible at will into 90% of DBSI's stock. (Otherwise, the share ownership was not in Digilog's name.) Since Digilog did not control DBSI (control is defined as 50% or more ownership), DBSI was not consolidated, and the initial losses were not reported in Digilog's financial statements. (See *CICA Handbook* paragraph 1590.08 for the usual presumptions concerning the level of ownership leading to control.) Several hundred thousand dollars of losses in the first two years of DBSI operations were not consolidated. Ultimately, the venture became profitable and was absorbed into Digilog.

Audit Trail

DBSI's formation was not a secret. It was authorized and the incorporation papers were available. Loan documents showing the terms of Digilog's loans to DBSI were in the files.

AUDIT APPROACH ANALYSIS

Audit Objective

The auditor's objective is to obtain evidence determining whether proper accounting methods (cost, equity, and consolidation) were used for investments.

Controls Relevant to the Process

The relevant control in this case would rest with the integrity and accounting knowledge of the senior officials who arranged the transaction. Proper documentation of authorization as well as financing and operating transactions between the two corporations should be in the companies' files.

AUDIT PROCEDURES

Tests of Controls

Enquiries should be made about large and unusual financing transactions. Minutes of the board of directors meetings should be studied to find related authorizations. These authorizations and supporting papers signal the accounting issues and interpretations of GAAP required in the circumstances.

Tests of Details of Balance

The central issue in this case is the interpretation of accounting standards regarding required consolidation. Existence, completeness, valuation, and ownership were not problematic audit issues. Unless these are extenuating factors as per *CICA Handbook* paragraph 1590.08, accounting standards requires consolidation of subsidiaries over 50% owned, and prohibits consolidation of subsidiaries less than 50% owned. Digilog's purpose in financing DBSI with loans instead of direct share ownership was to skirt the 50% ownership criterion, thus keeping the DBSI losses out of the Digilog consolidated financial statements. The "test of the balance" (decision of whether to require consolidation) amounted to an interpretation of the substance versus form of ownership through convertible notes instead of direct shareholding.

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AUDIT RESULTS

Digilog, with concurrence of its independent audit firm, adopted the narrow interpretation of ownership. Since Digilog did not "own" DBSI stock, DBSI was not "controlled," and its assets, liabilities, and results of operations were not consolidated. The regulator disagreed and acted on the position that the convertible feature of the loans and the business purpose of the DBSI formation were enough to attribute control to Digilog. The company was enjoined from activities resulting in violations of certain reporting and anti-fraud provisions of the *Provincial securities Act* and was required to amend its financial statements for the years in question. The regulator also took action against the audit firm partner in charge of the Digilog audit.

OTHER ASPECTS OF CLEVER ACCOUNTING AND FRAUD

LO4 Describe the most common fraud problems in the finance and investment process.

Clever accounting and fraud that affect the fair presentation of material equity accounts, investments, and intangibles must be considered. Improper accounting presentations are engineered more frequently by senior officials than by middle management or those of lower ranks. Top management personnel who deal with the transactions involved in investments, long-term debt, and shareholders' equity are not subject to the kind of control that lower-level employees experience, and they often are able to override detail procedural controls.

Long-Term Liabilities and Owners' Equity

The clever accounting and fraud connected with liability and owners' equity accounts differ significantly from those associated with asset and revenue accounts. Few employees are tempted to steal a liability, although fictitious liabilities may be created as a means of misdirecting cash payments into the hands of an officer. Auditors should be alert for such fictions in the same sense that they are alert to the possibility of having fictitious accounts receivable. The area of liabilities and owners' equity also contains possibilities for company fraud against outsiders. This class of fraud is most often accomplished through material misrepresentations or omissions in financial statements and related disclosures.

Officers and employees can use share or bond instruments improperly. Unissued shares or bonds and treasury stock may be used as collateral for personal loans. Even though the company may not be damaged or suffer loss by this action (unless the employee defaults and the securities are seized), the practice is unauthorized and is contrary to company interests. Employees could gain access to shareholder lists and unissued coupons, using them for improper payments of dividends and interest on securities that are not outstanding.

Proper custodial control of securities (either by limited access vaults or an independent disbursing agent) prevents most such occurrences. Reconciling authorized dividend and interest payments to actual payments detects unauthorized payments. If the company did not perform this checking procedure, auditors should include it in their own analytical recalculation procedures. Many liability, equity, and off-balance-sheet transactions are outside the reach of normal internal control procedures, which can operate effectively over ordinary transactions (such as purchases and sales) processed by clerks and machines. Auditors are justified in performing extensive substantive auditing of long-term liability, equity, and other high-level managed transactions and agreements as control depends in large part on the integrity and accounting knowledge of management.

Income tax evasion and fraud result from actions of managers. Evasion and fraud may be accomplished by (1) simple omission of income, (2) unlawful deductions (such as contributions to political campaigns, capital cost allowance on nonexistent assets, or capital cost allowance in excess of cost), or (3) sham transactions for the sole purpose of avoiding taxation. Auditors should be able to detect errors of the first two categories if the actual income and expense data have been sufficiently audited in the financial statements. The

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last category, **contrived sham transactions**, is harder to detect because a dishonest management can skilfully disguise them. Some of the fraud awareness procedures outlined in Chapter 21 (available on Connect) may be useful and effective.

contrived sham transactions: fictitious transactions created for illegal purposes, such as evading taxes

Financial statements may be materially misstated through omission or understatement of liabilities and by failure to disclose technical defaults on loan agreement restrictions. These restrictions or debt covenants are very important to the viability of the client because, if they are violated, creditors can force the client into bankruptcy. Auditor knowledge of these restrictions and comparison with the client's current financial condition pinpoints audit risk areas and helps assess the going concern assumption. The procedures for search for unrecorded liabilities may be used to discover such omissions and understatements (Chapter 12). If auditors discover that loan agreement terms have been violated, they should bring the information to the client's attention and insist on proper disclosure in notes to the financial statements. In both situations (liability understatement and loan default disclosure), management's actions, reactions, and willingness to adjust the financial figures and to make adverse disclosures are important insights for auditors' evaluation of managerial integrity, something that has an important bearing on the auditors' perceptions of risk for the audit engagement as a whole.

Misstatements in the financial statements can arise from error or fraud. According to CAS 240, the term "error" refers to an *unintentional* misstatement in financial statements, including the omission of an amount or a disclosure, or an incorrect accounting estimate arising from oversight or misinterpretation of facts. The term "fraud" refers to an *intentional* act by one or more individuals to misstate the financial statements to deceive users and obtain an unjust or illegal advantage. Although fraud is a broad legal concept, the auditor is only concerned with fraud that causes a material misstatement in the financial statements. Auditors do not make legal determinations of fraud.

Intent is difficult to prove, but if the auditor identifies a possible bias on the part of management in making accounting estimates, the auditor should consider whether there is a risk of material misstatement due to fraud.[4] For example, is it possible that the cumulative effect of bias in management's accounting estimates is designed to smooth earnings over two or more accounting periods, or to achieve designated earnings level to deceive financial statement users? The audit needs to be performed with professional skepticism, meaning the auditor (a) should be aware of factors that increase the risk of misstatement, and (b) should be sensitized to evidence that contradicts the assumption of management's good faith.

If there are enough red flags present, the auditor will assess a higher inherent risk resulting in the following actions:

(a) Obtain more reliable evidence.
(b) Expand the extent of audit procedures performed.
(c) Apply audit procedures closer to or as of the balance sheet date.
(d) Require more extensive supervision of assistants, and/or assistants with more experience and training.

In essence, if the auditor suspects that the financial statements are misstated, he should perform procedures to confirm or dispel that suspicion. Generally, however, the auditor is less likely to detect material misstatements arising from fraud because of the deliberate concealment involved. When the auditor does obtain evidence of a nontrivial misstatement or fraud, he or she should inform the appropriate level of management, and the audit committee or board of directors should be informed.[5]

A company, its individual managers, and the auditors easily might violate securities regulations. Chapter 2 covers the general framework of regulation by provincial securities

4 *CICA Handbook*, paragraph 5135.081.
5 *CICA Handbook*, section 5135.

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commissions. Auditors must know the provisions of the securities laws so that they can identify both situations that constitute obvious fraud and transactions that may be subject to the law. Having recognized or raised questions about a securities transaction, auditors should submit the facts to competent legal counsel for an opinion. Auditors are not expected to be legal experts, but they have the duty to recognize obvious instances of impropriety and to pursue investigations with the aid of legal experts.

Similarly, auditors should assist clients in observing securities commission rules and regulations on matters of timely disclosure. Timely disclosure rules are phrased as management's duties, and auditors are not required to carry out any specific procedures or to make any specific disclosures. The regulations require management to disseminate any material information, favourable or unfavourable, so that investors can incorporate it in their decision making. Announcements and disclosures must be made very soon after information becomes known. If situations arise during the year when the independent auditors are not present, they cannot be held responsible or liable. However, auditors may learn of the information inadvertently or the client may come to the auditor for advice. In such cases, auditors should advise their clients according to the requirements of law and regulations.

Auditors are currently pressured to discover more information about off-balance-sheet contingencies and commitments and to discover the facts of management involvement with other parties to transactions. Auditors' knowledge of these things that are not in accounting records depends in large part on information the management and its legal counsel reveals. Nevertheless, certain investigative procedures are available (see Chapters 7; and 21 [available on Connect]). The expectation that auditors discover more information is a part of the public pressure on them to take more responsibility for fraud detection.

Investments and Intangibles

Theft, diversion, and unauthorized use of investment securities can occur in several ways. If safekeeping controls are weak, securities can simply be stolen, in which case it is a police problem rather than an auditing problem. Diversions, such as using securities as collateral during the year, returning them for a count, then giving them back to the creditor without disclosure to the auditor, are more common. If safekeeping methods require entry signatures (as for a safety deposit box), auditors may be able to detect the in-and-out movement. The best chance of discovery is creditor confirmation of the collateral arrangement. In a similar manner, securities may be removed by an officer and sold, then repurchased before the auditors' count. The auditors' record of the certificate numbers should reveal this change, since the returned certificates (and their serial numbers) will not be the same as the ones removed. The rapid growth in use of derivative securities as investments and hedges has created new and rather unique problems for auditors, not the least of which is lack of familiarity with these financial instruments. Appendix 14A provides an overview of the problems in this area.

Cash receipts from interest, royalties on patent licences, dividends, and sales proceeds may be stolen. The accounting records may or may not be manipulated to cover the theft. In general, this kind of defalcation should be prevented by cash receipts control; however, since these receipts usually are irregular and infrequent, the cash control system may not be as effective as it is for regular receipts on trade accounts. If the income accounts are not manipulated to hide stolen receipts, auditors will find less income in the account than their audit calculations based on other records tell them should be there. If sales of securities are not recorded, auditors will notice that securities are missing when they try to inspect or confirm them. If the income accounts have been manipulated to hide stolen receipts, vouching of cash receipts will detect the theft, or vouching may reveal some offsetting debit buried in some other account.

Accounting values may be manipulated in a number of ways: purchases of assets at inflated prices, leases with affiliates, acquisitions of patents for shares given to an inventor or promoter, sales to affiliates, and fallacious decisions about amortization. Business history

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has recorded several cases of non-arm's-length transactions with promoters, officers, directors, and controlled companies (even "dummy" companies) designed to drain the company's resources and fool the auditors.

In one case, a company sold assets to a dummy purchaser set up by a director to bolster sagging income. The auditors did not know that the purchaser was a shell. All the documents of sale looked to be in order, and cash sales proceeds had been deposited. The auditors were not informed of a secret agreement by the seller to repurchase the assets at a later time. This situation illustrates a devious manipulation. All transactions with persons closely associated with the company (related parties) should be audited carefully with reference to market values, particularly when a nonmonetary transaction is involved (such as shares exchanged for patent rights). Sales and lease-back and straight lease transactions with insiders likewise should be audited carefully.

REVIEW CHECKPOINTS

14-21 What is the single most significant control consideration in connection with clever accounting and fraud in finance and investment accounts?

14-22 Which is more likely to exist in the finance and investment cycle accounts: (1) fraud against the company or (2) fraud by the company in financial or tax reporting? Explain.

14-23 What should an auditor do when violation of securities laws is suspected?

14-24 What is the danger for auditors when company officials engage in undisclosed related-party transactions?

SUMMARY

- The finance and investment process contains a wide variety of accounts—share capital, dividends, long-term debt, interest expense, tax expenses and future income taxes, financial instruments, derivatives, equity method investments, related gains and losses, consolidated subsidiaries, goodwill, and other intangibles. These accounts involve some of the most technically complex accounting standards. They create most of the difficult judgments for financial reporting.
- Transactions in these accounts generally are controlled by senior officials. Therefore, internal control is centred on the integrity and accounting knowledge of these officials. The procedural controls over details of transactions are not very effective because senior managers can override them and order their own desired accounting presentations. As a consequence, auditors' work on the assessment of control risk is directed toward the senior managers, the board of directors and their authorizations, and the design of finance and investment deals.
- Substantive programs are developed by linking the auditor's risk assessments to the risks of material misstatements in the financing and investing transactions. The chapter provided examples of typical substantive procedures that would be considered, depending on the risks assessed in each particular case.
- Fraud and clever accounting in the finance and investment cycle get directed most often to producing misleading financial statements. While theft and embezzlement can occur, the accounts in this cycle frequently have been the ones manipulated and misvalued so that financial positions and results of operations look better than the company's reality. Off-balance-sheet financing and investment transactions with related parties are explained as areas easily targeted for fraudulent financial reporting.

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Analysis of Financial Statement Relationships

The audit of the finance and investment process verifies that there is not a material misstatement in the balance of long-term investments and liabilities (financial instruments) and share capital or in the transaction streams that are related to them, dividends and interest. As an example, the continuity of the share capital account is shown below.

AUDITED AMOUNT	FINANCIAL STATEMENT WHERE AMOUNT IS REPORTED
Opening balance of share capital	Balance sheet (prior year comparative figures)
Add:	
Proceeds of shares issued during the year	Statement of Shareholders' Equity and Cash flow statement (financing activity)
Deduct:	
Reductions for shares redeemed during the year	Statement of Shareholders' Equity and Cash flow statement (financing activity)
Ending balance of share capital	Balance sheet (current year figures)

Misstatement Analysis

As an example of a type of misstatement that might be discovered in the finance and investment process, consider a situation where the auditor discovers the auditee has obtained new long-term debt during the year with a total balance of $250,000. Inspection of the loan contract reveals that $50,000 of the total is due for repayment during the following year, but the accountant has failed to set that amount out in the current liabilities section of the balance sheet in preparing the financial statements. This is a misclassification type of misstatement that affects two amounts within the balance sheet, such that it has no income impact. But is has a significant impact on current liabilities, the current ratio, and other information that may have an impact on users, so it should be accumulated as a misstatement for overall analysis at the end of the audit. (See Exhibit 16–1.)

This chapter ends the book's coverage of audit applications for various processes and their related accounts. Chapters 15 and 16 contain several topics involved in putting the finishing touches on an audit.

KEY TERMS

articles of incorporation
contrived sham transactions
debt instruments
off the balance sheet

EXERCISES AND PROBLEMS

EP 14-1 **ICQ for Equity Investments.** LO1, LO2 Cassandra Corporation, a manufacturing company, periodically invests large sums in marketable equity securities. The investment policy is established by the investment committee of the board of directors. The treasurer is responsible for carrying out the committee's directives. All securities are held by Cassandra's brokerage company.

Your ICQ with respect to Cassandra's investments in equity securities contains the following three questions:

1. Is investment policy established by the investment committee of the board of directors?
2. Is the treasurer solely responsible for carrying out the investment committee's directive?
3. Are all securities stored in a bank safety deposit box?

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Required:

a. What is the purpose of the above three questions?

b. What additional questions should your ICQ include concerning the company's investment in marketable equity securities? (*Hint:* Prepare questions to cover the control objectives—validity, completeness, authorization, accuracy, classification, accounting, and proper period.)

(AICPA adapted)

EP 14-2 Long-Term Investment Securities. LO3 You are auditing the financial statements of Bass Corporation for the year ended December 31, and you are about to begin an audit of the noncurrent investment securities. Bass's records indicate that the company owns various bearer bonds, as well as 25% of the outstanding common shares of Commercial Industrial Inc. You are satisfied with evidence supporting the presumption of significant influence over Commercial. The various securities are at two locations as follows:

a. Recently acquired securities are in the company's safe in the custody of the treasurer.

b. All other securities are in a bank safety deposit box. All securities in Bass's portfolio are actively traded in a broad market.

Required:

a. Assuming that the system of internal control over securities is satisfactory, what are the objectives (specific assertions) for the audit of the noncurrent securities?

b. What audit procedures should you undertake with respect to the audit of Bass's investment securities?

(AICPA adapted)

EP 14-3 Securities Examination and Count. LO3 You are in charge of the audit of the financial statements of the Demot Corporation for the year ended December 31. The corporation has had the policy of investing its surplus funds in marketable securities. Its share and bond certificates are kept in a safety deposit box in a local bank. Only the president and the treasurer of the corporation have access to the box.

You were unable to obtain access to the safety deposit box on December 31 because neither the president nor the treasurer was available. Your assistant will accompany the treasurer to the bank on January 11 to examine the securities but he has never examined securities that were being kept in a safety deposit box and requires instructions. The inspection should only take an hour.

Required:

a. List the instructions you would give for examining the share and bond certificates in the safety deposit box. Include the details of the securities to be examined and the reasons for examining these details.

b. Your assistant reports that the treasurer had entered the box on January 4 to remove an old photograph of the corporation's original building. The photograph was lent to the local chamber of commerce. List the additional audit procedures required because of the treasurer's action.

(AICPA adapted)

EP 14-4 Securities Procedures. LO3 You were engaged to examine the financial statements of Ronlyn Corporation for the year ended June 30. On May 1, the corporation borrowed $500,000 from the Second National Bank to finance plant expansion. However, because of unexpected difficulties in acquiring the building site, the expansion had not begun as planned. To make use of the borrowed funds, management decided to invest in shares and bonds; on May 16 the $500,000 was invested in securities.

Required:

In your audit of investments, how would you:

a. Audit the recorded dividend or interest income?

b. Determine market value?

c. Establish the authority for security purchases?

(AICPA adapted)

EP 14-5 Research and Development. LO3 The Hertle Engineering Company depends on new product development to maintain its position in the market for drilling tool equipment. The company conducts an extensive research and development program, and has charged all research and development costs to current operations in accordance with *CICA Handbook* requirements.

The company began a project called Project Able in January 20X1 with the goal of patenting a revolutionary drilling bit design. Work continued until October 20X2, when the company applied for a patent. Costs were charged to the research and development expense account in both years, except for the cost of a computer program that engineers plan to use in Project Baker, scheduled to start in December 20X2. The computer program was purchased from Computeering Inc. in January 20X1 for $45,000.

Required:

a. Give an audit program for the audit of research and development costs on Project Able. Assume that you are auditing the company for the first time at December 31, 20X2.

b. What evidence would you require for the audit of the computer program that has been capitalized as an intangible asset? As of December 31, 20X2, this account has a balance of $40,000 (cost less $5,000 amortized as a part of Project Able).

(AICPA adapted)

EP 14-6 Intangibles. LO1, LO2 Sorenson Manufacturing was incorporated on January 3, 20X1. The corporation's financial statements for its first year's operations were not examined by a PA. You have been engaged to audit the financial statements for the year ended December 31, 20X2, and your examination is substantially completed.

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A partial trial balance of the company's accounts is given in Exhibit EP14-6:

EXHIBIT EP14-6 Sorenson Manufacturing Corporation Partial Trial Balance at December 31, 20X2

	TRIAL BALANCE	
	DEBIT	CREDIT
Cash	$11,000	
Accounts receivable	42,500	
Allowance for doubtful accounts		$ 500
Inventories	38,500	
Machinery	75,000	
Equipment	29,000	
Accumulated amortization		10,000
Patents	85,000	
Leasehold improvements	26,000	
Prepaid expenses	10,500	
Goodwill	24,000	

The following information relates to accounts which may yet require adjustment:

1. Patents for Sorenson's manufacturing process were purchased January 2, 20X2, at a cost of $68,000. An additional $17,000 was spent in December 20X2 to improve machinery covered by the patents and charged to the patents account. The patents had a remaining legal term of 17 years.
2. The balance in the goodwill account includes $24,000 paid December 30, 20X1, for an advertising program estimated to increase Sorenson's sales over a period of four years following the disbursement.
3. The leasehold improvement account includes (*a*) the $15,000 cost of improvements, with a total estimated useful life of 12 years, which Sorenson, as tenant, made to leased premises in January 20X1; (*b*) movable assembly line equipment costing $8500, which was installed in the leased premises in December 20X2; and (*c*) real estate taxes of $2500 paid by Sorenson which, under the terms of the lease, should have been paid by the landlord. Sorenson paid its rent in full during 20X2. A 10-year nonrenewable lease was signed January 3, 20X1, for the leased building that Sorenson used in manufacturing operations. No amortization of the leasehold improvements has been recorded.

Required:

Prepare adjusting entries as necessary.

(AICPA adapted)

EP 14-7 Long-Term Note. LO3 You were engaged to examine the financial statements of Ronlyn Corporation for the year ended June 30. On May 1 the corporation borrowed $500,000 from the Second National Bank to finance plant expansion. The long-term note agreement provided for the annual payment of principal and interest over five years. The existing plant was pledged as security for the loan.

Due to unexpected difficulties in acquiring the building site, the plant expansion had not begun as planned. To make use of the borrowed funds, on May 16, management invested the $500,000 in securities.

Required:

a. What are the audit objectives in the examining of long-term debt?

b. Prepare an audit program for the examination of the long-term note agreement between Ronlyn and Second National Bank.

(AICPA adapted)

EP 14-8 Long-Term Financing Agreement. LO3 You have been engaged to audit the financial statements of Broadwall Corporation for the year ended December 31, 20X2. During the year, Broadwall obtained a long-term loan from a local bank pursuant to the following financing agreement:

1. Loan was to be secured by the company's inventory and accounts receivable.
2. Company was to maintain a debt-to-equity ratio not to exceed 2:1.
3. Company was not to pay dividends without permission from the bank.
4. Monthly instalment payments were to commence July 1, 20X2.

In addition, the company also borrowed, on a short-term basis, substantial amounts from the president of the company just prior to the year-end.

Required:

a. For the purposes of your audit of the financial statements of Broadwall Corporation, what procedures should you employ in examining the described loans? Do not discuss internal control.

b. What financial statement disclosures should you expect to find with respect to the loan from the president?

EP 14-9 Bond Indenture Covenants. LO3 The following covenants are extracted from the indenture of a bond issue. Failure to comply with its terms in any respect automatically advances the due date of the loan to the date of noncompliance (the regular date is 20 years hence).

Required:

Give any audit steps or reporting requirements you believe should be taken or recognized in connection with each of the following from the indenture:

1. The debtor company shall endeavour to maintain a working capital ratio of 2:1 at all times, and, in any fiscal year following a failure to maintain said ratio, the company shall restrict compensation of officers to a total of $500,000. Officers for this purpose shall include chairman of the board of directors, president, all vice presidents, secretary, and treasurer.

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2. The debtor company shall keep all property which is security for this debt insured against loss by fire to the extent of 100% of its actual value. Policies of insurance comprising this protection shall be filed with the trustee.
3. The debtor company shall pay all taxes legally assessed against property that is security for this debt within the time provided by law for payment without penalty, and shall deposit receipted tax bills or equally acceptable evidence of payment of same with the trustee.
4. A sinking fund shall be deposited with the trustee by semiannual payments of $300,000, from which the trustee shall, at his discretion, purchase bonds of this issue.

(AICPA adapted)

EP 14-10 Shareholders' Equity. LO1, LO3 You are a PA examining the financial statements of Pate Corporation for the year ended December 31. The financial statements and records of Pate Corporation have not been audited by a PA in prior years.

The shareholders' equity section of the balance sheet at December 31 follows:

Shareholders' equity:	
Share capital—10,000 no par value shares authorized; 5000 shares issued and outstanding	$ 50,000
Contributed capital	32,580
Retained earnings	47,320
Total shareholders' equity	$129,900

Pate Corporation was founded in 1992. The corporation has 10 shareholders and serves as its own registrar and transfer agent. There are no capital share subscription contracts in effect.

Required:

a. Prepare the detailed audit program for the examination of the three accounts of the shareholders' equity section of the balance sheet. Organize the audit program under broad financial statement assertions. (Do not include in the audit program the audit of the results of the current year's operations.)

b. After every other figure on the balance sheet has been audited, it may appear that the retained earnings figure is a balancing figure and requires no further audit work. Why don't auditors audit retained earnings as they do the other figures on the balance sheet? Discuss.

(AICPA adapted)

DISCUSSION CASES

DC 14-1 Intercompany and Interpersonal Investment Relations. LO3 You have been engaged to audit the financial statements of Hardy Hardware Distributors Inc., as of December 31. In your review of the corporate nonfinancial records, you have found that Hardy Hardware owns 15% of the outstanding voting common shares of Hardy Products Corporation. Upon further investigation, you learn that Hardy Products Corporation manufactures a line of hardware goods, 90% of which are sold to Hardy Hardware.

Mr. James L. Hardy, president of Hardy Hardware, has supplied you with objective evidence that he personally owns 30% of the Hardy Products voting shares and that the remaining 70% is owned by Mr. John L. Hardy, his brother and president of Hardy Products. James L. Hardy also owns 20% of the voting common shares of Hardy Hardware Distributors. Another 20% is held by an estate of which James and John are beneficiaries, and the remaining 60% is publicly held.

Hardy Hardware consistently has reported operating profits greater than the industry average. Hardy Products Corporation, however, has a net return on sales of only 1%. The Hardy Products investment always has been reported at cost, and no dividends have been paid by the company. During the course of your conversations with the Hardy brothers, you learn that you were appointed as auditor because the brothers had a heated disagreement with the former auditor over the issues of accounting for the Hardy Products investment and the prices at which goods have been sold to Hardy Hardware.

Required:

a. Identify the issues in this situation as they relate to (1) conflicts of interest and (2) controlling influences among individuals and corporations.

b. Should the investment in Hardy Products Corporation be accounted for on the equity method?

c. What evidence should the auditor seek with regard to the prices paid by Hardy Hardware for products purchased from Hardy Products Corporation?

d. What information would you consider necessary for adequate disclosure in the financial statements of Hardy Hardware Distributors?

Instructions for Discussion Cases DC14-2 and DC14-3

These cases are designed like the ones earlier in the chapter. They give the problem, the method, the

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audit trail, and the amount. Your assignment is to write the audit approach analysis portion of the case, organized around these sections:

Audit objectives: Express the objective in terms of the facts supposedly asserted in financial records, accounts, and statements. (Refer to discussion of assertions in Chapter 5.)

Control procedures relevant to the process: Write a brief explanation of control considerations, especially the kinds of manipulations that may arise from the situation described in the case.

Tests of controls: Write some procedures for getting evidence about existing controls, especially procedures that could discover management manipulations. If there are no controls to test, then there are no procedures to perform; go then to the next section. A "procedure" should instruct someone about the source(s) of evidence to tap and the work to do.

Tests of details of balance: Write some procedures for getting evidence about the existence, completeness, valuation, ownership, or disclosure assertions identified in your objective section above.

Audit results: Write a short statement about the discovery you expect to accomplish with your procedures.

DC 14-2 Related Party Transaction "Goodwill." LO3

Problem: Gulwest Industries, a public company, used a contrived amount of goodwill to overstate assets and disguise a loss on discontinued operations. The company had decided to discontinue its unprofitable line of business of manufacturing sporting ammunition. They had capitalized the startup cost of the business, and, with its discontinuance, the $7 million deferred cost should have been written off. Instead, Gulwest formed a new corporation named Amron and transferred the sporting ammunition assets (including the $7 million deferred cost) to it in exchange for all the Amron shares. In the Gulwest accounts, the Amron investment was carried at $12.4 million, which was the book value of the assets transferred (including the $7 million deferred cost).

In an agreement with a different public company (Big Industrial), Gulwest and Big created another company (BigShot Ammunition). Gulwest transferred all the Amron assets to BigShot in exchange for (1) common and preferred shares of Big, valued at $2 million, and (2) a note from BigShot in the amount of $3.4 million. Big Industrial thus acquired 100% of the shares of BigShot. Gulwest management reasoned that it had "given" Amron shares valued at $12.4 million to receive shares and notes valued at $5.4 million, so the difference must be goodwill. Thus, the Gulwest accounts carried amounts for Big Industrial shares ($2 million), BigShot note receivable ($3.4 million), and goodwill ($7 million).

Audit trail: Gulwest directors included in the minutes an analysis of the sporting ammunition business's lack of profitability. The minutes showed approval of a plan to dispose of the business, but they did not use the words "discontinue the business." The minutes also showed approval of the creation of Amron, the deal with Big Industrial along with the formation of BigShot, and the acceptance of Big's shares and Bigshot's note in connection with the final exchange and merger.

Amount: As explained above, Gulwest avoided reporting a writeoff of $7 million by overstating the value of the assets given in exchange for the Big Industrial shares and the BigShot Ammunition note.

DC 14-3 Related Party Transaction Valuation. LO3 Follow the instructions preceding exercise, DC14-2. Write the audit approach section of this case.

In Plane View

Problem: Whiz Corporation overstated the value of shares given in exchange for an airplane and, thereby, understated its loss on disposition of the shares. Income was overstated. Whiz owned 160,000 Wing Company shares, carried on the books as an investment in the amount of $6,250,000. Whiz bought a used airplane from Wing, giving in exchange (1) $480,000 cash and (2) the 160,000 Wing shares. Even though the quoted market value of the Wing shares was $2,520,000, Whiz valued the airplane received at $3,750,000, indicating a share valuation of $3,270,000. Thus, Whiz recognized a loss on disposition of the Wing shares in the amount of $2,980,000.

Whiz justified the airplane valuation with another transaction. On the same day it was purchased, Whiz sold the airplane to the Mexican subsidiary of one of its subsidiary companies (two layers down; but Whiz owned 100% of the first subsidiary, which in turn owned 100% of the Mexican subsidiary). The Mexican subsidiary paid Whiz with US$25,000 cash and a promissory note for US$3,725,000 (market rate of interest).

Audit trail: The transaction was within the authority of the chief executive officer, and company policy did not require a separate approval by the board of directors. A contract of sale and correspondence with Wing detailing the terms of the transaction were in the files. Likewise, a contract of sale to the Mexican subsidiary, along with a copy of the deposit slip, and a memorandum of the promissory note were on file. The note itself was kept in the company vault. None of the Wing papers cited a specific price for the airplane.

Amount: Whiz overvalued the Wing shares and justified this with a related party transaction with its own subsidiary company. The loss on the disposition of the Wing shares was understated by $750,000.

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DC 14-4 Audit of Long-Term Debt. LO3 In Note 12 of its December 2001 consolidated financial statements, Bell Canada reported long-term debt outstanding totalling $9075 million. This amount is made up of 35 separate debentures, with maturity dates ranging from 2001 to 2054, in amounts ranging from $125 to $700 million, with interest rates ranging from 2.7% to 11.45%. The income statement for the year reports interest expense on this long-term debt of $725 million.[6]

Required:
List the assertions relating to Bell Canada's long-term debt and interest expense. Describe the audit procedures that you would perform to verify the debt and interest expense for 2001.

DC 14-5 Long-Term Debt Working Paper Review. The long-term debt working paper in Exhibit DC14-5 (see page 624) was prepared by client personnel and audited by AA, an audit staff assistant, during the calendar year 20X2 audit of Canadian Widgets Inc., a continuing audit client. You are the engagement supervisor, and your assignment is to review this working paper thoroughly.

Required:
Identify and prepare a list explaining the deficiencies that should be discovered in the supervisory review of the long-term debt working paper.

(AICPA adapted)

DC 14-6 Audit of Pension Expense. LO3 Clark, PA, has been engaged to perform the audit of Kent Ltd.'s financial statements for the current year. Clark is about to commence auditing Kent's employee pension expense. Her preliminary enquiries concerning Kent's pension plan lead her to believe that some of the actuarial computations and assumptions are so complex that they are beyond the competence ordinarily required of an auditor. Clark is considering engaging Lane, an actuary, to assist with this portion of the audit.

Required:

a. What are Clark's responsibilities with respect to the findings of Lane, if she wishes to rely on those findings?

b. Distinguish between the circumstances where it is and is not appropriate for Clark to refer to Lane in the auditor's report.

(CGA-Canada adapted)

DC 14-7 Board of Directors, Control Role. LO2 What is the role of the company's board of directors in controlling management's activities? Why is this particularly important in the financing and investing cycle? How does the board exercise this control, and how can the auditor evaluate the board's effectiveness?

DC 14-8 Derivative Instruments, Controls, and Audit Procedures. LO2, LO3 Barrick Gold, a Canadian public corporation, has operations in six main countries. Barrick produces and sells gold, its primary product, as well as byproducts such as silver and copper. These activities expose Barrick to a variety of market risks, such as changes in commodity prices, foreign-currency exchange rates, and interest rates. Barrick has a risk-management program that seeks to reduce the potentially adverse effects of volatility in these markets on its operating results. It uses derivative instruments to mitigate significant unanticipated earnings and cash flow fluctuations that may arise. These instruments include spot deferred sales contracts, options contracts, interest-rate swaps, and foreign-currency forward exchange contracts. Barrick's derivatives activities are subject to the management, direction, and control of its finance committee as part of its oversight of Barrick's investment activities and treasury function. The finance committee, comprising five members of Barrick's board of directors, including its CEO, approves corporate policy on risk-management objectives, provides guidance on derivative instrument use, reviews internal procedures relating to internal control and valuation of derivative instruments, monitors derivatives activities, and reports to the board. Implementation of these policies is delegated to Barrick's treasury function.[7]

Required:

a. Identify the control risks in Barrick's derivatives activities and the key controls indicated in the above description. Provide a brief description of specific control procedures that likely are used by Barrick's treasury function to implement the risk-management policies.

b. Describe audit procedures that could be used to test these controls and substantive tests for derivatives activities at Barrick.

DC 14-9 Audit of Finance Transactions: Internet Business. City Search Inc. (CSI) is a technology company providing local search engine services in the Greater Toronto Area (GTA). CSI combines online search capability with a print directory (City Pages) focusing specifically on GTA websites. Consumers use the search engine and print directory to locate local businesses. Businesses use the search engine and print directory to attract potential customers to their places of business through paid advertisements. CSI began operations in March 20X3 and launched its first sales campaign for print and online search advertisements in June 20X3. Since that time, over 600,000 copies of the City Pages have been distributed to businesses and residences.

The original financing to start CSI came from several wealthy investors who purchased common shares. Additional common shares were issued to the public in late 20X4. These shares initially sold

6 Bell Canada, 2001 Consolidated Financial Statements.

7 Barrick Gold Corporation, 2001 Consolidated Financial Statements.

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EXHIBIT DC14–5

CANADIAN WIDGETS, INC.
Working Papers December 31, 20X2

Index	K1	
	Initials	Date
Prepared by	AA	3/22/X2
Approved by		

Lender	Interest Rate	Payment Terms	Collateral	Balance 12/31/X1	20X2 Borrowings	20X2 Reductions	Balance 12/31/X2	Interest paid to	Accrued Interest Payable 12/31/X2	Comments
Φ First Commercial Bank	12%	Interest only on 25th of month, principal due in full 1/1/X6, no prepayment penalty	Inventories	$ 50,000 ✓	$300,000 A 1/31/X2	$100,000 ⊕ 6/30/X2	$ 250,000 CX	12/25/X2	$2,500 NR	Dividend of $80,000 paid 9/2/X2 (W/P N-3) violates a provision of the debt agreement, which thereby permits lender to demand immediate payment; lender has refused to waive this violation.
Φ Lender's Capital Corp.	Prime plus 1%	Interest only on last day of month, principal due in full 3/5/X4	2nd Mortgage on Park St. Building	100,000 ✓	50,000 A	—	200,000 C	12/31/02	—	Prime rate was 8% to 9% during the year.
Φ Gigantic Building & Loan Assoc.	12%	$5,000 principal plus interest due on 5th of month, due in full 12/31/X13	1st Mortgage on Park St. Building	720,00 ✓	—	60,000 ⊖	660,000 C	12/5/02	5,642 R	Reclassification entry for current portion proposed (See RJE-3)
Φ J. Lott, majority shareholder	0%	Due in full 12/13/X5	Unsecured	300,000 ✓	—	100,000 N	200,000 C	—	—	Borrowed additional $100,000 from J. Lott on 1/7/X3.
				$1,170,000 F	$350,000 F	$260,000 F	$1,310,000 T/B F		$8,142 T/B F	

Tick-mark legend

- F Readded, foots correctly.
- C Confirmed without exception, W/P K-2.
- CX Confirmed with exception, W/P K-3.
- NR Does not recompute correctly.
- A Agreed to loan agreement, validated bank deposit ticket, and board of directors authorization, W/P W-7.
- ⊖ Agreed to cancelled cheques and lender's monthly statements.
- N Agreed to cash disbursements journal and cancelled cheques dated 12/31/X2, clearing 1/8/X3.
- T/B Traced to working trial balance.
- ✓ Agreed to 12/31/X1 working papers.
- Φ Agreed interest rate, term, and collateral to copy of note and loan agreement.
- ⊕ Agreed to cancelled cheques and board of director's authorization, W/P W-7.

Interest costs for long-term debt

Interest expense for year	$ 281,333 T/B
Average loan balance outstanding	$1,406,667 R

Five year maturities (for disclosure purposes)

Year end		
	12/31/X3	$ 60,000
	12/31/X4	260,000
	12/31/X5	260,000
	12/31/X6	310,000
	12/31/X7	60,000
	Thereafter	360,000
		$1,310,000 F

Overall Conclusions

Long-term debt, accrued interest payable, and interest expense are correct and complete at 12/31/X2.

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for $2.40, but, during 20X5, the share price fell to less than $1.00. The decline in price is mainly because two of the original investors sold large blocks of shares for whatever they could get as the business was not proving to be as successful as they expected. In early 20X5, the CSI board of directors hired a new president, Bill Dorado, to aggressively promote the CSI directory as a superior directory for local shopping and entertainment searches, and to find innovative ways to increase revenues and CSI's share price.

Businesses that are clients of CSI pay an advertising fee for print and online directory listings that include the business name, address, phone number, type of products/services offered, and website link. CSI will also create a website for clients for a one-time fee that varies depending on the number of pages, links, and type of content the client wants. CSI clients also can purchase banner advertising that pops up when users browse through the online directory. Clients sign a contract for the ad frequency they require, and are billed monthly. Clients can also purchase additional advertising features, such as moving graphics, audio, and a special patented "bull's-eye target" (BT) feature, which concentrates the client's ads in directory locations they choose. For example, a home decorating service can sign up for BT service that will cause their ads to be shown whenever users are searching for home products businesses.

In February 20X6, CSI entered into an agreement with Flogg Investments Inc. (FII) in which FII agreed to sell newly issued common shares of the company for total gross proceeds of up to $8 million. The proceeds raised from the new common shares will be used by CSI to support its growth initiatives and for working capital and general corporate purposes, including repayment of loans from shareholders that amounted to approximately $4 million as of December 31, 20X5.

Your firm was recently engaged to audit CSI's 20X5 financial statements. The previous auditors that reported on the 20X3 and 20X4 financial statements have resigned. In communicating with the predecessor auditors, you find out that they resigned due to a change in circumstances that lead to their firm's partners not being independent of CSI. To date, CSI has provided the audit partner of your firm, who is in charge of the audit, with preliminary financial statements (prior to audit) for its most recent year end, December 31, 20X5. You are assigned to plan the audit. From reviewing these preliminary financial statements and talking to Bill Dorado you have learned the following:

1. CSI recognizes revenue on a straight-line basis as each service is provided over the terms of its individual client contracts. The contracts range in length from three months to four years, with the majority lasting for two years. Revenues from contracts ranging from one to four years are deferred and amortized as each service is provided. Upfront direct costs associated with these revenues, including the production costs and selling commissions, are deferred and amortized over the life of each client contract on a straight-line basis. Adjustments are made to deferred revenue and deferred production costs for cancellations at the time they are made. Cancellations are permitted if clients relocate outside the GTA or close their business. CSI management estimates the future value of contracts in progress and compares this value with deferred production costs to ensure these costs are fully recoverable.
2. CSI's revenue is generated mainly through the sale of advertising to local businesses, many of which are small- and medium-sized enterprises (up to 50 employees). In the ordinary course of operations, CSI may extend credit to these advertisers for advertising purchases on a case-by-case basis, a practice that is common in the industry. CSI management evaluates the collectability of its trade receivables from its clients, based upon a combination of factors, including aging of receivables, on a periodic basis, and records a general allowance for doubtful accounts and bad debt expense. When management becomes aware of a client's inability to meet its financial obligations to CSI (such as in the case of bankruptcy or significant deterioration in the client's financial position and payment experience), a specific bad debt provision is recorded to reduce the client's related trade receivable to its estimated net realizable value.
3. CSI is a registered member of three barter networks serving the Greater Toronto Area (GTA) marketplace. CSI sells its services and purchases goods and services through these networks. The full market value of a contract sale settled through a barter network is recorded in accounts receivable and deferred revenue at the time of the sale. Revenues are recognized in income on a straight-line basis over the term of the contract. Receivables are reduced when a good or service purchased through a barter network has been received. The president believes this bartering arrangement was an astute business move that "saves us tons of cash and increases revenues at the same time."
4. CSI has signed contracts with two well-known, local retail chains that want to start direct online retailing, and have paid CSI $13.5 million to develop all their online shopping systems, including customer relation management and payment processing. CSI has never completed this type of system before, but has the technical expertise from developing its own systems. CSI expects the contract to be completed by the end of 20X6. CSI recorded $6.5 million of the $13.5 million as revenues in 20X5, deferring the rest to be reported when the work is completed.

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5. The president and several top CSI executives have received options to purchase common shares at a fixed price of $1 per share. None of the options have been exercised yet.
6. The BT technology was patented by CSI in early 20X4. In late 20X4, the BT patent was sold for $7 million to LivePatents Inc., which is owned by one of the original CSI investors, who is also a board member of CSI. CSI repurchased the patent in early 20X5 for $10 million, by paying $7 million in cash and issuing a loan payable to LivePatents Inc. for the remainder. The patent is shown on CSI balance sheet at its cost of $10 million, and is being amortized over 17 years.
7. Internal search engine development costs are recorded at cost. The company provides for amortization of these costs at the following annual rates:
   - Directory, research and design costs—30% declining-balance basis
   - Internal directory design costs—30% declining-balance basis

Required:

Prepare a detailed and complete audit plan that addresses the accounting and other information items noted in this case. Also, suggest any other information that you would want to obtain for planning the audit.

DC 14-10 Critical Thinking Regarding Accounting Rules, Fairness of Presentation, and the Lehman Bros. Investment Bank Reporting before Its Failure. LO4

As indicated in the box in this chapter, Lehman attempted to structure end-of-quarter transactions as sales of financial instruments when in substance it turned out be temporary borrowing of cash. This allowed it to hide up to $50 billion of debt in some quarters. The auditor claimed this was in accordance with GAAP. In a lawsuit filed by New York's Attorney General in December 2010, the official claim is that the auditor knowingly committed fraud and conspired with Lehman Brothers to reclassify tens of billions of dollars on the balance sheet. This is the first time the Martin Act (New York's more stringent securities regulation that served as a model for the SEC Acts) has been used against auditors. On March 22, 2012, the auditor was unsuccessful in moving the case from New York's state court to federal court.

Discuss in class whether Lehman's financial statements were in conformity with U.S. GAAP (Refer to FASBs SFAS 140: Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities). Did the financial statements present fairly? Discuss.

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CHAPTER 15

Completing the Audit

In this chapter, we will complete the field work, tying up the loose ends of the audit. The chapter covers the issues, techniques, procedures, and documents that are considered in completing an audit of financial statements. The audit of the flow accounts that are reported in the income statement, the cash flow statement, and the statement of retained earnings can only be completed once all the period's transactions have been completed at the period end. The audit procedures related to revenue and expense accounts are covered in the first part of the chapter.

Other audit procedures relate to the year-end amounts on the balance sheet. The audit of many of these amounts has already been covered in Chapters 11 through 14. However, there are procedures—such as audit for subsequent events, contingencies, commitments or contractual obligations, overall evaluation of audit results, overall analysis of the financial statements, and presentation and disclosure issues—that still need to be considered after the balances have been audited but before forming a conclusion on whether the financial statements are fairly stated. These and related issues are covered in the second part of this chapter.

At the completion of the audit, the audit engagement partner must provide an opinion that is properly supported by the audit evidence, which all must be documented in the audit files. The application of professional judgment in assessing the adequacy of the audit work and the fairness of the overall financial statement presentation, forming the audit opinion, and writing the appropriate audit report are topics covered in Chapter 16.

EcoPak Inc.

Donna and Boris have pulled together the audit files and most of the work has been done and documented. One of the last procedures required is to obtain a response from the company's lawyers to the legal inquiry letter regarding any legal claims. Nima has sent off the letter to EcoPak's law firm, Rotie, Cicery and Associates, LLP, and provided a copy to Donna. EcoPak's letter states that "there are no claims or possible claims with respect to which the law firm's advice or representation has been sought and which are outstanding," and it instructs the law firm to respond directly to the M&G audit firm.

LEARNING OBJECTIVES

After completing this chapter, you will be able to do the following:

LO1 Describe the balance sheet account groups that the major revenue and expense accounts are associated with, as well as the substantive analytical procedures applied to audit revenues and expenses.

LO2 Outline the overall analytical procedures to be performed at the final stage of the audit, including analysis of the income statement, cash flow statement, financial statement presentation, and disclosures.

LO3 Explain the purpose of lawyers' letters and how they are used at the completion stage of an audit to identify any contingencies and claims.

LO4 Given a set of facts and circumstances, classify a subsequent event by type and proper treatment in the financial statements, and outline the implications of the timing of discovery of the event for the auditor's report.

LO5 Explain why written management representations are obtained and what items are generally included in the representation letter, including identification of related parties.

LO6 Outline the procedures used to complete the documentation of the audit engagement.

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When the lawyer who handles EcoPak, Charles Rotie, receives the inquiry letter, he immediately realizes there is a problem. He has done a good deal of work preparing a defence for EcoPak against a possible claim. Several customers of a fast food company that uses EcoPak food packages claim they were made ill by toxic content either from the food or the packaging. Their lawyer has been in touch with lawyers for both the fast food chain and EcoPak as packaging supplier to discuss the case they are pulling together in support of the customers' claim. Charles arranges a conference call with Nima and Kam to discuss his response to the letter of inquiry.

"As you know, I have been advising you on a possible claim regarding the three customers of Fast&Good Inc. who believe the food and/or your packaging may have caused them some serious illness. This possible claim was not included in your inquiry letter, so it won't be mentioned in my response letter, to maintain the confidentiality of our lawyer-client communications. However, in these circumstances, it is important for me to advise you that you do have a responsibility to inform your auditors of the possible claim and to ensure that your financial statements contain all disclosures and adjustments necessary for fair presentation. The work I have done so far indicates it is unlikely the claim will proceed against EcoPak as we can quite easily show this same EcoPak product has been used safely many thousands of times in identical applications with no ill effects, and the particular batch that the packages in question came from has had no other incidence of this type of problem."

On the last day of the field work, the engagement partner and manager, Tariq and Boris, have arranged to meet with Nima and Kam at the EcoPak offices to go over the final draft of the financial statements and discuss any remaining outstanding issues, including the written representations that Nima and Kam will be asked to provide in a letter dated as of the upcoming board meeting at which the financial statements will be approved. Donna attends the meeting as well and is surprised to find the atmosphere in the meeting room extremely tense and unfriendly. Nima seems like a different person from the one she has gotten to know over the past days of working on the audit.

Once Tariq gets through all the points he wants to raise, he asks if there are any issues Nima or Kam wish to add, and if they will be able to sign the representations that Tariq has drafted. Nima points to one line in the representation letter and says, "We will need to alter this line about us not being aware of any legal claims against the company. Our lawyer has advised us that even though this is a remote possibility, and could never add up to more than a very small amount, there is a possible legal claim against us that we should let you know about. But we are not going to accrue or even disclose the matter—in our view it is a ridiculous claim that should not be given the time of day, let alone a disclosure in our financial statements! I am not going to let something so stupid jeopardize our debt covenants or our opportunity to make an IPO next year."

Donna is quite upset by the all this emotion and animosity from Nima, but she is very impressed with how Tariq is able to calm everything down. "No need to jump to any conclusions now, Nima," he replies. "If the claim is remote and not likely to amount to a material amount, the treatment you are suggesting, no accrual or disclosure, may well be acceptable under GAAP. But as independent auditors, you understand that we will need to have more of the details, and it would be preferable if your lawyer could provide them, so we can meet our responsibility to base our conclusion on sufficient appropriate evidence."

Once the secret is out, Donna feels the air clear quickly, and the good relations with Nima and Kam return. Nima agrees to contact Charles and give him permission to respond to the inquiry with all the details of the possible claim he has been working on. After the meeting, Donna and Caleb pack up their things to head back to their own office. As they are saying goodbye to Nima, she says to them, "Thanks to you both for your efficient work and being so considerate of my staff's time. I know there will probably be a few more questions that will come up as you tie up all the loose ends to complete the audit documentation files, so don't hesitate to call me if I can help. Take care!"

THE COMPLETION STAGE OF THE AUDIT

engagement partner: one of the most experienced members of the audit team who makes the final decision on the audit opinion

The completion stage of the audit can be viewed as the nexus of all the audit work and judgments involved in reaching a final conclusion on whether the financial statements are fairly presented. All members of the audit team are involved in this final stage, but especially so the most experienced members, such as the audit **engagement partner,** who makes

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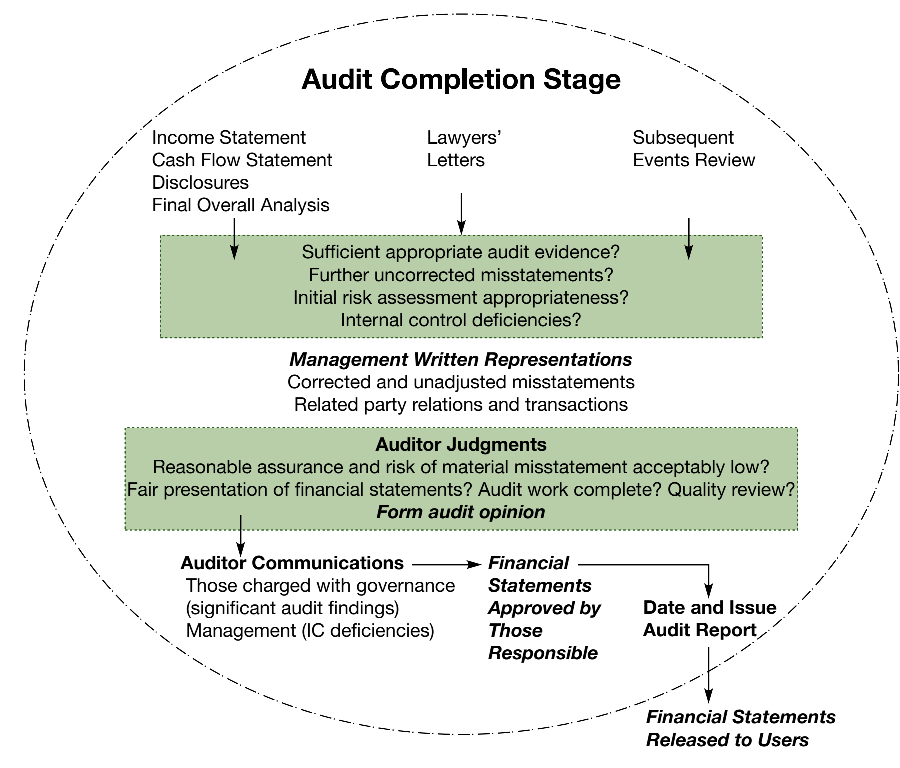
the final decision on the audit opinion. The activities and decisions taken at the completion stage are advanced topics in auditing, but in this introductory text, we present them to finish the story of how the audit work supports the ultimate and public product of the audit engagement, the auditor's report. Many of the procedures and decisions we will discuss occur concurrently. Exhibit 15–1 provides an overview, showing these activities as a framework for the discussion in this and the next chapter.

EXHIBIT 15–1 Audit Completion Activities and Judgments



COMPLETING THE AUDIT OF REVENUES AND EXPENSES

LO1 Describe the balance sheet account groups that the major revenue and expense accounts are associated with, as well as the substantive analytical procedures applied to audit revenues and expenses.

As the field work nears its end, the major revenue and expense accounts will have been audited in connection with related balance sheet accounts. Next, auditors need to consider other revenue and expense accounts. The broad financial statement assertions are the basis for specific assertions and audit objectives for these accounts. Those typical to the revenue and expense accounts are as follows:

1. Revenue accounts represent all the valid transactions recorded correctly in the proper account, amount, and period.
2. Revenue recognition policies are in accordance with established accounting principles and are consistent with the underlying economic substance of the earnings process.
3. Expense accounts represent all the valid expense transactions recorded correctly in the proper account, amount, and period.
4. Revenues, expenses, and cost of goods sold as well as extraordinary, unusual, or infrequent transactions are adequately classified and disclosed.

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Revenue

The following types of revenue and related topics have been audited, either in whole or in part, prior to the completion stage of the engagement:

Revenue and Related Topics	Related Account Groups
Sales and sales returns	Receivables
Lease revenue	Fixed assets and receivables
Franchise revenue	Receivables and intangibles
Dividends and interest	Receivables and investments
Gain or loss on asset disposals	Fixed assets, receivables, and investments
Rental revenue	Receivables and investments
Royalty and licence revenue	Receivables and investments
Long-term sales commitments	Revenue and receivables
Product-line reporting	Revenue and receivables
Accounting policy disclosure	Revenue and receivables

The working papers' cross-references to the revenue accounts in the trial balance should reflect the extent to which the revenue items have already been audited with the related accounts, and revenues not audited completely should be evident. By reviewing the trial balance cross-references, auditors will verify that all revenue and gain or loss accounts and their amounts are listed.

Analytical procedures can be used as substantive procedures to compare the revenue accounts and amounts with prior-year data and with multiple-year trends, to look for unusual fluctuations. Comparisons with budgets, internal monthly reports and forecasts, and relevant nonfinancial data will determine whether any events need explanation or analysis. The explanations would then be verified by further audit procedures. For example, if management explains that the sales dollar increase is a consequence of a price increase, the auditor can corroborate that by referencing price lists used in the audit tests of sales transactions.

All miscellaneous or other revenue accounts and all clearing accounts with credit balances are analyzed by identifying each important item and amount in the account, followed by document vouching and enquiry to determine whether amounts should be classified elsewhere. All clearing accounts should be eliminated and the amounts classified as revenue, deferred revenue, liabilities, deposits, or contra-assets. Miscellaneous revenue and clearing accounts can harbour accounting errors, since accountants use them for unusual items they are not sure how to record; for example, proceeds from sale of assets, insurance premium refunds, and insurance proceeds.

Exhibit 15–2 is an example showing selected procedures that would be part of an audit program for revenues and expenses.

Expenses

Most major expense items will have been audited in connection with other account groupings, but minor expenses may still be unaudited. As a brief review, the following major expenses may have been audited in whole or in part as the audit nears its end:

Expenses	Related Account Groups
Purchases and cost of goods sold	Inventories
Inventory valuation losses	Inventories
Warranty and guarantee expenses	Inventories and liabilities
Royalty and licence expenses	Inventories and liabilities
Marketing and product R&D	Investments and intangibles
Investment value losses	Investments and intangibles
Rental property expenses	Investments and intangibles
Amortization of intangibles	Investments and intangibles

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Bad debt expenses	Receivables
Amortization expenses	Fixed assets
Property taxes and Insurance expenses	Fixed assets and liabilities
Lease and rental expenses	Fixed assets
Repairs and maintenance expenses	Fixed assets and liabilities
Legal and professional fees	Liabilities
Interest expense	Liabilities
Pension and retirement benefits	Liabilities and payroll
Payroll and compensation costs	Payroll
Sales commissions	Payroll

EXHIBIT 15–2 Example of an Audit Program for Revenues and Expenses: Selected Procedures

REVENUES

1. Obtain auditee's monthly analyses of sales, cost of goods sold, and gross profit by product line, department, division, or location.
   a. Trace amounts to the general ledger.
   b. Compare the analyses with prior years and seek explanations for significant variations.
   c. Determine one or more standard markup percentages and calculate expected gross profits. Enquire for explanations of significant variations compared with actual results.
2. Coordinate procedures for audit of revenue with evidence obtained in other audit programs:

Sales and Sales returns	Sales control	Gain, loss on asset disposals	Fixed assets
	Cash receipts control		Investments
	Accounts receivable	Rental revenue	Accounts receivable
Lease revenue	Capital assets		Investments
	Accounts receivable	Royalty and licence revenue	Accounts receivable
Franchise revenue	Accounts receivable		Intangibles
	Intangibles	Long-term sales commitments	Accounts receivable
Dividends and Interest	Accounts receivable		Inventory
	Investments		

3. Scan the revenue accounts for large or unusual items and for debit entries. Enquire as to the nature of any such items. Vouch to supporting documentation.
4. Obtain written management representations about terms of sales, completeness of recorded sales transactions, rights of return, consignments, and unusual or infrequent transactions.

EXPENSES

5. Obtain schedules of expense accounts comparing the current year with one or more prior years.
   a. Trace amounts to the general ledger.
   b. Compare the current expenses to prior years and seek explanations for significant variations.
   c. Be alert to significant variations that could indicate failure to defer or accrue expenses.
6. Compare the current expenses with the company budget, if any. Enquire and investigate explanations for significant variances.
7. Coordinate procedures for audit of expenses with evidence obtained in other audit programs:

Purchases, Cost of goods sold	Acquisition control	Bad debt expense	Accounts receivable
	Cash disbursement control	Depreciation expense	Fixed assets
	Inventory	Property taxes, insurance	Prepaids and accruals
Inventory valuation losses	Inventory		Fixed assets
Warranty and guarantee expense	Inventory	Lease and rental expense	Fixed assets
	Prepaids and accruals	Repairs and maintenance	Fixed assets
	Accounts payable	Interest expense	Long-term liabilities
Royalty and licence expense	Inventory	Pension and retirement benefits	Liabilities
Marketing and product R&D	Investments		Payroll control
	Intangibles	Payroll and compensation	Payroll control
Investment value losses	Investments	Sales commissions	Payroll control
Rental property expenses	Investments		
Amortization of intangibles	Intangibles		

8. Prepare analyses of sensitive expense accounts, such as legal and professional fees, travel and entertainment, repairs and maintenance, taxes, and others unique to the company. Vouch significant items therein to supporting invoices, contracts, reimbursement forms, tax notices, and the like for proper support and documentation.
9. Scan the expense accounts for large or unusual items and for credit entries. Enquire as to the nature of any such items. Vouch to supporting documentation.
10. Obtain written management representations about long-term purchase commitments, contingencies, completeness of recorded expenses, and unusual or infrequent transactions.

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As with the revenue accounts mentioned in the previous section, if audit work is complete for expense accounts, there will be cross-referencing from the working papers to the trial balance. Some significant expenses may not have been audited completely (such as property tax expense), and some finishing-touch vouching of supporting documents may be required.

Minor expenses, such as office supplies, telephone, utilities, and similar accounts, are not audited until late in the engagement. Generally, the dollar amounts in these individual accounts are not material, and there is little relative risk that they will result in misleading financial statements. Auditors usually audit these kinds of accounts with substantive analytical procedures, such as comparing the balances with those of one or more prior periods. The dollar amounts are reviewed for unusual changes (or lack of, if reasons for change are known). Comparing balances and enquiring to get reasonable explanations may be enough to decide whether the amounts are fairly presented.

On the other hand, the questions may suggest a risk of misstatement. If more evidence is needed, auditors may vouch some expenses to supporting documents (invoices, cancelled cheques, correspondence with professional advisors). If the auditors performed tests of controls on a sample of expenditure transactions in the purchases, payables, and payments process audit program, some of these expense transactions were selected for testing auditee compliance with control objectives (validity, completeness, authorization, accuracy, classification, accounting, and proper period). This evidence should be used. Analytical comparisons with budgets, internal reports and forecasts, and relevant nonfinancial data may also be made. Management may have already explained any variations from the budget, or the auditors may need to investigate variations.

All miscellaneous or other expense accounts and clearing accounts with debit balances should be analyzed by listing each important item on a working paper and vouching it to supporting documents. These may include abandonments of property, items not deductible for tax purposes, and payments that should be classified in other expense accounts. Clearing accounts should be analyzed and the contents classified by type or source and accounted for properly.

Advertising, travel and entertainment expense, and contributions accounts are analyzed in detail as they are particularly sensitive to management policy violations and income tax consequences. They must be documented carefully if they are to stand a Canada Revenue Agency auditor's examination. Questionable items may have an impact on the income tax expense and liability. Minor embezzlements or falsification can be detected by careful auditors; however, a detailed audit of expense account payments may be of greater interest to the efficiency-minded internal auditor than to the independent auditor. The independent auditors are concerned that the paid-out amount is fairly presented, regardless of whether employees did overstate their expenses. Evidence of expense account falsification may be presented to management, but the overpayments are still an expense of the business and need to be included in its financial statements.

REVIEW CHECKPOINTS

15-1 Certain revenue and expense accounts usually are audited in conjunction with related balance sheet accounts. List the most likely related balance sheet accounts for these revenue and expense accounts: lease revenue, franchise revenue, royalty and licence revenue, amortization expense, repairs and maintenance expense, and interest expense.

15-2 Why are many of the revenue and expense accounts audited by analytical procedures only?

15-3 What procedures can be applied to audit minor expense accounts?

LO2 Outline the overall analytical procedures to be performed at the final stage of the audit, including analysis of the income statement, cash flow statement, financial statement presentation, and disclosures.

OVERALL ANALYTICAL PROCEDURES

Analytical procedures are used at these three points during the audit:

1. For risk assessment at the planning stage (discussed in Chapter 6)
2. As a substantive test procedure (discussed in Chapters 8, 11–14)
3. During the overall evaluation of the financial statements at the end of the audit

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Canadian auditing standards (CASs) require the auditor to design and perform overall analytical procedures at the completion stage of the audit to help form a conclusion about whether the financial statements are a fair representation of what the auditors learned in the course of the audit (CAS 520). Using analytical procedures to assess the reasonableness of reported results after most of the audit work has been performed is an effective means of obtaining assurance.

STANDARDS CHECK

CAS 520

Analytical Procedures that Assist When Forming an Overall Conclusion

6. The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity. (Ref: Para. A17–A19)

Source: *CICA Handbook—Assurance*, 2012.

The results of overall analytical procedures of the final draft financial statements help the auditor reach reasonable conclusions to base the auditor's opinion on. The procedures are similar to those for risk assessment; for example, comparing financial and nonfinancial data and examining ratios and trends for unexpected relationships. However, by performing this analysis at a late stage in the audit, the auditors have the benefit of considerable knowledge about the auditee's business and a better basis on which to form expectations about the financial statement relationships, increasing their chances of noticing something out of line. This analysis can be sharper and more focused on finding potential misstatements than the preliminary risk assessment was. It may identify a risk of material misstatement not recognized at the early stage, in which case the planned audit procedures are revised to address this new risk. The final analysis procedures are a very important over-arching element of forming an audit opinion and will be referred to again we consider different steps in finalizing the audit report in Chapter 16.

The cash flow statement is prepared after the balance sheet and income statement are finalized, so it is audited at the completion stage of the audit. Verifying the cash flow statement explains the major changes in balance sheet accounts and thus provides analytical evidence that the financial statement relations are properly presented. It also bridges the balance sheet and income statement by explaining the relationship between net income and operating cash flow when the indirect method is used. These alternative presentations of the financial performance and changes in financial position should be evaluated by the auditors in relation to their knowledge of the year's activity. For example, a large financing inflow from new debt should match up with disclosure about the new loan. Also, many items of the cash flow will tie into audits of other balances; for example, cash flows for both additions to and proceeds from disposal of fixed assets should tie in to audit working paper information on fixed assets.

Auditors also verify the information presented in the statement of changes in retained earnings and shareholders' equity at this stage, to ascertain that account classifications, aggregations, and summarizations are comparable to those of the prior year in an assessment of the consistency of the financial reporting and the overall adequacy of disclosures. Certain other tests done later in the engagement, such as the search for contingent liabilities, commitments, and guarantees, will result in information that requires disclosure but no amounts recognized in the balance sheet. Auditors may use a checklist to ensure all disclosures required by generally accepted accounting principles (GAAP) are considered. An example of such a checklist is shown in the box that follows. Remember that checklists like this are useful starting points for auditors, but they need to be tailored to the circumstances of each audit engagement—they are not a substitute for the auditor's judgments about what is relevant in a particular situation.

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FINANCIAL STATEMENT PRESENTATION AND DISCLOSURE CHECKLIST

AUDITEE: ECOPACK INC.	**FILE INDEX:** 315		
FINANCIAL STATEMENT PERIOD: y/e DECEMBER 31, 20x1			
This checklist is to be used to assess whether the financial statements and the notes include all required disclosures for fair presentation.	Disclosure Assertions [OCO,C,CU,AV]*	Response	File reference
Consider the following: Do the notes disclose, where relevant, all specific disclosure requirements as per GAAP or applicable financial reporting framework, such as the following? • Contingent liabilities, commitments, guarantees • Accounting changes • Significant estimates • Going-concern considerations • Related-party transactions • Measurement uncertainties • Restatements • Impaired assets • Other required information needed for fair presentation Do the notes accurately describe the policies used in preparing the financial statements? Is the comparative information provided appropriate? Are the financial statements and notes correctly cross-referenced? Do all events, transactions, and other information presented and disclosed in the financial statements pertain to the entity? Are the disclosures complete, based on the audit findings?			

AUDITOR'S CONCLUSION

On appropriateness and completeness of overall financial statement presentation and disclosure:

____

____

____

Prepared by ______________________ Date ______________________

Reviewed by ______________________ Date ______________________

***Note:** CAS 315, paragraph A111(c) sets out special assertions related to presentation and disclosure that reflect their purpose in augmenting the financial statements for users by providing further details and interpretations, as follows:

(i) Occurrence and rights and obligations—disclosed events, transactions, and other matters have occurred and pertain to the entity. [OCO]
(ii) Completeness—all disclosures that should have been included in the financial statements have been included. [C]
(iii) Classification and understandability—financial information is appropriately presented and described, and disclosures are clearly expressed. [CU]
(iv) Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts. [AV]

Unusual Transactions

Significant audit evidence and reporting problems can arise if management transactions artificially create earnings. Generally, these transactions will run through a complicated structure of subsidiaries, affiliates, and related parties, and they involve large amounts of revenue. While transactions may not be concealed, there might be certain guarantees that management has not revealed to the auditors. The transactions may be carefully designed and timed to provide the most favourable income result.

It is difficult to characterize these unusual transactions as they vary so widely. Controversies have arisen in the past over revenue recognized on bundled sales of hardware, software, and technology services; on the construction percentage-of-completion method; on sales of assets at inflated prices to management-controlled dummy corporations; on sales of real estate to independent parties with whom the seller later associates for development of the property (making guarantees on indemnification for losses); and on disclosure of revenues by source. Often transactions are designed to exploit weaknesses

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or loopholes in the current accounting standards, the "gaps in GAAP." These revenue issues pose a combination of evidence-gathering and reporting-disclosure problems. Three illustrations of such problems are given in the box that follows.

UNUSUAL REVENUE TRANSACTIONS

Merger

National Fried Chicken Inc., a large fast-food franchiser, began negotiations in August to purchase Provincial Hot Dog Company, a smaller convenience food chain. At August 1, 20X6, Provincial's net worth was $7 million, and National proposed to pay $8 million cash for all the outstanding shares. In June 20X7, the merger was consummated and National paid $8 million, even though Provincial's net worth had dropped to $6 million by that time. Consistent with prior years, Provincial lost $1 million in the 10 months ended June 1, 20X7, after showing a net profit of $1.5 million for June and July 20X7. At June 1, 20X7, the fair value of Provincial's net assets was $6 million, and National accounted for the acquisition as a purchase, recording $2 million goodwill. National proposed to show in consolidated financial statements the $1.5 million of post-acquisition income.

Audit Resolution. The auditors discovered that the purchase price was basically set at 16 times expected earnings and that management had carefully chosen the consummation date in order to maximize goodwill (and reportable net income in fiscal 20X7). The auditors required that $1 million of goodwill be treated as a goodwill impairment in the year ended July 31, 20X7, so that bottom-line income would be $500,000.

Real Estate Deal

In August, a company sold three real estate properties to BMC for $5,399,000 and recognized profit of $550,000. The agreement covering the sale committed the company to use its best efforts to obtain permanent financing and to pay underwriting costs for BMC. The agreement also provided BMC with an absolute guarantee against loss from ownership and a commitment by the company to complete construction of the properties.

Audit Resolution. The auditors determined that the terms of this agreement made the recognition of profit improper because the company had not shifted the risk of loss to BMC.

Real Estate Development, Strings Attached

In December 20X6, Black Company sold one half of a tract of undeveloped land to Red Company in an apparent arms-length transaction. The portion sold had a book value of $1.5 million, and Red Company paid $2.5 million in cash. Red Company planned to build and sell apartment houses on the acquired land. In January 20X7, Black and Red formed a new joint venture to develop the entire tract. The two companies formed a partnership, each contributing its one half of the total tract of land. They agreed to share equally in future capital requirements and profits or losses.

Audit Resolution. The auditor discovered that Black and Red were both controlled by the same person. The $1 million profit from the sale was not recognized as income in Black's 20X6 financial statements, and Black's investment in the joint venture was valued at $1.5 million.

REVIEW CHECKPOINTS

15-4 How might usual revenue transactions cause significant audit evidence and reporting problems?

15-5 How are analytical procedures used for overall evaluation of the financial statements at the final stage of the audit? How does the use of analysis at this stage differ from its use at the risk assessment stage? at the substantive evidence gathering stage?

15-6 What procedures can be used to verify the accuracy of the information presented in the cash flow statement?

Sequencing of Audit Events

At this point, it is helpful to note the sequencing of audit events. Based on the organization of the audit, some audit work might be done at an interim period sometime before the balance sheet date, followed by completion of the work at later dates. Interim audit work is done months before the balance sheet date, with auditors working at the auditee's offices for a time, leaving, then returning at the exact balance sheet date for certain procedures, such as cutoff tests, and then returning again after the balance sheet date for the year-end field work. At the year-end visit, the auditor will have the first draft of management's unaudited financial statements (or trial balance) prepared by the auditee personnel. The audit team then can start where the interim work left off, completing the work on control risk assessment and audit of balances. Certain procedures, however, such as lawyers' letters,

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written management representation letters and subsequent events reviews, discussed below, are always left to the very final stages of the audit work. Often, they will be completed back at the audit firm's office after the field work visit has finished.

LAWYER'S LETTERS TO DETECT CONTINGENCIES AND CLAIMS

LO3 Explain the purpose of lawyers' letters and how they are used at the completion stage of an audit to identify any contingencies and claims.

The audit procedures of obtaining the lawyer's letter, and the written management representations discussed in this learning objective, are performed toward the end of the audit work. These written communications are dated at the audit report date because the auditors are responsible until that date for determining whether important events occurring after the balance sheet date are properly entered in the accounts or disclosed in the financial statement notes.

Communication with Auditee's Lawyer

The lawyer's letter is one of the most important audit confirmations. CAS 501 requires auditors to perform procedures identifying litigation and claims against the auditee, and where there is a risk of material misstatement, auditors must communicate directly with the auditee's legal counsel. This is done by an enquiry letter from management to the lawyer, with a copy of the lawyer's response going directly from the lawyer to the auditor. The objective is to provide audit evidence about any potentially material litigation or claims against the auditee, to determine if management's estimates of the possible costs of these are reasonable, and to assess whether there are any unrecorded liabilities that should be reported in the financial statements. Exhibit 15–3 is an example of an enquiry letter. The auditor asks management to send enquiry letters to all lawyers who performed work for the auditee during the period under audit. This request informs the lawyer that their client, the auditee, is waiving the privilege of confidentiality of communications between lawyer and client, and gives the lawyer permission to give information to the auditors.

As implied by the letter in Exhibit 15–3, questions about contingencies, litigations, claims, and assessments should be directed to both legal counsel and management because an auditor has the right to expect to be informed by management about all material contingent liabilities. Audit procedures useful in this regard include the following:

- Enquire and discuss with management the policies and procedures for identifying, evaluating, and accounting for litigation, claims, and assessments.
- Obtain from management a description and evaluation of litigation, claims, and assessments.
- Examine documents in the auditee's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers.
- Obtain assurance from management that it has disclosed all material unasserted claims that the lawyer has advised them might result in litigation.
- Read minutes of meetings of shareholders, directors, and appropriate committees. Read contracts, loan agreements, leases, and correspondence from taxing or other governmental agencies.
- Obtain information concerning guarantees from bank confirmations.

The enquiry letter is an effective means of learning about material contingencies. Even so, a devious or forgetful management or a careless lawyer may fail to tell the auditor of some important factor or development. Auditors have to be alert and sensitive to all possible contingencies so that they can ask the right questions at the right time. Auditors have a natural tendency to look out for adverse contingencies, but potentially favourable events should also be investigated and disclosed (such as the contingency of litigation for damages wherein the auditee is the plaintiff). If management or its lawyers fail to provide adequate information about lawsuit contingencies, the auditor should consider whether this

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EXHIBIT 15–3 Sample Lawyer Letters[1]

Version 1—When there are claims or possible claims to be listed

(On client letterhead)

(To law firm)

(Date)

Dear Sir(s):

In connection with the preparation and audit of our financial statements for the fiscal period ended (date) (which include the accounts of the following entities),[2] we have made the following evaluations of claims and possible claims with respect to which your firm's advice or representation has been sought:

Description	Evaluation
(name of entity, name of other party, nature, amount claimed and current status)	(Indicate likelihood of loss (or gain) and estimated amount of ultimate loss (or gain), if any; or indicate that likelihood is not determinable or amount is not reasonably estimable.)

Would you please advise us, as of (effective date of response), on the following points:

(a) Are the claims and possible claims properly described?
(b) Do you consider that our evaluations are reasonable?
(c) Are you aware of any claims not listed above which are outstanding? If so, please include in your response letter the names of the parties and the amount claimed.

This enquiry is made in accordance with the Joint Policy Statement of January 1978 approved by The Canadian Bar Association and the Auditing and Assurance Standards Board of the Canadian Institute of Chartered Accountants.

Please address your reply, marked "Privileged and Confidential," to this company and send a signed copy of the reply directly to our auditor, (name and address of auditor).

Yours truly,

c.c. (name of auditor)

1 The letter should be appropriately modified if the client advises that certain matters have been excluded in accordance with paragraph 12 of the Joint Policy Statement.

2 Delete if inapplicable. If applicable, refer to paragraph 11 regarding signing of the enquiry letter.

Source: © *CICA Handbook*, CAS 501.

represents a scope limitation on the audit. A serious audit scope limitation requires a qualification in the audit report or a disclaimer of opinion.

Auditors face other challenges when it comes to using lawyers' responses to audit the presentation and disclosure of contingencies. The following box illustrates the kinds of wording lawyers provide in their letters.

INTERPRETING THE LAWYERS' LETTERS

Lawyers take great care in forming responses to auditees' requests for information to be transmitted to auditors. This care causes problems of interpretation for auditors. The difficulty arises over lawyers' desire to preserve lawyer-client confidentiality yet cooperate with auditors and the financial reporting process that seeks full disclosure.

The Canadian Bar Association policy statement observes that "[i]t is in the public interest that the confidentiality of lawyer-client communications be maintained." Accordingly, any *possible* claims omitted from the enquiry letter will not be referred to by the law firm in its response letter.[1] However, the policy statement does require the law firm to specify in its response any *identified* claim that has been omitted from the client's inquiry letter. It notes that it is in the public interest that financial statements contain all disclosures and adjustments necessary for fair presentation, thus the law firm should discuss any omitted possible claims with the client to ensure the client is informed of its responsibility to inform its auditor of such matters.

Consequently, lawyers' responses to auditors may contain vague and ambiguous wording. Auditors need to determine whether a contingency is "likely, unlikely, or not determinable."[2] Although there are no comparable Canadian guidelines, in the United States the following lawyer responses can be properly interpreted to mean "remote," even though the word is not used:

- We are of the opinion that this action will not result in any liability to the company.
- It is our opinion that the possible liability to the company in this proceeding is nominal in amount.
- We believe the company will be able to defend this action successfully. We believe that the plaintiff's case against this company is without merit.
- Based on the facts known to us, after a full investigation, it is our opinion that no liability will be established against the company in these suits.

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However, auditors should view the following response phrases as unclear, or providing no information, about the probable, reasonably possible, or remote likelihood of an unfavourable outcome for a litigation contingency:[3]

- We believe the plaintiff will have serious problems establishing the company's liability; nevertheless, if the plaintiff is successful, the damage award may be substantial.
- It is our opinion the company will be able to assert meritorious defences. ["Meritorious," in lawyer language, apparently means that the judge will not summarily throw out the defences.]
- We believe the lawsuit can be settled for less than the damages claimed.
- We are unable to express an opinion on the merits of the litigation, but the company believes there is absolutely no merit.
- In our opinion the company has a substantial chance of prevailing. ["Substantial chance," "reasonable opportunity," and similar phrases indicate uncertainty of success in a defence.]

1 *CICA Handbook*, CAS 501, Appendix, "Joint Policy Statement Concerning Communications with Law Firms," paragraph 14.

2 Ibid., paragraph 13 and 15.

3 Adapted from AU 9337.

Exhibit 15–4 shows an example of a lawyer's response letter.

EXHIBIT 15–4 Sample Lawyer's Response Letter

(On law firm letterhead)

Privileged and Confidential

(To auditee)

(Date – as close as possible to audit report date)

Dear Sir(s):
In connection with the preparation and audit of your financial statements for fiscal period ended (date), in response to your enquiries regarding the following claim and possible claim with respect to which our firm's advice of representation has been sought:

Description	Evaluation
A product liability claim has been made by a customer who was permanently injured while using a product purchased from the company.	Likelihood is not determinable and amount of claim is not likely to be significant.

We advise that, as of (effective date of response), the above claim is properly described, and the evaluation of the likelihood of loss and amount of claim are reasonable.

(c) Are you aware of any claims not listed above which are outstanding? If so, please include in your response letter the names of the parties and the amounts claimed.

This response is made in accordance with the Joint Policy Statement of January 1978 approved by The Canadian Bar Association and the Auditing and Assurance Standards Board of the Canadian Institute of Chartered Accountants.

As requested, a signed copy of the reply has been sent directly to your auditor, (name and address of auditor).

Yours truly,

Lawyer representing auditee in the claim

c.c. (name of auditor)

Source: Based on © *CICA Handbook,* CAS 501 Appendix, schedule A.

REVIEW CHECKPOINTS

15-7 The following was included in a letter auditors received from the auditee's lawyers, in response to a letter sent to them that was similar to Exhibit 15–4: "Several agreements and contracts to which the company is a party are not covered by this response since we have not advised or been consulted in their regard." How might the auditor's report be affected by that statement in the letter regarding a pending lawsuit against the auditee? Explain.

15-8 In addition to the lawyer's letter, what other procedures can be used to gather evidence regarding contingencies?

15-9 Why might companies and auditors experience difficulty making appropriate disclosures about litigation contingencies?

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EVENTS SUBSEQUENT TO THE BALANCE SHEET DATE

LO4 Given a set of facts and circumstances, classify a subsequent event by type and proper treatment in the financial statements, and outline the implications of the timing of discovery of the event for the auditor's report.

Material events that occur after the balance sheet date may require adjustments to and/or disclosures in the financial statements. Auditors (and management) are responsible for gathering evidence on these subsequent events and evaluating how they should be reflected in the financial statements (CAS 560). Their impact on the audit report depends on whether they are discovered before or after the audit report date. This section first describes the two different types of subsequents that can occur, and then considers how the timing of discovery affects how the auditor addresses them in the audit report.

STANDARDS CHECK

CAS 560

Events Occurring between the Date of the Financial Statements and the Date of the Auditor's Report

5. The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions. (Ref: Para. A6)

Source: *CICA Handbook—Assurance,* 2012.

Two Types of Subsequent Events

Material subsequent events can be classified into two different types, based on how each type is treated in the financial statements. The first type are those events that existed at year-end but are coming to light after the year-end date; these actually require adjustment of the dollar amounts of one or more financial statement line items (along with the addition of any related explanatory disclosure required in the notes). We will refer to this type as "Subsequent event type requiring adjustment in financial statement numbers." The second type are those events arising after year-end that should not be reflected in the year-end financial statement numbers, but that need to be disclosed in the notes to those statements. The disclosure is required because the event may have an important impact on the entity in the future, so users need to know about it when they make decisions based on the year-end numbers. We will refer to the second type as "Subsequent event type requiring financial statement disclosure only." Sometimes, for the second type of subsequent event, pro forma financial statements would be provided to help users see how the financial statement would have looked with the event included, even though it is not appropriate to include it in the historic financial statement amounts under GAAP.

Subsequent Event Type Requiring Adjustment in Financial Statement Numbers

This type of subsequent event provides new information regarding financial conditions that existed at the date of the balance sheet, and thus they affect the numbers in it. Amounts in the financial statements for the period under audit need to be changed as a result. The following are examples of this type of subsequent event:

- A loss on uncollectible trade accounts receivable resulting from the bankruptcy of a major customer (the customer's deteriorating financial condition existed prior to the balance sheet date)
- Litigation settled for an amount different than was estimated (the litigation had taken place prior to the balance sheet date)

Subsequent Event Type Requiring Financial Statement Disclosure Only

These are subsequent events that relate to the period after the balance sheet date and thus do not require adjustment of financial statement line items. Recall that the auditor's responsibility for adequate disclosure runs to the audit report date. Consequently, even for events that arise after the balance sheet date, auditors consider their importance to users and

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pro forma financial data: the presentation of financial statements as if the event had occurred on the date of the balance sheet; for example, perhaps the best way to show the effect of a business purchase or other merger

whether fair presentation of the financial statements requires their disclosure. This type of subsequent event may be significant enough that disclosure is necessary to keep the financial statements from being misleading. Disclosure is normally in the form of a narrative note, but occasionally an event is so significant that the best disclosure is **pro forma financial data**—presentation of the financial statements "as if" the event had occurred on the date of the balance sheet. Such pro forma data are given in a note disclosure. For example, in addition to historical financial statements, pro forma financial data may be the best way to show the effect of a business purchase or other merger, or the sale of a major portion of assets.

Examples of this second type of subsequent event are as follows:

- Loss on an uncollectible trade receivable resulting from a customer's fire or flood loss subsequent to the balance sheet date (in contrast to a customer's slow decline into bankruptcy cited above as a subsequent event type requiring adjustment in financial statement numbers)
- Issue of bonds payable or share capital
- Settlement of litigation when the event giving rise to the claim took place subsequent to the balance sheet date
- Loss of plant or inventories as a result of fire or flood subsequent to year-end

Retroactive recognition of the effect of stock dividends and splits is an exception covered in the box below. The issue here is timely and informative communication to financial statement users; the stock dividend or split will have been completed by the time the financial statements reach users and to report financial data as if they had not occurred might be considered misleading.

SUBSEQUENT EVENT STOCK SPLIT

On February 15, the company approved a two-for-one stock split to be effective on that date. The fiscal year-end was the previous December 31, and the financial statements as of December 31 showed 50 million shares authorized, 10 million shares issued and outstanding, and earnings per share of $3.

Audit Resolution. Note disclosure was made of the split and of the relevant dates. The equity section of the balance sheet showed 100 million shares authorized, 20 million shares issued and outstanding. The income statement reported earnings per share of $1.50. Earnings per share of prior years were adjusted accordingly. The note disclosed comparative earnings per share on the predividend shares. The audit report was dual dated, with February 1 as the report date except for the note disclosure, which was dated February 15. (Dual dating audit reports for subsequent events is discussed in Chapter 16.)

Subsequent Events and the Audit Report

Subsequent events are taken into account in finalizing the audit report, and in some cases can affect the audit report dating. This is discussed in Chapter 16 with the topic of dating the audit report.

Audit Program for the Subsequent Period

An example of an audit program to search for subsequent events is given in Exhibit 15–5. Some audit procedures in the period subsequent to the balance sheet date may include those in the audit program for determining cutoff and proper valuation of balances as of the balance sheet date (Part A in Exhibit 15–5). However, procedures specifically designed for gathering evidence about the two types of subsequent events are different and separate from the rest of the audit program (Part B in Exhibit 15–5).

Summary of Subsequent Events in an Audit

Auditing standards for subsequent events consider two types of events: (1) events that occurred or conditions that existed on or before the audit report date that would have caused the auditor to amend the audit report, or (2) events and conditions that arise after the balance sheet date but that are important for understanding the financial statements, nonetheless. The subsequent event or subsequently acquired knowledge may arise at three

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EXHIBIT 15–5 Auditing Procedures for the Period Subsequent to the Balance Sheet Date

A. Procedures performed in connection with other audit programs

1. Use a cutoff bank statement to:
   a. Examine cheques paid after year-end that are, or should have been, listed on the bank reconciliation.
   b. Examine bank posting of deposits in transit listed on the bank reconciliation.
2. Vouch collections on accounts receivable in the month following year-end for evidence of existence and collectability of the year-end balances.
3. Trace cash disbursements of the month after year-end to accounts payable for evidence of any liabilities unrecorded at year-end.
4. Vouch write downs of fixed assets after year-end evidence that such valuation problems existed at the year-end date.
5. Vouch sales of investment securities, writedowns, or write offs in the months after the audit date for evidence of valuation at the year-end date.
6. Vouch and trace sales transactions in the month after year-end for evidence of proper sales and cost of sales cutoff.

B. Additional auditing procedures for subsequent events

1. Obtain the latest available interim financial statements and:
   a. Compare them with the financial statements being reported on, and make any other comparisons considered appropriate in the circumstances. Investigate any unusual fluctuations.
   b. Enquire of officers and other executives having responsibility for financial and accounting matters about whether the interim statements have been prepared on the same basis as that used for the statements under examination. Assess impact of any changes on comparability.
2. Scan the accounting records for the subsequent event period (such as general ledger, general journal entries, sales journal, purchases journal, cash receipts journal, and cash disbursements journal), and investigate any unusual transactions or entries.
3. Enquire of and discuss with officers and other executives having responsibility for financial and accounting matters (limited where appropriate to major locations):
   a. Whether any substantial contingent liabilities or commitments existed at the date of the balance sheet being reported on or at the date of enquiry.
   b. Whether there was any significant change in the share capital, long-term debt, or working capital to the date of enquiry.
   c. The current status of items in the financial statements being reported on that were accounted for on the basis of tentative, preliminary, or inconclusive data.
   d. Whether any unusual adjustments have been made during the period from the balance sheet date to the date of enquiry.
4. Read the available minutes of meetings of shareholders, directors, and appropriate committees; enquire about matters dealt with at meetings for which minutes are not available.
5. Request that the client send a letter to legal counsel enquiring about outstanding claims, possible claims, and management's evaluation, with the reply to be sent directly to the auditor.
6. Obtain written representations, dated as of the date of the auditor's report, from appropriate officials, generally the chief executive officer and chief financial officer, about whether any events occurred subsequent to the date of the financial statements that, in the officer's opinion, would require adjustment or disclosure in these statements.
7. Make such additional enquiries or perform such procedures as considered necessary and appropriate to dispose of questions that arise in carrying out the foregoing procedures, enquiries, and discussions.

different times: (1) before the audit report date, (2) after the audit report date but before issuance of the report, or (3) after the audit report is issued. The most important things to remember are that auditors have an active, procedural responsibility for discovering both type of subsequent events up to the audit report date and for ensuring they are properly reported in the financial statements, but they are not required to perform procedures after the audit report date. However, because they are associated with financial statements upon which they have given an audit opinion, auditors have responsibilities once they become aware of the facts or omitted procedures. These issues are further discussed in Chapter 16, where we will cover the independent auditor's report.

REVIEW CHECKPOINTS

15-10 What are the two types of subsequent events? How are they treated differently in the financial statements?

15-11 What treatment is given stock dividends and splits occurring after the balance sheet date but before the audit report is issued? Explain.

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MANAGEMENT'S WRITTEN REPRESENTATIONS

LO5 Explain why written management representations are obtained and what items are generally included in the representation letter, including identification of related parties.

management representation letter: the written statements by management provided to the auditor to confirm certain matters or to support other audit evidence as required by CAS 580

Management responds to numerous auditor enquiries during the course of an audit. These representations are very important components of audit evidence, but they are not sufficient by themselves. As much as possible, auditors should corroborate management representations with evidence from additional procedures.

Auditors should also obtain written representations from management on matters of audit importance (CAS 580). These representations exist as a letter on the auditee's letterhead, addressed to the auditor, signed by responsible officers (normally the chief executive officer, chief financial officer, and other appropriate managers), and dated as of the date of the auditor's report. The letter, referred to as the **management representation letter**, covers events and representations running beyond the balance sheet date up to the audit report date.

In most cases, written management representations are assertions, such as the ones already in the financial statements, but perhaps more detailed. They are not sufficient evidence for auditors and not a good defence against criticism for failing to perform audit procedures independently. ("Management told us in writing that the inventory costing method was FIFO and adequate allowance for obsolescence was provided" is not a good excuse for failing to get the evidence from the records and other sources!) However, in some cases these are the only evidence about important matters of management intent; for example, (1) "We will discontinue the parachute manufacturing business, wind down the operations, and sell the remaining assets" (i.e., accounting for discontinued operations); and (2) "We will exercise our option to refinance the maturing debt on a long-term basis" (i.e., classifying maturing debt as long-term).

A primary purpose of the management representation letter is to impress upon the management its responsibility for the financial statements. They also may establish an auditor's defences against questions of management integrity: A management lie to the auditors will be captured in writing in the letter. Auditors draft the management representation letter to be prepared on the auditee's letterhead for signature by company representatives. This draft is reviewed with senior auditee personnel, and then finalized.

Auditing standards indicate that the following written representations must be obtained in all audits:[1]

- That management has fulfilled its responsibility for the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework, as set out in the terms of the audit engagement
- That management has provided the auditor with all relevant information to conduct the audit engagement, as agreed in the terms of engagement
- That all transactions have been recorded and are reflected in the financial statements

STANDARDS CHECK

CAS 580

Written Representations about Management's Responsibilities

Preparation of the Financial Statements

10. The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation, as set out in the terms of the audit engagement. (Ref: Para. A7-A9, A14, A22)

Information Provided and Completeness of Transactions

11. The auditor shall request management to provide a written representation that:

    (a) It has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement; and

    (b) All transactions have been recorded and are reflected in the financial statements. (Ref: Para. A7-A9, A14, A22)

Description of Management's Responsibilities in the Written Representations

12. Management's responsibilities shall be described in the written representations required by paragraphs 10 and 11 in the manner in which these responsibilities are described in the terms of the audit engagement.

Source: *CICA Handbook—Assurance*, 2012.

1 *CICA Handbook*, CAS 580.

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The auditor may consider it necessary to get other written representations in some circumstances. These other representations could include the following:

- That the selection and application of accounting policies are appropriate
- That the financial statements have appropriately recognized, measured, presented, or disclosed
- Plans or intentions that may affect the carrying value or classification of assets and liabilities
- Liabilities, both actual and contingent
- Title to, or control over assets, liens or encumbrances on assets, and assets pledged as collateral
- Aspects of laws, regulations, and contractual agreements that may affect the financial statements, including noncompliance

In situations of fraud risk or known frauds, going-concern uncertainty, correction of material misstatements uncovered in the audit, material estimates, related parties, and subsequent events, other written representations may be required. Several other representations may be relevant in particular businesses or industries; for example, environmental liabilities, derivative financial instruments, the appropriateness of accounting policies for complex areas of accounting, and areas involving management's judgment and estimates, such as revenue recognition, fair value measurements, transfers of receivables, hedging relationships, and consolidation of variable interest entities.

The representation letter provides management with a summary of the uncorrected financial statement misstatements found by the auditor during the audit, and it obtains management's representation of its belief that these are immaterial to the financial statements—a summary of such items is included in or attached to the letter. Management representations are also required for auditors involved with prospectuses[2] and for review engagements.[3] An example of a written representation letter is shown in Exhibit 15–6.

Audit of Related-Party Transactions

A representation letter answers these key questions: Has the auditee identified all its related parties to the auditor? Has the auditee been involved in any related-party transactions? (See Exhibit 15–6) Auditors have a responsibility to obtain reasonable assurance that related parties have been identified and that there is appropriate disclosure with such parties in the financial statements.[4] Related parties exist when one party has the ability to exercise either control or joint control, directly or indirectly, or has significant influence over the other. Parties are related when they are subject to common control, joint control, or common significant influence. Related parties could include management and immediate family members. Related-party transactions are particularly important in Canada because of the high concentration of corporate ownership.

The problem with related-party transactions is that since they are not arm's length, they may not reflect the normal terms of trade that occur with most transactions with external parties. The *CICA Handbook* ASPE provides measurement and disclosure standards for related-party transactions, and IFRS (IAS 24) only requires disclosures. The auditor's main problem is identifying these transactions. Management enquiry is the main procedure (as in the management representation obtained in Exhibit 15–6), but others include reading the minutes of meetings of shareholders, directors, and executive and audit committees, as well as acquiring a general knowledge of the auditee's business.[5]

Unusual transactions might point to undisclosed relationships, so being skeptical about these in the course of doing an audit is critical. The team discussions provide a good opportunity to ensure that the audit team is aware of related-party relationships and

2 *CICA Handbook,* Assurance, Other Canadian Standards, section 7110.

3 *CICA Handbook*, Assurance, Other Canadian Standards, section 8200.

4 CAS 550.

5 CAS 550, CAS 315.

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EXHIBIT 15–6 Illustrative Written Representation Letter

(Auditee Letterhead)

(To Auditor) (Date)

This representation letter is provided in connection with your audit of the financial statements of ABC Company for the year ended December 31, 20XX, for the purpose of expressing an opinion as to whether the financial statements are presented fairly, in all material respects, in accordance with International Financial Reporting Standards.

We confirm the following:

Financial Statements

- We have fulfilled our responsibilities for the preparation and presentation of the financial statements as set out in the terms of the audit engagement dated [insert date] and, in particular, the financial statements are fairly presented in accordance with International Financial Reporting Standards.
- Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable.
- Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of International Financial Reporting Standards.
- All events subsequent to the date of the financial statements and for which International Financial Reporting Standards require adjustment or disclosure have been adjusted or disclosed.
- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter.
- [Any other matters that the auditor may consider appropriate, such as whether financial statements have appropriately recognized, measured, presented, or disclosed:
  - Plans or intentions that may affect the carrying value or classification of assets and liabilities
  - Liabilities, both actual and contingent
  - Title to, or control over, assets, and the liens or encumbrances on assets, and assets pledged as collateral
  - Aspects of laws, regulations, and contractual agreements that may affect the financial statements, including noncompliance
  - A going concern uncertainty, if any]

Information Provided

- We have provided you with:
  - All information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements.
  - Additional information that you have requested from us.
  - Unrestricted access to those within the entity.
- All transactions have been recorded in the accounting records and are reflected in the financial statements.
- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.
- We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves:
  - Management.
  - Employees who have significant roles in internal control.
  - Others where the fraud could have a material effect on the financial statements.
- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators, or others.
- We have disclosed to you all known actual or possible noncompliance with laws and regulations whose effects should be considered when preparing financial statements.
- We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware.
- [Any other matters that the auditor may consider necessary.]

{signed} {signed}

Auditee CEO Auditee CFO

Source: Adapted from CAS 580.

transactions that could leave the financial statements susceptible to fraud or error. Some indications of the existence of undisclosed related parties are as a follows:

- Abnormal terms of trade, such as unusually high or low selling prices, interest rates, and repayment terms.
- Large, unusual transactions, particularly those recognized at or near the balance sheet date.
- Transactions that lack an apparent business reason, or where the legal form of the transactions seems to conceal its actual economic substance.

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In addition to the auditor's business risk assessment, the following further procedures can help to identify the existence of related-party transactions:[6]

- Review prior-year working papers for related-party transactions.
- Review the entity's procedures for identifying related parties.
- Obtain written representation from management concerning identification and adequacy of related-party disclosures.

Having identified related-party transactions, the auditor can perform the following substantive procedures:

- Confirm the terms and amounts of the transactions with the related parties.
- Inspect evidence in possession of the related party.
- Confirm or discuss information with persons associated with the transactions, such as banks, lawyers, guarantors, and agents.

CAS 550 also requires the auditor to communicate significant matters identified during the audit that concern related-party transactions or relationships to those charged with governance.

The box below illustrates how related-party transactions can be used to significantly alter the financial statements. The illustration is based on an actual Canadian company trading on NASDAQ and the TSX.

TURNING EXPENSES INTO REVENUES

CB is a major biotechnology company in Canada that did not like the effect which expensing R&D had on its earnings. So, CB proceeded to create a related entity, CC, to which it made a capital contribution of $100 million. A series of share exchanges involving shares of both companies had the net effect of a debit to retained earnings and a credit to cash for $100 million on CB's financial statements. An agreement was then reached in which CC paid CB a fee in exchange for a technology licence. CC used the $100 million it had received from CB to repay CB for CB's R&D costs. CB accounted for the amounts received from CC as revenue.

In the words of CB's chairman of the board, "This initiative will enable us to leverage our investment in R&D and pursue the ongoing development of exciting new products, without unduly affecting the company's baseline earnings."

REVIEW CHECKPOINTS

15-12 What is the purpose of a management representation letter?

15-13 What representations would you request that management make in the representation letter with respect to related parties? receivables? inventories? minutes of meetings? subsequent events?

15-14 Why are written management representations and lawyers' letters obtained at the final stage of the audit and dated as close as possible to the audit report date?

15-15 How can related-party transaction affect the financial statements?

AUDIT DOCUMENTATION WORKING PAPER REVIEW

LO6 Outline the procedures used to complete the documentation of the audit engagement.

A typical audit team would include the engagement partner, audit manager, on-site supervisor, one or more audit staff members, and any experts required. Soon after completion, each audit documentation working paper is reviewed by the audit supervisor,

6 CAS 550.

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and sometimes by the audit manager, to ensure that all tick-mark notations are clear, that all procedures performed are adequately documented, and that all necessary procedures were performed with due professional care. To wrap up the audit field work, the supervisor or manager makes a final review of the all the working papers, which may be recorded in paper, electronic, or other media. This final review ensures that all accounts on the trial balance have a **working paper reference index**, the sign that audit work has been finished on that account, and that all procedures in the audit program are "signed off" with a date and initials. Any outstanding work or issues would be summarized at this point for the manager's and partner's attention; usually in a working paper called the "to-do list."

working paper reference index: table of contents listing all the index numbers used to identify sections of the audit working paper files

The manager and engagement partner's review would come next, and it focuses more on the overall scope of the audit. They are very involved with the planning of the audit and may perform some of the field work on difficult areas, but they are usually not involved in preparing the detailed working papers. Even though the working papers are reviewed by the on-site supervisor, the partner who is going to sign the audit report should review them as well, since he or she has the final responsibility for ensuring sufficient appropriate audit evidence has been obtained and documented. Additions to the to-do lists, citing omissions or deficiencies, are prepared during these reviews and must be cleared by the audit staff before the final work is completed.

Treatment of the to-do lists varies among audit firms. Some prefer to destroy the lists after the work is performed and documented in the working papers as a "clean up" of notes relating to loose ends. Other firms keep the lists as signed off, and cross-reference them for the work performed, believing the lists are evidence of careful review and completion of the audit. Sometimes, retained to-do lists backfire on auditors by showing questions raised but not resolved.

For *listed public entities*, the audit firm's quality control policies (CSQC-1) require **engagement quality review** an engagement-quality review of the working papers and financial statements, including notes, to be performed by a partner not responsible for the client relationship. This second-partner review ensures that the quality of audit work and reporting is in keeping with the quality standards of the audit firm. This engagement quality review must be complete before the audit report can be issued (the specific requirements are set out in CAS 220). Audit firm's quality control policies may require engagement quality reviews in other situations, such as first time audits or engagements that are considered very risky. Considering all the professional judgments that have been made in completing the audit to this stage, these reviews allow the files to be reviewed with a fresh set of eyes by someone very experienced and competent. This can increase the chance that any questionable or erroneous judgments will be scrutinized and resolved, indicating how the quality control mechanism can be very effective in improving the quality of audit outcomes.

engagement quality review: review of working papers and financial statements by a partner not responsible for client relations; ensures that quality of audit work is in keeping with the standards of the audit firm

The completed working paper files are assembled for secure, long-term storage. Those retained in electronic files must have data integrity controls in place. Usually, the files are completed within sixty days of the audit report date, and are retained for at least five years. When field work is complete, the final audit time reports for billing purposes and audit staff performance evaluation reports are prepared by the audit supervisor.

REVIEW CHECKPOINTS

15-16 What is the purpose of to-do lists in the audit documentation? What is a good reason for keeping the to-do lists in the audit working paper files?

15-17 Describe an engagement quality review. Who performs it and what is its purpose?

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APPLICATION CASE WITH ANALYSIS

When in Doubt, Defer!

DISCUSSION CASE

Jack is now starting into his third year of auditing and is accumulating some valuable experiences. One day, he has lunch with a former classmate Stella, who now works for the securities market regulator as an inspector. They are discussing some of the ways auditors get in trouble, Stella tells him about a case her boss had worked on a few years ago. "This really showed me why, even when all the staff does a good job, audits just can't work if the partner isn't independent," Stella said. As he listens to this case, Jack thinks about some similar issues partners on his audits had to fight their way through to make sure the financial statements ended up being fairly presented and realizes it take a lot of integrity provide a high quality audit result.

SaCom manufactured electronic and other equipment for private customers and government military defence contracts. The company was deferring costs under the headings of work-in-process, military contract claims, and R&D test equipment, thus overstating assets, understating cost of goods sold, and overstating income. Disclosure of the auditor's fees was manipulated and understated. SaCom reported net income of about $542,000 for the year, an overstatement of approximately 50%.

To achieve better reported profit, near the end of the year, the company used a journal entry to remove $170,000 from cost of goods sold and to defer it as tooling, leasehold improvements, and contract award and acquisition costs. The company capitalized certain expenditures as R&D test equipment ($140,000) and claims for reimbursement on defence contracts ($378,000).

In connection with a public offering of securities, the firm doing the audit billed SaCom $125,000 for professional fees. The underwriters objected so the auditors agreed to forgive $70,000 of the fees while SaCom agreed to pay higher fees the following year (150% of standard billing rates). SaCom disclosed audit fees in the registration statement in the amount of $55,000. This amount was paid from the proceeds of the offering.

Audit Trail

The $170,000 deferred costs were primarily labour costs, and the company altered the labour time records to be able to provide substantiating documentation. The auditors discovered the alterations as the jobs were left with labour costs that were too small, in light of the work performed. The R&D test equipment cost had already been charged to cost of goods sold with no indication of a reason for deferral when originally recorded. Deferral was accomplished with an adjusting journal entry. The company did not have documentation for the adjusting entry, except for an estimate of labour cost (44% of all labour cost in a subsidiary was capitalized during the period). The claim for reimbursement on defence contracts did not have documentation specifically identifying the costs as being related to the contract. (Auditors know that defence department auditors insist on documentation and justification before approving such a claim.) The audit fee arrangement was known to the audit firm, and it was recorded in an internal memorandum.

AUDIT APPROACH ANALYSIS

Audit Objective

The auditors' objective is to obtain evidence of the validity of production costs deferred as tooling, leasehold improvements, contract award and acquisition costs, R&D test equipment, and claims for reimbursement on defence contracts.

Controls Relevant to the Process

The major control lies in the procedures for documenting the validity of cost deferral journal entries.

AUDIT PROCEDURES

Tests of Controls

The procedure is to select a sample of journal entries, suspect ones in this case, and vouch them to supporting documentation and authorization. Experience has shown that nonstandard adjusting journal entries are the source of accounting errors and fraud more often than standard accounting for regular transactions. This makes adjusting journal entries a ripe field for control and substantive testing.

Tests of Details of Balance

The account balances created by the deferral journal entries can be audited in a dual-purpose procedure by auditing the supporting documentation. These balances were created entirely by the journal entries, and their "existence" as legitimate assets, deferrals, and reimbursement claims depends on the believability of the supporting explanations. In connection with the defence contract claim, auditors can review it knowing the extent of documentation required by government contract auditors. (As a separate matter, the auditors could "search for unrecorded liabilities," but they already knew about the deferred accounting fees anyway.)

AUDIT RESULTS

By performing the procedures outlined, the audit team discovered all the questionable accounting. However, the

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partners in the auditing firm insisted on rendering unqualified opinions on the SaCom financial statements, without adjustment. One partner owned 300 shares of the company's stock in the name of a relative (without the consent or knowledge of the relative). Another audit partner later arranged a bank loan to the company to get $125,000 to pay past-due audit fees. This partner and another, along with their spouses, guaranteed the loan. (When the bank later disclosed the guarantee in a bank confirmation, the confirmation was removed from the audit working paper file and destroyed.)

Regulatory Actions against the Auditors

The securities market regulator investigated the auditors' conduct in the SaCom audit and, among other things, barred the audit firm for a period (about six months) from accepting new audit clients, and it also barred the partners involved in the SaCom audit work from involvement with new audit clients for various periods of time. The partners had violated several rules of professional conduct and were therefore subject to disciplinary action by their provincial institute (see Chapter 3 for discussion of rules of professional conduct).

REVIEW CHECKPOINTS

15-18 What red flag is raised when a company has an unbilled contract revenue account in its general ledger?

15-19 Why should auditors always select the auditee's adjusting journal entries for detail audit?

SUMMARY

This chapter covered several aspects of completing an audit.

- As the work draws to a close, several income and expense accounts may still need to be audited. This work is largely done through analytical comparisons of these balances with those of prior years and with current expectations. While large and significant revenues and expenses usually have already been audited in connection with the audit of other accounts in the process, at this stage in the audit it is a good idea to step back and review large and unusual revenue and gain transactions recorded near the end of the year. Often, these have been the vehicles for income statement manipulation. Some examples were given in the chapter.
- Final analytical procedures performed at the end of the audit were explained in terms of their role of allowing the most senior members of the audit team, usually the engagement partner, to ensure the financial statements reflect the evidence and knowledge obtained in the course of performing the audit.
- Information from lawyers is especially important in evidence about litigation contingencies and their disclosure, according to the *CICA Handbook* section 3290 and IAS 37. The most important topic, preparing and obtaining the lawyer's letter as confirmation regarding any outstanding claims and contingencies, was discussed. A special insert described particular problems in interpreting lawyers' letters.
- Management's written representations provide key evidence regarding many important details and assertions, and without them the audit scope is considered limited. Several requirements for the management representation letter were specified in the chapter.
- Subsequent events were explained in detail, including the two types of subsequent events that can affect financial statements, and the auditor's procedural responsibility for events following the balance sheet date.
- The chapter ended with coverage of the final file review process and the compilation of a file of audit documentation for review and retention by the audit firm, to be available

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for inspection or for the auditors' defence in the case of a lawsuit. These are firm-level and engagement-level requirements that exist to increase the quality of audits, as set out in CSQC-1 and CAS 220. These files are the documentary basis for forming the audit opinion, to be covered next.

Forming the audit opinion based on the audit findings will be covered in detail in the next chapter, which explains the application of professional judgment to achieve the final objective and focal point of the whole financial statement audit engagement, and its only public result—the auditor's report.

KEY TERMS

engagement partner
engagement quality review
management representation letter
pro forma financial data
working paper reference index

EXERCISES AND PROBLEMS

EP 15-1 Management Written Representation Letter. LO5 In connection with your audit, you request that management provide you with a letter containing certain representations, such as the following:

1. The auditee has satisfactory title to all assets.
2. No contingent or unrecorded liabilities exist except as disclosed in the letter.
3. No shares of the company's stock are reserved for options, warrants, or other rights.
4. The company is not obligated to repurchase any of its outstanding shares under any circumstances.

Required:

a. Explain why you believe a letter of representation should be provided to you.

b. In what way, if any, do these management representations affect your audit procedures and responsibilities?

(AICPA adapted)

EP 15-2 Engagement and Management Representation Letters. LO5 The two major written understandings between an auditor and management, in connection with an audit of financial statements, are the engagement letter and the management representation letter.

Required:

a. (1) What are the objectives of the engagement letter?
(2) Who should prepare and sign the engagement letter?
(3) When should the engagement letter be sent?
(4) Why should the engagement letter be renewed periodically?

b. (1) What are the objectives of the management representation letter?
(2) Who should sign the management representation letter?
(3) When should the management representation letter be obtained?
(4) Why should the management representation letter be prepared for each examination?

c. An auditor's responsibilities for providing accounting services sometimes involve an association with unaudited financial statements. Discuss the need for each of the following in this circumstance:
(1) An engagement letter.
(2) Management representation letter.

(AICPA adapted)

EP 15-3 Subsequent Events and Contingent Liabilities. LO4, LO5 Crankwell Inc. is preparing its annual financial statements and report to shareholders. Management wants to be sure that all of the necessary and proper disclosures are incorporated into the financial statements and the annual report. Two classes of items that have an important bearing on the financial statements are subsequent events and contingent liabilities. The financial statements could be materially inaccurate or misleading if proper disclosure of these items is not made.

Required:

a. With respect to subsequent events:
(1) Define subsequent events.
(2) Identify the two types of subsequent events and explain the appropriate financial statement presentation of each type.

b. With respect to contingent liabilities:
(1) Identify the essential elements of a contingent liability.
(2) Explain how a contingent liability should be disclosed in the financial statements.

c. Explain how a subsequent event may relate to a contingent liability. Give an example to support your answer.

(CMA adapted)

EP 15-4 Lawyer's Letters. LO3 Auditors are required to obtain representation letters from the auditee's lawyer to elicit information on claims and possible claims that may affect the financial statements.

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Required:

a. Discuss the audit evidence provided by a lawyer's letter. Explain which assertions and financial statement amounts the lawyer's letter relates to. What other audit evidence is available for these assertions, if any?

b. What other evidence may be available to an auditor that can corroborate the completeness of the claims the auditee has listed in the lawyer's letter?

c. What should be the effective date of the lawyer's letter? Why?

EP 15-5 Management Representation Letters. LO5 Refer to the example of a written management representation letter illustrated in Exhibit 15–5.

Required:

a. What are the assumptions about the audit engagement in this management representation letter?

b. Which of the representations in the example letter need to be provided regardless of their materiality?

c. If an event subsequent to the date of the balance sheet has been disclosed in the financial statements, what modification would be made to the example letter?

d. If management has received a communication regarding an allegation of fraud or suspected fraud, what modification would be made to the example letter?

EP 15-6 Procedures for Identifying Contingent Liabilities. LO3 In 2009, Jay Inc. and Vee Ltd., both Canadian manufacturing companies, decided to form a joint venture to build and operate a manufacturing plant in Asia. Their joint venture would have lower operating costs and faster access to Asian markets. Your audit client, Jay, borrowed $4,000,000 and arranged for further long-term debt from its banker, Manufacturing Bank of Canada. Jay is currently being sued because it cancelled a purchase agreement it had with another company, Boilers Inc., to purchase some equipment.

Required:

Prepare four audit procedures, in addition to obtaining a representation from the audtitee management and communicating with the company's law firm, to identify the contingent liabilities, if any, of Jay. Do not include any analytical procedures in your list.

(Adapted from CGA-Canada AU1 Examination September 2010)

EP 15-7 Business Processes, Financial Statement Articulation, and XBRL Application. LO1, LO2, LO6 The final review stage of the audit involves taking an overall view of the financial statements and assessing how fairly they reflect the underlying economic events and conditions that occurred in the entity. This exercise involves pulling together difference aspects of the text material that help auditors take this overall integrated view, and considering the case of a real company's financial statements.

Required:

a. Obtain an example of a current set of financial statements from the data base of public company documents available at SEDAR.com. For each of the items included in the entity's business processes in Exhibit 6–13, identify which financial statement it will appear in and all the other financial statement items to which it is related.

b. Using the file index system illustration in Appendix 11C (available on Connect), provide an index of what a typical audit file for your example company financial statements would be likely to contain.

c. XBRL is an Internet-based technology for presenting financial data on Web pages and exchanging it over the Internet with other users' systems. Companies are increasingly being required to provide their financial statements in XBRL format. Information on the underlying structure of XBRL and how it works can be found at the website XBRL.org. Further research can be done at other websites for reference: for example, edgr.com (EDGAR online). For the financial statement items you identified in (a) above, describe how each data item could be defined/tagged in XBRL to appear in the financial statements. If the financial data item has been audited, can XBRL allow the auditor's assurance to be communicated to users at the same time as the data? How?

DISCUSSION CASES

DC 15-1 Management Representations Letter Omissions. LO5 During the audit of the annual financial statements of Amis Manufacturing Inc., the company's president, Vance Molar, and Wayne Dweebins, the engagement partner, reviewed matters that were supposed to be included in a written representation letter. Upon receipt of the following representation letter, Dweebins contacted Molar to state that it was incomplete.

To John & Wayne, Public Accountants:

In connection with your examination of the balance sheet of Amis Manufacturing Inc., as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended, for the purpose of expressing an opinion on whether the financial statements present fairly the financial position, results of operations, and cash flows of Amis Manufacturing Inc., in conformity with generally accepted accounting principles, we confirm, to the best of our knowledge and belief, the following representations made to you during your audit. The following were not present:

- Plans or intentions that may materially affect the carrying value or classification of assets or liabilities
- Communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices

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- Agreements to repurchase assets previously sold
- Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency
- Unasserted claims or assessments that our lawyer has advised are probable and that must be disclosed in accordance with Canadian GAAP
- Capital stock purchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements
- Compensating balance or other arrangements involving restrictions on cash balances

Vance Molar, President
Amis Manufacturing Inc.
March 14, 20X3

Required:
Identify the other matters that Molar's representation letter should specifically confirm.

(AICPA adapted)

DC 15-2 Subsequent Events Procedures. LO4 You are in the process of winding up the field work on Top Stove Corporation, a company that manufactures and sells kerosene space heating stoves. To date, there has been every indication that the financial statements of the company present fairly the position of the company at December 31 and the results of its operations for the year then ended. Top Stove had total assets at December 31 of $4 million and a net profit for the year (after deducting federal and provincial income taxes) of $285,000. The principal records of the company are a general ledger, cash receipts record, accounts payable register, sales register, cheque register, and general journal. Financial statements are prepared monthly. Your field work will be completed on February 20, and you expect the company's board to meet and approve the final financial statements on March 12.

Required:

a. Write a brief statement about the purpose and period to be covered in a review of subsequent events.

b. Outline the program you would follow to determine what transactions involving material amounts, if any, have occurred since the balance sheet date.

(AICPA adapted)

DC 15-3 Subsequent Events: Cases. LO4 The following events occurred in independent cases, but in each instance the event happened after the close of the fiscal year under audit but before all members of the audit team had left the office of the auditee. For each case, state what impact, if any, you would expect on the financial statements (and notes). The balance sheet date in each instance is December 31, 20X1.

1. On December 31, the commodities handled by the company had been traded in the open market for $1.40 per pound. This price had prevailed for two weeks, following an official market report that predicted vastly enlarged supplies; however, no purchases were made at $1.40. The price throughout the preceding year, and several prior years, had been about $2. On January 18, 20X2, the price returned to $2, following disclosure of an error in the official calculations of the prior December—correction of which destroyed the expectations of excessive supplies. Inventory at December 31, 20X1, had been valued on a lower-of-cost-or-net-realizable-value basis.
2. On February 1, 20X2, the board of directors adopted a resolution accepting an investment banker's offer to guarantee the marketing of $100 million of preferred shares.
3. On January 22, 20X2, one of the auditee's three major plants burned down, a $50 million loss that was covered to $40 million by insurance.
4. The auditee in this case is an open-end-type investment company. In January, 20X2, a new management took control. By February 20X2 it had sold 90% of the investments carried at December 31, 20X1, and had purchased substantially more speculative ones.
5. This company has a wholly owned but not consolidated subsidiary producing oil in a foreign country. A serious rebellion began in that country on January 18, 20X2, and continued beyond the completion of your audit work. There has been extensive coverage of the fighting here.
6. The auditee, Comtois Corp., sells property management software systems. Shortly before its December 31, 20X1, year-end, Comtois' president finalized a large sale to a provincial ministry. The contract has been completed and all the terms agreed to by the assistant deputy minister, but the minister herself is the only one authorized to sign the contract because of the large dollar amount involved. As of the last day of audit fieldwork, March 3, 20X2, Comtois has not yet received the signed contract because the minister has not been available. The president wants to recognize the revenue in Comtois' 20X1 fiscal year anyway so that the sales people and managers involved can be paid a bonus this year based on it. The auditee's stated accounting policy for revenue recognition on these types of sales, established five years earlier, is to recognize revenue when the sales contract is signed.
7. During its fiscal year ending December 31, 20X1, Noriker Inc. issued common shares to its vice-president of marketing. At the date of issuing these shares, the company also provided the vice-president with a non-interest-bearing loan of $50,000 to purchase the shares. While reviewing the minutes of all the Noriker board of directors meetings during the audit fieldwork, Noriker's auditor notes that in a meeting on February 12, 20X2, the Noriker board agreed to forgive this loan, effective on that day.

(AICPA adapted)

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DC 15-4 **Subsequent Events: Cases.** LO4 In connection with your examination of the financial statements of Olars Manufacturing Corp. for the year ended December 31, your post-balance sheet audit procedures disclosed the following items:

1. January 3: The provincial government approved construction of an expressway. The plan will result in the expropriation of land owned by Olars Manufacturing Corp. Construction will begin late next year. No estimate of the expropriation award is available.
2. January 4: The funds for a $25,000 loan to the corporation made by Mr. Olars on July 15 were obtained by him with a loan on his personal life insurance policy. The loan was recorded in the loan payable to officers account. Mr. Olars' source of the funds was not disclosed in the company records. The corporation pays the premiums on the life insurance policy, and Mrs. Olars, wife of the president, is the owner and beneficiary of the policy.
3. January 7: The mineral content of a shipment of ore en route on December 31 was determined to be 72%. The shipment was recorded at year-end at an estimated content of 50% by a debit to raw material inventory and a credit to accounts payable in the amount of $20,600. The final liability to the vendor is based on the actual mineral content of the shipment.
4. January 15: A series of personal disagreements have arisen between Mr. Olars, the president, and Mr. Tweedy, his brother-in-law, the treasurer. Mr. Tweedy resigned, effective immediately, under an agreement whereby the corporation would purchase his 10% share ownership at book value as of December 31. Payment is to be made in two equal amounts in cash on April 1 and October 1. In December the treasurer had obtained a divorce from Mr. Olars' sister.
5. January 31: As a result of reduced sales, production was curtailed in mid-January and some workers were laid off. On February 5 all the remaining workers went on strike. To date, the strike is unsettled.
6. February 10: A contract was signed whereby Mammoth Enterprises purchased from Olars Manufacturing all of the latter's capital assets (including rights to receive the proceeds of any property expropriation), inventories, and the right to conduct business under the name "Olars Manufacturing Division." The transfer's effective date will be March 1. The sale price was $500,000, subject to adjustment after a physical inventory. Important factors contributing to the decision to enter into the contract were the policy of the board of directors of Mammoth Industries to diversify the firm's activities and the report of a survey conducted by an independent market appraisal firm, which revealed a declining market for Olars' products.

Required:

Assume that the above items came to your attention prior to completion of your audit work on February 15. For each of the above items:

a. Give the audit procedures, if any, that would have brought the item to your attention. Indicate other sources of information that may have revealed the item.

b. Discuss the disclosure that you would recommend for the item, listing all details. Indicate those, if any, that should not be disclosed. Give your reasons for recommending or not recommending disclosure of these.

(AICPA adapted)

DC 15-5 **Lawyer's Letters.** LO3 The controller of Kim Engineering Ltd. (KEL) sent a legal representation letter to KEL's law firm at the request of the company's auditors. The controller told the auditors that there are no lawsuits presently ongoing. The lawyers replied to the letter, agreeing that there were no outstanding or possible claims of which they have knowledge, or for which their advice has been sought.

However, the controller was not aware that the board of directors had sought legal advice from a second law firm regarding a harassment lawsuit. Due to the nature of the matter, the board of directors did not want anyone to know about the possible claim. There are no records of it outside of the president's office, but the auditor noticed it when reviewing the minutes of the board of directors' meetings. The auditor, therefore, requested that a letter be sent to the second law firm as well.

One of the members of the board of directors is Yung, who had started the company 20 years ago, but is now retired from any duties other than being a director. When the company first started, Yung performed almost all of the duties himself, but over the years, his duties have been assigned to other people. For example, only the controller or the president of the company can sign cheques on behalf of the company, and the controller's authority is limited to $15,000. Any cheque request must be supported by an authorized purchase requisition, and any request over $15,000 must be authorized by the president. The accounting manager does all of the bank reconciliations herself, but her assistant enters the journal entries according to the accounting manager's instructions.

Required:

a. Indicate what the effect would be on the audit if the auditor receives no response from the second law firm.

b. If the second law firm replies and provides information to the auditor, indicate how the auditor should treat this information for financial statement purposes.

c. State whether the control risk is high or low, and support your decision with *four* points.

(CGA-Canada adapted)

DC 15-6 **Subsequent Events, Pro Forma Disclosures.** LO4, LO6 Assume that you are the financial statement

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auditor in the following independent cases, and you are completing your audit in February 20X2.

1. During January 20X2, the company's management decided to sell rental real estate properties that accounted for approximately 40% of its total revenues in 20X1.
2. The company's main factory was closed for six weeks in January and February of 20X2 because of ice storm damage. The factory resumed full operations in late February.
3. One of the company's factories was destroyed by a fire in January. The plant was old and will not be replaced, as production can be taken up by excess capacity in other plants.
4. In late February, the company's board of directors agreed to settle an outstanding claim by paying \$15 million to former employees. The employees suffered health problems related to asbestos exposure during the years of their employment. A contingent liability was disclosed but not accrued as of December 31, 20X1, because of the uncertainty surrounding the outcome of the lawsuit.
5. For the past four years, the company has made 90% of its revenues and profits from sales of specialty cable to computer manufacturers. Early in 20X2, it has become apparent that there is massive overcapacity in this industry, and demand for the product has fallen to almost zero. It is not expected to recover for several years, and may never recover if alternate technologies developed in the meantime make the product unnecessary.

Required:

a. For each of these subsequent events, indicate if you would require the auditee company to adjust its December 20X1 year-end financial statements, disclose the event in the 20X1 financial statements, and/or provide pro forma financial information in the 20X1 financial statements. Give reasons to support your responses, and state any assumptions you make.

b. Explain how you would document your findings and conclusions in the audit files.

DC 15-7 **Franchising Revenues.** LO1, LO6 You are an auditor with ZZ, a PA firm. Your firm has just accepted a new engagement to audit the annual financial statements of Chestnut Limited, a medium-sized restaurant business. Chestnut operates a chain of specialty fast food restaurants. Most of the restaurants are franchised, and Chestnut receives franchise fees based on the franchisee store's net sales revenues.

Chestnut receives 4% of net sales as a base franchise fee, 1% as an advertising fee, and 0.5% as an administration fee for processing franchisee accounting information and issuing reports in standard format. Franchisee sales information is uploaded daily to Chestnut's central accounting system, where it is input into the franchise reporting system to generate daily, monthly, and year-end management reports.

Required:

Assume you are an audit manager reviewing the audit work on the franchise revenues that has been documented by the staff during their field work at Chestnut. What procedures will you expect to have been included in their audit work? State any assumptions you make.

DC 15-8 **Lawyer's Letter Responses.** LO3 Omega Corporation is involved in a lawsuit brought by a competitor for patent infringement. The competitor is asking \$14 million actual damages for lost profits and unspecified punitive damages. The lawsuit has been in progress for 15 months, and Omega has worked closely with its outside counsel preparing its defence. Omega recently requested its outside lawyers with the firm of Wolfe & Goodwin to provide information to the auditors.

The managing partner of Wolfe & Goodwin asked four different lawyers who have worked on the case to prepare a concise response to the auditors. They returned the following:

1. The action involves unique characteristics wherein authoritative legal precedents bearing directly on the plaintiff's claims do not seem to exist. We believe the plaintiff will have serious problems establishing Omega's liability; nevertheless, if the plaintiff is successful, the damage award may be substantial.
2. In our opinion, Omega will be able to defend this action successfully, and, if not, the possible liability to Omega in this proceeding is nominal in amount.
3. We believe the plaintiff's case against Omega is without merit.
4. In our opinion Omega will be able to assert meritorious defences and has a reasonable chance of sustaining an adequate defence, with a possible outcome of settling the case for less than the damages claimed.

Required:

a. Interpret each of the four responses separately. Decide whether each is (1) adequate to conclude that the likelihood of an adverse outcome is "remote," requiring no disclosure in financial statements, or (2) too vague to serve as adequate information for a decision, requiring more information from the lawyers or from management.

b. What kind of response do you think the auditors would get if they asked the plaintiff's counsel about the likely outcome of the lawsuit? Discuss.

DC 15-9 **Revenue, Audit Procedures.** LO1, LO6 While performing analytical procedures as part of her audit of the revenue and expense accounts at Galloway Inc., PA notes that Galloway's sales revenues in the current year have increased by 20% over the prior year. Galloway manufactures and sells business forms and has seen declining sales over the past few years as its customers have been changing to paperless,

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online process methods. In fact, in the prior year's audit there was concern about Galloway's ability to meet its long-term debt covenants which require at least a 2:1 current ratio and pre-tax earnings that are at least 10 times long-term debt interest charges. To meet these debt covenant restrictions, no bonuses were paid to management in the prior year. When PA discussed the current year sales figures with the sales manager, he informed her that Galloway had increased its prices by 50% in the third quarter of the current year, to offset the lower sales volumes. Management had determined that Galloway's remaining customers were restricted to using paper-based documentation for various business reasons and thus would accept higher prices. During this interview, the chief accountant was passing by and, overhearing the topic, made the following comments: "Note that accounts receivable balance is also much higher than last year, which is totally consistent with the higher sales. This should tie together your analysis, so your audit work on sales and AR must now be complete. We are looking forward to having our boardroom back when you auditors finally finish the job and leave!"

Required:

Discuss the nature and the persuasiveness of the audit evidence PA is gathering in the above scenario. What additional evidence would you recommend she obtain to support her conclusion on the sales revenue figure? How would you recommend this audit work be documented in the audit files?

DC 15-10 Revenues, General Journal Entries. LO1, LO6 Town & Country Cable Inc. (TCC) is a cable television provider servicing customers in small towns and rural areas. Its shares are privately held, but it issued a 20-year bond eight years ago to the public. The bond contains restrictive covenants, which include requirements for TCC to maintain a current ratio of at least 2:1 at each fiscal year-end, and a ratio of operating cash flow to current liabilities of at least 1:0. If the covenants are violated, the bond holders have the right to demand repayment, raise the interest rate, and/or liquidate the company. In recent years, TCC has seen very little growth from new customer installations as most people are now choosing satellite service instead of cable. At the same time, TCC's existing installed customer base has been shrinking as many have switched to satellite for more channels and more reliable service. As a result of these changes in its operating environment, TCC has been close to violating its restrictive covenants in the past two years.

PA is the senior on the current-year audit. While scrutinizing a 300-page printout of the general journal entries for the year for material entries and seeing nothing but small adjustments for payroll and purchasing discounts, PA is about to sign off on the procedure. Then she notices ten journal entries in a row in the middle of November that debit account #22000 (current accrued liabilities) and credit account #54400 (other operating income). The entries are all for different immaterial amounts, but all are to the same two accounts, and all have the same explanatory note: "To adjust accrued liabilities as per instructions memo of Nov 2." On further investigation, PA finds 40 more entries to these accounts with the same explanation. The entries are all for different, immaterial amounts but add up to a large, material amount. The accountant who made these general journal entries is no longer employed by TCC, and no one else in the accounting department knows anything about the "memo of November 2."

Required:

a. What are some possible explanations for the PA's findings described above? How can the PA determine whether these entries result in a misstatement to the financial statements?

b. If these entries do result in financial statements that are materially misstated, what other procedures in the audit may have revealed these entries?

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CHAPTER 16

Applying Professional Judgment to Form the Audit Opinion and Issue the Audit Report

At the completion of the audit, the auditor is required to provide an opinion that is properly supported by the audit evidence and findings reflected in the audit files. The misstatements uncovered in the audit must be analyzed and assessed against the materiality level. Professional judgment must be applied by auditors in forming a conclusion on whether the financial statements are not materially misstated and are fairly presented, and on whether the audit evidence obtained is sufficient and appropriate to support the opinion. An audit report must be issued that presents the appropriate form of opinion. These and related issues are covered in this chapter.

EcoPak Inc.

EcoPak's board meeting with its auditors to approve the annual financial statements has been scheduled for February 28. Tariq has reviewed all the files and has asked his partner Phil to do an engagement quality review, since it is a new audit engagement and the company has plans to do an IPO in the near future. M&G's policy is to have an audit team meeting after these reviews are completed to prepare the audit engagement partner for this board meeting and to finalize the auditor communication with those charged with governance.

Tariq has concluded that the scope of the audit has been acceptable, and that the financial statements comply with generally accepted accounting principles (GAAP; International Financial Reporting Standards [IFRS]) and include all the disclosures needed to achieve fair presentation. All the misstatements identified by the audit were adjusted, though their overall impact on income was much less than materiality. Two misclassification misstatements were addressed appropriately in the final

LEARNING OBJECTIVES

After completing this chapter, you will be able to do the following:

LO1 Describe the role of professional judgment in achieving the overall objectives of the independent auditor in conducting an audit of financial statements as set out in Canadian Auditing Standard (CAS) 200.

LO2 Explain how accumulated misstatements are evaluated at the conclusion of an audit to form an opinion on the fair presentation of general purpose financial statements.

LO3 Describe the different forms of audit opinion and the decisions underlying the auditor's choice of form.

LO4 Explain the purpose of emphasis of matter (EOM) and other matter (OM) paragraphs in an audit report.

LO5 Summarize the auditor's communications throughout and at the conclusion of the engagement.

CHAPTER APPENDIX

Appendix 16A: Audit Completion Checklist *(online)*

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version of the financial statements. Several control issues that arose during the audit have been noted for inclusion in the management letter; Tariq has discussed these points with Nima, and she has agreed they also should be reported to the board at this upcoming meeting.

Prior to the board meeting, Nima also informed Tariq about a recent development. A venture capital firm is interested in investing in EcoPak shares, a substantial investment that would allow EcoPak to greatly reduce its bank debt and give it a much stronger balance sheet. The venture capitalists want to see the audited financial statements and likely will base their offer on a multiple of last year's earnings before taxes, interest, and depreciation/amortization. Tariq realizes that being aware of this specific financial statement user affects the risk profile of the engagement, and perhaps would have lowered the overall materiality level they selected at the initial planning stage. However, he notes that they had already selected a relatively low performance materiality level due to it being a first-time audit, so they are probably fine even with this major change in the type of users who will be making decisions based on the financial statements.

At the February 28 board meeting, Tariq informs the board that M&G plans to issue an unmodified opinion in the audit report and that it will also include an OM paragraph noting the prior year's financial statements were audited by a different firm, as is standard practice for M&G and other auditing firms. EcoPak's board and management affirm to Tariq that in their view all the required financial statements and disclosures have been included. The board passes a resolution stating that it has taken full responsibility for the financial statements' fair presentation in accordance with IFRS, and this resolution is duly recorded in the minutes. Nima and Kam provide Tariq with a signed letter containing all the representations he has recommended. After the meeting ends, Tariq issues and signs the audit report with a date of February 28.

APPLYING PROFESSIONAL JUDGMENT TO FORM THE AUDIT OPINION

LO1 Describe the role of professional judgment in achieving the overall objectives of the independent auditor in conducting an audit of financial statements as set out in CAS 200.

Throughout our discussion of the audit process to this point in the text, we have seen many examples of the panoply of decisions auditors need to make. For example, should the engagement be accepted at all, what is material to users, what are the risks of material misstatement, what audit procedures are required to respond to these risks to provide assurance that the financial statements are not materially misstated, is the evidence we have sufficient and appropriate provide reasonable/high assurance regarding a material misstatement, and what does the evidence indicate? In making these decisions, auditors have needed to apply their professional judgment. This section provides a brief discussion of the role of professional judgment in meeting the auditor's overall objectives, as set out in CAS 200. Forming the audit opinion is the culmination of these professional judgments.

What are the auditor's overall objectives in conducting a financial statement audit in accordance with CASs? CAS 200 sets these out as follows:[1]

11. (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

11. (b) To report on the financial statements, and communicate as required by the CASs, in accordance with the auditor's findings.

12. In all cases, when reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient in the circumstances for purposes of reporting to the intended users of the financial statements, the CASs require that the auditor disclaim an opinion or withdraw (or resign) from the engagement. . . .

1 *CICA Handbook—Assurance*, 2012.

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As introduced in Chapter 2, CAS 200 provides a framework of the key principles that guide the conduct of a financial statement audit in accordance with generally accepted auditing standards (GAAS). It explains the nature and scope of an audit engagement that will achieve the above objectives. By defining the scope, authority, and structure of the CASs, it establishes general responsibilities of an independent auditor that are applicable in all audits, including the obligation to comply with the CASs. Now that you have covered the most of the audit process leading up to achieving the overall objectives, it would be very useful to re-read CAS 200 and apply the perspectives you have gained in the context of the auditor's ultimate responsibility—forming the audit opinion.

STANDARDS CHECK

CAS 200

3. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with CASs and relevant ethical requirements enables the auditor to form that opinion.
5. As the basis for the auditor's opinion, CASs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. (Ref: Para. A28–A52)

Objectives Stated in Individual CASs

21. To achieve the overall objectives of the auditor, the auditor shall use the objectives stated in relevant CASs in planning and performing the audit, having regard to the interrelationships among the CASs, to: (Ref: Para. A67–A69)
    (a) Determine whether any audit procedures in addition to those required by the CASs are necessary in pursuance of the objectives stated in the CASs; and (Ref: Para. A70)
    (b) Evaluate whether sufficient appropriate audit evidence has been obtained. (Ref: Para. A71)

Failure to Achieve an Objective

24. If an objective in a relevant CAS cannot be achieved, the auditor shall evaluate whether this prevents the auditor from achieving the overall objectives of the auditor and thereby requires the auditor, in accordance with the CASs, to modify the auditor's opinion or withdraw from the engagement (where withdrawal is possible under applicable law or regulation). Failure to achieve an objective represents a significant matter requiring documentation in accordance with CAS 230. (Ref: Para. A75–A76)

Source: *CICA Handbook—Assurance,* 2012.

To achieve the overall objective of an audit, the auditor needs to formulate and report an audit opinion on the financial statements. In reaching this goal, auditors need to exercise professional judgment and maintain professional skepticism throughout planning and performing the audit. Professional judgment is defined as the application of relevant training, knowledge, and experience within the context provided by auditing, accounting, and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement. Professional skepticism refers to an auditor attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence. (CAS 200, paragraphs 15 and 16.)

At the conclusion of the audit process, the engagement partner must form an opinion on the auditee's financial statements and prepare an appropriate audit report. Throughout the text to this point, we have seen many situations where the auditors have been required to use their judgment to decide on materiality levels, assess risk, design appropriate procedures responding to the risk, and draw conclusions about potential misstatements based

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on their findings. Auditor judgments include evaluating the auditee management's judgments in applying accounting policies, making accounting estimates, and preparing the financial statements and notes, by considering such issues as those following:[2]

- Is there documentation of the relevant accounting standards and other applicable sources that were considered by management and the auditor?
- Are the judgments based on facts and circumstances that are clearly documented?
- Are any assumptions used justified and documented by management? Did the auditor challenge them and subject them to audit procedures?
- Were ranges of probable outcomes considered and documented by management? Were these evaluated for reasonability by the auditor? If not reasonable, what additional procedures did the auditor perform to support an opinion?
- Did the auditor consult, and is this documented? ("fly alone; die alone")

All decisions and conclusions need to be well documented so that an experienced auditor can understand the significant professional judgments that have been made. It is not enough for the auditor just to say a decision was "based on my professional judgment"; the documentation must show clearly the facts and circumstances—or sufficient, appropriate audit evidence—and explain how these support the decision.

Given the complexity of many audit engagements, and the tendency of people (even auditors!) to succumb to biases or shortcuts in their thinking, audit practice has developed requirements for consultation. These can take the form of one-on-one meetings with experts or audit team meetings. Auditors must have the necessary competencies to achieve reasonable judgments, and consultations facilitate this as audit team members with appropriate knowledge, seniority, and experience (who may be internal or external to the firm, whichever is required), and full information exchange relevant facts. These meetings play an important role in application of professional judgment at all stages in the audit. As a general rule, the less experienced the practitioner or engagement team, and the less knowledge they have of the specific industry or accounting topic, the greater their need for consultation. The greater the matter's complexity, materiality, and risk, the greater is the need for consultation.

Documentation of consultations is key, both for ensuring all sides to the consultation acknowledge the issues discussed and resulting conclusions, and for demonstrating to subsequent reviewers or inspectors that necessary consultations took place.

Based on facts and circumstances known by the auditor up to the date of the report, consultation assists in making informed and reasonable judgments.

REVIEW CHECKPOINTS

16-1 What is the overall objective of an audit of an organization's financial statements, and how does an auditor achieve this objective?

16-2 What judgments are made by the auditee's management in preparing its financial statements?

16-3 How does consultation facilitate good professional judgment at the conclusion of the audit?

OVERALL EVALUATION OF AUDIT EVIDENCE AND MISSTATEMENTS

LO2 Explain how accumulated misstatements are evaluated at the conclusion of an audit to form an opinion on the fair presentation of general purpose financial statements.

Once the audit team's evidence-gathering work is completed and documented, the engagement partner reviews the files to make a final evaluation of the adequacy of the work. Judgment is applied to evaluate whether the evidence documented adequately addresses

2 Adapted from Paul Lohnes, "CPAB Presentation on Professional Judgment" to CICA-SME, February 2008.

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the risks identified, and to note the effect of identified and likely misstatements that could cause the financial statements not to be fairly presented in accordance with GAAP (the applicable fair presentation framework) or to be misleading to users. The box below relates a story in which an auditor was not satisfied with the evidence the firm was able to collect and had to resign. The story also delves into current challenges auditors and regulators are facing in the current international business environment.

TSX-LISTED CHINESE FORESTRY COMPANY'S AUDITOR RESIGNS

Sino-Forest Corp. reported that Ernst & Young LLP resigned as the company's auditor in April 2012, in yet another setback for the scandal-plagued Chinese timber company. The accounting firm refused to sign off on the Mississauga-based and Hong Kong-headquartered company's financial results, after a $50 million internal investigation was unable to resolve key questions surrounding Sino-Forest's relationships and dealings with its business partners. In its resignation letter, Ernst & Young noted that Sino-Forest "remained unable to satisfactorily address outstanding issues in relation to its 2011 financial statements."

Sino-Forest's downward spiral began in June 2011, when U.S. short seller Muddy Waters LLC accused it of fraudulently exaggerating the size of its forestry assets. Though its executives defended the company against Muddy Waters' allegations, shareholders abandoned the company, causing its shares to collapse. Trading in Sino-Forest was halted in August 2011, when the stock fell to C$5 from more than C$20 before the Muddy Waters report surfaced. Sino-Forest was forced to enter bankruptcy protection after its independent committee failed to unwind the company's third-party relationships despite a seven month, $50-million investigation. According to documents released by the committee of directors investigating fraud allegations against the TSX-listed firm, several executives of Sino-Forest, including its former chief executive officer and its co-founder, had financial ties to the parent company of a key supplier of forestry assets. Those links raise questions about whether Sino-Forest bought and sold Chinese forest land at fair-market value, as they would have if all the deals were with arm's-length parties. The Muddy Waters report alleges that the company used related parties to "fabricate sales transactions" without tipping off auditors. The company says the allegations paralyzed its business and forced it into bankruptcy protection. Its shares were delisted from the Toronto Stock Exchange as of May 9, 2012, due to its bankruptcy filing and its inability to file audited financial statements.

The Chinese timber firm's collapse sent shock waves through the investment community and focused attention on its audit firm, Ernst & Young LLP. Ernst & Young was Sino-Forest's longtime auditor, signing off on the company's financial statements for years. It came under the spotlight when Sino-Forest was accused of fraud and was named in multiple class action lawsuits related to the company's collapse.

Around the same time, Canada's audit regulator, the Canadian Public Accountability Board released results of a three-month review of work done by Canadian audit firms with Chinese clients, saying their work has been a "disappointment." ". . . a lot of things that we felt were fundamental auditing processes and procedures were just not applied," CPAB chief executive officer Brian Hunt said in an interview. The findings include misapplied fundamental audit procedures, notably around cash confirmations, as well as a failure of the auditors to have a sufficient understanding of the entity and its environment. CBAP found a lack of professional skepticism when auditors are confronted with evidence that should have raised red flags regarding potential fraud risk. CPAB called its report "a wakeup call" for Canada's auditing profession to improve its work in foreign jurisdictions, and it has demanded accounting firms fix deficiencies in their audits of 12 China-based companies whose shares trade on Canadian stock exchanges. In 2011, 56 companies from China and other parts of Asia were listed on the TSX or TSX Venture Exchange, many of these gained their listings by reverse takeovers of dormant shell companies.

University of Alberta accounting department chairman Karim Jamal says CPAB's review highlights the wide gulf in auditing standards between Canada and China. If CPAB can spot weaknesses and errors after reviewing the Canadian audit files, so should the Canadian partners who sign the audits after reviewing the work done in China. Lynn Turner, former chief accountant at the U.S. Securities and Exchange Commission, says there are legitimate questions about whether global accounting firms should put their names on audit work that is done to different standards in Asia and elsewhere, because investors assume the work is done to North American standards. "It's a different culture [in Asia]," Mr. Turner argues. "Auditors are much more reluctant to challenge management."

In fact, a central issue in the US$4-billion lawsuit that Sino filed in April 2012 against Muddy Waters LLC, its founder Carson Block, and other short sellers that profited when the forestry firm collapsed—and the broader Sino-Forest saga—is how business is conducted in China compared with the West. Sino argues that Mr. Block exploited the differences for his own gain. "Muddy Waters and Block consistently preyed on Western notions that are completely at odds with Chinese business practices," the statement of claim says. Perhaps the most startling of those practices is downplaying the size of one's business and operating in an opaque manner, which Sino implied are commonplace and not evidence of fraud. In its suit, the company gave this surprising explanation for why Chinese firms act this way: "The purpose of downplaying the size of the business is understood and accepted in China: to not attract attention from governmental authorities."

The CPAB review does not identify the audit firms whose work was reviewed, but Mr. Hunt said they include the major national audit firms as well as a number

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of smaller firms that offer auditing of Chinese companies. CPAB noted that it could not review all the documentation for six of the audits involving major national firms because the work was performed by affiliated firms in foreign countries and the paperwork was not available. A major obstacle to CPAB was access to the audit files, a problem it shares with the PCAOB in the U.S. China does not permit foreign regulators to inspect audit work papers in China, and it is a violation of China's accounting laws to remove audit work papers from China. Without access to complete audit files, audit regulators like CPAB and PCAOB cannot do their jobs. An agreement on cooperative examinations is needed to make this possible, and may happen in the near future to resolve this "regulatory hole." Mr. Hunt said he does not believe the problems CPAB identified are unique to audits of Chinese companies, however, and CPAB plans to expand its reviews to companies based in other developing countries whose shares trade in Canada, including Russia, India, and Brazil.

In March 2012, the Ontario Securities Commission, Canada's most powerful securities regulator, issued a report on its review of Canadian stock listings by companies with most of their operations in China and other emerging markets. That report found weak links at every stage of the listing process, including the role played by auditors. The OSC's review of emerging market issuers stemmed from the allegations against Sino-Forest.

Sources: Euan Rocha and Jennifer Kwan, "3-Sino-Forest auditor resigns; shares being delisted," April 5, 2012, at http://www.reuters.com/article/2012/04/05/sinoforest-auditor-idUSL2E8F52PG20120405; Carolyn King, "Sino-Forest auditor resigns," Dow Jones Newswires, April 5, 2012, at http://online.wsj.com/article/BT-CO-20120405-708806.html; Peter Koven, "Sino-Forest auditor resigns," *Postmedia News*, April 6, 2012, at http://www.ottawacitizen.com/news/Sino+Forest+auditor+resigns/6419886/story.html; Peter Koven, "Sino-Forest defends opaque procedures in lawsuit against shortseller," April 3, 2012, at http://business.financialpost.com/2012/04/02/sino-forest-defends-opaque-procedures-in-lawsuit-against-shortseller/; Andy Hoffman, "Sino-Forest executives linked to key timber supplier," Asia-Pacific Reporter, *The Globe and Mail*, December. 11, 2011, at http://www.theglobeandmail.com/globe-investor/sino-forest-executives-linked-to-key-timber-supplier/article2267389/; Andy Hoffman "Sino-Forest auditor Ernst & Young resigns," Asia-Pacific Reporter, *The Globe and Mail*, April. 05, 2012, at www.theglobeandmail.com/.../sino-forest-auditor.../article2393251/; Janet McFarland, "Canadian audits of China firms had major gaps: regulator...," *The Globe and Mail*, February. 21, 2012, at http://www.theglobeandmail.com/globe-investor/canadian-audits-of-china-firms-had-major-gaps-regulator/article2344920/; "News and opinion on accounting in China: Canadian regulators and Chinese companies," China Accounting Blog, at http://chinaaccountingblog.com/weblog/canadian-regulators-and.html.

As discussed in Chapter 15, the engagement partner also would perform final analytical procedures at this stage, to check whether the results corroborate the audit findings, or suggest additional risks that may not have been addressed. As you can appreciate from your study of the audit process, an audit team learns a lot more about the entity and the events of the audited period after performing their work than they could know at the planning stage. If at any point in the audit the findings suggest materiality or risk assessments should be revised, auditors must determine if it is necessary to go back and perform additional procedures to respond to the revised materiality or risk. The final evaluation stage is the last chance for the team to get it right so this is an important decision for the audit partner. In practice, auditors may use audit completion checklists as an aid, to help ensure all the key matters have been addressed and considered to conclude the audit work. An example of this type of practice aid is provided in Appendix 16A (available on Connect).

STANDARDS CHECK

CAS 200

A20. Professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example, in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

A22. The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less-than-persuasive audit evidence when obtaining reasonable assurance.

Source: *CICA Handbook—Assurance,* 2012.

Once the partner is satisfied with the adequacy of the evidence, any remaining uncorrected misstatements must be discussed with the auditee management, and any necessary adjustments approved by them. The audit standards require that all identified and likely misstatements, other than those that are "clearly trivial" must be accumulated in a summary

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of misstatements and discussed with management. Note that the amount to be used to assess what is "clearly" trivial needs to be decided and documented in the planning so it is applied consistently by everyone working on the engagement. In the case of identified misstatements, management often will approve appropriate journal entries to correct them. For various reasons, however, there may be adjustments that are "waived," which means the auditor agrees with the auditee management that they will remain unadjusted. The auditing standards require that any such uncorrected misstatements be quantitatively and qualitatively immaterial.

Since identified misstatements are matters on which there usually is general agreement, you may wonder why management would not simply correct them all in the interests of more accurate presentation. However, there are practical considerations that make this a cost-benefit decision. Recall from your study of the double entry accounting model what happens when we change one number—at least one other number has to change somewhere to keep the balance. In the case of income misstatements, not only will the bottom line change, but something on the balance sheet will also have to change. Also, the income tax will change. There may also be bonuses, dividends, or other payments that are based on a percentage of income; those also will change. And in some cases, management may have issued a press release showing their earnings long before the audit is completed and then may find it would raise questions if a different number appeared in the audited reports, even if the difference is not material. In some cases, management may not agree that the misstatement exists. For all these reasons, it is quite common for some identified misstatements to be left unadjusted. In the case of an unadjusted income misstatement, its impact remains in the opening retained earnings balance carried forward to the next period, and it will reverse (i.e., have the opposite impact on income) in that and/or future periods.

Auditing research shows that the ultimate decisions regarding adjustment of misstatements result from audit-client negotiations at the final stages of the audit.[3] Management may be reluctant to adjust the financial statements in certain situations, such as when the adjustments change income and an earnings number has already been published in the press. The audit scandals discussed throughout the book can be viewed as situations where the auditors did not negotiate successfully and management prevailed. Obviously, there was a high cost to firms like Arthur Andersen for allowing materially misstated financial statements to be released to the public.

Exhibit 16–1 illustrates a working paper used to summarize all the misstatements uncovered in an audit, indicate different areas where they arose, and address their impact on the financial statements. While each individual error is less than the materiality of $10,000, when accumulated their total exceeds materiality, so some action is required to correct them. Otherwise, the financial statements are materially misstated. Exhibit 16–1 illustrates that some of the discovered misstatements have been adjusted by management, while others have not and now must be evaluated by the audit partner. Take particular note of those misstatements that affect both the balance sheet and income statement. These errors are of concern since many key user decisions are based on the income measure. Other types of error involve misclassifications within the balance sheet or income statement. While such errors do not affect the income measure, they are also a concern as they may distort important ratios that users rely on; for example, debt covenants requiring a minimum current ratio to be maintained.

Ideally, management would correct every misstatement, and this would make an audit partner's job much easier! But, as discussed above, often management has reasons to resist adjusting certain errors, and if the resulting overall misstatement of the financial statements is less than materiality, an audit partner does not have a strong negotiating position to insist on further adjustments as the audit standards essentially require adjustment of material levels of misstatement.

Up to this point, we have dealt with identified monetary, quantitative misstatements, but the audit partner must also be concerned with the potential for likely misstatements,

3 For example, see McCracken, Gibbins, and Salterio, "The auditor-client management relationship in financial reporting negotiations: Focusing on the dyad," *Accounting Organizations & Society,* 2009; and Gibbins, McCracken, and Salterio, "The chief financial officer's perspective on negotiations with auditor on financial reporting issues," *Contemporary Accounting Research*, 2007.

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unrealistic estimates, disclosure inadequacy, and other qualitative considerations affecting the fair presentation of the financial statements. On this basis, the auditor will form an opinion on whether the financial statements are fairly presented. The auditor must reach a final conclusion on whether the audit has provided reasonable assurance that the risk of material misstatement is acceptably low. While such assessments are dependent on the specific context of each audit engagement, an important point to appreciate here is that the partner really needs to exercise good judgment in a very complex and risky assessment. This takes experience and strong moral reasoning, and in some cases, sheer courage to fight for what the auditor thinks is the right thing to do. This is why it typically takes 10 or more years of audit experience at increasing levels of responsibility before an auditor is considered capable of being an engagement partner.

Auditee Approval of Adjusting Entries and Financial Statement Disclosure

The financial statements, including adjustments to the draft version, are the responsibility of management. Some adjusting entries identified in the audit may be approved by management as they are dealt with during the ongoing field work, and others may be approved at the final wrap-up.

Exhibit 16–1 is a summary worksheet ("scoresheet") showing the misstatements accumulated in the various sections of the audit files. It is the basis for the auditor's end-of-audit, proposed adjusting journal entries. Auditors evaluate the uncorrected misstatements to see how these will affect the financial statements and to help decide which ones must be adjusted to support an unmodified ("clean") audit opinion and which ones may be passed. A passed adjustment is one the auditors decide not to insist on because the uncorrected misstatement does not materially effect the financial position and results of operations.

The proposed adjustments shown in Exhibit 16–1 are the misstatements noted in the summary sections shown in Chapters 11 to 14. They are (1) recording cheques written and mailed but not in the books, (2) reversing recorded sales for goods shipped after the balance sheet date and reversing the 60% cost of goods sold, (3) writing off obsolete and damaged inventory, (4) recording the understated expense found in the search for unrecorded liabilities, (5) recording the understated payroll expense found in the audit of payroll (6) correcting an amortization calculation error, (7) reclassifying the current portion of long-term debt, and (8) recording a tax refund asset for overpaid income taxes based on the overstated income number (could be a debit to tax liability if all the taxes for the year had not already been paid). Summary effects on income, current assets, current liabilities, and working capital are shown at the bottom of the worksheet. These help auditors assess the potential impact of the adjustments on financial statement users, for example, on lenders who are monitoring working capital ratio limits in debt covenants.

The adjusting entries shown in Exhibit 16–1 are labelled "proposed" as they are still subject to management's approval. A final list of all approved adjusting entries is given to the auditee accounting staff so that formal entries can be made, bringing the accounting records into balance with the financial statements.

The auditee must also approve all disclosure in the notes. Any additional disclosures auditors consider necessary usually are drafted as proposed notes. They must be considered carefully before being presented to management for acceptance as company disclosures.

Evaluation of Misstatement Materiality

The accumulated audit evidence is the main basis for deciding if the amount of uncorrected misstatement is material. Chapter 5 explained how the audit is planned with the objective of detecting misstatements that are material, either individually or in aggregate, to the financial statements as a whole. Recall that the auditor considers materiality at the planning stage, while performing the audit, and at the final evaluation stage, when forming the audit

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EXHIBIT 16–1 Example of Working Paper for Accumulated Misstatements

AUDITEE: *EcoPak Inc.*
FINANCIAL STATEMENT PERIOD: *y/e December 31, 20x1*

SUMMARY OF ACCUMULATED MISSTATEMENTS

FILE INDES: *335*

Prepared by	Reviewed by
Date	Date

F/S MATERIALITY *10,000*

Description of Misstatement	W/p REF.	AMOUNT OF OVERSTATEMENT(UNDERSTATEMENT) OF FINANCIAL STATEMENTS: ASSETS DEC 31, 20x0	LIABILITIES	PRE-TAX INCOME	PROPOSED ADJUSTING ENTRIES: ACCOUNTS	INCOME STATEMENT Debit	INCOME STATEMENT Credit	BALANCE SHEET Debit	BALANCE SHEET Credit
1. Unrecorded cash disbursements (Ch.12)	*BB-1*		42,000		ACCOUNTS PAYABLE			42,000	
		42,000			CASH				42,000
2. Improper sales cutoff (Ch.11)	*705*	13,000		13,000	SALES	13,000			
		(7,800)		(7,800)	ACCOUNTS RECEIVABLE				13,000
					INVENTORY			7,800	
					COST OF SALES (60%)		7,800		
3. Inventory write-off (Ch.13)	*D-1*	21,000		21,000	COST OF SALES	21,000			
					INVENTORY				21,000
4. Under-accrued electricity bill (Ch.12)	*BB-1*		(3,700)	3,700	UTILITIES EXPENSE	3,700			
					ACCOUNTS PAYABLE				3,700
5. Omitted accrual for last day's payroll (Ch.12)	*730*		(2,500)	2,500	PAYROLL EXPENSE	2,500			
					ACCRUED LIABILITIES				2,500
6. Software amortization calculation error for first year of use (Ch.12)	*U-1*	(17,000)		(17,000)	ACCUM. AMORTIZATION			17,000	
					AMORTIZATION EXPENSE		17,000		
7. Current portion of long-term debt misclassified as long-term liability (Ch.14)	*kk-1*		50,000		LONG TERM DEBT			50,000	
			(50,000)		CURRENT PORTION LT DEBT				50,000
8. Income tax impact of the above net income overstatement ($15,400*40%)		(6,160)		(6,160)	INCOME TAXES PAYABLE			6,160	
					INCOME TAX EXPENSE		6,160		
		45,040	35,800	9,240		40,200	30,960	122,960	132,200

SUMMARY OF F/S IMPACT:

NET INCOME CHANGE	(9,240)
CURRENT ASSETS CHANGE	(62,040)
CURRENT LIABILITIES CHANGE	14,200
WORKING CAPITAL CHANGE	(76,240)

Note that Exhibit 16–1 illustrates a minimal method of assessing whether misstatements aggregate to a material amount. It is referred to as "minimal" because it is based only on identified factual misstatements. In this method, the uncorrected misstatements are aggregated in various ways to see if they total to a material amount. For example, if materiality is based on net income and is assessed to be 10% of recorded net income, the auditor must aggregate all misstatements affecting net income. This can be based on either (1) changes in net assets (assets less liabilities) or the equivalent, or (2) revenues less expenses. Given the nature of the double-entry system, either approach should yield the same number. In this exhibit's example, the net effect of uncorrected identified misstatements on net income is computed as follows:

misstatements in net income = misstatements in changes in net assets = misstatements in changes in assets − misstatements in changes in liabilities

Using the values in this exhibit,

42,000(A) + 13,000(A) + 21,000(A) − 7,800(A) − 17,000(A) − 6,160(A) − [+ 42,000(L) − 3,700(L) − 2,500(L) + 50,000(L) − 50,000(L)] = $9,240

= misstatements in revenues − misstatements in expenses

= 13,000(R) − [6,160(E) + 7,800(E) − 21,000(E) − 3,700(E) − 2,500(E) + 17,000(E)] = $9,240

= total net misstatements in net income (overstatement; i.e., to eliminate all the misstatements, auditee's proposed net income must be reduced by $9,240).

This total of $9240 is then compared with the predetermined overall materiality. If $9240 is less than material, the auditor may conclude that further adjustments are not necessary. In the exhibit, we assume the materiality is $10,000, so if management decided not to make the adjusting entries to income the auditor could find this acceptable. The misclassification of the current portion of long-term debt would be material, and would need to be corrected. An implication of not correcting the income misstatements is that in the following year (in the case of current assets or liabilities, or over the life of the asset for amortization) they will reverse; that is, have the opposite impact on income. When adjustments are passed, due to immateriality, auditors still need to keep track of these reversals, as these could push the total level of misstatement in the current year over the limit.

This analysis, in summary, is based on uncorrected, identified misstatements only, and it is perfectly appropriate in cases where the auditor tests 100% of the transactions. This level of testing is likely done for cash, capital assets, noncurrent liabilities, and owner's equity. For accounts such as inventory, receivables, and payables, which can represent large populations of individual items, the auditor may wish to use sampling theory concepts to include likely and possible misstatement in the assessment of whether the misstatements are material. Adjustments and decision making based on sampling situations are covered in Appendix 10A. Possible misstatements in the form of forecast errors that lead to accounting risk (as discussed in Chapter 19) should also be considered by the auditor, especially for evaluating fairness of presentation in the circumstances.

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opinion. The auditor uses professional judgment to determine a materiality level for planning and performing the audit, basing this on the amount of misstatement that would probably influence decisions of a person relying on the financial statements for making business and economic decisions. At the final evaluation stage, the auditor considers individual and aggregate misstatements discovered, their nature and cause, whether they indicate a possibility of further misstatements, and how they quantitatively and qualitatively affect the financial statements.

Misstatements have various causes, such as arithmetical mistakes (e.g., an addition error in a physical inventory count), use of inappropriate accounting principles, incorrect application of accounting principles, and disagreements about valuation or other estimates. They may occur accidentally or through misunderstanding, be the result of embezzlement, or be deliberate misrepresentations. As discussed in Chapter 5, a key qualitative factor in the auditor's assessment is evidence of deliberate misstatements intended to improve or defer earnings in order to achieve management's goals. These goals, such as obtaining an earnings-based bonus, may not be aligned with those of the company's capital providers, who are usually the most important users of the audited financial statements.

Exhibit 16–2 (which is based on AuG-41)[4] illustrates four possible outcomes of an audit and explains how professional judgment is applied in each case to determine the impact on the audit opinion. For evaluating whether the financial statement as a whole are materially misstated, uncorrected misstatements can be classified into three main categories: known, likely, and further possible. In the terminology of AuG-41, **known misstatements** are those factual misstatements actually identified during the audit, so there is no uncertainty about their existence. **Likely misstatements** are those that probably exist, based on audit evidence examined, for example, the projected effect of misstatements identified in representative samples or management accounting estimates or of policy choices that the auditor considers unreasonable. **Further possible misstatements** are those that could exist over and above the total of known and likely misstatements because of the fundamental limitations of auditing, for example, sampling and nonsampling risks (as discussed in Chapter 10), forecasting uncertainties in accounting estimates, and minimum review accounts (those subjected to minimal verification as they have a very low assessed risk of misstatement). The amount of possible misstatement cannot be precisely quantified, but the auditor must exercise professional judgment in addressing this possibility, particularly when the total approaches materiality, or when misstatements are due to general control breakdowns rather than isolated instances. The relationship between the known and likely misstatements and materiality is important as it determines the nature of the auditor's opinion on the financial statements.[5]

known misstatement: the total amount of actual monetary error found in a sample

likely misstatement: the projection of a known misstatement identified in a representative sample to the whole population

further possible misstatements: those that could exist over and above the total of known and likely misstatements because of the limitations of the testing concept of auditing

Complications in audit evaluation can arise from measurements involving management estimates. Auditors are supposed to keep track of the differences between management estimates and the most reasonable estimates supported by audit evidence. They also identify estimates with high risk due to forecast errors, and assess whether these are fairly presented in the circumstances. In areas where GAAP are evolving, such as fair valuation of financial instruments (as discussed in Chapter 14), the accounting standards might not provide detailed implementation guidance, so the auditor needs to exercise judgment, guided by general principles and reporting objectives, to assess fair presentation. As will be discussed in Chapter 19, calibration techniques can be applied to different levels of aggregation within the financial statements, combined with probability management techniques using stochastic modelling methods such as the Monte Carlo method with calibrated estimates from "subject matter experts." There is increasingly sophisticated company- and industry-based data that auditors can use with probability management, and

4 The approach described here is based on guidelines and concepts that were provided in the *CICA Handbook*, AuG-41: Applying the concept of materiality.

5 Adjustments based on likely and possible misstatements are covered in Appendix 10A, and are less common in practice. The likely and further possible misstatements are auditor estimates, so it may be difficult for the auditor to make a defensible argument that they should be adjusted, and for the auditee to agree to adjust them.

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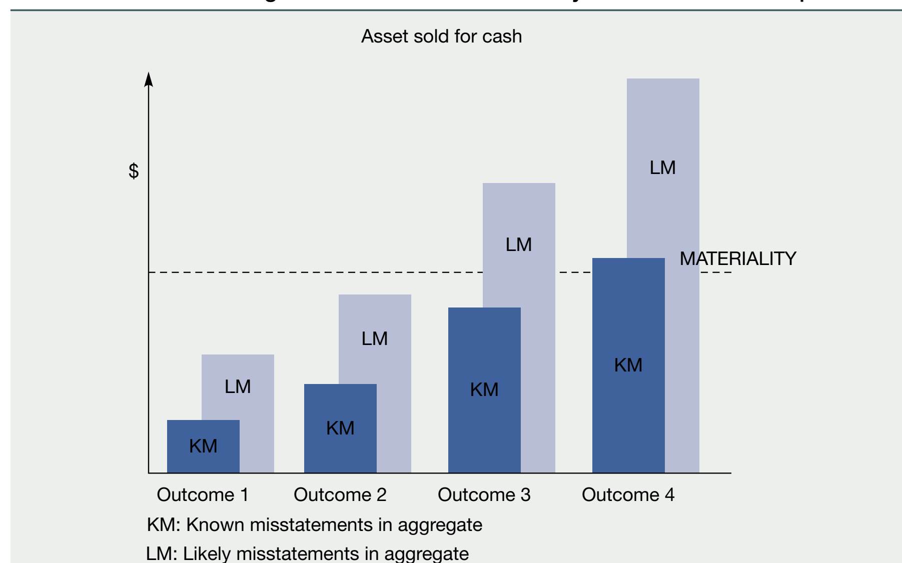
EXHIBIT 16–2 Relating Misstatements to Materiality to form the Audit Opinion



Explanations of Outcomes

This guidance assumes that sufficient testing has been done for all of the following outcomes. In other words, that there is no audit deficiency in terms of sufficiency of evidence. The actual audit risk (evidence risk) is at an acceptable level (planned audit risk). We know from sampling theory of Chapter 10 that if this is not the case the auditor must reject all outcomes, because insufficient evidence has been gathered to provide reasonable assurance on which to base an opinion. If the auditor is not in a position to know the amount of misstatement based on a testing perspective, then the auditor cannot reliably estimate the amount of misstatement! This is predicted by statistical sampling theory, as discussed in Chapter 10 also. Hence, the following outcomes all assume that sufficient audit work has been done. This is a matter of professional judgment, which can be guided by models, such as those in Chapter 10.

Outcome 1: This outcome is frequently encountered in practice when auditees agree to correct most known misstatements. The level of known and likely aggregate misstatement is well below materiality, so the auditor may consider it very unlikely that the maximum possible misstatement (including further possible misstatements) would be quantitatively material. The auditor always also needs to consider the effect of the qualitative factors discussed in Chapter 5 when assessing whether the misstatement should be considered material, in order to reach a final conclusion on whether an unqualified or a qualified opinion should be given. An important qualitative factor to consider is whether uncorrected known misstatements should be treated as "intentional" misstatements. The SEC treats such situations as intentional. Note this also means that qualitatively they become "material" under the SEC's view. This explains why some auditors do not report minor known misstatements to the auditee, rating them as "trivial."

Outcome 2: The sum of known and likely misstatements is close to, but below, materiality. This indicates that the auditor's best estimate is that financial statements are not materially misstated. The auditor still must assess whether further possible misstatements exist at a level that might cause the financial statements to be materially misstated. In this case, the auditor might propose that some or all known misstatements be corrected to bring the level of misstatement well below materiality so that an unqualified opinion could be given. The auditor might also consider performing additional auditing procedures to reduce the assessment of likely and further possible misstatements. Ultimately, the auditor will have to consider qualitative factors and exercise professional judgment in deciding whether an unqualified opinion is appropriate. Statistical sampling theory can provide especially useful guidance in such situations, since the theory allows the calculation of a bound on the maximum misstatements at specified (acceptable) level of risk of material misstatement (i.e., beta risk of Chapter 10). This also indicates to the auditor whether sufficient evidence has been obtained, since a statistical test always rejects sample results if the sample size is too small relative to desired/planned/acceptable beta risk (even if no errors are found in the sample).

Outcome 3: The known misstatements are less than materiality but, when combined with likely misstatements, the level exceeds materiality. In this case, the auditor's best estimate is that the financial statements are materially misstated. Statistical sampling with outcome 3 (and outcome 4) quantitative results always rejects the recorded amount. The auditor would need management to correct some or all misstatements to reduce the levels to sufficiently below materiality so that an unqualified opinion can be given, subject also to consideration of qualitative factors.

Outcome 4: The level of known misstatements exceeds materiality. In this case a qualified opinion is required, unless management will correct misstatements to reduce the levels of known and likely misstatements to be sufficiently below materiality to enable an unqualified opinion to be given. Again, the final decision is subject to consideration of qualitative factors.

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this is likely to be a source of audit innovation in the future. Of course, much depends on how the profession deals with the basic problems of accounting for uncertainty, as will be discussed in Chapter 19.

Auditors are also supposed to evaluate the estimate differences as a group for indications of a systematic bias (CAS 540, paragraphs 21 and A125), and examine the combination of differences and other likely misstatements found by other audit procedures. Accumulated uncorrected misstatements (passed adjustments) from prior periods may also have an impact as they may reverse and affect the materiality of current year's misstatements (CAS 450, paragraph 11[b]).

Overall evaluation also connects materiality to assertions. Materiality is defined as the amount of misstatements from all sources that would affect a user decision. Thus, materiality may also presume that users mainly care that the aggregate misstatement for all assertions is less than material, rather than which particular assertions were affected. Again, review Exhibit 16–1 and consider the assertions affected by the misstatements: completeness, valuation, existence, and presentation.

REVIEW CHECKPOINTS

16-4 Why are auditors' drafts of adjusting entries and note disclosures near the end of the audit always labelled "proposed"?

16-5 What are uncorrected misstatements, and what role do they play in forming the audit opinion on the financial statements?

16-6 Outline the auditor's considerations at the end of the audit to form the opinion, especially referring to those requiring professional judgment.

WRITING AN AUDIT OPINION ON THE FINANCIAL STATEMENTS

Forms of Audit Opinion

LO3 Describe the different forms of audit opinion and the decisions underlying the auditor's choice of form.

To form an opinion on whether the financial statements are presented fairly in all material respects and in accordance with GAAP, the auditor must make a number of professional judgments as set out in CAS 700. The forms of opinion were discussed in Chapter 4, and now we will revisit this decision in the context of having completed the audit work. The first decision is whether the audit team has obtained sufficient appropriate audit evidence providing reasonable assurance that the financial statements as a whole are free from material misstatement due to fraud or error. As discussed in Chapter 4, any deficiency in the scope of the audit can lead to a modified opinion, if the scope limitation effects can be isolated, or to a disclaimer, if the effects could have a pervasive impact on the financial statements overall. Opinion formation also includes deciding if any uncorrected misstatements are material, either individually or in aggregate. If there is a material level of misstatement that can be isolated in specific items in the financial statements, a qualified opinion can be provided, but if the misstatements are pervasive so the financial statements, an adverse opinion is called for.

Under CAS 200 the auditor must also decide whether the applicable reporting framework chosen by management is acceptable. Acceptable reporting frameworks can be either special purpose or general purpose, and can also be classified as either fair presentation frameworks or compliance frameworks. These are summarized in the four categories in the following box.

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FOUR CATEGORIES OF ACCEPTABLE FINANCIAL REPORTING FRAMEWORKS

	General Purpose Financial Statements	Special Purpose Financial Statements
Fair Presentation Framework	1	2
Compliance Framework	3	4

Source: CAAA 2008 Audit Education Update.

The most common reporting framework in Canada is the fair presentation framework, since Canadian GAAP (e.g., IFRS, ASPE) are considered to provide fair presentation for general purpose reporting. The importance of the fair presentation framework is that auditors can use the words "present fairly" only for fair reporting frameworks. This difference in wording can be appreciated by studying the two wording examples in the box below.

KEY DIFFERENCE IN AUDITOR'S STANDARD OPINION WORDING–GENERAL PURPOSE FINANCIAL STATEMENTS

FAIR PRESENTATION FRAMEWORKS	COMPLIANCE FRAMEWORKS
". . . the financial statements present fairly, in all material respects, the . . . in accordance with (the applicable fair presentation financial reporting framework–generally this is IFRS for public companies, or Canadian accounting standards for private enterprises)." (CAS 700)	". . . the financial statements have been prepared, in all material respects, in accordance with (applicable acceptable general purpose framework) . . . (CAS 700)

Source: CAAA 2008 Audit Education Update.

What exactly is a "fair" framework? CAS 200 and CAS 700 together state that the following requirements need to be met for a fair presentation framework:

(i) The framework acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond the specific requirements of the framework (CAS 200 paragraph 13.); or

(ii) The framework acknowledges explicitly that, in extremely rare circumstances, it may be necessary for management to depart from a specific requirement of the framework to achieve fair presentation of the financial statements (CAS 200 paragraph 13.).

(iii) CAS 700 (para. 10) specifies that a fair presentation framework (as opposed to a "compliance" framework) "embodies sufficiently broad principles *that can serve as a basis* for developing and applying accounting policies that are consistent with the underlying requirements of the framework"(CAS 200, paragraph A6) (emphasis added).

These three criteria for fair presentation reporting suggest principles-based reasoning for accounting following the same logic as principles-based reasoning in professional ethics as discussed in Chapter 3. In principles-based reasoning, if there is a conflict between a more detailed accounting standard and a more general principle, then the general principle

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has precedence and can override the detailed rule. This is how the auditor can logically justify deviating from detailed accounting standards in a fair presentation framework. Such conflict should be rare, however, since the detailed rules are supposed to provide more detailed guidance in the application of a principle. That is, usually the principle and rule should be consistent. Probably the most common example of an inconsistency would be when an accounting estimate results in significant or unacceptably high accounting risk, as will be discussed in Chapter 19.

To assess fair presentation, the audit engagement partner considers the results of the final overall financial statement analysis, and assesses whether the overall presentation, structure, and content of the financial statements and notes represent the underlying transactions and events fairly, from the perspective of users (CAS 520).

The auditor must be satisfied that the information presented in the financial statements is relevant, reliable, comparable, and understandable. Fair presentation also requires the financial statements to adequately disclose the significant accounting policies applied so that users can understand the effect of transactions and events on the information. The auditor assesses whether the terminology used and the titles of financial statements are appropriate and understandable. The final analysis considers the qualitative aspects of the accounting used, including indications of management bias in selecting accounting policies and making accounting estimates. The accounting risk concept is intended to help auditors guide reasonableness of forecasts in accounting estimates. For example, if management's assumption leads to an unacceptably high accounting risk estimate, the auditor may question the reasonableness of that assumption. An adjustment to the estimate, note disclosure of the questionable assumption(s), or note disclosure of the estimation uncertainties may be necessary for fair presentation.[6] Such adjustments and additional disclosures are what differentiate fair presentation reporting from compliance reporting. Compliance reporting is discussed in Chapter 21 (available on Connect). Examples of compliance reporting include cash basis reporting and tax basis financial reporting.

The trend in auditing is to replace qualitative analysis with more objective quantitative analysis or models. This parallels trends in other fields, such as finance. Prime examples are the audit risk model and risk-based auditing generally, which are greatly influenced by statistical sampling theory. Different qualitative misstatements may require different concepts of risk, such as accounting risk or fraud risk, which are discussed in Chapter 19 and Chapter 21 (available on Connect), respectively.

Summary

When the auditor concludes that the financial statements are presented fairly in all material respects in accordance with GAAP, an unmodified opinion can be expressed. If, based on the audit evidence, the auditor concludes that the financial statements are not free from material misstatement (GAAP departure), or is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements are free from material misstatement (scope limitation), the auditor must give a modified opinion in the auditor's report in accordance with CAS 705.

REVIEW CHECKPOINTS

16-7 List the four types of financial reporting frameworks for financial statements set out in CAS 200. Explain which type of framework IFRS and ASPE would be classified as.

16-8 What requirements must be met for a financial reporting framework to be considered to provide fair presentation?

16-9 Describe the four main types of modified opinions and the reasons each would be used in an audit report.

6 Bell and Griffin, Commentary on auditing high-uncertainty fair value estimates, *Auditing: A Journal of Practice & Theory American Accounting Association,* Vol. 31(1), p. v, 2012; Christensen, Glover, and Wood. Extreme estimation uncertainty in fair value estimates: Implications for audit assurance, *Auditing: A Journal of Practice & Theory* 31(1), p. v, 2012.

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Date of Opinion

Since the auditor's opinion is provided on financial statements that are the responsibility of management, the auditor is not in a position to conclude that sufficient appropriate audit evidence has been obtained until evidence is obtained that management has prepared all the financial statements and related note disclosures required by the applicable financial reporting framework, and has accepted responsibility for them.

STANDARDS CHECK

CAS 700

41. The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that: (Ref: Para. A38–A41)
    (a) All the statements that comprise the financial statements, including the related notes, have been prepared; and
    (b) Those with the recognized authority have asserted that they have taken responsibility for those financial statements.

Source: *CICA Handbook—Assurance,* 2012.

The evidence of this acceptance having occurred results from a formal decision of the board, those charged with governance, or management to accept the final financial statements. Typically, the auditor would attend this meeting, and also obtain a copy of the minutes showing the decision as documentation. The date of this meeting is the audit report date, and the auditor is responsible for searching for evidence in relation to the fair presentation of the financial statements up to this date.

Chapter 15 discussed subsequent events that can in some situations give rise to information being included in financial statements that came to light after the audit report date but before the financial statements were issued to user. Such situations can result in a need to put dual dates on an audit report, as explained below.

Subsequent Events and the Audit Report

To understand the impact of subsequent events on finalizing the audit report, consider the three possible scenarios listed in the following box and the responsibilities that follow from them. These three situations and their different impact on the audit and audit report are illustrated in a timeline format in Exhibit 16–3.

Dual Dating in the Audit Report

Dual dating refers to instances of dating the audit report as of the date that financial statements are approved by the auditee's responsible parties (e.g., the company's board of directors) and attaching an additional later date to disclosure of a significant subsequent event of the type that requires financial statements to be amended. Sometimes, after completion of the audit but before issuance of the report, a significant event comes to the audit team's attention. The purpose of dual dating is twofold: (1) to provide a means of inserting important information learned after the audit report date into the financial statement note disclosures, and (2) to inform users that the auditor takes full responsibility for discovering subsequent events only up to the audit report date and for the specifically identified later event. However, responsibility is not taken for other events that may have occurred after the audit report date. Dual dating is used to cut off the subsequent event procedural responsibility at the earlier date. An example of dual dating wording is as follows: "(Date of auditor's report), except as to Note Y, which is as of (date of completion of audit procedures restricted to amendment described in Note Y)." (CAS 560, paragraph A12.)

dual dating: refers to instances of dating the audit report as of the date that financial statements are approved by the auditee's responsible parties; includes an additional date indicating that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements described in the relevant note to the financial statements, which outlines the effects of the subsequent event or events causing that amendment

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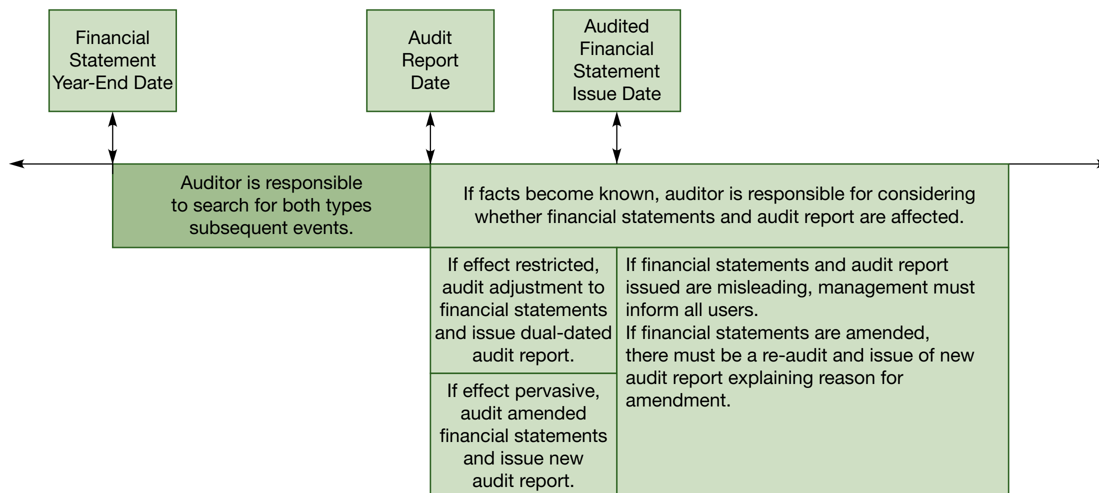
TIMING OF SUBSEQUENT EVENT	IMPACT ON AUDIT AND REPORT
1. Events that occurred between the date of the financial statements and the date of the auditor's report	Auditors are responsible for actively searching for these to ensure they are properly reflected in the financial statements if required. Procedures to search for subsequent events that are relevant to the assertions in the financial statements will be included in every audit program.
2. Facts the auditor learns of after the date of the auditor's report but before the date the financial statements are issued	Auditors are responsible for making sure these are properly reflected in the financial statements. If it is appropriate to amend the financial statements, the auditor carries out the procedures necessary on the amendment, and amends the audit by including an additional date restricted to that amendment. Dual dating is used because the original date applies to everything except the subsequent event as the auditor is not required to extend the search for other possible subsequent events up to the second date. Only the subsequent events are audited up to the second date, so both dates are included.
3. Facts the auditor becomes aware of after the financial statements and audit report have been issued to users.	This should be a rare occurrence if audits are performed diligently. But if information does come to light that could or should have been known at the time the financial statements and audit report were issued, the following determinations are required. If the auditors would have amended the auditor's report had the facts been known, they must determine with management whether financial statements need amendment. If so, and management amends, the auditor must extend procedures and issue a new audit report that emphasizes reasons for amended financial statements. If management does not amend, the auditor takes steps to prevent users from relying on the audit report.

EXHIBIT 16–3 Timeline for Auditor's Subsequent Events Responsibilities



Facts Become Known after Financial Statements Issued

While auditors are under no obligation to continue audit procedures past the report date, if they happen to learn later of relevant facts they have an obligation to determine (1) if the information is reliable and (2) if the facts existed at the date of the report. When these conditions are affirmed and the auditors believe that people are relying on the report, steps should be taken to withdraw the first report, perform the additional procedures required,

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issue a new report, and inform anyone currently relying on the financial statements. Basically, the decisions relate to the importance and impact of the information, the cooperation of the auditee in taking necessary action, and the actions to be taken. The auditee's cooperation facilitates all of this, but the auditors have a duty to notify the public of an earlier, potentially misleading audit report, even if the auditee does not cooperate.

STANDARDS CHECK

CAS 560

Facts Which Become Known to the Auditor after the Financial Statements Have Been Issued

17. If management does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements is informed of the situation and does not amend the financial statements in circumstances where the auditor believes they need to be amended, the auditor shall notify management and, unless all of those charged with governance are involved in managing the entity, those charged with governance, that the auditor will seek to prevent future reliance on the auditor's report. If, despite such notification, management or those charged with governance do not take these necessary steps, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report. (Ref: Para. A18)

A18. Where the auditor believes that management, or those charged with governance, have failed to take the necessary steps to prevent reliance on the auditor's report on financial statements previously issued by the entity despite the auditor's prior notification that the auditor will take action to seek to prevent such reliance, the auditor's course of action depends upon the auditor's legal rights and obligations. Consequently, the auditor may consider it appropriate to seek legal advice.

Source: *CICA Handbook—Assurance,* 2012.

REVIEW CHECKPOINTS

16-10 What is the purpose of dual dating an audit report?

16-11 What is the difference between a subsequent event that occurs between the balance sheet date and the audit report date and the discovery after the audit report date of facts that existed at the report date? Describe the auditor's responsibility for each.

16-12 If, subsequent to issuing a report, the auditor discovers information that existed at the report date and materially affects the financial statements, what actions should the auditor take if the auditee consents to disclose the information? What action should be taken if the auditee (including the board of directors) refuses to make disclosure?

16-13 After the audit report has been issued, someone discovers that the auditee had a material, unrecorded bank loan outstanding at year-end. There was no confirmation requested from that bank as the auditors were not aware of the auditee's relation with that bank. What steps should an auditor should take in this situation?

SIGNIFICANT MATTER PARAGRAPHS: ADDITIONAL INFORMATION IN THE AUDIT REPORT

LO4 Explain the purpose of emphasis of matter (EOM) and other matter (OM) paragraphs in an audit report.

Sometimes auditors opt to add additional information in the audit report. There are two types of additions possible under CAS 706: emphasis of matter (EOM) paragraphs or other matter (OM) paragraphs. These are used for enriching the information content beyond the standard unqualified report wording. Under CAS 706, the EOM paragraph can be used for a broad range of issues. One or more paragraphs can be added to the audit report regarding something in the financial statements that the auditor believes readers should consider important or useful, even when the auditor intends to write an unmodified opinion paragraph. For example, EOM paragraphs are required when a material uncertainty regarding the going concern assumption is properly disclosed, and an unmodified opinion is given. Indeed, the matter emphasized is not supposed to be mentioned in the opinion sentence. The following box shows an illustration of such an EOM paragraph related to a significant uncertainty affecting the financial statements.

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EXAMPLE OF AN EMPHASIS OF A MATTER PARAGRAPH

Without qualifying our opinion, we draw attention to Note X to the financial statements. The Company is the defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The Company has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the matter cannot presently be determined and no provision for any liability that may result has been made in the financial statements.

Source: CAS 706, *CICA Handbook—Assurance*, 2012.

OM paragraphs are distinguished from EOM paragraphs by the information they reference. EOMs refer only to information presented or disclosed in the financial statements, whereas OMs relate to information which is not required to be disclosed in the financial statements. For example, OMs can refer to other information included with the financial statements, such as MD&A or comparative information from other periods, especially when there appear to be discrepancies between the two.

EOM and OM paragraphs can be viewed as other ways in which the CASs attempt to make operational the fair presentation concept. Note that EOM and OM paragraphs are not modified opinions. If the final evaluation discussed above results in conclusion that there are deficiencies in either the audit evidence obtained or the fair presentation of the financial statements, the types of modifications discussed in Chapter 4, and above, come into play.

Evolution of the Audit Report

The current CAS 700 audit report has been used in Canada only since 2011. The International Standards on Auditing (ISA) report on which it is modelled came into effect in 2007. As compared to the previous format, the new format primarily expands the description of the auditor's responsibilities and the work performed. In the previous version, this took half of a paragraph; and now there are three full paragraphs devoted to it. While this may make it seem that it is the state of the art in audit reporting, there are wide ranging discussions underway to look at ways to improve the report further. Many commenters feel that the public concerns and criticisms of the previous version still have not been addressed. The box below outlines current research into the deficiencies of audit reports and the standard-setting projects underway that propose fairly radical changes.

EVOLUTION OF AUDIT REPORTING—THUNDER CLOUDS ON THE HORIZON

The long-standing view of the auditing profession that audit reporting should be highly standardized to best serve the public is embodied in CAS 700, paragraph 4, which states, "*This CAS promotes consistency in the auditor's report. Consistency in the auditor's report, when the audit has been conducted in accordance with CASs, promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards. It also helps to promote the user's understanding and to identify unusual circumstances when they occur.*" Academic and professional research, however, is currently addressing concerns about the relevance and understandability of standardized audit reports that are often perceived by users as boiler plate reports that communicate little valuable information. Many of the recommendations coming out of this research point to breaking away from highly standardized wording, to allow more flexibility and more detailed information to be disclosed by the auditor.

In the academic literature, Church et al. (2008) summarize research on audit reports, and find three main issues:

1. Audit report conclusions are affected by factors that auditors may not be aware of, such as the order in which evidence is collected, the biases of the auditor doing the primary audit work (usually the on-site audit senior), or audit staff members preconceptions about the audit partner's beliefs—in other words, human nature.
2. Research suggests that the nature of accounting standards—how precise they are—influences the outcomes of auditor-client negotiations. It is found that more rigid, rules-based standards are somewhat easier for auditors to enforce than principles-based standards, as the latter invite debate about subjective matters that do not have clear answers.

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3. Audit reports tend to be viewed merely as symbols representing the auditor's reputation, and not as communications of the results of the audit despite most of the expansions in the wording being related to this aspect. Generally, the standardized nature of the reports and the generalized information they contain is not specific enough for users to find it informative, so they are rarely read it.

In a 2011 study, Gray, Turner, Coran, and Mock conducted focus sessions with five different stakeholder groups—financial statement preparers (CFOs), users (bankers, analysts, and nonprofessional investors), and external auditors. This approach allowed detailed comparisons between the perceptions of the different stakeholder groups affected by the auditor's report. Findings include that financial statement users value the audit, but do not read the entire auditor's report. It is not clear to users, preparers, and auditors what the auditor's report is intended to communicate or the level of assurance being provided by the report. While stakeholders offered numerous suggestions to improve the auditor's report, they also recognized that those suggestions could significantly change the auditor's risk profile and increase audit fees. The authors suggest future research to determine if potential changes to the auditor's report would change users' behaviour, and if any resulting benefits would outweigh the additional risks and costs.

In the important emerging issue of auditing fair value accounting estimates, which can involve highly uncertain measurements, Bell and Griffin (2012) note the preponderance of audit deficiencies found in PCAOB inspections that relate to the difficulties of auditing fair value estimates. They call for additional quantitative disclosures of management's historical estimation accuracy and current levels of inherent measurement uncertainty. Their conclusions propose additional disclosures on management's estimation processes, assumptions, and historical estimation accuracy, to improve the verifiability of decision-useful information on inherent measurement uncertainty. They also suggest a modified audit report conveying that only negative assurance has been obtained for high-uncertainty FVA estimates, the reasons why, and an overview of the procedures performed by the auditor, which they contend would provide a more faithful representation of the true nature and extent of assurance provided to users.

Also on the issue of uncertainty in fair value estimates, Christensen, Glover, and Wood (2012) note that while complexity and estimation uncertainty in financial statements have increased in recent decades, the content of the audit report and the information conveyed on the face of financial statements have changed relatively little, including the format of the balance sheet and income statement, the content in the auditor's report, and the level and nature of assurance provided on estimates. They find that fair value and other estimates based on management's subjective models and inputs contain estimation uncertainty or imprecision that is many times greater than materiality. These highly uncertain estimates can also impact reported net income and earnings per share. The point estimates reported on the face of the financial statements, when coupled with an audit opinion that purportedly provides high assurance that these point estimates are materially correct, may contribute to a false sense of precision. As extreme estimation uncertainty in account values and net income have become more common, in response to user demands for information that is more current and relevant than historic costs, the authors question whether auditing and financial reporting standards provide for effective conveyance of the uncertainty contained in financial statements. They suggest that the expectations of standards setters, regulators, and users may be placing an increasingly difficult, and likely unrealistic, burden on auditors. While they allow that auditors are probably operating as best as can be expected given the current state of auditing and financial reporting standards, no amount of auditing can remove the underlying estimation uncertainty of reported values that are determined by management-derived estimation models which are hypersensitive to small changes in inputs—inputs that are subjectively chosen by management from within a reasonable range. They also discuss deficiencies in the current standards for auditing fair value estimates, a topic explored in more detail in Chapter 20 (available on Connect) of this text. In interviews of national-level partners at the U.S. Big 4 firms, the authors found that audit partners commonly consult with the national offices over concerns about giving opinions on the fairness of estimates with extreme uncertainty, and that these partners currently justify the opinion not based on criteria suggested by the standards (that the estimate is "fairly stated in all material respects"), but rather based on comparisons with how other auditors would audit the estimates, and the underlying potential litigation risk.

Like other researchers, they conclude that, except in rare situations (e.g., going-concern opinion), the current wording of the standard audit opinion provided in the financial statements of all public companies is similar and conveys relatively little information. Yet the audit opinion is the only information the auditor formally conveys to the users of the financial statements. In addition to more informative reporting on uncertainties in financial statements, the authors call for changes in auditing standards. One change would be from estimates based on models whose inputs are selected by management and are sensitive to small changes within a reasonable range such that the auditor is unable to provide high assurance that the estimates themselves are fairly stated within materiality, to, instead, estimates that provide positive assurance only with respect to the rigour and soundness of the entity's estimation model, valuation processes, and related controls, and provide negative assurance with respect to the fairness of the reported point estimate. Another would involve changes to the form and content of the audit report, to include a list of accounts with extreme measurement uncertainty (i.e., uncertainty that is multiples of materiality). This list could include a description of the audit procedures performed and the type of assurance provided, and the audit report could refer to the accounts flagged as highly uncertain and then indicate the type of assurance provided and the audit procedures performed.

Regardless of any changes to the auditor's report and type or assurance level (i.e., low, moderate, high) provided about estimates with extreme uncertainty, the authors question whether such changes would effectively communicate uncertainty if financial accounting standards do not induce a change toward more transparency such that estimation uncertainty is clearly indicated on the face of the financial statements.

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In considering the role of auditing in the 2008 global financial crisis, Humphrey, Loft, and Woods (2009) suggest that the audit is a function that works well in good times but really struggles in more turbulent times when companies are under real pressure to deliver favourable results. They note that the standard external audit report is not helpful in this regard, being full of general, standardized statements on the role and limitations of the audit and containing little about the specific work undertaken and findings obtained by auditors.

They put forward some ways by which the substance and quality of audit work could be more visibly profiled and demonstrated. For instance, a section within the corporate annual report could focus on key audit findings. Disclosures could include operational levels of audit risk and materiality, the significant errors detected and adjusted, and information about the scale, nature and results of tests done to verify the value of assets marked to market or to model. Such disclosures could conceivably go beyond the technical fair presentation assessment and include information about any assistance provided by the auditor to the company in helping to ensure that a modified opinion is avoided (e.g., by good planning and the implementation of documentation processes to demonstrate that the company is a credible, going concern) or preventing the company from going into liquidation and thereby preserving jobs. Recognizing that such suggestions invite debate on the relative merits of short versus long and/or free form reporting, they do highlight just how little of the work of the auditor is made visible in standard audit reporting processes, and how judgment permeates the auditors' work in relation to valuations, use of experts, materiality, and going concern issues, and so on.

In professional research, important proposals for change are included the IAASB Consultation Paper, *Enhancing the Value of Auditor Reporting: Exploring Options for Change*, which lays out four points for discussion:

- Additional auditor commentary
- Provision of conclusions on going concern and other issues in the annual report
- More disclosure of the nature of the risk-based audit approach, the meaning of technical terms, materiality level used, and the actual name of the engagement partner signing the report
- A building block reporting model so that different national reporting regimes can be given flexibility in how they conform to the ISA report (the formal reporting aspect of the audit is the component most highly subject to local laws, regulations, and customs) as well as the types of entities that predominate in different national jurisdictions.

Overall, the IAASB has to grapple with trade off between international consistency in audit reports and reporting that is flexible enough to be relevant in a wide variety of national circumstances.

In another regulatory development, the Advisory Committee on the Auditing Profession (ACAP) in the United States recommended in 2008 that the Public Company Accounting Oversight Board (PCAOB) undertake a project to consider changes to the auditor's standard reporting model. The committee argued that because the "increasing complexity of global business operations are compelling a growing use of judgments and estimates, including those related to fair value measurements, . . . standardized wording does not adequately reflect the amount of auditor work and judgment."

Sources: B. K. Church, S. M. Davis, S. A. McCracken, "The auditor's reporting model: A literature overview and research synthesis," *Accounting Horizons*, 22(1), 2008, pp. 69–90; G. L. Gray, J. L. Turner, P. J. Coram, and T. J. Mock, "Perceptions and misperceptions regarding the unqualified auditor's report by financial statement preparers, users, and auditors," *Accounting Horizons*, 25(4), 2011, pp. 659–684; T. B. Bell and J. B. Griffin, "Commentary on auditing high-uncertainty fair value estimates," *Auditing: A Journal of Practice & Theory*, 31(1), 2012, pp. 147–155; B. E. Christensen, S. M. Glover, and D. A. Wood, "Extreme estimation uncertainty in fair value estimates: Implications for audit assurance," *Auditing: A Journal of Practice & Theory*, 31(1), 2012, pp. 127–146; C. Humphrey, A. Loft, and M. Woods, "The global audit profession and the international financial architecture: Understanding regulatory relationships at a time of financial crisis," *Accounting, Organizations and Society*, 34, (6–7), August–October, 2009, pp. 810–825; "Enhancing the value of auditor reporting: Exploring options for change," IAASB Consultation Paper, May 2011, at http://www.ifac.org/publications-resources/enhancing-value-auditor-reporting-exploring-options-change.

REVIEW CHECKPOINTS

16-14 Explain the difference between EOM and OM paragraphs.

16-15 Give an example of a situation that would be reported in an EOM paragraph in an audit report containing an unmodified opinion.

AUDITOR COMMUNICATIONS

LO5 Summarize the auditor's communications throughout and at the conclusion of the engagement.

Throughout the audit, the engagement partner and team members communicate continuously with the auditee's management, those charged with governance, and its personnel. Most of this communication is oral, and some involves written correspondence. This section outlines the key formal communications that are required.

Summary of Audit Correspondence

Many types of formal correspondence have been mentioned in this text. Since we are now at the final stage of audit, having completed the work and formed the audit opinion, this is a good place to summarize these correspondence items and when they typically occur.

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Exhibit 16–4 is such a summary of audit correspondence. Refer also to the detailed flow diagram on the inside cover, which shows the communications that auditors are required to make throughout the audit process.

EXHIBIT 16–4 Audit Correspondence

TYPE	FROM	TO	TIME
Engagement letter (acceptance)	Auditor (auditee)	Auditee (auditor)	Before engagement
Independence letter	Auditor	Auditee	Before engagement
Internal control deficiencies	Auditor	Auditee	Interim or after audit
Confirmations (replies)	Auditee (third parties)	Third parties (auditor)	Throughout the audit
Lawyer's letter (reply)	Auditee lawyer	Lawyer (auditor)	Near end of audit
Management representation letter	Auditee management	Auditor	Audit report date
Communication with those charged with governance of auditee (e.g., audit committee)	Auditor	Directors	Planning, during audit, and after audit report

Communications with Those Charged with Governance (Audit Committees or Equivalent)

Once the auditor has concluded the audit work, the audit files are reviewed and complete, and a decision is made on the appropriate form of audit opinion, it is time for the auditor to communicate with those charged with governance regarding the significant audit findings and the planned audit report. Those charged with governance are responsible for ensuring that the organization is accountable to its stakeholders. The organization's financial statements are a key component of this accountability obligation, and those charged with governance must take responsibility for them before the auditor can issue her audit report. This section will review all the communications occurring throughout the audit and then discuss those carried out at the completion of the audit.

The two main communications occurring at the end report significant audit findings to those charged with governance (CAS 260), and report internal control weaknesses discovered during the audit to management (CAS 265). If the control deficiencies are significant, they are also reported in writing to those charged with governance (CAS 265). Exhibit 16–5 provides an example of a letter to those charged with governance, reporting the findings of the audit of a private real estate investment company.

EXHIBIT 16–5 Example of Auditor Communication of Audit Findings: Letter to Those Charged with Goverance, per CASs 260 and 265

May 17, 2012

The Board of Directors
Richmond Limited
1600 90th Street
Cogito, Ontario

Dear Sirs:

We have been engaged to audit the financial statements Richmond Limited ("the company") for the year ending December 31, 20X1.

Canadian generally accepted auditing standards for audit engagements require that we communicate annually with you regarding certain matters relating to the audit. These matters are as follows:

Responsibilities

Our responsibility is to form and express an opinion on the financial statements which have been prepared by the company's management with the oversight of those charged with governance. An audit does not relieve management or those charged with governance of their responsibilities.

Planning

During the course of the audit, we provided management with an overview of the planned scope and timing of the audit. The level of materiality, which is the amount of cumulative misstatement at which the statements would be viewed by users as misleading, was set at $75,000.

Comments Regarding Internal Control

1. There are currently no identifiable controls over revenue completeness at the Little Hotel. We recommend that this situation be reviewed and appropriate controls implemented.

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EXHIBIT 16–5 Continued

2. During the audits of Home-away Corp., we encountered problems with receivables collection, accounting estimates, and general audit documentation which were not encountered in other files. We recommend that the control and reporting structures of this company be evaluated with a view to making improvements in these areas.

Other Audit Findings

1. A Phase II environmental assessment was done with respect to the possible sale of the LaCroix Mall property and concluded that annual visual inspection of asphalt and soil conditions at the site was an appropriate course of action. The consultants were also of the view that the property could be financed by most major lenders under these conditions. The potential buyer has asked for certification by the Ministry of the Environment before they will complete the purchase, which would cost roughly $70,000. Since the company does not have to sell the property and could continue to operate it in normal fashion, which is expected to more than recover the property's cost, there is no impairment to the value of the property value at this time. We agree with management's view that this issue is not of sufficient significance to disclose in the financial statements at this time.
2. We have made some recommendations to Your Home Rentals Ltd. with respect to clarifying the treatment of Harmonized Sales Tax in several of its residential real estate joint venture agreements to clarify the HST treatment of various non-arms-length transactions. There is considerable complexity in this area of HST. While some progress has been made on these matters, there remains a lack of a comprehensive approach to this issue.

Independence

We are required to identify and report to you relationships between the company and ourselves that, in our professional judgment, may reasonably be thought to bear on our independence.

In determining which relationships to report, the standards require us to consider relevant rules and related interpretations prescribed by the Institute of Chartered Accountants of Ontario and applicable legislation, covering such matters as:

a) Holding a financial interest, either directly or indirectly, in a client
b) Holding a position, either directly or indirectly, that gives the right or responsibility to exert significant influence over the financial or accounting policies of a client
c) Personal or business relationships of immediate family, close relatives, partners, or retired partners, either directly or indirectly, with a client
d) Economic dependence on a client
e) Provision of services in addition to the audit engagement

We have prepared the following comments to facilitate our discussion with you regarding independence matters arising since May 25, 2011.

We are not aware of any relationships between the company and ourselves that, in our professional judgment, may reasonably be thought to bear on our independence, which have occurred to date.

Canadian generally accepted auditing standards for audit engagements require that we confirm our independence to management or persons having oversight responsibility for the financial reporting process. However, since the Rules of Professional Conduct of the Institute of Chartered Accountants of Ontario deal with the concept of independence in terms of objectivity, our confirmation is to be made in that context. Accordingly, we hereby confirm that we are objective with respect to the company within the meaning of the Rules of Professional Conduct of the Institute of Chartered Accountants of Ontario as of May 17, 20X2.

This report is intended solely for the use of the board of directors, management, and others charged with governance of the company and should not be used for any other purposes.

We are available to discuss the matters contained in this letter at any time.

Yours truly,

Gustav & Myers
Public Accountants, LLP

The communication with those charged with governance is an opportunity for the auditors to present issues that, if they are insightful and well supported by facts and circumstances encountered during the audit, can be very helpful to those with the responsibility for directing an organization. In many organizations, those charged with governance will be a separate committee of board members, the audit committee, formed specifically to oversee the presentation of the audited financial statements, and in other organizations it will be the board of directors itself. The following discussion will assume an audit committee, and similar requirements would follow for other types of governance structures. The auditor and management should, in advance, review the information to be covered with the audit committee. On some matters (e.g., company operations), management should report and the auditor then comment. On other matters, such as audit findings, the auditor should report and management then comment. Both should be present in meetings with those charged with governance to discuss these reports, which may be written or oral. When the auditor communicates in writing with an audit committee, the report should indicate that it is intended solely for use by the audit committee. In some instances, the auditor may identify matters to discuss without the presence of management.

The auditor should keep notes of these audit committee discussions, and they should be compared with the audit committee minutes of the meeting. Any inconsistencies must be resolved with the audit committee or board of directors. The auditor should also

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communicate all matters affecting approval of the annual financial statements to the board of directors prior to such approval. Normally, the auditor would work within the audit committee's regular cycle of meetings.

The audit committee's expectations need to be clarified and put in writing. The most important matters arising from the audit of financial statements that should be communicated to the audit committee include the following:

1. Auditor responsibility under GAAS
2. Planning of the current audit
3. Material weaknesses in internal controls
4. Illegal acts
5. Fraud
6. Significant accounting principles and policies selected by management
7. Management judgments and accounting estimates
8. Misstatements, adjusted and uncorrected
9. Other information in annual reports (e.g., narrative information)
10. Disagreements with management
11. Consultation with other accountants by management
12. Significant findings of the audit
13. Difficulties encountered in performing the audit (e.g., unreasonable delays in obtaining information from management)
14. Effects of new developments in accounting standards, or of legislative or regulatory requirements, on the auditee's financial reporting
15. Use of experts
16. Audit and nonaudit services that the auditor is providing to the auditee
17. Summary of the audit approach

If the auditor considers that an audit committee's response to the matters communicated are seriously inappropriate, he or she may need to communicate directly with the board of directors or even have an obligation to report to outside regulatory authorities. For example, the "well-being reporting requirement" under federal financial institutions legislation may require the auditor to report to the Superintendent of Financial Institutions "any significant weaknesses in internal control which have the potential to jeopardize the financial institution's ability to continue as a going concern."[7] As auditee confidentiality is an issue, the auditor should seek legal advice about the best manner of reporting to outside authorities.

REVIEW CHECKPOINTS

16-16 What is the purpose of the auditor's communication with those charged with governance at the completion of the audit? What are some important matters that this communication should include?

16-17 Why must the auditor communicate significant findings with those charged with governance prior to dating the audit report?

16-18 What information would the auditor communicate to management and to those charged with governance regarding internal control deficiencies discovered during the audit?

7 As described in the *CICA Handbook*, Assurance and Related Services Guideline, AuG–17, "Transactions or conditions reportable under the 'well-being reporting requirement' in federal financial institutions legislation."

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APPLICATION CASE WITH ANALYSIS

Final Overall Analysis Uncovers Unusual Related-Party Transactions

DISCUSSION CASE

In his third year as an auditor, Jack assists an audit partner in completing the final analytical procedures and working paper review for a new audit of a group of mining companies. The audit file shows that in 20X9 Alta Gold Company, a public "shell" corporation, was purchased for $1000 by the Blues brothers.

Operating under the corporate names of Diamond King and Pacific Gold, the brothers had also purchased numerous mining claims in auctions conducted by the Ministry of Natural Resources. They invested a total of $40,000 in 300 claims between the two companies. A series of transactions followed.

(a) Diamond King sold limited partnership interests in its 175 Northwest Territories diamond claims to local investors, raising $20 million to begin mining production.

(b) Pacific Gold then traded its 125 British Columbia gold mining claims for all the Diamond King assets and partnership interests, valuing the diamond claims at $20 million. Diamond King valued the gold claims received at $20 million as the fair value in the exchange.

(c) The brothers then put $3 million obtained from dividends into Alta Gold and, with the aid of a $15 million bank loan, Alta Gold purchased half of the Diamond King gold claims for $18 million.

(d) The Blues brothers then arranged for Alta Gold to obtain another bank loan of $38 million to purchase the remainder of Diamond King's assets and all of Pacific Gold's mining claims. They paid off the Diamond King limited partners.

(e) At the end of 20X9, Alta Gold had cash of $16 million and mining assets valued at $58 million, with liabilities on bank loans of $53 million.

Alta Gold had in its files the partnership offering documents, receipts, and other papers showing partners' investment of $20 million in the Diamond King limited partnerships. The company also had Pacific Gold and Diamond King contracts for the exchange of mining claims. The $20 million value of the exchange was justified in light of the limited partners' investments.

Appraisals in the files showed one report that there was no basis for valuing the exchange of Diamond King claims other than the price limited partner investors had been willing to pay. The second appraiser reported a probable value of $20 million for the exchange, based on proven production elsewhere, but no geological data on the actual claims had been obtained. The $18 million paid by Alta Gold to Diamond King had similar appraisal reports.

Audit Trail

The transactions occurred over a period of 10 months. The Blues brothers had $37 million cash in Diamond King and Pacific Gold, as well as the $16 million in Alta. All of the cash was borrowed from a bank that had granted the loan to Alta Gold with the mining claims and production as security. The mining claims that had cost $40,000 were now in Alta's balance sheet at $58 million; the $53 million in loans from the bank was secured by 300 mining claim papers.

AUDIT APPROACH ANALYSIS

The auditors' objective is to obtain evidence of the existence, valuation, and rights (ownership) in the mining claim assets. The review of the working papers indicated a number of audit issues and outstanding procedures still to be done.

Controls Relevant to this Process

The audit file documentation assessing of internal controls relevant to accounting for mining property investments indicated that Alta Gold, Pacific Gold, and Diamond King had no control structure. All transactions were engineered by the Blues brothers, including the hiring of friendly appraisers. The only control that might have been effective was the bank loan–granting process, but the bank failed to exercise appropriate procedures to evaluate the risk in the loans to Alta Gold.

Another effective control could have been engagement of competent, independent appraisers. Since the auditors will use (or try to use) the appraisers' reports, the procedures involve investigating the reputation, engagement terms, and independence of the appraisers. The auditors can use local business references, local financial institutions with lists of approved appraisers, membership directories of the professional appraisal associations, and interviews with the appraisers themselves.

AUDIT PROCEDURES

Test of Details of Balance

The procedures for auditing the asset values include tracing and analyzing the path of each transaction. This includes obtaining knowledge of the owners and managers of the several companies and the identities of the limited partner investors. If the Blues brothers have not disclosed their connection with the other companies (and perhaps with the limited partners), the auditors need to enquire at

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the government's commerce department offices to discover the identities of the players in this flip game. Numerous complicated pre-merger transactions in small corporations and shells often signal manipulated valuations. Loan applications and supporting papers should be examined to determine the representations made by Alta Gold when obtaining the bank loans. These papers may reveal some contradictory or exaggerated information. Ownership of the mining claims might be confirmed with the government's resource department auctioneers or found in the local deed records (spread all over the Northwest Territories and British Columbia).

AUDIT RESULTS

Based on their final file review and analysis, Jack and the partner find that the audit staff assigned had documented the many transactions and loans, but they had not been able to unravel the complicated exchanges and they never questioned the relationship of Alta Gold to Diamond King and Pacific Gold. They never investigated and discovered the Blues brothers' involvement in the other side of the exchanges and the purchase transactions. They accepted the appraisers' reports as competent and independent but had not adequately supported these conclusions. The audit partners realize that the audit is far from complete. Attempting to contact the Blues brothers, the only directors of all the corporations, to communicate the findings at this point of the audit, it is learned that both have left the country on extended trips and cannot be contacted. Further investigation reveals the identities of the various related parties in the flips. The audit cannot be completed, and the initial decision to accept this new engagement is deemed not appropriate based on the facts learned subsequently. Jack's audit firm withdraws from the engagement without issuing a report (a close call; the bank that lent the $53 million was not so lucky). The audit firm begins an investigation to find out how the inappropriate acceptance decision was made, so it can implement necessary improvements to its quality control procedures.

REVIEW CHECKPOINTS

16-19 What impact can related-party transactions have in some cases of asset valuation?

SUMMARY

This chapter ended this text's adventures in auditing with a review of the professional judgments applied to form the audit opinion at the completion of the engagement. This closes the circle that began back in Chapter 4, which explained the write up of the audit report itself. Chapter 4 introduced the audit report to show you the final objective and focal point of the whole financial statement audit engagement. Chapters 5 through 16 have elaborated on how auditors achieve this ultimate objective—assessment of audit evidence and findings to form the auditor's opinion.

- The many professional judgments made in the process of achieving the overall objectives of the independent auditor were outlined in the context of CAS 200.
- The chapter described how misstatements identified over the course of the audit are accumulated for evaluation in comparison to materiality. The nature of various types of misstatements and their impact on evaluating whether there is a material misstatement at the overall financial statement level were discussed.
- At the conclusion of an audit, the engagement partner evaluates the sufficiency and appropriateness of the evidence documented in the audit files to determine whether the scope of the audit supports a clean opinion. The evaluation of fair presentation involves not only considering the nature and size of misstatements but also qualitative considerations of whether the presentation and disclosures achieve fair presentation. Different types of applicable financial reporting frameworks, and the reporting appropriate for a fair presentation framework were explained.
- The purpose of emphasis of matter (EOM) and other matter (OM) paragraphs was outlined, this being to provide additional information in an audit report, separately from the decision on the form of opinion. EOM paragraphs expand on information that is contained in the financial statements, and OM relate to issues that are not in the financial statements but that the auditor believes are important for users to be aware of.

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- The auditor's communications throughout and at the conclusion of the engagement were summarized. Auditor correspondence was listed, and the end-of-audit communications with those charged with governance were detailed.

The next chapter will discuss other types of engagements that are common in public practice, and the remaining chapters will present a variety of advanced issues in the public accounting profession.

KEY TERMS

dual dating
further possible misstatements
known misstatement
likely misstatement

EXERCISES AND PROBLEMS

EP 16-1 Misstatements, Adjustments. LO2 For the following findings, indicate the income statement and balance sheet accounts that are affected and whether these accounts are over or understated, and provide an adjusting entry to correct the misstatement, if required. Assume a December 31 year-end.

Required:

a. Outstanding cheques totalling $44,000 were deducted from the cash balance on December 23, but deliberately not mailed out to avoid a bank overdraft over the holidays. The cheques were in payment of various raw material supplier accounts.

b. Sales of $79,000 were recorded on goods that were shipped after year-end and included in the year-end inventory count. The cost of these goods is $53,000.

c. A lawyer's bill for services rendered in November was not paid or accrued.

d. The allowance for bad debts has a credit balance of $80,000. The accounts receivable balance is $150,000, and a reasonable estimate is that all but $10,000 of this will be collected.

e. As of December 31 the company has recognized $250,000 of revenue on a $750,000 contract to construct a bridge. The construction work has not yet started, but $40,000 of building materials for the job were received and expensed as contract costs. At this point, the company has not been able to estimate the total costs of construction.

EP 16-2 Professional Judgment. LO1 Professional judgment is essential to auditors and the quality of audits.

Required:

a. Explain professional judgment in the context of an audit, giving three examples of situations in the audit process that require use of it.

b. The generally accepted auditing standards from the *CICA Handbook* include specific standards intended to enhance the quality and value of audits. Identify three requirements in CAS that relate to general, examination, and reporting standards and explain how each one can help junior auditors develop their professional judgment.

EP 16-3 Auditor Communication with Entity and Liability. LO5 Requirements set out in the auditing standard CAS 260 require an auditor to communicate certain issues and information to those charged with governance of the auditee entity as a financial statement audit proceeds.

Required:

Review the requirements in CAS 260 and discuss how they may affect the risk of an auditor's being liable to the auditee entity. Contrast this with the impact, if any, on the auditor's liability to shareholders (as discussed in Chapter 3). As an analytical perspective, consider the auditor's exposure to both sides as resulting from the three-party accountability relationship (discussed in Chapter 3). Provide your conclusion on whether this CAS requirement reduces auditor liability risk from either of these sides.

EP 16-4 Form of Opinion, Misleading Financial Statements. LO3 At the end of her audit of Jolie Angelique Inc., Emma concludes that there are material misstatements affecting many accounts, with the result that the financial statements as a whole are misleading. The company's management refuses to adjust the financial statements, however.

Required:

a. List the four forms of modified audit opinions set out in CAS 705.

b. Explain which form of audit opinion would be appropriate in this situation.

EP 16-5 Form of Opinion, EOM For Going Concern Uncertainty. LO4 Courtney Heart is completing the audit of Profile Framing Ltd. The framing business is seasonal and very competitive. She discovers that a major long-term debt in the draft financial statements is actually due for repayment two months after the close of the financial year. The company president is negotiating with Profile's bank to renew the debt for a further two-year term and has been in to see two other banks about arranging new loans.

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The president has been keeping a close eye on cash flow and negotiating with suppliers about payment terms and extensions of credit. The cash flow for the current year has declined considerably since the year before, and the operating cash flow is negative due to pressure to reduce prices to compete with a discount framing chain that has been opening shops close to Profile's. With the busy holiday gift season approaching, Profile needs to purchase inventory, but it has no cash and its suppliers have all refused to provide any more goods except on a cash-only delivery basis.

Required:

a. Discuss the liquidity and solvency issues faced by Profile. How do these issues affect Profiles financial statements? Consider the disclosures that should be made regarding its financial condition.

b. Assuming Courtney is satisfied that Profile's financial statements adequately disclosed the financial uncertainties it is facing, describe the form of opinion and the emphasis of matter paragraph she will include in her audit report.

DISCUSSION CASES

DC 16-1 Warranty Provision Audit Issues. LO1, LO3 Breton Inc. manufactures industrial lighting fixtures with two main product lines: interior and exterior fixtures. The fixtures are sold with a one-year warranty on parts and labour. During 20X0, Breton's engineering group undertook a five-year review of its warranty claims history and costs, and established that an appropriate accounting policy for warranty costs is to accrue 3% of annual sales for exterior fixtures and 2% of annual sales for interior fixtures. PA, Breton's auditor, has used this analysis as the basis for evaluating provision for estimated warranty cost at year-end for the past two year's audits. During 20X3, Breton's competition increased as light fixtures from China entered the market, selling for prices 40 to 50% lower. To maintain its customer base, Breton's senior management decided to promote the higher quality of Breton's products, and expanded Breton warranty coverage to two years to support these quality claims. However, to keep costs in line, there were no changes to materials used or production methods. PA is now assessing the 20X3 year-end provision for estimated warranty costs and learns that there is no plan to change the approach for developing the estimate. Breton sales people receive commissions of 1% of gross sales. Senior managers, including the CFO, receive bonuses only if the company's pre-tax profit exceeds $300,000.

Required:

a. Discuss the implications of the changes in Breton's competitive environment and business strategy for the audit of its warranty liability estimate. Do you think it is fairly presented?

b. If you were the CFO, what arguments would you make to support not changing the method used to estimate warranty liability for the current year?

c. What actions do you recommend PA take in this case?

DC 16-2 Fixed Asset Dispositions, Accounting Misstatements. LO2 During the current year, Karabakh Ltd. sold off all the heating and air conditioning equipment in one of its buildings because it was being converted from an assembly plant to a warehouse. It was sold to a neighbouring business, which paid $400,000 cash. The equipment was about 10-years old, originally cost $1 million, and was approximately 90% depreciated. Karabakh's bookkeeper recorded the sale as follows:

dr Cash	400,000	
cr Sales revenue		400,000

Required:

a. What impact does the misstatement have on Karabakh's financial statements? Outline which accounts will be affected and the dollar amounts of these effects.

b. Assume this transaction is material to Karabakh's financial statements. What procedures would allow the Karabakh auditor to find this bookkeeping error?

c. Propose a draft adjusting journal entry to correct the entry.

DC 16-3 Going Concern Uncertainty and Audit Reporting. LO1, LO2, LO3, LO4 The auditors of the CRX Inc. (CRX) financial statements for the year ended December 31, 20X7, have decided that there is substantial doubt that CRX can continue to exist as a going concern, because the company has experienced significant operating losses since 20X5 and has had to get permission from its lenders to postpone its debt payment requirements. CRX's management has agreed to describe the problems in the president's message to the shareholders in their annual report, but has decided not to reflect this situation in the notes to the financial statements.

Required:

Discuss fully the type of audit opinion to be issued in this situation, including a description of any information that would be necessary to the standard audit report. Describe what change(s) would be necessary for CRX to obtain an unmodified audit opinion in this case.

DC 16-4 Scope Limitation and Audit Reporting. LO3 Yue is auditing the accounts receivable for Slawson & Slawson, LLP, a large law partnership. The managing partner of the law firm has prohibited the auditor from confirming any of the law firm's accounts receivable. The lawyers are concerned that their clients would consider it a breach of confidentiality for the auditor to know they had engaged the lawyer's

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services and would not understand that the auditor is also operating under strict professional rules that require confidentiality. The accounts receivable balance is highly material. Yue is not able to satisfy himself as to the receivable balance by alternative means.

Required:

a. Describe the type and format of audit report that should be issued in this case.

b. Explain the type of evidence that Yue was trying to obtain by confirming the law firm's account receivable balances, and the assertion(s) and the specific audit objectives that this evidence relates to.

c. Why do you think it was not possible to obtain this evidence by alternative means?

DC 16-5 Subsequent Discovery of Facts and Audit Reporting. LO3, LO4 Refer to the application case and analysis at the end of the chapter. Assume that, instead of withdrawing from the engagement, the auditors in this case had issued a clean audit report on all the companies in the case for the 20X9 year-end. They used the appraisals and other representations from the Blues brothers as evidence that the mining properties were correctly valued and the financial statements were fairly presented. One month after the audited financial statements were issued to shareholders, the auditors contact the companies' accountant about their unpaid fees and learn that the companies have run out of cash and ceased operations. It is suspected that the Blues brothers took all the cash that the bank had lent to the companies and fled the country.

Required:

What are the auditors' responsibilities in this situation?

DC 16-6 Management Letter Issues, Internal Audit. LO5 Goal Products Limited (GPL) is the official manufacturer and distributor of soccer balls for the North American League Soccer (NALS), a professional soccer association. GPL was founded 15 years ago and became a Canadian publicly traded company on July 1, 20X1. GPL has one plant in Canada, and it has one in the U.S. that is operated through a subsidiary of GPL.

It is now October 20, 20X3. You, PA, were recently hired as the manager of financial reporting for GPL. In your first week, you must review the first draft of the quarterly reporting package and provide comments to the financial reporting team on any issues you note. As you start your review you receive an email from the chief financial officer, Joey Bonaducci (Exhibit DC16-6–1).

EXHIBIT DC16-6–1 Email from Joey Bonaducci

Hi PA,

Before you start on reviewing the quarterly reporting packages, we need to prepare a response to the management letter we received from the external auditors for the year ended June 30, 20X3, for presentation at the next audit committee meeting next week.

Sandra Dee, who is responsible for GPL's internal audit work among her many other duties, has looked into the issues and prepared our responses (Exhibit DC16-6–2). Please review the draft report prepared by Sandra and make sure the auditors will be satisfied with our response.

Joey B.

EXHIBIT DC16-6–2 Auditor's Management Letter Excerpts and GPL's Internal Audit Department Responses

PA, I'm sure you will agree with my conclusions once you read the details below. Let me know, though, if you think we need to implement any new controls.

Based on the procedures I performed and those performed by the external auditors at year-end, and the fact that they did not note any material differences, our existing controls are considered adequate.

Sandra Dee, GPL Internal Audit Manager

MANAGEMENT LETTER ISSUE	ISSUE RAISED BY EXTERNAL AUDITOR	INTERNAL AUDIT TESTING AND RESPONSE
Capital asset software	We identified several deficiencies in our review and evaluation of amortization processes. A software program calculates an amortization amount on a monthly basis, which is then recorded as a journal entry directly to the general ledger. However, the program has not been reviewed to ensure additions and deletions are recorded properly and amortization policies are applied appropriately. Due to recent staffing changes, current staff members have inadequate knowledge of the software.	I performed my own test of reasonability. There were minimal acquisitions during the year ended June 30, 20X3. Any variances resulted from differences between the amortization rates used in the system and those used in my reasonability tests. The variances were immaterial.

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EXHIBIT DC16-6–2 Continued

	As a result, the software is no longer tracking the detailed cost build-up of individual assets for acquisitions. Only the final costs of assets are known. Also, there is no process for completing a reasonability check of the balances.	
Sales contract monitoring	We identified deficiencies in management's sales contract process again this year. There is no monitoring process to ensure sales contracts are adequately authorized and nonstandard contracts are reviewed and approved by authorized personnel. As a result, not all contracts were approved or reviewed, and in some cases no final versions of contracts could be found.	I performed a test of details on a few of our current contracts, and everything was fine.
Sales contract monitoring	In addition, there is a lack of segregation of duties. The person maintaining the contract files is also responsible for making deposits and doing bank reconciliations. Since there are insufficient controls for contract approval and modification, this person could modify contracts and deposits to disguise fraud.	Unfortunately, the accounting department is short staffed. Nothing can be done to address the segregation of duties issue.
Internal audit	Only one person within the organization is responsible for the internal audit procedures, and that person does not possess a recognized designation. Also, that person spends a significant amount of time performing other duties, so has little time to dedicate to internal audit responsibilities.	Well, yes, I am very busy. But I have always been able to fit all my assigned duties into the work week.
Consolidation procedures	The Canadian and U.S. companies are consolidated using a large spreadsheet that is maintained solely by the accounting manager. Modifications have been made to the spreadsheet, and as a result, small differences are recorded in retained earnings. No formal process is in place to verify the accuracy of the spreadsheet.	I examined the spreadsheet last year, and it was fine. We have always adjusted for the differences because they are not material enough for us to spend more time on them.

Required:

a. Take on the role of PA in the case, and comment on the general process being used by GPL to prepare the responses to the external auditor's management letter and bring them to the audit committee.

b. In the role of PA in the case, assess the adequacy of the internal auditor's work and responses. State your conclusions on whether Sandra's responses will be satisfactory to the external auditor.

c. Take the role of the external auditor in the case. Discuss what impact the weaknesses, if not addressed, will have on planning the audit engagement for next year.

(CICA adapted)

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PART 4 Advanced Issues in Professional Public Accounting Practice

CHAPTER 17

Other Public Accounting Services and Reports—Reviews and Compilations

Public accountants (PAs) offer assurance services on information other than the standard historical financial statements. These services grow out of business, government, and public consumer demand for the objective expert association offered by PAs. However, PAs need to be careful that they do not suggest more credibility than is warranted in their reports on the information.

As you study the topics in this chapter, you will see the standards for PA engagements other than audits of financial statements. The Canadian Institute of Chartered Accountants (CICA) has decided to adopt only the international *audit* standards at this time and will consider at a future date what, if any, other international standards it will adopt. Existing Canadian standards for other PA services and reports, as they are outlined at the beginning of Chapter 4, will remain in effect for the time being. In this chapter, we cover some of these other types of association in more detail: review engagements, compilation engagements, and audits of internal control.

The standards in this chapter are covered under the original *CICA Handbook* system of numbered recommendations and, thus, do not refer to Canadian Auditing Standards (CASs).

EcoPak Inc.

Kam has recently landed a couple of large accounts in Quebec, so he and Mike have been looking into buying another packaging business in that region, to serve the new customers more efficiently. They have started negotiating with two different companies and have obtained the most recent financial reports for both.

One company's financial statements have a review engagement report attached. The review was done by a mid-sized Quebec firm of PAs and reports that nothing came to the accountants' attention to indicate the financial statements are not fairly presented. The company is less profitable than EcoPak, but after touring its operations, Mike sees a number of ways EcoPak could increase its efficiency and profitability, so he is not concerned.

The second company looks very attractive based on its financial statements. It has a higher profit margin even than EcoPak, and its productive equipment is hardly depreciated at all, so it appears to be very new. Its financial statements have a "Notice to Reader" report attached by another mid-sized PA firm, stating the financial statements were compiled by the PA firm from information provided by management and were not audited or reviewed. When Mike arranges a visit to their factory, he is quite surprised that they could be so profitable; their machines look to be in poor shape, as only one of the four is running and it breaks down twice in the four hours he spends at the factory.

LEARNING OBJECTIVES

After completing this chapter, you will be able to do the following:

LO1 Prepare reports for review and compilation of unaudited financial statements, given specific facts.

LO2 Write a report on a review of interim financial information.

LO3 Describe the various reports on internal control and their connection with public reporting and reporting to a client's audit committee.

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When he gets back to the office and goes over the two sets of financial statements with Nima, she notes a number of odd relationships and inconsistencies in the second company's numbers that indicate it may be understating a number of its costs, including depreciation. Since the PA's report gives no assurance at all, Nima concludes the financial statements are not very reliable indicators of the company's performance. The first company's financial statements seem to tie together with what Mike has observed in their operations, and the PA's report provides some negative assurance that the information is reliable.

Nima, Mike, and Kam agree the first company seems to be a better deal and is less risky than the second. They decide to make an offer for the operating assets of the first company very close to what that company's current owners were asking.

UNAUDITED FINANCIAL STATEMENTS

LO1 Prepare reports for review and compilation of unaudited financial statements, given specific facts.

Many PA practices offer accounting and review services for small-business clients. These engagements include bookkeeping, financial statement preparation, and financial statement review to help small businesses prepare financial communications. Until the late 1970s, auditing standards concentrated on one level of assurance based on a full audit, and appeared to deny small clients the full benefit of PAs' services.

The investigations by the Adams Committee in Canada and the U.S. Congress during 1977–78 highlighted the problem by focusing attention on the idea that auditing standards handicapped the business of small public accounting firms and the services they offered small-business clients. The argument has become known as the "Big GAAS–Little GAAS" question. Big GAAS was portrayed as the villain in the play, with its proposal that existing standards were enacted under the influence of large PA firms whose practices are centred on big business. Even though this proposition is not true, the fact is that small PA firms want to give and small businesses want to receive some level of assurance as a result of accountants' work even though an audit in accordance with generally accepted auditing standards (GAAS) is not performed. As a result, a separate part of the *CICA Handbook,* the 8000 sections, and the International Standard on Review Engagements (ISRE) 2400 have been set aside to deal with review engagements. The *CICA Handbook,* section 9200, and the International Standard on Related Services (ISRS) 4410 deal with compilation engagements.

Review Services

The review services explained in this section apply specifically to accountants' work on unaudited financial statements. In a review services engagement, an accountant performs some procedures to achieve a moderate level of assurance, not the same as that obtained by performing an audit in accordance with GAAS. The *CICA Handbook* paragraph 8100.05 states the following:

> Reviews are distinguishable from audits in that the scope of a review is less than that of an audit and therefore the level of assurance provided is lower. A review consists primarily of enquiry, analytical procedures, and discussions related to information supplied to the public accountant by the enterprise, with the limited objective of assessing whether the information is being reported on appropriate criteria. In this section, the word *plausible* is used in the sense of appearing to be worthy of belief based on the information obtained by the public accountant in connection with the review.

The *CICA Handbook* paragraph 8100.15 identifies standards applicable to a review engagement, and a similar set of standards is given in the ISRS 2400. They are as follows:

> **General Standard**
> The review should be performed and the review engagement report prepared by a person or persons having adequate technical training and proficiency in conducting reviews, with due care and with an objective state of mind.

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Review Standards

(*i*) The work should be adequately planned and properly executed. If assistants are employed, they should be properly supervised.

(*ii*) The public accountant should possess or acquire sufficient knowledge of the business carried on by the enterprise so that intelligent enquiry and assessment of information obtained can be made.

(*iii*) The public accountant should perform a review with the limited objective of assessing whether the information being reported on is plausible in the circumstances within the framework of appropriate criteria. Such a review should consist of:

(*a*) Enquiry, analytical procedures, and discussion; and

(*b*) Additional or more extensive procedures when the public accountant's knowledge of the business carried on by the enterprise and the results of the enquiry, analytical procedures, and discussion cause him or her to doubt the plausibility of such information.

Reporting Standards

(*i*) The review engagement report should indicate the scope of the review. The nature of the review engagement should be made evident and be clearly distinguished from an audit.

(*ii*) The report should indicate, based on the review:

(*a*) Whether anything has come to the public accountant's attention that causes him or her to believe that the information being reported on is not, in all material respects, in accordance with appropriate criteria; or

(*b*) That no assurance can be provided.

The report should provide an explanation of the nature of any reservations contained therein and, if readily determinable, the effect.

These standards suggest that auditors need special training and experience in conducting reviews, especially with respect to working within a plausibility framework. The second review standard shows that obtaining knowledge of the business is critical to the review engagement, as it is necessary in determining whether the information gathered through the engagement process is plausible—or worth believing. Sufficient knowledge of the business (and industry) is required to make intelligent enquiries and a reasonable assessment of responses and other information obtained. However, the knowledge required for review engagements is normally less detailed than that required in an audit. The "plausible" concept also means that there is a higher risk of undetected material misstatement than there is in an audit engagement. This is why review engagements are considered to provide only moderate-level assurance; that is, reviews might be considered to fall in a 70–80% assurance range as compared with the 90–99% assurance looked for in an audit engagement.

When a PA doubts the plausibility of the information reported, sufficient additional or more extensive procedures should be carried out to resolve doubt or confirm the need for a reservation.

The review standards indicate that review work on unaudited financial statements consists primarily of enquiry and analytical procedures. The information gained is similar to audit evidence, but the limited procedures recommended suggest that typical auditing procedures of assessing control risk, conducting physical observation of tangible assets, sending confirmations, or examining documentary details of transactions are not performed. Following is a list of the recommended procedures:

- Obtain knowledge of the client's business. Know the accounting principles of the client's industry. Understand the client's organization and operations.
- Enquire about the accounting system and bookkeeping procedures.
- Perform analytical procedures to identify relationships and individual items that appear to be unusual.
- Enquire about actions taken at meetings of shareholders, directors, and other important executive committees.
- Read (study) the financial statements for indications that they conform with GAAP.
- Obtain reports from other accountants who audit or review significant components, from subsidiaries or from other investees.

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- Enquire of officers and directors about the following: conformity with GAAP, consistent application of accounting principles, changes in the client's business or accounting practices, matters that raised questions when other procedures were applied (listed above), and events subsequent to the date of the financial statements.
- Perform any other procedures considered necessary if the financial statements appear to be incorrect, incomplete, or otherwise unsatisfactory.
- Prepare working papers showing the matters covered by the enquiry and analytical review procedures, especially the resolution of unusual problems and questions.
- Obtain written representation letters from the owner, manager, or chief executive officer and from the chief financial officer.

Many firms will perform more detailed procedures, such as bank reconciliations and bank confirmations, to corroborate information obtained by enquiry. However, current review standards do not require this. Reviews have traditionally provided negative assurance, or (in the words of the assurance conceptual framework, to be discussed later in this chapter) a moderate level of assurance that indicates the financial information is "plausible" (paragraph 5025.12, to be discussed in Chapter 21 [available on Connect]) or "moderate."[1] The term negative assurance has become traditional through use of the "nothing has come to my attention . . . " wording in the review report (Exhibit 17–1).

A review service is not a basis for expressing an opinion on financial statements. Each page of the financial statements should be conspicuously marked as unaudited. The standards indicate that a report on a review services engagement should include the following statements:

- A review service was performed and the scope of the review engagement was in accordance with generally accepted auditing standards for review engagement.
- Review procedures consist primarily of enquiries of company personnel and analytical procedures applied to financial data.
- A review service does not constitute an audit, and an opinion on financial statements is not expressed (a disclaimer of any audit opinion).
- The accountant is not aware of any material modifications that should be made; or, if aware, a disclosure is made of departure(s) from generally accepted accounting principles (a negative assurance.).

When other independent accountants are involved in audit or review of parts of the business, the principal reviewer cannot divide responsibility by referring to the other accountants in the review report, unless the disclosure helps explain the reason for a reservation. In review engagements, PAs follow the spirit of the auditing standards to write the form and content of the reference to the work and reports of other PAs.[2] An example of a review report is given in Exhibit 17–1.

EXHIBIT 17–1 Public Accountant's Report

To (person engaging the public accountant),

I have reviewed the balance sheet of Client Limited as at ……., 20XX, and the statements of income, retained earnings, and changes in cash flow for the year then ended. My review was made in accordance with Canadian generally accepted auditiing standards for review engagements and accordingly consisted primarily of enquiry, analytical procedures, and discussion related to information supplied to me by the company.

A review does not constitute an audit and, consequently, I do not express an audit opinion on these financial statements.

Based on my review, nothing has come to my attention that causes me to believe that these financial statements are not, in all material respects, in accordance with Canadian generally accepted accounting principles.

City (signed)................................
Date PUBLIC ACCOUNTANT

Source: © *CICA Handbook,* 2012, paragraph 8200.42.

1 *CICA Handbook,* 2012, paragraph 5025.12 or ISRE 2400.9.

2 CAS 600, paragraphs 11 and A8–A9.

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Compilation Services

Compilation is a synonym for an older term—*write-up work*. Both terms refer to an accountant's helping a client to "write up" the financial information in the form of financial statements. In a compilation service, an accountant performs few, if any, procedures, and substantially less than in a review service. The description of a compilation of financial statements, according to *CICA Handbook* paragraph 9200.03, follows, and a similar description is given in ISRS 4410.3:

> [A compilation service is] one in which a public accountant receives information from a client and arranges it into the form of financial statements. The public accountant is concerned that the assembly of information is arithmetically correct; however, the public accountant does not attempt to verify the accuracy or completeness of the information provided. Unlike an audit or review engagement in which the public accountant does sufficient work to issue a communication that provides assurance regarding the financial statements, no expression of assurance is contemplated in a compilation engagement.

Since compilation engagements provide no assurance credibility, the PA is limited in the action she or he can take. PAs do, however, have a responsibility not to be associated with misleading information:

> When the public accountant is aware that there are matters which the public accountant believes would cause the financial statements to be false or misleading, she or he should request additional or revised information in order to complete the statements. If the client does not provide the information requested or agree with the statements, the public accountant should not release the statements and should withdraw from the engagement.[3]

Financial statements may be compiled on a basis other than GAAP if, in the auditor's judgment, this is appropriate for the circumstances. Appropriate non-GAAP bases are traditionally referred to as *another appropriate disclosed basis of accounting (AADBA)* in the literature. These are discussed in Chapter 21 (available on Connect) as part of the suitable criteria of the assurance framework.

The best way to disclose AADBA statements is through their title (e.g., Statements Based on Income Tax Accounting) or in a note discussing the statements. Titles and notes are also the best method for indicating the reasons for the compilation. The presentation of the compiled financial statements can range from "bare bones," single-column presentations to GAAP-form financial statement presentations with all known notes. If the PA is aware that the financial statements may be misleading and requests additional or revised information but the client does not provide the information or agree with the statements, then the PA should not release them and should withdraw from the engagement. The minimum standard is that the financial statements not be "false or misleading." This, of course, includes arithmetic accuracy and conformity with the appropriate disclosed basis of accounting. This is accounting credibility or the "value added" that the PA association provides in compilation engagements.

At the outset, the PA should have an understanding and written agreement with the client as to the services that will be provided. An engagement letter is normally the clearest record of agreement. Although compilation engagements do not provide any attest assurance or credibility, they do provide accounting credibility—the reason to pay the extra cost to have a PA to do the compilation.

unaudited—see Notice to Reader: note accountant places on each page of financial statements in performing write-up or compilation work

In a compilation service, an accountant should understand the client's business, read (study) the financial statements looking for obvious clerical or accounting principle errors, and follow-up on information that is incorrect, incomplete, or otherwise unsatisfactory. Each page of the financial statements should be marked **unaudited—see Notice to Reader**. The report can be issued by an accountant who is not independent, provided the lack of independence and the reasons for it are disclosed in the financial statements and in the "Notice to Reader" (Exhibit 17–2).

3 *CICA Handbook,* 2012, paragraph 9200.18; also see ISRS 4410.14.

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EXHIBIT 17–2 Notice to Reader

I have compiled the balance sheet of Client Limited as at December 31, 20X1, and the statements of income, retained earnings, and cash flows for the (period) then ended from information provided by management (the proprietor). I have not audited, reviewed, or otherwise attempted to verify the accuracy or completeness of such information. Readers are cautioned that these statements may not be appropriate for their purposes.

I am not independent with respect to Client Limited.

City (printed or signed)..................

Date PUBLIC ACCOUNTANT

Source: © *CICA Handbook,* 2012, paragraph 9200.24.

The report [or notice to reader] should contain the following:

- An assertion that the public accountant compiled the statement from information provided by management (or proprietor)
- A statement that the public accountant has not audited, reviewed, or otherwise attempted to verify the accuracy or completeness of such information
- A caution to readers that the statement may not be appropriate for their purposes
- No expression of any form of opinion or negative assurance

Note that the notice to reader is not a proper place to make non-GAAP AADBA disclosures because the notice to reader does not mention GAAP or any other basis of accounting. The proper place to make the necessary disclosures for nonmisleading financial statements, and possibly also the intended purpose of the financial statements, is in the financial statements.

Exhibit 17–2 illustrates that two kinds of reports on compiled financial statements can be given: (1) a report stating that the accountant is not independent (as in Exhibit 17–2), or (2) a report by a public accountant who is independent, and would therefore exclude the last sentence of the report in Exhibit 17–2. In either case, the basis of accounting may be an AADBA, just like other kinds of accounting services.

The possible components of a compilation file are as follows:

- Financial statements and notice to reader
- Engagement letter
- Adjustments
- Working papers to support computations (e.g., capital asset schedule, etc.)
- Documentation that the PA has resolved all matters leading to belief that the financial statements might be false or misleading
- Other working papers to meet the firm's quality control standards

Exhibit 17–3 summarizes the major differences among audit, review, and compilation engagements.

EXHIBIT 17–3 Audit versus Major Nonaudit Engagements Summary

COMPILATION	REVIEW	AUDIT
Criteria: prepared for internal use of restricted users	Criteria: Plausibility, consistency	Criteria: present fairly in conformity with GAAP, GAAS
Internal control (IC) not evaluated	IC not evaluated	Evaluate IC
No independent corroborating evidence	Some evidence	Independent, corroborating evidence
Compilation, bookkeeping	Enquiry-based review, discussions	Substantive and compliance testing
Accounting credibility	Negative or moderate assurance	Positive assurance or high assurance
Notice to reader	Public accountant's report or review engagement report	Auditor's report

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OTHER REVIEW AND COMPILATION TOPICS

There are several other aspects of review and compilation engagements and reports that differ from audit standards. The following topics point out some of the different problems in dealing with unaudited financial statements.

Prescribed Forms

Industry trade associations, banks, government agencies, and regulatory agencies often use prescribed forms (standard, reprinted documents) specifying the content and measurement of accounting information required for special purposes. These forms may not request disclosures or measurements required by or conforming to GAAP.

When such forms are compiled (but not when reviewed) by an accountant, the compilation report does not need to call attention to the GAAP departures or disclosure deficiencies. Nothing in either *CICA Handbook* section 9200 or in the guideline AuG-5, "Compilation Engagements—Financial Statement Disclosures," requires public accountants to disclose known departures from GAAP in either the compiled statements or the notice to readers.[4] In the latter case, the accountant specifically states that he or she has made no attempt to determine if the statements contain GAAP departures. In fact, disclosing known departures could be confusing or even misleading, as readers might assume the accountant was responsible for disclosing *all* GAAP departures, and that the only departures present are the ones disclosed. This responsibility is beyond the scope of a compilation engagement.

How should the auditor deal with situations of known departures from GAAP or other AADBA? The notice to readers does caution readers that the financial statements may not be appropriate for their purposes. Compiled statements may not be appropriate for general purposes and their use is restricted, depending on the purpose of the engagement. For example, compiled statements are frequently prepared for management, who are aware of the limitations. Moreover, "when the accountant is aware that the statements may be misleading for some users or purposes, then the public accountant may need to include appropriate disclosures (in the statements themselves, not the notice to reader) to prevent them from being misleading. Of course, if management will not allow the disclosures considered necessary, the public accountant has no alternative but to withhold the statements and withdraw from the engagement."[5] Remember that, despite this responsibility, compilations are limited, and there is no assurance that the PA can determine whether the financial statements achieve the specified intended purpose.

Personal Financial Plans

Personal financial planning has become a big source of business for PA firms. Most personal financial plan documentation includes personal financial statements. Ordinarily, an accountant associated with such statements would need to give the standard compilation report (disclaimer), which seems rather awkward when the client is the only one using the statements. In Canada, a PA who wishes to meet the requirements as a certified financial planner under the Financial Planning Standards Council of Canada must satisfy that body's rules of conduct by disclosing any potential conflicts of interest to his or her clients. In Canada, there is no distinction for compilation of personal financial information. U.S. standards exempt personal financial statements from the reporting requirement; however, the following report must be given, with each page of the financial report marked "See accountant's report":

> The accompanying Statement of Financial Condition of Edward Beliveau, as of December 31, 20X9, was prepared solely to help you develop your personal financial plan. Accordingly, it may be incomplete or contain other departures from generally accepted accounting principles and should not be used to obtain credit or for any purposes other than developing your financial plan. We have not audited, reviewed, or compiled the statements.

---

4 AuG-5.

5 R. J. Johnston, *CA Magazine,* May 1988, p. 53.

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A Note on GAAP Departures and Review Engagement Reports

GAAP departures must be treated carefully in review reports. As in audit reports, the accountant can and should add an explanatory paragraph pointing out known departures, including omitted disclosures. Having knowledge of GAAP departures means that the accountant must make exception to them in the negative assurance sentence, such as the following: "Except for the failure, as described in the preceding paragraph, to (describe the departure), based on my review nothing has come to my attention. . . ."

A separate paragraph describing the departure in more detail would be inserted as the next to last paragraph in the review engagement report. See Exhibit 17–4 for the complete report.

The range of possible review reports is similar to that for audit reports, and they arise for similar reasons. Exhibit 17–5 illustrates an adverse report resulting from a GAAP departure, and Exhibit 17–6 illustrates a disclaimer of assurance report as a result of a newer scope limitation.

EXHIBIT 17–4 **Qualification Resulting from a Departure from Generally Accepted Accounting Principles When the Effects Are Not Readily Determinable**

REVIEW ENGAGEMENT REPORT

To (person engaging the public accountant)

I have reviewed the balance sheet of Client Limited as at ……., 20XX, and the statements of income, retained earnings, and cash flows for the year then ended. My review was made in accordance with Canadian generally accepted auditing standards for review engagements and accordingly consisted primarily of enquiry, analytical procedures, and discussion related to information supplied to me by the company.

A review does not constitute an audit and, consequently, I do not express an audit opinion on these financial statements.

Note . . . indicates that the investments in companies subject to significant influence have not been accounted for on the equity basis. The effects of this departure from generally accepted accounting principles on the unaudited financial statements have not been determined.

Except for the failure, as described in the preceding paragraph, to account for the investments on an equity basis, based on my review, nothing has come to my attention that causes me to believe that these financial statements are not, in all material respects, in accordance with Canadian generally accepted accounting principles.

City (signed)................................

Date PUBLIC ACCOUNTANT

Source: © *CICA Handbook,* 2012, section 8200, Appendix B, Example C.

EXHIBIT 17–5 **Adverse Report Resulting from a Departure from Generally Accepted Accounting Principles**

REVIEW ENGAGEMENT REPORT

To (person engaging the public accountant),

I have reviewed the balance sheet of Client Limited as at ……., 20XX, and the statements of income, retained earnings, and cash flows for the year then ended. My review was made in accordance with Canadian generally accepted auditing standards for review engagements and accordingly consisted primarily of enquiry, analytical procedures, and discussion related to information supplied to me by the company.

A review does not constitute an audit and, consequently, I do not express an audit opinion on these financial statements.

Note . . . indicates that commencing this year the company ceased to consolidate the financial statements of its subsidiary companies because management considers consolidation to be inappropriate when there are substantial noncontrolling interests. Under Canadian generally accepted accounting principles, the existence of such noncontrolling interests is not an acceptable reason for not consolidating the financial statements of subsidiary companies with those of the reporting enterprise. Had consolidated financial statements been prepared, virtually every account in, and the information provided by way of notes to, the accompanying

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EXHIBIT 17–5 Continued

financial statements would have been materially different. The effects of this departure from generally accepted accounting principles on the accompanying financial statements have not been determined.

My review indicates that, because the investment in subsidiary companies is not accounted for on a consolidated basis, as described in the preceding paragraph, these financial statements are not in accordance with Canadian generally accepted accounting principles.

City (signed)................................

Date PUBLIC ACCOUNTANT

Source: © *CICA Handbook,* 2012, section 8200, Appendix B, Example D.

EXHIBIT 17–6 Disclaimer of Assurance

REVIEW ENGAGEMENT REPORT

To (person engaging the public accountant),

I have reviewed the balance sheet of Client Limited as at ………, 20XX, and the statements of income, retained earnings, and cash flows for the year then ended. My review was made in accordance with Canadian generally accepted auditing standards for review engagements and accordingly consisted primarily of enquiry, analytical procedures, and discussion related to information supplied to me by the company, except as explained below.

A review does not constitute an audit and, consequently, I do not express an audit opinion on these financial statements.

My review indicated serious deficiencies in the accounting records of the company. As a consequence, I was unable to complete my review. Had I been able to complete my review, I might have determined adjustments to be necessary to these financial statements.

Because of my inability to complete a review, as described in the preceding paragraph, I am unable to express any assurance as to whether these financial statements are, in all material respects, in accordance with Canadian generally accepted accounting principles.

City (signed)................................

Date PUBLIC ACCOUNTANT

Source: © *CICA Handbook,* 2012, section 8200, Appendix B, Example F.

REVIEW CHECKPOINTS

17-1 Explain what led to the creation of review and compilation standards.

17-2 What considerations should a successor accountant make in accepting a new engagement?

17-3 How should a public accountant disclose misleading statements detected during a compilation engagement?

17-4 What is the difference between a review engagement and a compilation engagement regarding historical financial statements? Compare both with an audit engagement.

INTERIM FINANCIAL INFORMATION

LO2 Write a report on a review of interim financial information.

Interim financial information is not a basic and necessary element of financial statements that conform to GAAP. When interim information is presented, however, it should conform to the accounting recommendations in the *CICA Handbook.*[6] Audited interim financial statements might be prepared for buy/sell situations for a business or to fulfill financial

6 *CICA Handbook,* 2012, Part I, IAS 34.

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reporting requirements of regulatory authorities, particularly Canadian companies that are traded in U.S. capital markets and thus must comply with the Securities and Exchange Commission (SEC) requirements. On occasion, regulators, such as the SEC, insist that the interim financial information be audited, but interim statements are not normally audited.

A review of interim financial statements or information is a common type of review engagement. This review differs considerably from an audit. According to the *CICA Handbook* section 7050, the key objective of a review of interim financial statements is to assess whether accounting principles have been applied on a basis that is consistent with the annual report and the corresponding interim financial statements of the previous year. In particular, the auditor is concerned that interim financial statements are not misleading relative to the annual report. The interim review does not require a complete assessment of internal control risk each quarter or that sufficient appropriate evidence is gathered for an opinion. The nature, timing, and extent of review procedures explained below presume that the reviewer has a knowledge base of the company from the audit of the most recent annual financial statements. A review done on this knowledge base is guided by significantly more information than one done without this, and it might, therefore, provide more assurance than a review without an audit knowledge base. For example, the public accountant with an existing audit knowledge base has familiarity with the system of internal controls.

Nature of Review Procedures

Reviews consist mainly of enquiry and analytical procedures. The *CICA Handbook* paragraph 8200.23 and ISRE 2400.20 suggest checklists that can be used for interim information, and include the following:

- Enquire about the accounting system.
- Obtain an understanding of the system. Determine whether there have been any significant changes in the system used to produce interim information.
- Perform analytical procedures to identify relationships and individual items that seem unusual.
- Read the minutes of shareholder, board of director, and board committee meetings to identify actions or events that may affect interim financial information.
- Read (study) the interim financial information and determine whether it conforms to GAAP.
- Obtain reports from other accountants who perform limited reviews of significant components, subsidiaries, or other investees.
- Enquire of officers and executives about the following: conformity with GAAP, consistent application of accounting principles, changes in the client's business or accounting practices, questions that have arisen as a result of applying other procedures (listed above), and events subsequent to the date of the interim information.
- Obtain written representations from management about interim information matters.

Timing of Review Procedures

Review procedures should be performed at or near the date of the interim information. Starting the engagement prior to the cutoff date will give auditors a chance to deal with problems and questions without undue deadline pressures.

Extent of Review Procedures

The accountant needs to acquire a sufficient knowledge of the client's business, as if it were a regular audit. The extent of review procedures depends on the accountant's professional judgment about problem areas in the system of internal control, the severity of unique accounting principles problems and the errors that have occurred in the past. With knowledge of these areas, the accountant can direct and fine-tune the review procedures in the interest of improving the quality of the interim information.

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Review engagement working papers include the following:

- Financial statements and review engagement report
- Engagement letter
- Evidence of planning
- Documentation of knowledge of client's business
- Names of persons requiring enquiries
- Memoranda of enquiries and discussions
- Analytical procedures
- Details of documents examined
- Lead schedules normally in comparative form; conclusion that the items dealt with are plausible in the circumstances, or, if not plausible, their effect on the report
- Review engagement questionnaires
- Letter of representation (failure to obtain one constitutes a scope restriction)

Reporting on a Review of Interim Information

An accountant may report on interim information presented separately from audited financial statements, provided that a review has been satisfactorily completed. The basic content of the report is as follows:[7]

- Statement that a review was made in accordance with standards established for review engagements
- Identification of the interim information reviewed
- Description of the review procedures
- Statement that a review is not an audit
- Denial of opinion on the interim information
- Negative assurance about material conformity with the disclosed basis of accounting
- Mark indicating "unaudited" status on each page

When the interim information is presented, voluntarily under GAAP, as supplemental information in a note to audited annual financial statements and the client requests a review, the auditors give the standard audit report without mentioning the reviewed interim information, unless there is a reason to take exception. Under this exception-based reporting, interim information is mentioned in a modified standard audit report only if (1) it departs from IAS 34 principles, (2) management indicates the auditor performed procedures without also saying they express no opinion, or (3) management fails to label interim information as "unaudited" in the note to annual audited financial statements.

An example report on reviewed interim information presented in a quarterly report (not within an annual report) is shown in Exhibit 17–7.

Additional Interim Information Communication

During the difficult economic times of the 1980s, especially in financial institutions, auditors in the United States were criticized for taking no action when they became aware of material problems with interim financial information. The auditors responded that they were not required to take any action because they were not engaged to perform an interim review and issue a report.

Several regulatory agencies were distressed that some companies issued misleading interim information—sometimes with auditors' knowledge—but nothing was done to inform the public or the regulators. The American Institute of Certified Public Accountants (AICPA) Auditing Standards Board responded with SAS 100, "Communication of Matters about Interim Financial Information Filed or to Be Filed with Specified Regulatory Agencies—An Amendment to SAS No. 36, Review of Interim Financial Information."

7 *CICA Handbook,* 2012, paragraph 8100.15.

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EXHIBIT 17–7 Report on Interim Information in a Company's Quarterly Report (section 7050.61)

The Shareholders, XYZ Inc.:

At the request of the Board of Directors and Stockholders, we have made a review of the unaudited condensed balance sheets of Analog Devices Inc., at April 28, 20X6, and April 29, 20X5, the related unaudited consolidated statements of income for the three-and six-month periods ended April 28, 20X5, and April 29, 20X5, and the unaudited consolidated statements of cash flows for the six-month periods ending April 28, 20X6, and April 29, 20X5, in accordance with standards established by the CICA.

A review of interim financial information consists principally of obtaining an understanding of the system for the preparation of the interim financial information, applying analytical review procedures to financial data, and making inquiries to persons responsible for financial and accounting matters. It is substantially less in scope than an examination in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, nothing has come to our attention that causes us to believe that the accompanying financial statements are not in all material respects in accordance with generally accepted accounting principles.

Public Accountants
Montreal, Quebec
May 16, 20X6

This AICPA standard requires auditors to act when they learn that interim information filed or to be filed with specified agencies is probably materially misstated as a result of a departure from GAAP. The required action is to (*a*) discuss the matter with management as soon as possible, (*b*) inform the company's audit committee if management does not take appropriate and timely action, and (*c*), if the audit committee does not respond appropriately, decide whether to resign from the interim review engagement or resign as the company's auditor. However, auditing standards do not require resignation or direct communication to the "specified agencies." This appears to be a compromise between regulators who probably wanted direct reporting and auditors who wanted to handle difficult problems within the affected companies. This requirement only affects Canadian companies falling within the jurisdiction of the SEC.

REVIEW CHECKPOINTS

17-5 Must interim financial information required to be presented for annual financial statements be in conformity with GAAP?

17-6 In what ways is a review of the interim financial information similar to a review of the unaudited annual financial statements?

17-7 When interim information is presented in a note to annual financial statements, under what circumstances would an audit report on the annual financial statements be modified with respect to the interim financial information?

PUBLIC AND RESTRICTED REPORTS ON INTERNAL CONTROL

LO3 Describe the various reports on internal control and their connection with public reporting and reporting to a client's audit committee.

Several different kinds of reports on internal control, each based on a particular study of controls, have evolved in practice:

- Public reports on control in effect as of a specific date
- Public reports on control in effect during a specified period
- Restricted-use reports based on the control risk assessment work during an audit, not sufficient for expressing an opinion on control

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- Restricted-use reports based on regulatory agencies' pre-established criteria
- Restricted-use reports based on a review without tests of controls or based on application of agreed-upon procedures

In this section, we focus on an unqualified report regarding the first bulleted item above. The other reports are covered in Appendix 17A on Connect. Exhibit 17–8 illustrates the AICPA recommended report applying to privately held companies. In this exhibit, the last paragraph expresses positive assurance (opinion) on the controls. We will discuss general assurance engagements later in this chapter.

The report in Exhibit 17–8 points to a problem with internal control evaluation. For example, should only accounting controls be evaluated? accounting controls plus operational controls? or accounting controls plus operational plus management controls? These questions point to issues regarding internal control objectives for publicly issued internal control reports. The criteria to be used in evaluating controls are another issue in public general-purpose internal control reports. For example, is management and operating control effectiveness too subjective to be measured and evaluated? Current standards focus on accounting controls. Also, what procedures should auditors perform to support such a report, and how should they distinguish between review and examination of internal controls? Some feel these issues can be addressed in a broader attestation/assurance framework rather than in a specific internal control framework.

EXHIBIT 17–8 Reporting on Internal Accounting Control

To the Company, Directors, Stockholders,
Management, a Regulatory Agency, or Specified Others:

We have made a study and evaluation of the system of internal accounting control of Anycompany and subsidiaries in effect at December 31, 20X5. Our study and evaluation were conducted in accordance with standards established by the American Institute of Certified Public Accountants.

The management of Anycompany is responsible for establishing and maintaining a system of internal accounting control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles.

Because of inherent limitations in any system of internal accounting control, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions, or that the degree of compliance with the procedures may deteriorate.

In our opinion, the system of internal accounting control of Anycompany and subsidiaries in effect at December 31, 20X5, taken as a whole, was sufficient to meet the objectives stated above insofar as those objectives pertain to the prevention or detection of errors or irregularities in amounts that would be material in relation to the consolidated financial statements.

/s/ Auditor signature, PA

February 18, 20X6

Note: See CICA OCS 5925, paragraph A82, for the Canadian standard for an independent auditor's report on internal control over financial reporting.

In May 1990, the CICA sponsored a conference on "criteria of control." Its conclusion was that the CICA needed to develop systems criteria, similar to GAAP in accounting, for reporting on internal control. Only then would auditors be able to address Recommendation 49 of the Macdonald Commission Report (1988), which called for evaluation and reporting on the design and functioning of internal control systems of financial institutions. With this goal in mind, the CICA's board of governors established the Criteria of Control Committee in 1992. This committee's primary focus was financial reporting controls, but attempts were made to develop generic control principles applicable to operations also.

In November 1995, the Criteria of Control Committee of the CICA issued a publication in the control and governance series, *Guidance on Criteria of Control* (CoCo). The

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executive summary of the exposure draft, shown below, provides a useful perspective on the committee's work efforts:

> The guidance describes and defines control and sets out criteria for its effectiveness. The guidance is applicable to all kinds of organizations, and to a part of an organization.
>
> The guidance adopts a broad understanding of control. It involves the coordination of activities toward the achievement of objectives, and includes the identification and mitigation of known risks, the identification and exploitation of opportunities, and the capacity to respond and adapt to the unexpected. Thus, control can provide assurance regarding a broad range of objectives in three general categories: the effectiveness and efficiency of operations, the reliability of financial and management reporting, and compliance with applicable laws and regulations and internal policies.
>
> While people at all levels of an organization participate in control, the decisions and actions of senior management and the board of directors and their level of interest in control set the tone. Management is accountable for control, and therefore needs to assess its overall functioning.
>
> The guidance sets out a control framework, which is a way of looking at an organization so that important aspects of control and relationships between them are apparent. The guidance acknowledges that no one control framework will be perfectly suited to all organizations. It also gives examples of how the criteria can be reorganized into other frameworks, and how other management approaches such as total quality management can be compared to the control framework.
>
> The guidance sets out twenty-three control criteria, stated at a high level in order to be broadly applicable. They address areas such as the culture and values that support good control; objective-setting, risk assessment, and planning; control activities that provide assurance that necessary actions are performed; and the monitoring of all aspects of performance to learn what improvements are required. Considerable judgment will be required in applying the criteria, for example, in interpreting them into actionable steps that can be integrated with other management activities; in identifying indicators or early-warning signs so that timely reporting about control can be integrated with reporting about other aspects of performance; and in deciding on the acceptability of risk remaining after control processes have been taken into account.

The terms in CoCo are general and abstract so that it provides a flexible framework for other guidelines. Auditors asked to provide assurance on the reliability of assertions about effectiveness of controls are the intended users of the guidelines. Control is defined as "those elements of an organization (including its resources, systems, processes, culture, structure, and taxes) that, taken together, support people in the achievement of the organization's objectives."

According to the guidance, key concepts in evaluating controls are as follows:

1. Control is effected by people throughout the organization, including the board of directors or its equivalent, management, and all other staff.[8]
2. People who are accountable, as individuals or teams, for achieving objectives should also be accountable for the effectiveness of control that supports achievement of those objectives.
3. Organizations are constantly interacting and adapting.
4. Control can be expected to provide only reasonable assurance, not absolute assurance.
5. Effective control demands that a balance be maintained:
   i) Between autonomy and integration—keeping this balance often involves shifting between centralization and decentralization and between imposing constraints to achieve consistency and granting freedom to act.
   ii) Between the status quo and adapting to change—keeping this balance often involves shifting between demanding greater consistency to gain efficiency and granting greater flexibility to respond to change.

8 The governing body of a government or not-for-profit entity may be called by a different name. In a unit within an organization, the equivalent to the board of directors is the senior management or other leadership group.

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Perhaps the most important features of the guidelines are the twenty control criteria they identify. They are quite detailed but can be summarized by the following categories or components:

1. Purpose groups criteria, which provide a sense of the organization's direction:
   - Objectives (including mission, vision, and strategy)
   - Risks (and opportunities)
   - Policies
   - Planning
   - Performance targets and indicators
2. Commitment groups criteria, which provide a sense of the organization's identity and values:
   - Ethical values, including integrity
   - Human resource policies
   - Authority, responsibility, and accountability
   - Mutual trust
3. Capability groups criteria, which provide a sense of the organization's competence:
   - Knowledge, skills, and tools
   - Communication processes
   - Information
   - Coordination
   - Control activities
4. Monitoring and learning groups' criteria, which provide a sense of the organization's evolution:
   - Monitoring internal and external environments
   - Monitoring performance
   - Challenging assumptions
   - Reassessing information needs and information systems
   - Follow-up procedures
   - Assessing the effectiveness of control

The basic control framework consists of the definition of control and the criteria as summarized by the broad categories.

Response so far has been favourable toward the criteria. They are consistent with the Canadian philosophy of developing guidelines that are not so detailed that they resemble a "cookbook" for evaluating controls. The deliberately high level of the criteria allows them to be applied to all systems at all organizations. There is scope for experimentation and creativity with them, and auditors will have to use considerable professional judgment in applying the criteria to specific situations.

The United States has an equivalent document titled "Internal Control—An Integrated Framework," or **COSO (Committee of Sponsoring Organizations of the Treadway Commission)**. Although CoCo and COSO share the objective of providing guidance for control and criteria for control, CoCo builds on COSO by expanding the concept of control and taking a particularly people-oriented approach towards it.

COSO (Committee of Sponsoring Organizations of the Treadway Commission): an organization that investigated corporate fraud and developed a control framework that has become the standard for the design of controls by companies and evaluation of controls by auditors; the COSO control framework is cited by the PCAOB in its auditing standards on internal control as an acceptable framework against which control design and effectiveness should be evaluated

The guidance is not currently included in the *CICA Handbook,* and it therefore does not have the authority of *CICA Handbook* accounting or auditing recommendations. A member's decision to use the control guidance in assessing internal controls will depend on how useful and relevant they perceive the guidance to be. In this sense, the guidance is somewhat experimental.

A second project of the CICA Criteria of Control Committee is the document "Guidance for Directors—Governance Processes for Control," issued in December 1995. This is the second in a series addressing various aspects of control systems. The document sets out guidance on governance processes for meeting the control responsibilities of boards of directors.

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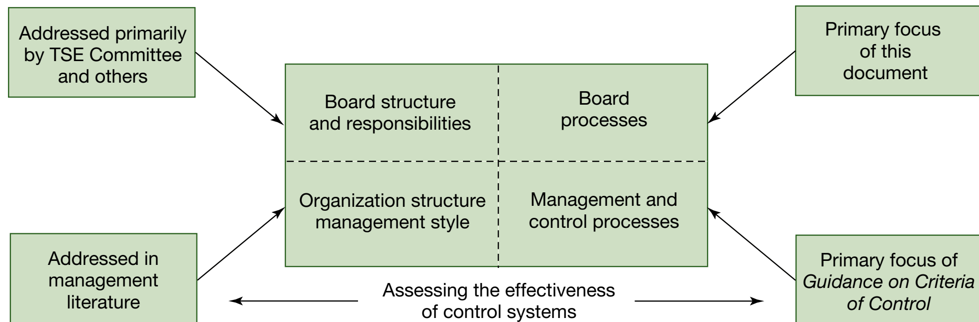
It identifies six key areas of board control responsibility:

1. Establish and monitor the organization's ethical values.
2. Approve and monitor mission, vision, and strategy.
3. Oversee external communication.
4. Evaluate senior management.
5. Monitor management control systems.
6. Assess board effectiveness.

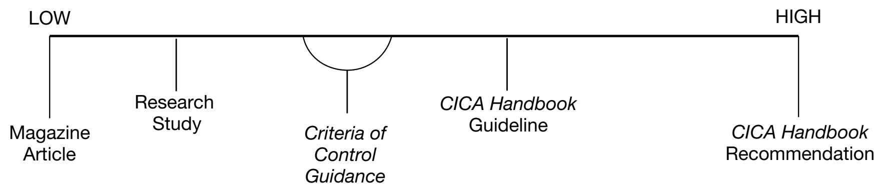
The primary focus of both the "Guidance for Directors" document and CoCo is shown in Exhibit 17–9. This exhibit shows the framework for evaluating management and operational controls evolving within the internal control framework. To assist auditors in interpreting this guidance relative to other authorities on the topic, the Criteria of Control Committee prepared a framework for degree of authoritativeness, presented in Exhibit 17–10. This exhibit makes clear that the control and governance series are not intended to become *CICA Handbook* recommendations. Rather, their intent is to get client organizations to experiment with the framework until a more finely tuned standard can be developed. First used for internal reporting, the framework might then develop sufficiently and support standards for external reporting.

EXHIBIT 17–9 CICA's *Criteria of Control Guidance*



Source: © CICA, *Criteria of Control Guidance.*

EXHIBIT 17–10 Degree of Authoritativeness Framework



Source: © CICA, *Criteria of Control Guidance.*

The U.S. Sorbanes-Oxley Act (SOX) of 2002 has greatly accelerated the evolution of internal control reporting because it requires public companies in the United States to report on internal controls and to have these reports audited, just as financial statements are. The CoCo may provide suitable criteria for evaluating internal control, and it may

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evolve further, along with assurance engagements on internal control. The ongoing evolution of criteria and the dynamic nature of the audit environment underscore the need for the broad framework of critical thinking as a guide for professional judgment.

AUDIT REPORTS ON INTERNAL CONTROL

As explained in Chapter 2 of the text, SOX in the United States and the increasing interest in corporate governance led to the addition of a new item in the audited financial statements: the internal controls statement called "Reporting on Internal Control over Financial Reporting."

Internal control can vary depending on the criteria used. However, for purposes of the internal control statement required by the CICA standard entitled "Reporting on Internal Control over Financial Reporting," they are limited to internal controls over financial reporting. This is consistent with U.S. requirements and is mainly concerned with accounting controls; that is, controls related to the accuracy of accounting recordkeeping and safeguarding of assets. This distinction was covered in more detail in Chapter 9. An example of an internal control statement by management follows in Exhibit 17–11.

EXHIBIT 17–11 Report of Management

REPORT OF MANAGEMENT
Big Corporation and Subsidiary Companies

Management's Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting of the company. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in Canada.

The company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in Canada, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management conducted an evaluation of the effectiveness of internal control over financial reporting based on the framework in Internal Control–Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, management concluded that the company's internal control over financial reporting was effective as of December 31, 20X0. Management's assessment of the effectiveness of the company's internal control over financial reporting as of December 31, 20X0, has been audited by Big Four LLP, an independent registered public accounting firm, as stated in their report which is included herein.

Chief Executive Officer	Chief Financial Officer
March 17, 20X0 +1	March 17, 20X0 +1

Under CICA rules, the auditors verify the accuracy of the internal controls statement for public companies just as they verify the accuracy of financial statements. In fact, the proposed standards require that the audit of financial statements and the audit of the internal control statement be part of the same engagement—primarily because of the close link between accounting controls and accuracy of the financial statements.

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In the *CICA Handbook* section 5925, the CICA recommends the wording of a separate audit report on management's internal control shown in Exhibit 17–12.

Note that in Exhibit 17–12, there are six paragraphs. The first, like the introductory paragraph of the audit of financial statements (regular audit), identifies the statement covered and the responsibilities of the auditor and management. The second paragraph is similar to the scope paragraph in a regular report and explains the character of the auditor's examination. Note that reasonable (high) assurance on the effectiveness of internal control is required in the engagement. The third paragraph is a new one that defines the internal controls covered by the audit.

The opinion paragraph is fourth, but first we discuss the two paragraphs following it. The fifth covers inherent limitations indicating the risk that controls will not guarantee financial statements that are free of material misstatements, with an added caution that the

EXHIBIT 17–12 Auditor Report on Internal Control over Financial Reporting: Unqualified Opinion Example from Section 5925, Paragraph A82

We have audited the effectiveness of [name of entity]'s internal control over financial reporting as at December 31, 20X0. The entity's management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion based on our audit, whether the entity's internal control over financial reporting was effectively maintained in accordance with [identify control criteria, for example, "criteria established in *Guidance on Criteria of Control* (CoCo) published by the Canadian Institute of Chartered Accountants or "Internal Control–Integrated Framework (COSO)" issued by the Committee of Sponsoring Organizations of the Treadway Commission."]

(Scope paragraph)
We conducted our audit in accordance with standards established by the Canadian Institute of Chartered Accountants (CICA) for audits of internal control over financial reporting. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances.

(Definition paragraph)
An entity's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and directors of the entity; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

(Opinion paragraph)
In our opinion, the entity maintained, in all material respects, effective internal control over financial reporting as at December 31, 20X0, in accordance with [identify control criteria, for example, "criteria established in *Guidance on Criteria of Control* (CoCo) published by the Canadian Institute of Chartered Accountants or *Internal Control–Integrated Framework* (COSO) issued by the Committee of Sponsoring Organizations of the Treadway Commission."

(Inherent limitations paragraph)
Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

We have also audited, in accordance with Canadian generally accepted auditing standards, the [identify financial statements] of [name of entity] and issued our report dated [date of report, which is the same as the date of the report on the effectiveness of internal control over financial reporting].

City (signed)………………………

Date PUBLIC ACCOUNTANT

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current evaluation of controls will not necessarily apply to the future. There is nothing comparable in the regular report. The sixth paragraph indicates that the audit is done in conjunction with the financial statement audit.

In the fourth paragraph shown in Exhibit 17–12, the opinion paragraph, note the reference to conformity with established criteria as the basis of the opinion, the reference to materiality, and a direct reporting opinion on the effectiveness of internal controls that does not refer to management's report. This paragraph also states that the opinions are given on the state of controls at a specific point in time ("as at"), that being the balance sheet date as is indicated in the sixth paragraph.

audit of internal control over financial reporting: the engagement that results in an audit report on the effectiveness of a client's internal control over financial reporting

The standard also requires that the financial statement auditor be the auditor of internal control over financial reporting. The term **audit of internal control over financial reporting** refers to the direct reporting audits of internal control. This standard is intended to meet the requirements of the Canadian Securities Administrators (CSA) National Instrument 52–109. Under current CSA rules, internal control statements by management are required for public companies, but the audits of internal controls are optional.

Under *CICA Handbook* section 5925, there is no requirement for the auditor to refer to management's internal control statement. If there was, this would be an attest engagement on management's internal control statement.

Other Communication on Control and Other Matters

Regulators, federal and provincial governments, and the public have been concerned about auditors' communication of internal control and other matters to upper levels of public corporations, especially banks and other financial institutions. In response, the CICA issued two auditing standards addressing auditors' responsibilities to communicate both (1) internal control matters noted in an audit,[9] and (2) certain matters to those having financial reporting oversight responsibility (usually, the audit committee).[10] When performing audits, auditors may notice significant deficiencies in the design or operation of the internal control structure that could adversely affect the organization's ability to record, process, summarize, and report financial data in conformity with GAAP.[11] These problems are referred to as **reportable matters.** Auditing standards do not require auditors to search for reportable matters, but they do require auditors to report the ones that come to their attention.[12] The report, preferably in writing, is to be addressed to the management, or to the board of directors or its audit committee. Exhibit 17–13 is an example of such a report.

reportable matters: significant deficiencies in the design or operation of the company's internal control structure, which could adversely affect its ability to report financial data in conformity with GAAP

EXHIBIT 17–13 Communication of Matters Identified During the Financial Statement Audit

During the course of my audit of ……………………..…… for the year ended ………., I identified matters which may be of interest to management. The objective of an audit is to obtain reasonable assurance whether the financial statements are free of material misstatement, and it is not designed to identify matters that may be of interest to management in discharging its responsibilities. Accordingly an audit would not usually identify all such matters.

The matters identified were ………………

This communication is prepared solely for the information of management and is not intended for any other purpose. I accept no responsibility to a third party who uses this communication.

Source: © *CICA Handbook—Assurance,* 2012, CAS 265, paragraphs 10–11.

9 CAS 265.

10 CAS 260.

11 AuG-13, "Special Reports on Regulated Financial Institutions."

12 CAS 265.

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Auditors might also issue a report called a management letter. This letter may contain commentary and suggestions on a variety of matters in addition to internal control matters; for example, operational and administrative efficiency, business strategy, and profit-making possibilities. Management letters are not required by auditing standards but are advice to management offered as a part of an audit.

Concern about reporting control-related matters within a company has spilled over to a set of other important matters that auditors are required to report on to companies' audit committees or others with oversight responsibility.[13] The purpose of these communications is to enhance the audit committees' ability to oversee the audit functions (external and internal) in a company. The auditors are responsible for informing the audit committee about the following matters:

- Independent auditors' responsibilities regarding financial statements and other information in documents that include the audited financial statements (e.g., the annual report to shareholders and filings with the regulatory agencies such as the OSC or Superintendent of Financial Institutions)
- Management's significant accounting policies
- Management judgments about accounting estimates used in the financial statements
- Significant audit adjustments recommended by the auditors
- Disagreements with management about accounting principles, accounting estimates, scope of the audit, disclosures in the notes, and wording of the audit report
- The auditor's view on accounting matters on which management has consulted with other accountants
- Major accounting and auditing issues discussed with management in connection with beginning or continuing an auditor–client relationship
- Illegal acts
- Difficulties with management encountered while performing the audit: delays in starting the audit or providing information, unreasonable time schedule, unavailability of client personnel, and failure of client personnel to complete data schedules

Auditors also have the responsibility to communicate, in a letter to the audit committee (or equivalent), on matters that bear on independence. CAS 260 requires a letter for the following:

- Confirmation of auditor's independence
- Disclosure of relationships that might impair independence
- Disclosure of total fees for audit and nonaudit services for clients having public accountability (such as companies whose securities are traded on regulated exchanges, public sector companies, and not-for-profit organizations)

REVIEW CHECKPOINTS

17-8 Does the standard public report on internal control give the opinion known as "positive assurance"?

17-9 What reports on control and other matters are auditors required to give to a company's management, board of directors, or audit committee?

17-10 What three types of engagements can produce an auditor's written internal control report intended for external use? Describe the reports in general terms.

13 CAS 260.

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SUMMARY

- Guided by the general concepts of assurance as well as auditing, accounting, and review service standards, PAs offer services and render reports in several areas. These standards were summarized in Exhibit 2–3.
- Unaudited financial statements have been around for a long time. In public practice, these are known as review and compilation services. The difference between the two lies in the amount of work performed and the level of assurance given that each offers. Review engagements involve less work than an audit, and the report gives a lower level of negative assurance. Compilation engagements involve the straightforward writing up of the financial statements, which is less work than a review, and the report gives an outright denial of assurance.
- An accountants' review of interim financial information (e.g., quarterly financial reports) is another possibility. Technically, it is similar to a review of unaudited financial statements, and the report on this review of free-standing interim financial statements gives the negative assurance.
- The issue of reporting on internal control spills over into auditing standards that are designed to allow auditors to publicly report on internal controls; and to require annual auditors to report internally to managers and the board of directors in a company about internal control deficiencies and relations with management.

KEY TERMS

audit of internal control over financial reporting

COSO (Committee of Sponsoring Organizations of the Treadway Commission)

reportable matters

unaudited—see Notice to Reader

EXERCISES AND PROBLEMS

EP 17-1 **Compilation Presentation Alternatives.** LO1, LO4 Jimmy operates a large service station, garage, and truck stop on Highway 95 near Plainview. His brother, Bill, has recently joined as a partner, even though he still keeps a small PA practice. One slow afternoon, they were discussing financial statements with Bert, the local PA who operates the largest public practice in Plainview.

Jimmy: The business is growing, and sometimes I need to show financial statements to parts suppliers and to the loan officers at the bank. The problem is, they don't like the way I put 'em together.

Bill: Jimmy, I know all about that. I can compile a jim-dandy set of financial statements for us.

Bert: No, Jimmy. Bill can't do compiled financial statements for you. He's not independent.

Jimmy: I know, Mom didn't let him outta the house 'til he was 24.

Bert: That so?

Jimmy: But, Bert, those fellas are always asking me about accounting policies, contingencies, and stuff like that. Said something about "footnotes." I don't want to fool with all that small print.

Required:
Think about the financial disclosure problems of Jimmy and Bill's small business. What three kinds of compiled financial statements can be prepared for them and by whom?

EP 17-2 **Negative Assurance in Review Reports.** LO1 A PA states in the report on a review services engagement the following: Based on my review, I am not aware of any material modifications that should be made to

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the accompanying financial statements in order for them to be in conformity with GAAP.

Required:

a. Is this paragraph a "negative assurance" given by the PA?

b. Why is negative assurance generally prohibited in audit reports?

c. What justification is there for permitting negative assurance in a review services report on unaudited financial statements and on interim financial information?

EP 17-3 Review Standards, Knowledge of Business. LO1 Two PAs are discussing review engagements.

A: As I see it, in a review we are providing a lower level of assurance, so we don't need the same extent of knowledge of the client's business and industry as we do in an audit.

B: That seems to be what the profession's review standards imply. But, at the same time, performing a review requires us to develop a "plausibility framework" that involves using enquiries and analytical procedures to assess whether the information being reported on is plausible in the circumstances. I don't see how this can be done unless I have an in-depth understanding of the client's business and its industry. To me this seems logically inconsistent: knowledge of the business and industry is critical in doing a review effectively, so how can I do a review with less knowledge than I need for an audit? And how do I know how much knowledge is "enough"?

A: I see your point. In some ways it seems knowledge of business is MORE critical in a review, not less, because in the audit you can rely on evidence. In a review you have to do it all by judgment.

B: And then, to make it even more confusing, there is also the "strategic systems approach" to auditing that some auditors use; that seems to rely heavily on gathering knowledge of the business, its strategy, and its industry environment, but less on gathering hard, transaction-based audit evidence. So how does an SSA audit differ from a review?

Required:

Discuss the differences between these types of engagement, the assurance levels provided, and the knowledge and procedures required. Are the standards consistent in your view? What factors do PAs need to consider in deciding how much knowledge is enough and what procedures are required in a particular assurance engagement?

EP 17-4 Review Procedures, Bank Confirmations. LO1 You have recently been hired as a junior accountant for a local PA firm. The firm's main practice involves reviews, compilations, and tax return preparation for small to medium business clients. The firm's policy for all review engagements is to always obtain a bank confirmation and re-perform the client's year-end bank reconciliation. You have recently been studying about review engagement standards for one of your professional accounting exams, and point out to your senior that these procedures are not actually required by the standards. This means your firm could save some money by skipping them. The senior agrees because, in her view, "cash is a pretty low-risk account anyway. It's either right or wrong." But she notes that the firm's five partners are the ones who set the policy. "Maybe you should pull together a report on the advantages and disadvantages of this policy and present it to the partners—you might be able to make a big impression on them right away!"

Required:

a. Prepare the report suggested by your senior, and include your conclusion on whether on not this policy is appropriate.

b. Why do you think the partners have this policy? How do you think they will respond to your report and your conclusion?

EP17-5 Compilations, Independence. LO1 The PA has compiled the annual financial statements for her sister's pharmacy business since it started four years ago. The financial statements are attached to the pharmacy's corporate tax return and are also provided to the company's banker to support the company's operating credit line. The banker has been satisfied with receiving tax-based financial statements compiled by the PA.

Required:

a. Draft the report that the PA should attach to the pharmacy company's financial statements.

b. Assume that, in the fifth year of the pharmacy's business, the PA's sister decides to increase her bank credit line to renovate the pharmacy store and stock an expanded product line. To approve the higher credit line, the banker now requires financial statements prepared in accordance with GAAP. What actions must the PA take under these new circumstances? How would these requirements differ if the PA was not related to the pharmacy's owner?

EP 17-6 Communications with Predecessor Auditor. LO7 Assume the role of the predecessor auditor, and state what you would include in your communication with the successor auditor in the following independent situations.

a. You resigned from the audit because the client has not paid your fees for the previous year's audit.

b. You resigned from the audit because of concerns about management's integrity after discovering that many personal expenses of the senior managers had been improperly charged to the company's account.

c. The client dismissed you as auditor over a disagreement about the amount of inventory that should be written down for obsolescence.

d. The client dismissed you because your audit report in the previous year was a "denial of opinion," resulting from serious deficiencies in the

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company's accounting records and internal controls.

e. For each of the situations in *a* to *d* above, assume instead that you are the successor auditor and have received the above communications from the predecessor auditor. What action would you take on receiving the communication in each case?

EP 17-7 **Reviews, Interim Reports.** LO2 The PA is the auditor of Shire Corp., a public company, and has also been engaged to review Shire's third-quarter interim financial statements. Shire's third-quarter financial statements will be filed with the securities regulator within 30 days of the quarter-end and will also be posted on Shire's corporate website at that time.

Required:

a. Describe the procedures the PA will use to review the quarterly financial statements and the contents of the PA's review engagement report.

b. How might the PA's work on the prior year-end audit relate to and help with the review of the third-quarter report? (Consider what difficulties the PA might have in conducting this review if the PA did not also do the audit.)

DISCUSSION CASES

DC 17-1 **Internal Control Reports.** LO3 Do a class survey of internal control reports by auditors in 2013 at www.sec.gov. What is the most common criterion used to evaluate internal controls? Discuss.

DC 17-2 **Controls and Financial Statements.** LO3 Should there be a relationship between audit reports on internal control statements and audit reports of financial statements? Discuss.

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CHAPTER 18

Professional Rules of Conduct Details and Auditor Responsibilities

This chapter highlights the regulation auditors and PAs. As you will see, regulation and discipline depend on published codes of ethics and effective enforcement practices.

EcoPak Inc.

EcoPak has expanded now, and its operations cover most of eastern Canada. Tariq has continued as the audit engagement partner through this growth period. After working quite closely with Nima over the years, he begins to realize that he really likes her and they seem to have a lot of interests and values in common. He asks her out for a coffee one day after a meeting and quickly realizes that Nima feels the same way.

Despite their strong feelings and the happiness it brings them both to start thinking about making a future together, this situation creates a great professional dilemma for Tariq. He would certainly not be able to continue as the engagement partner for EcoPak if he and Nima were to become spouses. To comply with the profession's code of ethics, M&G's policy is that no audits can be accepted for a company at which close relatives of audit partners or managers have key roles in management or governance, or significant ownership interests. These situations create conflicts of interests and would give a strong appearance of lack of independence. It would be quite costly for M&G to give up the audit and for EcoPak to have to find a new audit firm, however.

For Nima's part, she has become very successful and makes a good living, and she loves her job as the CFO of EcoPak. It would be a great loss for her to resign from this great position. Also, her shareholding in EcoPak is her main investment, and it is not a good time for her to sell since the value will increase considerably in future if they continue to run the business successfully. What are they to do?

Tariq discusses his situation with some of the senior partners at M&G and some partners he knows at other PA firms. Fairly quickly, he receives an offer from another PA firm to join as an audit partner. His reputation for integrity, quality work, and good client relations has made him an attractive candidate to other firms, so he is able to make the move with three months, notice. And right away he and Nima start making wedding plans.

LEARNING OBJECTIVES

After completing this chapter, you will be able to do the following:

LO1 Explain the practical importance of professional ethics in audit decision making.

LO2 Analyze whether a PA's conduct conforms to provincial rules of professional ethics.

LO3 Explain the major problematic sections of profe-ssional rules and their impact on auditors and PAs.

LO4 Outline the types of penalties that various provincial associations and government agencies can impose on PAs when enforcing rules of professional conduct.

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LO1 Explain the practical importance of professional ethics in audit decision making.

moral responsibilities: auditor responsibilities to conform to broad social norms of behaviour

professional responsibilities: the rules and principles for the proper conduct of an auditor in her work; necessary to obtain the respect and confidence of the public, achieve order within the profession, and to provide a means of self-policing the profession; also known as *professional ethics*

As part of a privileged profession, auditors are responsible to society. This responsibility can be divided into three categories: moral, professional, and legal. Morality deals with character and "doing the right thing" as is determined largely by social norms. Thus, auditors have a responsibility to conform to social norms. However, social norms change, and a study of ethics is helpful in preparing for lifelong adaptation. Auditors' **moral responsibilities** can be summarized as "public accountants should be upright, not kept upright." Ethics relates to proper conduct in life, and a study of ethics helps the auditor develop a set of principles to live by.

Professional responsibilities refer to the more formal ethical responsibilities of auditors. These responsibilities (or *professional ethics*) are the rules and principles for the proper conduct of an auditor in her work. Professional ethics are necessary for a number of reasons: to obtain the respect and confidence of the public, to distinguish the professional from the general public, to achieve order within the profession, and to provide a means of self-policing the profession. Chapter 3 provided you with an introduction to basic principles and concepts of professional ethics, critical thinking, and PA legal liability This chapter continues the study of provincial rules of professional conduct by focusing on the sections of the rules that cause the most practical problems: independence, competence and due care, confidentiality, contingency fees and commissions, advertising, form of organization, communications between predecessor and successor auditors, and discreditable acts. The chapter ends with a review of regulation and the disciplinary process.

Legal responsibilities are covered in more detail in Chapter 20 (available on Connect).

CODES OF PROFESSIONAL ETHICS

Detailed Independence Rules

LO2 Analyze whether a PA's conduct conforms to the detailed provincial rules of professional ethics.

Observing the rules regarding prohibited activities is an important way of maintaining the independence principle. The fact that the rules vary with the circumstances is a complication. A member may divest a prohibited financial interest before the first work on a new client begins, and, if the engagement continues, it is improper to reinvest. Direct or indirect financial interests are allowed up to the point of materiality; that is, until they make significant contributions to the PA's wealth. This provision permits members to hold mutual fund shares and have some limited business transactions with clients.

As noted previously in this text, the U.S. Sorbanes-Oxley Act (SOX) has been an influence, globally, in determining which threats to independence are against the public interest. The currently prohibited activities seem to focus on the self-review threat. Other threats will likely be identified, as the Canadian Institute of Chartered Accountants (CICA), the Canadian Public Accountability Board (CPAB), the U.S. Securities and Exchanges Commission (SEC), and the Public Company Accounting Oversight Board (PCAOB) establish more regulations that are deemed to be in the public interest. Earlier standards and rules of professional conduct focused on self-interest and intimidation threats through rules on financial interests and those related to conflicts of interest. The more detailed rules are reviewed next.

Permitted Loans

If the client is a bank or other financial institution, the codes of conduct generally allow home mortgages, immaterial loans, and secured loans, all made under a client's normal lending terms. Neither is independence considered impaired if a member obtains the following types of personal loans from assurance service clients: auto loans and leases, insurance policy loans based on policy surrender value, loans collateralized by cash deposits at the same financial institution, and credit card balances and cash advances equivalent to those of other customers in the normal course of business. For insurance company clients, the PA can borrow against the cash surrender value of a life insurance policy. However, the loans should have the same terms as granted to other customers of the institution in the normal

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course of business. Potentially, these kinds of permitted loans could be abused in spirit, as apparently happened in the United States. The key ethical judgment is in understanding "the normal course of business" and, more basically, awareness of the types of loans that could lead to even the perception of impairment of auditor independence.

Other Issues Related to the Independence Principle

Broadly defined, the codes of conduct collectively prohibit activities that amount to having the ability to make decisions for the client or to act as management. The appearance of independence is impaired if such a connection existed at any time during the period covered by the financial statements, regardless of whether the association was terminated prior to the beginning of the audit work. The presumption is that members cannot be independent and objective when attesting to decisions they took part in or are connected with.

In terms of ethical principles, these rules may be justified on a utilitarian theory basis as far as direct financial interests are concerned. The logic is something like this: The greatest good is created by making a situation free of any suspicious circumstances, no matter how innocent they may be in truth. The goodwill of public reliance and respect is greater than the PA's sacrifice of the opportunity to invest in securities of clients or participate in their management. Note that this reasoning relies on putting priority on the interests of third parties, which is why we noted in Chapter 3 that independence can be argued as the most important personal characteristic of the auditor (this is also stressed in CAS 200, paragraphs 14 and CA14). This increasing emphasis on independence reflects changes in societal norms with respect to the role of the external auditor, and these, in turn, influence the courts, regulators, and regulations affecting auditors.

In addition to the issues previously discussed, there are other rules relevant to the independence principle, now briefly described.

Honorary Positions in Nonprofit Organizations

Ordinarily, independence is impaired if a PA serves on an organization's board of directors. However, members can be honorary directors of charity hospitals, fund drives, symphony orchestra societies, and other nonprofit organizations so long as (1) the position is purely honorary, (2) the PA is identified as an honorary director on letterheads and other literature, (3) the only form of participation is the use of the PA's name, and (4) the PA does not vote with the board or participate in management functions. When all these criteria are satisfied, the PA/board member can perform assurance services because the appearances of independence will have been preserved.

Retired Partners

Independence problems do not end when partners retire, resign, or otherwise leave an accounting firm. A former partner can impair independence by association with a client of the former firm. However, the problems are solved and independence is not impaired if (1) the person's retirement benefits are fixed, (2) the person is no longer active in the accounting firm (some retired partners remain "active"), and (3) the former partner is not held out to be associated with the accounting firm by a reasonable observer. Regulators may have stricter rules relating to former partners.

Accounting and Other Services

If a PA performs the bookkeeping and makes accounting decisions for a company and the management does not know enough about the financial statements to take primary responsibility for them, the PA cannot be considered independent for assurance services. It might be perceived that the PA has both prepared the financial statements or other data and given an audit report or other assurance on his own work. The PA can perform the bookkeeping and counsel the client management about the accounting principle choices, but in the final analysis, the management must be able to say, "These are our financial statements (or other data); we made the choices of accounting principles; we take primary responsibility for them." Again, regulators may have stricter rules relating to such bookkeeping services.

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SOX prohibits the following services for auditors of publicly traded companies: internal audit services for the client, financial information system design and implementation, and even tax services. All of these services must be pre-approved by the client's audit committee and disclosed to regulators.

Rotation of Partners and Second Partner Review

The CPAB and SOX require rotation of the lead audit partner and/or concurring review partner (but not the audit firm) every five years. The five-year period includes time spent providing professional services as a non-partner (e.g., manager). The intent of the rule is to prevent auditors from becoming too complacent and not sufficiently skeptical with the client relationship. A second partner review is now mandated by both the CPAB and SOX.

Actual or Threatened Litigation

When a PA and a client move into an adversarial relationship and away from the cooperative one needed in an assurance engagement, independence is threatened by appearances of the PA trying to serve her own best interests. PAs are considered not independent when (1) company management threatens or actually starts a lawsuit against them, alleging deficiencies in audit or other assurance work, or (2) the PA threatens or starts litigation against the company management, alleging fraud or deceit. Such cases may be rare, but auditors get out of such difficult audit situations by ending the assurance engagement. Essentially, the PA–client relationship ends, and the litigation begins a new relationship.

Investor or Investee Relationships

In this context, the terms investor and investee have the same meaning as in rules about accounting for investments in the equity method, covered in accounting standard IAS 28 and *CICA Handbook* section 3050. The *investor* is the party that has significant influence over a business, and the *investee* is the business in which the investor has the significant influence.

When the PA's client is the investor, the PA's direct or material indirect financial interest in a nonclient investee impairs their independence. The reasoning is that the client investor, through its ability to influence a nonclient investee, can materially increase or decrease the PA's financial stake in the investee. If, on the other hand, the nonclient investee is immaterial to the investor, independence is not considered impaired when the PA's financial interest in a nonclient investee is immaterial in relation to the PA's wealth.

When a PA has an investment in a nonclient investor, (a) this investment may be a direct or material indirect financial interest that will diminish independence with respect to a client investee; (b) independence is not impaired, as long as the PA does not have significant influence over the actions or financial statements of the nonclient investor; but (c) independence is impaired when the PA's investment gives him significant influence over the actions of the nonclient investor, which might, in turn, influence the client investee. In any of these relationships, the independence of the PA is impaired because it puts him in a position similar to that of a member of management of the client investee.

Effect of Family Relationships

The codes of conduct and all the interpretations apply to members, but being a member of a professional accounting institute, society, or association should not be confused with the use of the word "member" in the rule. For purposes of independence, the terms member and member's firm generally include the following:

- All partners in the accounting firm
- All professional employees participating in the engagement, including audit, tax, and management consulting personnel
- All other manager-level employees located in a firm office that does a significant part of the audit

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- Any PA firm personnel formerly employed by or connected with the audit client in a managerial capacity unless the person (a) is disassociated from the client and (b) does not participate in the engagement
- Any PA firm professional (e.g., partner, manager, staff) who is associated with the client in a managerial capacity and is located in an office of the PA firm that does a significant part of the engagement

The term "member" excludes students registered under the bylaws of the professional body. However, the codes of conduct can include students, depending on the bylaws of the professional body.

All this is rather complicated, but the bottom line is that it is rare for any partners or shareholders in the firm to be able to have any of the financial or managerial relationships. It is possible for managers and staff to have such relationships, provided they are far removed from the actual work on the audit engagement.

Financial interests of spouses and dependent persons (whether related or not) and some financial interests of close relatives are attributed to the member. Thus, for example, independence would be impaired if (a) a spouse or dependent of a member had a direct financial interest in an audit client or (b) a member on an engagement knew about a brother's or nondependent child's material financial interest in a client.

Employment relationships of spouses, dependent persons, and close relatives can be attributed to a member. Positions that are "audit sensitive" or can exercise significant influence over the operating, financial, or accounting policies of the client are attributed to the member and impair independence. Positions that are "audit sensitive" (e.g., cashier, internal auditor, accounting supervisor, purchasing agent, inventory warehouse supervisor) are attributed to the member and impair independence. However, such employment poses no problem when it cannot influence the audit work (e.g., secretarial, nonfinancial positions).

The code of conduct rules are the minimum criteria relating to independence. PA firms can make more limiting rules. The anecdote in the box below shows some rules given to job applicants of a Big Four accounting firm.

Analysis of Independence Rules

Generally, the rules of professional conduct and corporate acts legislation imply a fine distinction between independence, integrity, and objectivity. The spirit of the rules is that integrity and objectivity are required in connection with all professional services, and, in addition, independence is required for assurance services. In this context, integrity and objectivity are the larger concepts, and independence is a special condition largely defined by the matters of appearance specified in the codes or their interpretations. Conflicts of interest, for example as cited in ICAO Rule 204, refers to avoiding business interests in which the accountant's personal financial relationships or relationships with other clients might tempt him not to serve the best interests of a client or the public that uses the results of the engagement.

The issue of independence gained even more prominence on January 6, 2000, when the SEC published a report citing thousands of violations by one of the Big Four firms of

IF EMPLOYED BY "ANONYMOUS FIRM," I UNDERSTAND THAT . . .

Professional staff members of the firm, their spouses, and dependents are prohibited from owning or controlling investments in any of our clients and certain related nonclients, and I will be required to dispose of any such investments before commencing employment with the firm.

I will be prohibited from disclosing non-public information regarding clients or other entities to anyone, other than for firm business, or using it for any personal purpose.

I will be expected to devote my energies to the firm to the fullest extent possible and refrain from other business interests that might require significant time or that could be considered a conflict of interest.

Neither an offer of employment nor employment itself carries with it a guarantee of tenure of employment, and my employment, compensation, and benefits can be terminated, with or without cause or notice, at any time at the option of the firm or me.

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rules requiring PAs to remain independent from companies they audit. This occurred despite concerns about independence that led to the May 1997 creation of a new private sector body, the Independence Standards Board. In 1999, the Board issued its first standard, requiring auditors to confirm their independence annually to audit committees. Other items on the Board's agenda included an official definition of independence as well as a conceptual framework for it. The Board was disbanded and replaced in 2002 by the PCAOB created under SOX. Fully operational since 2003, PCAOB has even more demanding objectives. It is clear that maintenance of independence is a continuing and growing concern within the profession.

Phrases such as "shall not knowingly misrepresent facts" and "[shall not] subordinate his or her judgment to others" emphasize conditions people ordinarily identify with the concepts of independence, integrity, and objectivity (CAS 200 paragraph 14 and CA 15). PAs who know about a client's lies in a tax return, false journal entries, material misrepresentations in financial statements, and the like, have violated both the spirit and the letter of the rules of conduct. As the profession becomes increasingly globalized, auditors will need to consider independence rules in a broader context; for example, do non-audit services provided to a related party of the auditee in one part of the world compromise independence of the auditor in another part of the world.

Professional Competence and Due Care

The professional competence and due care rules of the codes of conduct can be summarized as follows:

A. *Professional competence.* Undertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence.

B. *Due professional care.* Exercise due professional care in the performance of professional services.

C. *Planning and supervision.* Adequately plan and supervise the performance of professional services.

D. *Sufficient relevant data.* Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

Analysis of Competence and Due Care Rules

The professional competence and due care principles are a comprehensive statement of general standards that PAs are expected to observe in all areas of practice. These are the principles that enforce the various series of professional standards. For example, there is usually a specific rule relating to compliance with professional standards.

Compliance with Professional Standards

A member engaged in the practice of public accounting shall perform his professional services in accordance with generally accepted standards of practice of the profession, (from Rule 206 of the ICAO).

Analysis of Compliance Rule

This rule may be viewed as an extension and refinement of the due care principle. It implies adherence to technical standards in all areas of professional service, including review and compilation (unaudited financial statements), consulting, tax, and other professional services. The practical effect of this rule is to make non-compliance with all technical standards subject to disciplinary proceedings. Thus, failure to follow auditing standards, accounting and review standards, as well as assurance, compilation, and professional conduct standards is a violation of this rule.

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Accounting Principles

The compliance rule requires adherence to official pronouncements of accounting principles, but with an important exception related to unusual circumstances where adherence would create misleading statements. The rule itself concedes that unusual circumstances may exist; it permits PAs to decide for themselves how applicable the official pronouncements are, and makes them responsible for ethical decisions. The rule also allows PAs to exercise a utilitarian calculation for circumstances when adherence would be misleading. Misleading statements would result in financial harm for outside decision makers, so presumably the greater good would be realized by explaining a departure.

Note that the compliance rule requires the coherent integration of accounting, auditing, and ethical concepts, assumptions, rules, and principles. But, if there is a conflict, how should it be resolved? Critical thinking is helpful in these situations of dealing with the logical gaps and inconsistencies of professional standards in specific applications. These are illustrated in questions throughout the text. On some issues, such as confidentiality, discussed next, the courts have helped resolve the ethical conflicts. But, in other situations, the auditor will need to resolve conflicts in some reasonable way. This is the essence of professional judgment. Interestingly, lawyers and the courts use critical thinking to assist in their deliberations, and critical thinking courses are common in law schools.

Confidentiality

The general principle of confidentiality is that a PA must not disclose any confidential information without the specific consent of the client. This principle does not allow a PA to ignore the obligation to comply with a validly issued subpoena or summons or not to comply with applicable laws and government regulations.[1] Neither do confidentiality principles prohibit review of a PA's professional practice under member's handbook bylaws. In spite of the principles, a PA still must initiate necessary complaints to, and respond to enquiries by, their professional group (CAs, CMAs, or CGAs). Members of any professional association involved with professional practice reviews may not disclose any confidential client information that comes to their attention in carrying out those reviews, but neither should it restrict any exchange of information that is necessary for the review. Confidential information is information that should not be disclosed to outside parties unless demanded by a court or an administrative body with the power to do so. Privileged information, on the other hand, is information that cannot even be demanded by a court. Common law privilege exists for husband–wife, attorney–client, and physician–patient relationships. In all the recognized privilege relationships, the professional person is obligated to observe the privilege, which can be waived only by the client, patient, or penitent—the holders of the privilege. ICAO Council Interpretation 210.1, paragraph 1 states:

> The duty to keep a client's affairs confidential should not be confused with the legal concept of privilege. The duty of confidentiality precludes the member from disclosing a client's affairs without the knowledge or consent of the client. However, this duty does not excuse a member from obeying an order of a court of competent jurisdiction requiring the member to disclose the information.
>
> A court will determine whether or not a member should maintain the confidentiality of client information depending on the facts of each case.

PAs and clients have attempted to establish privilege for tax file workpapers to shield them from Canada Revenue Agency summons demands (tax file workpapers contain accountants' analyses of "soft spots" and potential tax liability for arguable tax positions) but have so far been unsuccessful. As noted in Chapter 2, privilege was invoked by a number of PA firms when the CPAB attempted to access audit files as part of its monitoring of quality control practices.

The rules of privileged and confidential communication are based on the belief that they facilitate a free flow of information between parties to the relationship. The nature of

1 C. Chazen, R. L. Miller, and K. I. Solomon, "When the rules say: See your lawyer," *Journal of Accountancy,* January 1981, p. 70.

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accounting services makes it necessary for the PA to have access to information about salaries, products, contracts, merger or divestment plans, tax matters, and other data required for the best possible professional work. Managers would be less likely to reveal such information if they could not trust the PA to keep it confidential. If PAs were to reveal such information, the resultant reduction of the information flow might be undesirable, so no PAs should break the confidentiality rule without a good reason.

Problems arise over auditors' obligations to "blow the whistle" on clients' shady or illegal practices. Generally, the codes indicate that confidentiality in such cases can be overridden through obtaining or following legal advice. If a client refuses to accept an audit report that has been modified because of illegal activities and their effects, the audit firm should withdraw from the engagement and give the reasons in writing to the board of directors. In such an extreme case, the withdrawal amounts to whistle-blowing, but the action results from the client's decision not to disclose the information. For all practical purposes, information is not considered confidential if disclosure of it is necessary to make financial statements not misleading.

Auditors are not, in general, legally obligated to blow the whistle on clients. However, circumstances may exist where auditors are legally justified in making disclosures to a regulatory agency or a third party. Such circumstances include when a client (1) has intentionally and without authorization associated or involved a PA in its misleading conduct, (2) has distributed misleading draft financial statements that were prepared by a PA for internal use only, (3) prepares and distributes an annual report or prospectus containing misleading information for which the PA has not assumed any responsibility, or (4) the situation falls under the requirements of anti–money laundering legislation.

Analysis of the Confidentiality Principle

PAs should not view the rules on confidential information as a licence or excuse for inaction where action may be appropriate to right a wrongful act committed or about to be committed by a client. In some cases, auditors' inaction may make them an accessory to a wrong. Such situations are dangerous and potentially damaging. A useful initial course of action is to consult with a lawyer about possible legal pitfalls of both whistle-blowing and silence. Then, decide for yourself.

Contingency Fees and Service without Fees

ICAO Rule 215 states, "A member engaged in the practice of public accounting or a related function shall not offer or agree to perform a professional service for a fee payable only where there is a specified determination or result of the service. . . . A member engaged in the practice of public accounting or a related function shall not represent that he or she performs any professional service without fee except services of a charitable, benevolent, or similar nature. . . ."

For a fee to be considered a contingency fee, two characteristics need to be met:

1. Its terms must be contracted for before any services are performed.
2. The amount paid for the performance must be directly affected by the results obtained.

Generally, if one of these characteristics is not present, the fee is not a contingency fee and, therefore, does not violate the ICAO's Rule 215 or similar rules by other accounting bodies, such as the CGA-Canada's Rule 508.[2] Fees are not contingent if they are fixed by a court or other public authority, determined as a result of the finding of judicial proceedings or government agencies, or when they are based on the work's complexity or time required. The current Rule 215 is quite restrictive, conflicting with some statutes such as

2 C. Schultz, "When talk turns to contingency fees," *CA Magazine,* May 1988, p. 29.

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the *Federal Bankruptcy Act* and *Provincial Trustee Acts,* which allow fees based on the results of the PA's work. Because of these conflicts with statutory law, some have called for modifications of the rules to apply to assurance engagements only.[3]

Rule 215 prohibits contingent fees in assurance engagements where users of financial information may be relying on the PA's work. Acceptance of contingent fee arrangements while engaged to perform any type of assurance engagement is considered an impairment of independence.

Fee Quotation

ICAO Rule 214 states that "a member shall not quote a fee for any professional services unless requested to do so by a client or prospective client, and no quote shall be made until adequate information has been obtained about the assignment." It is, thus, against Rule 214 to quote a fee over the phone or to quote a fixed charge for all audits. There is extensive anecdotal evidence that, particularly during economic downturns, some firms practise "low balling" or charging a fee that is below cost in order to obtain an engagement. This is at least in violation of the spirit of Rule 214, since presumably the need for the information about the assignment is to ensure that an adequate audit is done, in which the costs are recovered (no service should be provided for free unless for charitable purposes). The real concern is that auditors may cut back on audit procedures to the point of reducing the quality of audits.[4]

Discreditable Acts

CGA-Canada's Rule R101 states that "a member shall not permit the member's firm name or the member's name to be used with, participate in, or knowingly provide services to any practice, pronouncement, or act which would be of a nature to discredit the profession." Generally, we will refer to this and related rules as discreditable act rules.

Analysis of Discreditable Act Rules

The discreditable act rules may be called the moral clauses of the codes, but they are only occasionally the basis for disciplinary action. Penalties usually are invoked automatically under the bylaws, which provide for expulsion of members found by a court to have committed any fraud, filed false tax returns, been convicted of any criminal offence, or been found by a disciplinary committee to be guilty of an act discreditable to the profession. Discreditable acts can include (a) withholding a client's books and records when the client has requested their return; (b) practising employment discrimination in hiring, promotion, or salary practices on the basis of race, colour, religion, gender, or national origin; (c) failing to follow government audit standards and guides in governmental audits; and (d) making, or permitting others to make, false and misleading entries in records and financial statements. An extreme example of an actual discreditable act is given in the box below.

EXTREME EXAMPLE OF A DISCREDITABLE ACT

The Enforcement Committee found that Respondent drew a gun from his desk drawer during a dispute with a client in his office in contravention of section 501.41 [discreditable acts prohibition] of the [Texas] Rules of Professional Conduct. Respondent agreed to accept a private reprimand to be printed . . . in the Texas State Board Report.

Source: *Texas State Board* Report (February 1986).

3 Ibid., p. 33.

4 M. C. Carscallen, "Fee completion hurts integrity of accounting services," *The Bottom Line,* April 1991, p. 20.

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Advertising and Other Forms of Solicitation

The rules relating to solicitation state that a member shall not attempt to obtain clients by advertising or other forms of solicitation that are false, misleading, or deceptive. Solicitation through coercion, overreaching, or harassing conduct is prohibited as well.

Analysis of Solicitation Rules

The current rules apply only to PAs practising public accounting and relate to their efforts to obtain clients. The rules permit advertising with only a few limitations, and basic guidelines include the following:

- Advertising may not create false or unjustified expectations of favourable results.
- Advertising may not imply the ability to influence any court, tribunal, regulatory agency, or similar body or official.
- Advertising may not contain a fee estimate when the PA knows it is likely to be substantially increased, unless the client is notified.
- Advertising may not contain any representation that is likely to cause a reasonable person to misunderstand or be deceived, or that contravenes professional good taste.

Advertising consists of messages designed to attract business and are broadcast widely (e.g., through print, radio, television, billboards, and pop-up ads on various websites) to an undifferentiated audience. The guidelines basically prohibit false, misleading, and deceptive messages.

Solicitation, on the other hand, generally refers to direct contact (e.g., in person, email, telephone) with a specific potential client. The rules regarding solicitation basically prohibit extreme bad behaviour that brings disrepute on the profession.

The advertising rules have undergone many changes over the last three decades. Long ago, all advertising by PAs was prohibited. Then, institutional-type advertising on behalf of PAs in general was permitted. In 1979, in response to the Charter of Rights guarantee to members, the ICAO approved advertising "in good taste," with limitations on style, type size, and the like. The other professional bodies followed suit.

Most PAs carry out only modest advertising efforts, and many do no advertising at all. According to a recent article, advertising so far has been precisely targeted; for example, at chief financial officers of wholesalers in the food industry. Firms have generally used local rather than national advertising. The biggest problem so far is of members making claims they are unable to substantiate.

Firms rarely obtain new clients through advertising, but it can be effective in generating business in the form of new services for existing clients or from referrals. Overall, except for some isolated examples of creative advertising by some firms, the profession has not pursued advertising aggressively. Nevertheless, we see PA firm advertisements in an increasing variety of formats and media.[5] This seems to be especially true as websites by PA firms continue to proliferate.

THE ART OF ADVERTISING

In 1987, three charges were brought against "a partner of Ernst & Whinney" in Ontario under subsections (c), (a), and (d). The discipline committee found the member "not guilty" on the first charge, but "guilty" on the second and third. Both guilty charges concerned a 1985 ad he had placed in *The Globe and Mail* which stated, in part, "Canada's Fastest Growing Firm of Business Advisors Announces Its Newest Partners."

The committee found the ad misleading in two ways. First, "accountants do not have a monopoly on the term 'business advisors.'" Second, the claim was made on the basis of statistics that were "accurate as they relate to the participating chartered accountant firms [but] without disclosure of the necessary parameters or basis for the statement, it is misleading."

The member received a written reprimand, was assessed court costs of $6000, and was fined $5000.

Source: Tim Falconer, *CA Magazine,* October 1993, p. 46.

5 T. Falconer, "The art of advertising," *CA Magazine,* October 1993, pp. 43–46.

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Public practice is generally marked by decorum and a sense of good taste. However, there are exceptions, and they tend to get much attention, most of it disapproving, from other PAs and the public in general. The danger with bad advertising is that the advertiser may develop a professional huckster image, which may backfire on efforts to build a practice.

Communications between Predecessors and Successors

Successor auditors are required to make certain enquiries of predecessor auditors when a new client is obtained (e.g., Rule 302 of Professional Conduct of ICAO). Rule 302 and similar rules of other accounting bodies apply to all public accounting engagements, including compilation and review work.

Interpretation to Rule 302 gives advice to PAs when communicating with the predecessor. First, the successor PA should ask the new client to notify the predecessor (incumbent) PA of the proposed change. The successor should then ask the predecessor "whether there are any circumstances that should be taken in account which might influence the potential successors' decision whether to accept the appointment," per Interpretation 302. Normally, the successor should wait for the reply before commencing work for the new client. The interpretation also requires the predecessor to reply promptly. When enquiries are made, the successor must have the client's permission for the predecessor to disclose confidential information. When confidentiality is in doubt, legal advice should be obtained. The effort the predecessor should make in supplying information to the successor is an important issue. The interpretation suggests that, as a minimum, "reasonable information about the work being assumed" should be discussed, and it then gives advice on what constitutes "reasonable" (as discussed in Chapter 5).

In addition to the rules of professional conduct, PAs should be aware of any federal and provincial legislation, including securities legislation, regulating changes in professional appointments.

Commissions and Referral Fees

A practising PA must not accept a commission for recommending or referring any product or service to a client, or accept a commission for recommending or referring any product or service offered by a client. Neither should a member PA receive a commission when another member of his firm performs public accounting for that client. These prohibitions apply during the period in which the PA performs public accounting services and the period covered by any historical financial statements involved in these services. A member in public practice may, however, receive a commission from the sale or purchase of an accounting practice.

Analysis of Commissions Rules

A **commission** is a percentage fee charged for professional services related to executing a transaction or performing some other business activity. Examples are insurance sales commissions, real estate sales commissions, and securities sales commissions. Such fees are an impairment of independence when received from assurance engagement clients, just like ICAO's Rule 215 treats contingent fees.

commission: a percentage fee charged for professional services for executing a transaction or performing some other business activity

However, many PAs perform financial planning for businesses and individuals, and they have seen commissions for insurance, securities, mergers and acquisitions, and other transactions go to other professionals. They want some of this action. The rules permit such commissions, provided the engagement does not involve assurance services.

Most commission-fee activity takes place in connection with personal financial planning services. PAs often recommend insurance and investments to individuals and families. When the rule change was under consideration, critics pointed out that commission agents (e.g., insurance salespersons, securities brokers) cannot always be trusted to have the best interests of the client in mind when their own compensation depends, in large part, on

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client's buying the product that produces their commissions. Critics made the point that fee-only planning advisers, who do not work on commission, were more likely to have the best interests of the client in mind, directing them to investment professionals who handle a wide range of alternatives. Because of this, some PAs make it a point to provide financial planning services on a fee-only basis. This is also the position of the Financial Planners Standards Council of Canada, which is dedicated to maintaining a licensing system for certified financial planners (CFPs) in Canada. This organization is sponsored by the CICA, CGA-Canada, and SMAC, among other associations.

The rules also include fee arrangements related to commissions. Referral fees are those a PA receives for recommending another PA's services, or fees a PA pays to obtain a client, and they may or may not be based on a percentage of the amount of any transaction. Referral involves the practice of sending business to another PA and paying other PAs or outside agencies for drumming up business. These activities are banned by the rules of conduct on the basis that they impair the principle of objectivity. The sole exception is sale or purchase of an accounting practice, covered in Rule 216.

Form of Organization and Name

The general rule relating to PA organization is that each practice office should be under the personal charge of a member who is a public accountant. The name of the public accounting firm should not be misleading. Names of one or more past owners may be included in the firm name of a successor organization.

Analysis of PA Organization Rules

The rules allow members to practise in any form of organization permitted by provincial laws and regulations—proprietorships, partnerships, professional corporations, limited liability partnerships, limited liability corporations, and ordinary corporations. Most provincial accountancy laws prohibit the general corporate form of organization for PAs, but because of increased legal risk, there has been a recent push for the limited liability partnership structure. In the traditional form of partnership, all partners' personal assets are at risk. Under the limited liability partnership (LLP) form of organization, the only partners with personal assets at risk are those involved in the litigated engagement, while the others risk only their investment in the partnership. Thus, the limited liability partnership is a great improvement at a time of increased litigation, and many PA firms are now LLPs.

In 1992, the AICPA approved a move to permit PAs to practise in limited liability corporations and ordinary corporations. This has led to non-PA firms, such as American Express, owning PA firms.

PAs have experienced lawsuits for damages in which they and their insurers are the only persons left with any money (e.g., in cases of business failure), and multi-million dollar

PAs (ALMOST) SELL SHARES TO PUBLIC

Nearman & Lents, a Florida PA firm, formed a corporation named Financial Standards Group Inc., and filed a registration statement with the Securities and Exchange Commission to sell shares to the public. The accounting firm wanted to "go national on a large scale, and . . . raise $3 million or $4 million capital."

The registration became effective, and some shares were actually sold. However, Nearman & Lents withdrew the offering and gave the money back to the purchasers. Florida regulators had raised questions about the company practising public accounting without a license with non-PA ownership, which was prohibited. Financial Standards Group did not become the first publicly held PA firm.

The venture met resistance. Accounting traditionalists and lawyers who specialize in suing accountants for misconduct have generally frowned on letting accountants avail themselves of the limited legal liability provided by a corporation. Regulators have also discouraged accounting firms from issuing shares to outsiders for fear that outside equity partners might taint a firm's ability to judge [audit] a client's books impartially.

Source: *The New York Times,* June 14, 1990, and SEC.

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damages have been awarded to plaintiffs against them. In the proprietorship, partnership, and professional corporation forms of business, all the business and personal assets of PAs are exposed to plaintiffs. Many PAs think the tort liability litigation process has gotten out of hand, and so they seek some protection through new forms of organization. See the preceding box for some consequences that can arise from an attempt at innovative forms of PA firm organization.

The Canadian rules of conduct effectively block persons who are not PAs from being owners. This rule section creates problems for tax and management consulting services personnel who are not PAs. They cannot be admitted to full partnership or become shareholders without causing the other owners who are PAs to be in violation of the rule. Thus, an accounting firm may employ non-PAs who are high on the organization chart, but these persons may not be unrestricted partners or shareholders under current rules.

Rules of Conduct and Ethical Principles

LO3 Explain the major problematic sections of professional rules and their impact on auditors and PAs.

Specific items in the rules of conduct may not necessarily be based on one of the ethics principles, but, instead, they may involve various elements of different ethical theories. As is typical in a code of conduct, the rules take the form of duties or imperatives, but elements of various theories seem to be part of their rationales. If this perception is accurate, then pluralistic theories may be used by auditors in difficult decision problems where adherence to a rule would produce an undesirable result. Appendix 3A discusses other factors to consider in audit decision making and justification.

REVIEW CHECKPOINTS

18-1 What ethical responsibilities do members of the provincial associations/institutes have for acts of nonmembers who are under their supervision (e.g., recent university graduates who are not yet PAs)?

18-2 Is an incorporated accounting practice substantially different from an accounting practice organized in the form of a partnership? in the form of a limited liability partnership?

18-3 Define the term contingency fee, explaining how such fees apply to PAs. Do you feel a change is necessary to rules for contingency fees in Canada?

18-4 Do auditors need to report suspicious activities to the police? Explain.

REGULATION AND QUALITY CONTROL

LO4 Outline the types of penalties that various provincial associations and government agencies can impose on PAs when enforcing rules of professional conduct.

As a PA, you will be expected to observe the rules of conduct published in several codes of ethics. If you are a PA and have a client who is a public company, you will be subject to the following:

EXAMPLES OF RULES OF CONDUCT	APPLICABLE TO:
Members' Handbook ICAO, CGA-Canada's Code of Ethical Principles and Rules of Conduct	Persons licensed by provinces to practise accounting or, if no licence is required in the province, persons belonging to provincial institutes, societies, or organizations
Business Corporations Acts, Securities Acts at federal and provincial levels, and CGA requirements	PAs (usually PAs performing public accounting services) within the various jurisdictions
U.S. Securities and Exchange Commission and PCAOB	Persons who practise before the SEC as accountants and auditors for SEC-registered companies (including auditors of many large Canadian corporations)

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If you are an internal auditor, you are expected to observe the rules of conduct of the Institute of Internal Auditors. As a management accountant, you are expected to observe the Society of Management Accountants' standards of ethical conduct. Certified fraud examiners are expected to observe the Association of Certified Fraud Examiners' code of ethics.

Regulation and professional ethics go hand in hand. Codes of ethics provide the underlying authority for regulation. Quality control practices and disciplinary proceedings provide the mechanisms of self-regulation. **Self-regulation** refers to quality control reviews and disciplinary actions conducted by fellow PAs—professional peers. Elements of PAs' self-regulation have been explained in terms of the quality control standards in Chapter 2.

self-regulation: a situation where a professional group is given the power to monitor and discipline its members by the government

Self-Regulatory Discipline

Accounting firms, as well as individuals, are subject to the rules of professional conduct of the institutes, associations, or societies only if they choose to join these organizations. But anyone wishing to practise public accounting finds that the added credibility of belonging to a professional group greatly improves the chances of establishing a successful practice. Thus, enforcing the rules of conduct is an important means of regulating the profession. Regulators can suspend a member's activities on certain exchanges, and the professional bodies can initiate other disciplinary proceedings.

An Illustration of Self-Regulation: A Provincial Institute's Disciplinary Process

A provincial institute's bylaws and rules of professional conduct in its members' handbook provide the basis for self-regulation. The institutes have a duty to investigate all written complaints received about their members and students, as well as review information from the media that may indicate professional misconduct. While anyone can initiate a complaint, this is most frequently done by a client, and sometimes the provincial institute will do so.[6] The Professional Conduct Committee, which represents a cross-section of the membership, investigates the complaints and decides whether further action is necessary. The committee considers the respondent's reply and all relevant data in making its decision.

Three general conclusions are possible:

1. The member did not breach the rules and the process is ended.
2. The member did breach or may have breached the rules, but the infraction is not serious enough to prosecute before the discipline committee; the respondent is informally admonished in writing or at a committee meeting.

FRAUD EXAMINER EXPELLED FOR FRAUD

Curtis, C. was expelled by the board of regents at its regular meeting on August 4, 1991. Mr. C., formerly an internal auditor employed by the City of S, was a member from February 1989 until his expulsion. He was the subject of an investigation by the trial board for falsifying information.

Mr. C. wrongfully represented himself as a certified internal auditor, when in fact he did not hold the CIA designation. Such conduct is in violation of Article 1.A.4 of the CFE Code of Professional Ethics.

L. Jackson Shockey, CFE, CPA, CISA, chairman of the board of regents, said: "We are saddened that a member has been expelled for such conduct. However, in order to maintain the integrity of the CFE program, the trial board vigorously investigates violations of the Code of Professional Ethics. When appropriate, the board of regents will not hesitate to take necessary action."

Source: *CFE News.* Reprinted with permission from the September 1991, issue of *CFE News,* a publication of the Association of Certified Fraud Examiners, Inc., in Austin, Texas © 1991.

6 S. Arihara, "The importance of being ethical," *CA Magazine,* August 2008, p. 25.

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3. Charges are laid and the matter is brought up before the discipline committee where a process similar to a civil trial procedure is followed. The discipline committee can reach a decision of not guilty or guilty. There is also an appeal process, which is headed by the Appeal Committee.

   In a guilty verdict the penalties can include any one or more of the following:

- Reprimand
- Suspension from the institute
- Stricken from the student register in the case of students
- Expulsion from membership in the institute
- Completion of a professional development course(s) and/or an examination(s) and/or engagement of an adviser or tutor
- A period of supervised practice
- Reinvestigation by the professional conduct committee
- Charged with costs and/or fined
- Discipline as determined by the committee
- Publication of the decision, order(s), and member's or student's name

These penalties cover a range of severity. In many cases a discipline committee can admonish or suspend a PA and require additional continuing professional education (CPE) to be undertaken. The goal is to help the PA attain an appropriate level of professional competence and awareness. Although intended as a constructive resolution, the CPE requirement is similar to "serving time." Persons who fail to satisfy CPE conditions will find themselves charged with "actions detrimental to the profession," for violations of rules such as CGA-Canada's Rule R606 or ICAO's Rule 201, and expelled as second offenders. What PAs dread most is having their guilty verdict made public, as it can destroy their career.[7]

The expulsion penalty, while severe, does not prevent a PA from continuing to practise accounting. Membership in a professional group, while beneficial, is not required. However, a PA must have a valid licence in order to practise public accounting in certain provinces.

CGAs are subject to disciplinary action for any offence that constitutes a breach of professional conduct. This disciplinary action is brought on by the member's association or professional corporation, or, if the action is outside these groups, by the board of directors of CGA-Canada, per Rule R602.1.

Public Regulation Discipline

All provincial institutes of chartered accountants, associations of CGAs, and societies of CMAs are self-governing agencies. Depending on whether a province has a *Public Accounting Act,* they issue licences to practise accounting in their jurisdictions or certificates indicating that standards to be a PA have been met. Most provinces require a licence or certification procedure to use the PA, or Public Accountant, designation, and some limit the assurance (audit) function to licence holders. Most provinces do not regulate work in areas of management consulting, tax practice, or bookkeeping services.

Provincial institutes, associations, and societies have rules of conduct and disciplinary processes as outlined above. Through the disciplinary process, these organizations can admonish a licence holder; but, more importantly, they can suspend or revoke the licence to practise in some provinces, severe penalties because a person then can no longer use the PA title or sign audit reports. When candidates have successfully passed the PA examination or fulfilled other requirements and are ready to become PAs, some provincial institutes administer an ethics examination or an ethics course intended to familiarize new PAs with the rules of professional conduct.

7 Ibid., pp. 26–28.

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This traditional self-regulatory system is supplemented by CPAB, established in 2002. (Recall that the CPAB is a national body that reviews public company audits and the auditors' quality control systems.) This new system doubles the amount spent nationally on practice inspection. A review of the first report was provided in Chapter 2 and is publicly available on CPAB's website at www.cpab-ccrc.org. A CA Magazine article indicates that the most common problems in professional audit practice are as follows:

- Failure to properly document the audit and thereby support the audit opinion
- Failure to consult partners on complex accounting matters
- Failure of PA firms to internally monitor the quality of their audits[8]

Note that the first two points relate to failures of critical thinking and professional judgment. Recall that an improperly supported audit opinion can be construed as misleading because it indicates that the auditor does not have sufficient reasons to believe that the opinion is true. At the extreme, such as when no audit work supports the audit opinion, the audit report is a fraudulent document. The comparable PCAOB's quality inspection report of PA firms in the United States can be found at its website, www.pcaobus.org.

The goal of these accountability boards is to prevent problems arising from audits of public companies in both countries. Their initial round of inspections focused on compliance with quality control standards, similar to practice inspections and peer reviews discussed in Chapter 2. It also put the spotlight on the four largest PA firms with the largest clients. Subsequent inspections have been extended to many more PA firms and will increasingly stress the quality of the audit output. This will be done by analyzing the results of specific engagements. Thus, there will be increased stress on monitoring questionable accounting practices allowed by auditors, and on the effect that problems of independence and competence in clients' internal audit functions have on the external audit.

The results of the monitoring will be made public. In addition, all auditors will be subject to disciplinary actions by the accountability boards, including restrictions on their ability to perform audits of public companies. Further disciplinary action may be taken by the PA institutes or associations. CPAB is hoping that its inspection process of PA firms will be acceptable to PCAOB. In Canada, the profession will continue to set auditing, independence, and quality control standards, whereas in the United States the PCAOB has taken over this role for public company audits.

Exhibit 18–1 summarizes the disciplinary system for auditors of public companies in Canada arising from the creation of CPAB. AASOC and AcSOC stand for the Auditing and Assurance Oversight Council and the Accounting Standards Oversight Council, respectively, and PICA stands for Provincial Institutes of Chartered Accountants (or other relevant professional accounting bodies). The exhibit illustrates that standard setting (right side of exhibit) is separate from the monitoring of audit process (left side of exhibit). As noted, this is not the case in the United States. Note also that the CPAB can report PA firms to a professional body, which can then subject the firm to a provincial institute/association disciplinary process, as described previously.

As noted in Chapter 2, the provincial securities commissions sometimes file complaints with the professional conduct committees of the provincial institutes or associations. In addition, some securities commissions, notably the Ontario Securities Commission (OSC), have been assertive in not accepting financial statements that they consider at odds with generally accepted accounting standards (GAAP). The OSC issues staff accounting communiqués (SACs) in which it highlights major problem areas. Any company attempting to use the disfavoured technique may find that its financial statements are unacceptable to the OSC even though there is no reservation in the auditor's report.

8 J. Middlemiss, "From there to here," *CA Magazine,* June/July 2008, p. 26.

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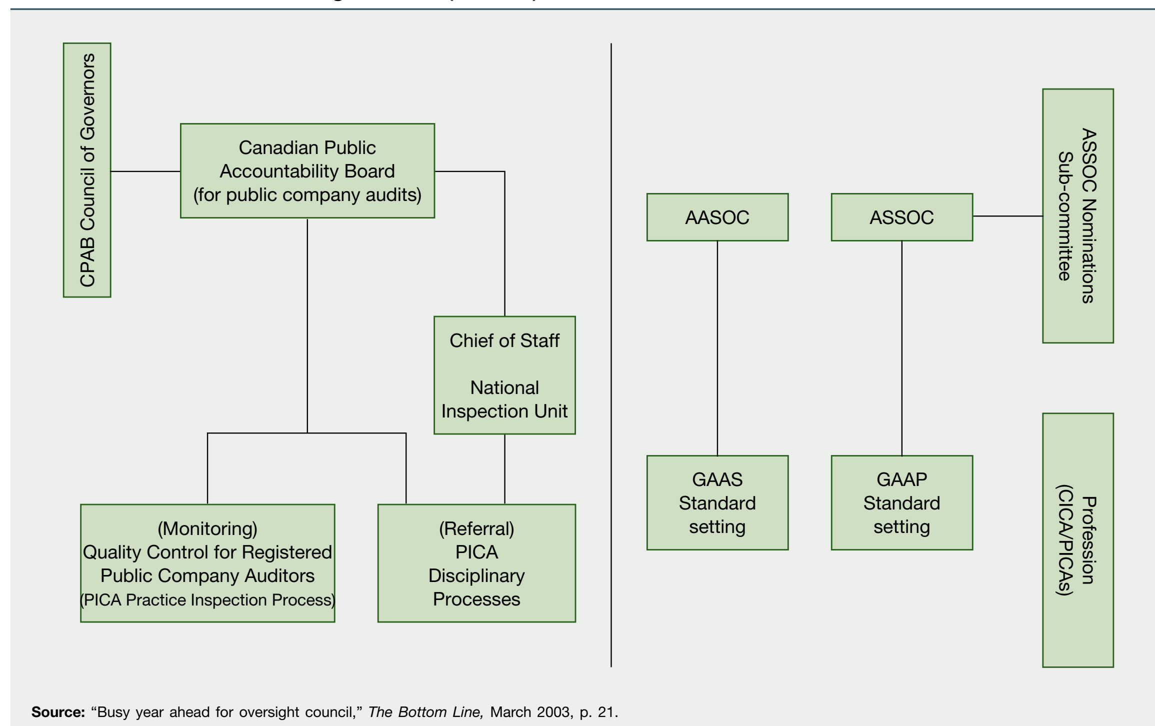
EXHIBIT 18–1 Public Oversight Model (Canada)



Source: "Busy year ahead for oversight council," *The Bottom Line,* March 2003, p. 21.

The OSC is going even further: it plans to increase its supervision of auditors and other financial advisers and to gain the power to take disciplinary action against them. Although these proposals have yet to be enacted, the OSC already exerts some control over firms via out-of-court settlements, as indicated in the box below.

Public regulation disciplinary actions are also conducted by the SEC. Its authority comes from its rules of practice, one of which, Rule 2(e), provides that the SEC can deny, temporarily or permanently, the privilege of practice before the SEC to any person (1) not qualified to represent others, (2) lacking in character or integrity or having engaged in unethical or improper professional conduct, or (3) having willfully violated any provision of the federal securities laws or their rules and regulations. When conducting a "Rule 2(e) proceeding," the SEC acts in a quasi-judicial role as an administrative agency.

The SEC penalty bars an accountant from signing any documents filed by an SEC-registered company and effectively stops the accountant's SEC practice. In a few severe cases, Rule 2(e) proceedings have resulted in settlements barring not only the individual accountant but also the accounting firm or certain of its practice offices from accepting new SEC clients for a period.

PREVENTIVE MEDICINE

In response to problems arising from the audit of National Business Systems Inc., the OSC agreed that the partner in charge of that audit would not act as the senior or second partner in charge of the audit of a public company for a year. It was also agreed that procedures and systems would be reviewed by an auditor from another firm and that the results would be resubmitted to the OSC. Moreover, arrangement was made to have the Toronto office inspected by a partner from outside Canada to ensure professional standards were met. The firm agreed to pay $70,000 to cover OSC expenses.

Source: J. Bedard and L. LeBlanc, *CA Magazine,* November 1991, p. 42.

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The OSC and other Canadian regulators have been pushing to have similar disciplinary powers. Clearly, if the self-regulating process of the institutes is not deterring bad practices, regulators are willing to step in. In 1991, members of the ICAO approved a proposal giving the institute the power to subject firms to disciplinary action. In 2002, the Ontario legislature passed legislation that not only opened up public practice rights to CGAs and CMAs but also increased the penalties for auditors associated with misleading reporting.

In Chapter 20, we will see how, in reaction to a Supreme Court of Canada ruling in the *Hercules v. Ernst & Young* case, new securities laws that have been passed in some provinces hold auditors firmly liable for any negligence in financial statement audits. Other regulatory developments include greater independence and enforcement powers for Ontario and Quebec securities commissions, and increased harmonization procedures between the Alberta and British Columbia commissions. These structural changes in the regulatory climate are likely to increase regulatory disciplinary actions against PAs in the future.

The Canada Revenue Agency can also discipline PAs as a matter of public regulation. It can suspend or disbar from practice before it any PA shown to be incompetent or disreputable or who has refused to comply with tax rules and regulations, as well as levy fines for improper practices. The Revenue Ministry has made public its willingness to prosecute those accountants it suspects of "deliberate attempt to defraud the federal treasury."[9]

According to a study by Brooks and Fortunato, most disciplinary actions by the ICAO stem from violating the standards affecting the public interest (200 level).[10] Over a roughly three-year period (1988–90), most violations involved just four rules:

Rule	Violations
Rule 201: Good Reputation of Profession representing 20% of all violations	36 violations
Rule 202: Integrity and Due Care representing 16% of all violations	29 violations
Rule 205: False and Misleading Representations representing 11% of all violations	20 violations
Rule 206: Expressing an Opinion without Complying with GAAS representing 12% of all violations	21 violations

This same study also found that "all but one of the ICAO convictions we examined resulted in disclosure of the convicted member's names, and 95% resulted in levying the costs of hearing on that person. Of those convicted, 78% were reprimanded, of which 44% were also suspended; 17% of the total convicted were expelled from the profession." The average fine levied for these cases was $5,695.[11] An updated list from a more recent survey indicates that the findings in the Brooks and Fortunato study have not changed much in the last 20 years.[12]

REVIEW CHECKPOINTS

18-5 What options does the Canada Revenue Agency have for disciplining PAs?

18-6 What organizations and agencies have rules of conduct that must be observed when practising public accounting? internal auditing? management accounting? fraud examination?

18-7 What penalties can be imposed on PAs by their provincial accounting body in their "self-regulation" of ethical code violators?

18-8 What penalties can be imposed by the CPAB on PAs who violate rules of professional conduct?

9 J. Middlemiss, "Too many accountants guilty of fraud, Liberals vow crackdown on shady advisers," *The Bottom Line,* March 1994, p. 1.

10 L. Brooks and V. Fortunato, "Disciplines at the ICAO," *CA Magazine,* May 1991, p. 45.

11 Ibid, pp. 42–43.

12 S. Arihara, "The importance of being ethical," *CA Magazine,* August 2008, p. 26.

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EXAMPLE OF PUBLIC DISCIPLINARY NOTICE

MEMBER FOUND GUILTY OF BREACHING RULE OF PROFESSIONAL CONDUCT 215

Re: Contingent Fees

A member has been found guilty of a charge of professional misconduct, laid by the professional conduct committee, under Rule of Professional Conduct 215, for agreeing to render professional services for a fee contingent on the results.

It was ordered that:

- The member be reprimanded in writing by the chairman of the hearing.
- The member be assessed costs of $1,500 to be paid within a specified time.
- The decision and order be published in *Check Mark.*

It was determined that the publication of the member's name was not necessary in the circumstances, as there was no evidence of any intent to breach the rules of professional conduct or of moral turpitude on the part of the member, and this was a matter of first instance.

CONSEQUENCES OF UNETHICAL/ILLEGAL ACTS

Ethics is serious business. Several sectors of professional and public activity exist under general clouds of suspicion. Even though many practitioners of accounting, business management, finance, journalism, law, medicine, and politics conduct themselves in an exemplary fashion, some people hold generally unfavourable perceptions of them. PAs used to rank near the top of trustworthy professions, but in the current environment, one could argue they have moved down in the rankings (see Chapter 1). This is a major problem because without the public's confidence, the accounting profession cannot meet the public interest.

However, conforming to rules of ethical behaviour is not always easy. A reason for this is the potential conflicts in the rules. The most troublesome potential conflict lies between the rules related to confidentiality on the one hand, and the prohibition against association with misleading information on the other. Whenever there is a conflict of interest situation for the auditor, there is a potential to create a threat to the auditor's independent state of mind. Brooks identified the following deficiencies in professional codes of conduct:

- No or insufficient prioritization is put forward to resolve conflicting interests.
- Consultation on ethical matters is encouraged for some members, but is inhibited for others.
- A fair reporting/hearing process is not indicated, so members are uncertain whether to come forward.
- Protection is not offered to a whistle-blower.
- Sanctions are often unclear, and their applicability is not defined.
- Resolution mechanisms for conflicts between professionals and firms, or employers, or employing corporations are not put forward.[13]

According to an article by Sandra Rubin, the latest round of mergers among the accounting firms is making these deficiencies even more critical to the integrity of the financial reporting system.[14] The problem is the perception of increased conflict of interest and that the merged firms will be so big that no single nation (or national body) will be able to regulate them. The role of the International Organization of Securities Commissions (IOSCO) will likely increase the future regulation of the huge international PA firms.

Professional ethics for PAs is not simply a matter covered by a few rules in a formal code of professional conduct. Concepts of proper professional conduct permeate all areas of practice. Ethics and its accompanying disciplinary potential are the foundation for PAs' self-regulatory efforts.

13 L. J. Brooks, *Professional Ethics for Accountants* (Minneapolis/St. Paul: West Publishing Company: 1995), p.126.

14 S. Rubin, *Financial Post,* November 13, 1997.

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SUMMARY

- Your knowledge of philosophical principles in ethics will help you make decisions about the provincial rules of professional conduct. This structured approach to thoughtful decisions is important not only when you are employed in public accounting but also when you work in government, industry, and education. The ethics rules may appear to be restrictive, but they are intended for the benefit of the public as well as for the discipline of PAs.
- PAs must be careful in all areas of practice. Regulators' views on ethics rules may differ in several aspects from the provincial institute views. As an accountant, you must not lose sight of the non-accountants' perspective. No matter how complex or technical a decision may be, a simplified view of it always tends to cut away the details of special technical issues to get directly to the heart of the matter. A sense of professionalism coupled with sensitivity to the impact of decisions on other people is invaluable in the practice of accounting and auditing.
- Finally, it should be noted that there is a strong link between codes of conduct and generally accepted auditing standards (GAAS). In fact, codes of conduct can be viewed as a means of fulfilling auditor responsibilities for GAAS and assurance standards. For example, the first GAAS standard, which relates to the personal attributes of the auditor (see Chapter 2), closely corresponds to the ethical principles of integrity, objectivity, independence, professional competence, and due care discussed previously. The dominance of ethical issues over accounting or auditing techniques is increasingly being recognized throughout the profession. Most audit failures appear to be attributable to poor professional judgment, at least in hindsight, that arises from improper consideration of conflicts of interest on various disclosure and measurement issues.[15] Critical thinking is intended to help address this problem, at least for the most contentious issues.

15 L. J. Brooks, *Professional Ethics for Accountants* (Minneapolis/St. Paul: West Publishing Company, 1995), p. 69; also see S. Gunz and J. McCutcheon, "Some unresolved ethical issues in auditing," *Journal of Business Ethics,* 1991.

KEY TERMS

commission
moral responsibilities
professional responsibilities
self-regulation

EXERCISES AND PROBLEMS

EP 18-1 General and Technical Rule Cases. LO2 Knowledge of the rules of conduct, interpretations thereof, and resolutions of Council related to general and technical standards will help you respond to the following cases.

Required:

For each case, state whether or not the action or situation shows violation of the ICAO rules of professional conduct, explain why, and cite the relevant rule or interpretation.

a. P. Stebbins, PA, helped Price Corporation prepare a cash flow forecast of hospital operations. The forecast was presented by Stebbins at a city council hearing for approval under the city's health services ordinance. Stebbins's report, which accompanied the forecast, consisted entirely of a full description of the sources of information used and the major assumptions made but did not include a disclaimer on the achievability of the forecast.

b. Kim Philby of Philby & Burgess, PAs, received a telephone call from his friend John, who is financial vice-president of U.K. Auto Parts. U.K. distributes parts over a wide area and does about $40 million of business a year. U.K. is not a client but is audited by Anderson, Olds & Watershed

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PAs, a venerable firm in the city. Kim has been hoping that John would switch auditors. Today, John wants to get Kim's opinion about accounting for lease capitalizations related to a particularly complicated agreement with franchise dealers. Kim makes notes and promises to call John tomorrow.

c. PA Maclean gave a standard unqualified audit report on the financial statements of Anglo Korp. The annual report document did not contain supplementary oil and gas reserve information required by the *CICA Handbook*.

d. Saul Panzer is a former university football player. Saul is a PA who works for Aggregate Corporation, which owns controlling interests in 42 other corporations. Theodolinda Bonner, president of Aggregate, has assigned Saul the task of performing audits of these corporations and submitting audit opinions directly to her for later presentation to the board of directors.

e. PA Blunt audits the Huber Hope Company. Huber's controller, also a PA, has conducted his own audit of Little Hope, Inc., Huber's single subsidiary, which amounts to 10% of the total assets, revenue, and income of the consolidated entity. Blunt has written an audit report that carefully explains reliance on "part of examination made by other independent auditors," with added language to explain the controller's role.

EP 18-2 Responsibilities to Clients' Cases. LO3 Knowledge of the rules of conduct and interpretations thereof on confidential client information and contingent fees will help you respond to the following cases.

Required:

For each case, state whether or not the action or situation shows violation of the ICAO rules of professional conduct, explain why, and cite the relevant rule or interpretation.

a. PA Sally Colt has discovered a way to eliminate most of the boring work of processing routine accounts receivable confirmations by contracting with the Cohen Mail Service. After the auditor has prepared the confirmations, Cohen will stuff them in envelopes, mail them, receive the return replies, open the replies and return them to Sally.

b. Cadentoe Corporation, without consulting its PA, has changed its accounting so that it is not in conformity with generally accepted accounting principles. During the regular audit engagement, the PA discovers that the statements based on the accounts are so grossly misleading that they might be considered fraudulent. PA Cramer resigns from the engagement after a heated argument. Cramer knows that the statements will be given to John Cairncross, his friend at the Last National Bank, and knows that John is not a very astute reader of complicated financial statements. Two days later, Cairncross calls Cramer and asks some general questions about Cadentoe's statements and remarks favourably on the very thing that is misrepresented. Cramer corrects the erroneous analysis, and Cairncross is very much surprised.

c. A PA who had reached retirement age arranged for the sale of his practice to another public accountant. Their agreement called for the transfer of all working papers and business correspondence to the accountant purchasing the practice.

d. Martha Jacoby, PA, withdrew from the audit of Harvard Company after discovering irregularities in Harvard's income tax returns. One week later, Ms. Jacoby was telephoned by Jake Henry, PA, who explained that he had just been retained by Harvard Company to replace Ms. Jacoby. Mr. Henry asked Ms. Jacoby why she withdrew from the Harvard engagement. She told him.

e. Amos Fiddle, PA, prepared an uncontested claim for a tax refund on Faddle Corporation's amended tax return. The fee for the service was 30% of the amount that the Canada Revenue Agency rules to be a proper refund. The claim was for $300,000.

f. After Faddle had won a $200,000 refund and Fiddle collected the $60,000 fee, Jeremy Faddle, the president, invited Amos Fiddle to be the auditor for Faddle Corporation.

EP 18-3 Other Responsibilities and Practices Cases. LO2 Knowledge of the rules of conduct and interpretations thereof regarding various other responsibilities and practices will help you respond to the following cases.

Required:

For each case, state whether or not the action or situation shows violation or potential for violation of the ICAO rules of professional conduct, explain why, and cite the relevant rule or interpretation.

a. R. Stout, PA, completed a review of the unaudited financial statements of Wolfe Gifts. Ms. Wolfe was very displeased with the report. An argument ensued, and she told Stout never to darken her door again. Two days later, she telephoned Stout and demanded he return (1) Wolfe's cash disbursement journal, (2) Stout's working paper schedule of adjusting journal entries, (3) Stout's inventory analysis working papers, and (4) all other working papers prepared by Stout. Since Wolfe had not yet paid her bill, Stout replied that provincial law gave him a lien on all the records and that he would return them as soon as she had paid his fee.

b. The PA firm of Durkin & Panzer had received promissory notes in payment of the Henshaw Hacksaw company tax return preparation fee. Six months after the notes were due, PA Durkin notified Dave Henshaw that the notes had been turned over to the North Country Bank for collection.

c. PA Panzer has been invited to conduct a course in effective tax planning for the City Chamber of

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Commerce. The C. of C. president said a brochure would be mailed to members giving the name of Panzer's firm, his educational background and degrees held, professional society affiliations, and testimonials from participants in the course held last year comparing his excellent performance with that of other PAs who have offered competing courses in the city.

d. PA Philby is a member of the provincial bar. Her practice is a combination of law and accounting, and she is heavily involved in estate planning engagements. Her letterhead gives the affiliations: Member, Provincial Bar of —, and Member, CICA.

e. The PA firm of Burgess & Maclean has made a deal with Cairncross & Company, a firm of management consulting specialists, for mutual business advantage. B&M agreed to recommend Cairncross to clients who need management consulting services. Cairncross agreed to recommend B&M to clients who need improvements in their accounting systems. During the year, both firms would keep records of fees obtained by these mutual referrals. At the end of the year, Cairncross and B&M would settle the net differences based on a referral rate of 5% of fees.

f. Sturm & Drang, PAs, conduct an aggressive, growing practice in Middle City. The firm pays 20% of first-year fees to any staff member (below partner) who brings in a new client.

g. Jack Robinson and Archie Robertson (both PAs) are not partners, but they have the same office, the same employees, and a joint bank account, and they work together on audits. A letterhead they use shows both their names and the description "Members, ICAO."

h. PA Dewey retired from the two-person firm of Dewey & Cheatham. One year later, D&C merged practices with Howe & Company, to form a regional firm under the name of Dewey, Cheatham & Howe Company.

i. Fritz Brenner, PA, died and widow Brenner inherited the interest he had in the PA firm of Brenner & Horstmann, P.C. Can widow Brenner share in the partnership as a passive investment? She is not a PA.

DISCUSSION CASES

DC 18-1 Rules of Professional Conduct. LO2 You and Laura Cooper are the two partners of a PA firm in Ottawa. After your two-week Caribbean vacation, you return to the office to discover that your secretary is busily preparing to mail some brochures. You have never seen the brochures before and your secretary explains that Laura had them printed during your absence. The brochures are colourful and glossy and the name of your firm is boldly displayed on the front cover. You pick up a brochure and notice that it describes your firm as "the PA firm where clients always come first." On the last page of the brochure, readers are advised that new audit clients will not be charged a fee for any management consulting services provided in the first full year.

You ask Laura about the brochures, and she tells you that she had them specially designed and printed to increase the firm's profile and competitiveness. She believes that mailing these brochures to all the top companies in Ottawa will not only increase the firm's client base but will also help it develop a high-quality image by getting a reputation for obtaining the "best clients." Furthermore, she plans to contact all recipients of the brochure in a few weeks to arrange a follow-up meeting to discuss their accounting and auditing needs.

Required:
Describe which rules of professional conduct may have been violated, and indicate your professional responsibilities and course of action.

(ICAO adapted)

DC 18-2 Conflict of Clients' Interests. LO3 Jon Williams, PA, has found himself in the middle of the real-life soap opera "Taxing Days of Our Lives."

The cast of characters:
Oneway Corporation is Jon's audit and tax client. The three directors are the officers and also the only three shareholders, each owning exactly one-third of the shares.

President Jack founded the company and is now nearing retirement. As an individual, he is also Jon's tax client.

Vice-president Jill manages the day-to-day operations. She has been instrumental in enlarging the business and its profits. Jill's individual tax work is done by PA Phil.

Treasurer Bill has been a long-term, loyal employee and has been responsible for many innovative financial transactions and reports of great benefit to the business. He is Jon's close personal friend and also an individual tax client.

The conflict:
President Jack discussed with PA Jon the tax consequences to him as an individual of selling his one-third interest in Oneway Corporation to vice-president Jill. Later, meeting with Bill to discuss his individual tax problems, Jon learns that Bill fears that Jack and Jill will make a deal, put him in a minority position, and force him out of the company. Bill says, "Jon, we have been friends a long time. Please keep me informed about Jack's plans, even rumours. My interest in Oneway Corporation

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represents my life savings and my resources for the kids' university. Remember, you're little Otto's godfather."

Thinking back, Jon realized that vice-president Jill has always been rather hostile. Chances are that Phil would get the Oneway engagement if Jill acquires Jack's shares and controls the corporation. Nevertheless, Bill will probably suffer a great deal if he cannot learn about Jack's plans, and Jon's unwillingness to keep him informed will probably ruin their close friendship.

Later, on a dark and stormy night, Jon ponders the problem. "Oneway Corporation is my client, but a corporation is a fiction; only a form. The shareholders personify the real entity, so they are collectively my clients, and I can transmit information among them as though they were one person, right? On the other hand, Jack and Bill engage me for individual tax work, and information about one's personal affairs is really no business of the other. What to do? What to do?

Required:
Give Jon advice about alternative actions, considering the constraints of the ICAO's Rules of Conduct.

DC 18-3 Independence and Management Responsibility for Financial Statements. LO3 PA has been engaged by Pinto Inc. for several years. His work involves compiling the monthly financial reports for Pinto's management and providing advice to Pinto's president on cost controls, taxes, and other financial reporting matters. PA has also performed a review engagement on the annual GAAP financial statements that are provided to the company's shareholders and its banker. As Pinto's business was growing rapidly, two years ago it hired a full-time CFO to handle the expanding accounting and reporting requirements. The CFO is a former banker who was laid off by the bank and was recommended for the job by Pinto's COO, an old school friend, even though he had never previously worked as a CFO. Over the two years that CFO has held the position, he has sought advice from PA on many accounting, tax, and reporting issues.

At first, PA thought the CFO was learning the job by asking all these questions. However, after two years, the P began to realize that the CFO was merely implementing whatever PA suggested, without questioning it. When PA insisted that the CFO complete various accounting and tax analyses for the current-year financial statements on his own, the CFO stalled at first and then finally admitted that he could not do the analyses. PA needed to work over the weekend to provide the required information so the company could file its tax returns and payroll tax information forms on time. As a result of these events, PA has become concerned that Pinto's management does not know enough about its own financial statements to take primary responsibility for them.

Just prior to the current year-end, the Pinto shareholders met to approve the appointment of PA as the company's independent accountant for another year. Pinto has three shareholders who each own 30% of the common shares, while 20 current and former employees own the remaining 10%. At this meeting, some of the shareholders expressed concern about the financial management at Pinto, and demanded that PA be engaged to audit the company's financial statements rather than just doing a review.

Required:
Discuss the professional issues raised in the above case. Assess whether or not PA should accept the audit engagement, and recommend an appropriate course of action for PA.

DC 18-4 CGA Code of Ethics. LO1 The issue of ethical conduct is becoming more and more important in the professional practice of PAs.

Required:

a. Identify the sequence of steps that have been proposed for an auditor to follow in attempting to resolve an ethical dilemma.

b. What are the two broad aims of the CGA Code of Ethical Principles and Rules of Professional Conduct?

c. Briefly describe the three mechanisms by which the CGA Code of Ethical Principles and Rules of Professional Conduct work.

(CGA-Canada adapted)

DC 18-5 Independence. LO3 You are an audit manager with the firm of Wu, Potter and McKinley, PAs. You and Ray St. Claire, a manager with another PA firm, are having a discussion about auditor independence. Ray says, "On the one hand, the public seems to be demanding more and more assurance from us about more and more aspects of a client's operations, but to maintain our practice in today's environment we have to be competitive to be able to attract new clients."

Required:

a. Identify and briefly explain the competitive practice on the part of auditors to which Ray is referring.

b. Why is this perceived as a threat to auditor independence and the quality of audits?

c. With reference to parts *a.* and *b.*, what could a client do, at least in theory, to take advantage of this situation? What is the reason this strategy might not work?

d. What does the CGA-Canada code of ethics say about this issue?

(CGA-Canada adapted)

DC 18-6 Audit Proposals. LO2 Smith and Mulberry (S&M) were asked by Behometh Ltd. to submit a proposal for its audit. This involved a 30-minute presentation to the board of directors and a written submission. The submission included a fixed-fee quote for the first two years, a detailed outline of the proposed audit strategy, and a list of the qualifications of the audit team to be assigned. Five other PA firms were invited to bid on the engagement. S&M put in a

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"lowball" bid because the partners saw this as a golden opportunity to get exposure in this industry.

Several weeks later, Edgar Brown, chairman of the board, telephoned Mike Mulberry, congratulating him on being awarded the audit. The conversation went as follows:

Edgar: I'm pleased to offer you the engagement, Mike, and I want you to know you weren't the lowest bid. What really impressed us was your attitude and promise to give us personal attention. It's so refreshing to find an auditor who openly states there needs to be a completely harmonious relationship between auditor and client.

Mike: We're really pleased to be your auditors, Edgar. We were a little apprehensive about not having any experience in your industry.

Edgar: Well Mike, since you did indicate you would hire someone experienced to oversee the engagement, I really see no problem. I certainly support your idea of Stan Biggs, since he knows the industry inside out. We're a little sorry to lose him. He had only been with us two years since obtaining his PA and was a fine controller.

Mike: Yes, his knowledge of your operations should allow us to complete the audit in the minimal time.

Edgar: There is one favour you can do FOR us right away, Mike. We would like to start a national ad campaign that depicts our auditor slashing prices to the bone on our products. We would like you to be the auditor in that ad.

Mike: Acting's not really my strong suit, Edgar, but I'm sure we can accommodate you on that.

Edgar: By the way Mike, to show how much we value our auditors, I want to give you a key to the executive washroom, a special pass that allows you to park in restricted zones, and a letter that will give you folks an additional 25% off our employee store prices.

Mike: Thanks very much, Edgar.

(ICAO adapted)

The following week Mike went out to review the working papers of the predecessor auditors. He was shocked at the poor quality of work evident in these files. However, given the rule against criticism of fellow members, he believed it would be inappropriate to mention this to Behometh.

The audit went very smoothly. In fact, with Biggs in charge, S&M even managed to turn a profit on the job.

Several months later some information came to light, about which Mike was not sure he should worry. Although Biggs had severed all employment ties with Behometh prior to joining S&M, apparently he still retained 1000 shares of voting stock in the company.

Required:

Discuss the ethical issues in this case.

(ICAO adapted)

DC 18-7 Rules of Professional Conduct. LO2 The Canada Revenue Agency was recently granted the power to impose new "preparer penalties" on individuals who have received payment for preparing a tax return in which the taxpayer is found to have understated its taxes payable. Tax preparers are liable for penalties of up to $100,000 if the CRA finds that the preparer was aware that the taxpayer was under-reporting its taxes payable. Formerly, only the taxpayer could be penalized.

Required:

Given that the rules of conduct for professional accountants already prohibit PAs from being associated with false or misleading information and require them to conduct themselves with integrity, why do you think these preparer penalties were considered necessary by federal law makers?

DC 18-8 Contingency Fees. LO2 PA provides assurance on a forecast income statement included in a the prospectus for a public offering of shares of Mustang Inc. PA's engagement letter with Mustang states that the fee for the assurance report will be 10% of the proceeds of the share issue.

Required:

Discuss the appropriateness of this fee arrangement in light of the rules of professional conduct.

DC18-9 Forms of Public Accountants' Organizations. LO2 Three forms of organization for public accountants are unlimited liability partnership, limited liability partnership, or limited liability professional corporation.

Required:

What are the pros and cons of each form from the perspective of public accountants in these firms and from the perspective of users of public accountants' assurance reports? In particular, consider the implications of these different organizational forms for public accountants' incentives to perform their functions with due care and with objectivity.

DC 18-10 Public Accounting as a Career. LO2 A and B, two 40-something PAs, are raising a few glasses at the local pub to celebrate their 15 years in partnership, and are taking the opportunity to reflect over their choice of career.

A: All in all, I think public accounting has been a good career choice for me. I've been able to do very challenging, analytical work. I've had the opportunity to be very helpful to many business owners and have seen a number of my clients become millionaires—and I think I can give some of the credit for that to the good financial advice I gave them, especially in those really tough times when they didn't know how they were going to cover the next payroll! And I think my assurance reports added value to financial reports and

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were helpful to the people using them, even if I didn't even know specifically who those people were a lot of the time. But, at the same time, it's been really hard work and long hours, and I probably could have made more money with less effort if I had become a lawyer or a doctor.

B: I think you are probably right about that. Sometimes I think being a public accountant is like taking some kind of "vow of poverty." Our clients get rich, but we are only allowed to charge by the hour because otherwise, say if we took shares in our client's companies instead of fees or took a percentage of the tax savings we identify for them, we would lose our appearance of independence. To me the big irony of being a public accountant is that our duty is to serve the public, and so we need to stay independent of the clients we report on, but the public doesn't pay us—our clients do! If we are going to make a living at this we need to maximize our profitability, and yet it seems the rules of professional conduct are designed to prevent us from ever making a lot of money at this!

Required:

Discuss the views of the two PAs, that public accountants' duty to the public and operating a profit-oriented business are incompatible. Do you agree? Generate some possible solutions that would resolve the dilemma they see. Evaluate the solutions you have generated in terms of their effectiveness and practicality, given the context in which public accounting is practised and the public needs that it fills. Which of your possible solutions do you think would be the most practical and effective?

DC 18-11 LO2

Required:

Use the critical thinking framework to explain why serving the public interest should be the most important principle for PAs.

DC 18-12 LO3

Required:

Explain how the independence principle can be derived from the critical thinking framework.

DC 18-13 LO1

Required:

Explain how insufficient reasons in audit documentation can lead to a fraudulent audit opinion.

DC 18-14 LO1

Required:

Use classical problems in moral theory to illustrate why, even with critical thinking, it may not always be possible to come up with good reasons for all actions.

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CHAPTER 19

The Audit of Accounting Estimates

In this chapter, you will learn how to audit accounting estimates. Audit of accounting estimates is becoming an increasingly important topic in the 21st century audit of financial statements. This topic is primarily covered in CAS 540: "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures."

Part II of this chapter is available on Connect and deals with advanced material related to the audit of accounting estimates.

EcoPak Inc.

EcoPak and its engineers have been quite successful in coming up with technological improvements to its production processes that greatly increase product quality and lower costs. However, the improvements also leave some of its older processing equipment with less value in use, possibly leading to a need to record impairment losses.

When Caleb comes back to do the EcoPak audit in a subsequent year as the audit senior, one of the key audit issues he investigates is impairment testing for the property, plant, and equipment. Caleb finds this a very interesting challenge. He has to gather a lot of information from the production engineers about the old processes, and about the improvements and changes introduced by the new equipment. He also needs to get information from the company's marketing department about products that are in demand for future sales and those that are being phased out due to low profit margins or lack of demand. He will do some independent research on the biomass-based packaging industry and any developments in the technologies it uses. Based on all of these, he can take a fairly critical view of the internally generated production variance reports and will identify equipment that may be impaired in terms of having a fair value or value in use that will not recover the carrying value shown on the balance sheet.

Some of EcoPak's older equipment is closer to being obsolete because of the greater efficiency of the newer equipment. Using a variety of estimation techniques and the data he has gleaned from the various sources, Caleb develops a reasonable range of values for the older equipment, for comparison to EcoPak's recorded carrying value for it. As he finds a carrying value to be significantly higher than a maximum value in this audit range, Caleb records the difference as a "likely error," and carries it forward to the accumulated summary of misstatements to be taken into account at the conclusion of the audit, in the decision on whether the financial statements are materially misstated.

LEARNING OBJECTIVES

After completing Part I of this chapter, you will be able to do the following:

- **LO1** Understand the traditional approach to dealing with accounting uncertainty and going concern.
- **LO2** Describe the main concepts of CAS 540 and its relevance for financial reporting.
- **LO3** Demonstrate an ability to apply CAS 540 in a qualitative way.
- **LO4** Explain the problems with existing standards.

CHAPTER APPENDX

Appendix 19A: A Quantitative Model for Information Risk *(online)*

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Phil, who has taken over from Tariq as EcoPak's audit engagement partner, takes a great interest in Caleb's analysis. He realizes this has potential to become a controversial negotiating point as they come to finalize the financial statements and audit report.

The chapter is divided into two parts. The first part introduces the basics of CAS 540 and a discussion of key concepts. This represents the official guidance, and especially the traditional way reasonableness has been defined. But there are gaps in the standards that standard setters are leaving to auditors in the field to deal with. Part II of the chapter (available on Connect) is the advanced part, illustrating the gaps in the guidance represented by existing standards. The fundamental problem is that the audit of accounting estimates overlaps with principles-based accounting standards which IFRS represents, and the CASs have not resolved the different terminology used between the accounting and auditing standard setters. This reconciliation is based on a 2012 article entitled "Principles-Based Reasoning About Accounting Estimates," in *Accounting Perspectives,* Volume 11, No. 4, by an author of this textbook.

We propose what we believe is a reasonable reconciliation, one that, at minimum, identifies the key issues for auditors to consider. We depict a major part of accounting measurement uncertainty as an **accounting risk** distinct from the audit risk model, offering simple techniques for representing it, ways of improving the representation, and use of this representation to decide if there are significant risks in the accounting estimate, as well as reporting options if the risks are significant. All this is achieved with the help of quantitative models of the uncertainty. Qualitative issues, such as the disclosure responsibilities, are also proposed. Even though this guidance is not in the standards, the advanced student should obtain a better understanding of the issues in implementing key aspects of CAS 540.

accounting risk: the part of information risk due to incorrectly predicting future events, especially in accounting estimates

Part I: Basic Material Relating to Accounting Estimates

INTRODUCTION

LO1 Understand the traditional approach to dealing with accounting uncertainty and going concern.

One of the most challenging but also increasingly important audit topics is the audit of accounting estimates. This is being recognized by CPAB, the European Union, and regulators and standard setters around the world. The audit of accounting estimates and the appropriateness of their reporting may become one of the most important auditing and financial reporting issues of the 21st century.

The audit of accounting estimates is gaining in importance because the number and complexity of estimates used in financial reporting continues to grow. The adoption of IFRS and fair value accounting has greatly increased the challenges for auditors. Regulators around the world are asking if some of the estimates are, indeed, even auditable.[1] Thus, in this chapter we will quickly get into the most fundamental topics of not only auditing but concepts in financial reporting as well.

Essentially, accounting and auditing standards are trying to keep up with the complexity of the financial reporting environment. A major source of this complexity is increased use of financial instruments and financial engineering. As noted in Chapter 14, a major reason for this financial engineering is the manipulation of financial statements. This means the auditor has to be more careful in distinguishing between the economic substance of a transaction and its financial form, a major issue in auditor litigation with respect to

1 "Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications Discussion Paper," International Federation of Accountants (IFAC), January 2011.

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the Lehman Bros. bankruptcy (Chapter 14). The box entitled "Accounting and the Global Credit Crisis" in Chapter 1 also made this evident; note that the people being quoted there are important individuals. The solutions to the issues raised are not obvious.

Because of the increased complexity of this topic, we have divided this chapter into two major parts. You probably have covered some of the material in your financial accounting courses, and here we look at the issues from the auditor's perspective. Part I is a straightforward review of CAS 540, the most relevant standard for this topic. Part II (on Connect) is more conceptual and based on both research and the authors' opinions. It provides a mental model as a foundation for addressing the problems identified in Part I. The second part is more advanced and deals with the gaps remaining in the standards and how auditors may cope with them. Part II is, however, not a part of the standards and is, therefore, not as authoritative as Part I. For this reason, Part II should be treated as an advanced topic in auditing. Part II stresses the quantitative aspects, which should be supplemented by qualitative issues associated with the audit decision. These are issues that auditors must somehow address in practice, keeping in mind that the courts expect them to deal with the gaps in a reasonable way that would be acceptable to the ordinary user; moral imagination comes into play here. While Part II is not as authoritative as Part I, it does attempt clarify some fundamental financial reporting issues raised by the standards. Even if you do not necessarily want to accept the guidance given in Part II, you should be ready as a critical thinking auditor to develop your own reasons that will provide alternative, well-supported conclusions. This also means that your conclusions should be well integrated with accounting theory and help resolve inconsistencies between accounting and audit logic involving estimates.

If auditors do not have good reasons for their judgment calls on estimates, they should make that clear in their report; otherwise, at best the auditor is incompetent and negligent and at worst, if aware that the opinion is unsupportable, he or she is lying (like Bernie Madoff's auditor). Auditors then risk being accused of committing fraud themselves, or at least of being incompetent. See Appendix 1B for an overview of the fraud of incompetence and Chapter 19 (available on Connect) for some aspects of legal reasoning on auditor judgments.

Part II of this chapter offers one method of supplying good reasoning for accounting estimates. It focuses on quantitative approaches as these can be invaluable aids in framing the problem so that qualitative issues are brought into sharper focus. For example, models from financial engineering and actuarial science (pension accounting) can be used to calculate accounting risks, the same ones introduced in this chapter. In this way, quantitative models and decision aids complement professional judgment so that together they effectively offer the most convincing reasoning for a conclusion. Accounting analysis has always included quantitative analysis, because accounting issues typically involve a measurement model. Financial reporting is an act of measuring, which in itself is a quantitative model, meaning that certain assumptions are being made about how to assign numbers for use in financial statements.

We begin our study of the audit of accounting estimates with the more familiar and intuitive aspects of audit standards, and then build on that to include less-familiar aspects of financial reporting. This chapter differs from the others here in that there is more stress on financial reporting concepts and principles and on their appropriate application. Prior chapters focused primarily on factual information, and a fundamental if unstated principle of financial reporting is that lying about facts is unacceptable. But the issue of "lying" within the context of accounting estimates is more problematic! GAAP reporting of accounting estimates that is mere compliance versus GAAP estimates that "present fairly," as the auditor claims in his or her report, will also need to be addressed. These distinctions are now made in CAS 200, and the auditor is therefore responsible for the meaning of the particular words selected for use in the auditor's report. Part II will, therefore, be reconsidering everything you learned in your financial accounting courses. That is what critical thinking can involve.

A good way to understand how this chapter differs from the earlier material is to think of two types of judgments—audit judgments and accounting judgments—a distinction proposed by PCAOB as a way to improve financial reporting.[2] Audit judgments, the focus of this textbook

2 Panel Discussion—CIFIR Proposal Relating to Judgments, PCAOB Standing Advisory Group Meeting Document, PCAOB, February 27, 2008 at www.pcaobus.org.

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thus far, are those related to gathering evidence. However, equally important are accounting judgments dealing with the choice or application of an appropriate financial reporting framework and in estimating the amount to record after all the facts have been verified through audit evidence. If there is an audit deficiency that does not lead to a scope qualification, an audit judgment error has occurred while an uncorrected accounting judgment deficiency by management should lead to an accounting deficiency report reservation by the auditor. Auditors are equally responsible for detecting and appropriately reporting on both the auditing and accounting deficiency problems in the auditor's report. For example, the audit of Lehman Bros. discussed in Chapter 14 involved the reporting of off-balance sheet borrowings (an accounting judgment issue) and evaluation of whistle-blower statements (an audit judgment).

Much of accounting judgment is covered in your financial accounting courses. But this coverage is not sufficient for an auditor in the 21st century! The auditor also needs to decide if the accounting "presents fairly," using a fair presentation financial reporting framework. This is where new judgment challenges can arise because the meaning of present fairly is not directly defined in the standards. Instead, the auditor needs to look at the underlying financial reporting principles, ethics, and critical thinking. Challenging? Yes! And that is why this is currently considered a major problem area of audit practice. There are, however, no authoritative solutions, and therefore this chapter is divided into its two major parts. The first part restricts itself largely to current (and incomplete) standards for guiding judgments, while the second, the advanced material, attempts to fill in the gaps of the first through use of quantitative methods, principles-based reasoning, and the critical thinking concepts introduced in Chapter 3.

TRADITIONAL APPROACH TO DEALING WITH ACCOUNTING UNCERTAINTY

In Chapter 4, you studied scope limitations in which either management or circumstances prevented the auditors from obtaining sufficient appropriate evidence about a part of the financial statements. A different type of problem arises when client uncertainties exist. We will refer to these as *accounting uncertainties* because they do not arise from scope restrictions. Instead, they are related to inexact measurements of accounting values or *measurement uncertainti*es of accounting standards. In the IFRS conceptual framework, measurement uncertainty characterizes the reliability of the measurement. A good example of an accounting uncertainty is an accounting contingency, which is defined in the *CICA Accounting Handbook* Part II, paragraph 3290.02 (also see IFRS/IAS 37):

> A contingency is . . . an existing condition, or situation, involving uncertainty as to possible gain ("gain contingency") or loss ("loss contingency") to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.

The *CICA Handbook* section 3290 sets forth accounting and disclosure standards for contingencies. One of the most common ones involves the uncertain outcome of litigation pending against a company. Accounting uncertainties include not only lawsuits but also such things as the value of fixed assets held for sale (e.g., a whole plant or warehouse facility) and the status of assets involved in foreign expropriations. Auditors may perform procedures in accordance with generally accepted auditing standards, yet the uncertainty and lack of evidence may persist. The problem is that it is impossible to obtain audit "evidence" about the future. The concept of audit evidence includes information knowable at the time a reporting decision is made and does not include predictions about future resolution of uncertainties. Consequently, auditors should not change (modify or qualify) the introductory, scope, or opinion paragraphs of the standard unqualified report when contingencies and uncertainties exist. When the audit has been performed in accordance with generally accepted auditing standards, and the auditor has done all things possible in the circumstances, no alteration of these standard paragraphs is necessary as long as the uncertainty has been properly disclosed. Whether the disclosure is proper, however, can be a major financial reporting issue and a key professional judgment of the auditor.

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Under Canadian audit standard CAS 706, the auditor may decide to place a "red flag" paragraph drawing attention to the uncertainty in the report. If there is material uncertainty about the going-concern assumption, for example, then CAS 706 requires that an emphasis of matter paragraph be added even when there is proper disclosure in the financial statements.

Uncertainty situations may cause audit reports to be qualified for departures from GAAP, if (1) management's disclosure of the uncertainty is inadequate, (2) management uses inappropriate accounting principles to account for the uncertainty, or (3) management makes unreasonable accounting estimates in connection with the effects of the uncertainty. The audit report also may be qualified because of a scope limitation regarding available evidence about an uncertainty.

A HISTORICAL NOTE: "SUBJECT TO" OPINIONS PRIOR TO 1980

From the early 1960s until 1980, auditors gave "subject to" opinions for accounting uncertainty situations. The opinion sentence was qualified with these words: "In our opinion, subject to the effects of such adjustments, if any, as might have been determined had the outcome of the uncertainty discussed in the preceding paragraph been known . . ." The explanatory paragraph was placed before the opinion paragraph, and the opinion was considered qualified. You may see this form of "subject to" opinion when you use reports issued in 1980 and earlier. However, the audit standards were changed in 1980, and now the "subject to" wording is prohibited, the explanatory paragraph is no longer used, and the opinion sentence itself is unqualified.

The inclusion of significant matter paragraphs discussed below appears to be one way that the basic red-flagging objective of "subject to" opinions may be resurrected.

EMPHASIS OF MATTER AND OTHER SIGNIFICANT MATTER PARAGRAPHS

As discussed in Chapter 16, two types of additional information paragraphs are provided for in CAS 706 that can be used to expand the information provided in the auditor's report. Emphasis of matter (EOM) paragraphs can be used to draw attention to information in the financial statements, such as note disclosure of a going-concern uncertainty. Other matter (OM) paragraphs can be used to provide additional information beyond the financial statements, such as the fact that comparative information was audited by a different audit firm. Exhibit 19–1 illustrates an EOM paragraph.

EXHIBIT 19–1 Example of an Emphasis of a Matter (EOM) Paragraph

The following is an illustration of an Emphasis of Matter (EOM) paragraph when the auditor is satisfied as to the adequacy of the note disclosure of a material uncertainty:

Emphasis of Matter

Without qualifying our opinion, we draw attention to Note X in the financial statements which indicates that the Company incurred a net loss of ZZZ during the year ended December 31, 20X1, and, as of that date, the Company's current liabilities exceeded its total assets by YYY. These conditions, along with other matters as set forth in Note X, indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern.

Source: *CICA Handbook—Assurance,* 2012, CAS 570, paragraph A21.

Other matter (OM) paragraphs are distinguished from EOM paragraphs by the information they reference. EOMs refer only to information presented or disclosed in the financial statements, whereas OMs relate to information which is not required to be disclosed in the financial statements. For example, OMs can refer to other information such as MD&A or comparative information from other periods, especially when there appear to be discrepancies between the two. OM paragraphs also matter in a situation where the prior-year financial statements were audited by a different audit firm.

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GOING CONCERN

Generally accepted accounting principles (GAAP) are based on the going-concern concept, that is, the entity is expected to continue operations and meet its obligations as they become due, without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations (e.g., a bank reorganization forced by the Superintendent of Financial Institutions), or similar actions. Thus, an opinion that financial statements are in conformity with GAAP means that continued existence may be presumed for a "reasonable time"—at least one year beyond the date of the financial statements.[3] This one-year time horizon was reiterated in the CICA's December 2008 "Risk Alert" on audit considerations during the economic crisis that began in 2008/2009.

Dealing with questions of going concern is difficult because auditors are forced to evaluate matters of financial analysis, business strategy, and financial forecasting. In other words, auditors must consider the client's business risks as introduced in Chapter 5. Most management is unwilling to give up and close their businesses without strong attempts to survive. Sometimes, survival optimism prevails until the creditors force bankruptcy proceedings and liquidation, and auditors are generally reluctant to puncture any balloons of optimism. Managers and auditors both view news of financial troubles in an audit report (an attention-directing paragraph or a disclaimer based on going-concern doubt) as a "self-fulfilling prophecy" that causes bankruptcy. However debatable this view might be, it still prevails and inhibits auditors' consideration of going-concern questions.

Auditors are responsible for determining whether there is a significant doubt about a company's ability to continue as a going concern, and no careful auditor should ignore signs of financial difficulty and operate entirely on the assumption that the company is a going concern. Financial difficulties, labour problems, loss of key personnel, litigation, and other such things may be important signals. Likewise, elements of financial flexibility (salability of assets, lines of credit, debt extension, dividend elimination) may be available as survival strategies. (In U.S. auditing standards, these elements of financial flexibility and management strategy are known as **mitigating factors** that may reduce the financial difficulties.)

mitigating factors: elements of financial flexibility (saleability of assets, lines of credit, debt extension, dividend elimination) available as survival strategies in circumstances of going-concern uncertainty, which may reduce the financial difficulty problems

Accounting and finance research efforts have produced several bankruptcy prediction models. These models use publicly available financial information to classify companies into "fail" and "nonfail" categories. An auditing firm might use such a model as an analytical review tool. Auditing standards, however, make no mention of research models and instead suggest many company-specific considerations and elements of internal information for analysis. (One bankruptcy prediction model, the Altman Z-score, is described briefly in Appendix 5A of this text.)

Since the going-concern assumption is so fundamental to financial reporting, it becomes a good example of how GAAP and GAAS can overlap, how predictions of the future come into play in financial reporting, and thus the importance of professional judgment in appropriately dealing with the reporting of going-concern problems. An important 1991 CICA research study, "The Going-Concern Assumption," gives recommendations based on key threshold probabilities. These recommendations are summarized in an article by J. E. Boritz.[4] Two key audit recommendations of the study are as follows:

1. Require auditors on every audit to perform procedures that provide reasonable assurance about the validity of the going-concern assumption.
2. Evaluate results of procedures performed.

A key judgment issue regarding going concern is the disclosure step: At what point is note disclosure insufficient and it becomes necessary to actually adjust accounting measurements of a reporting entity with going-concern problems? Despite changes in standards and recent exposure drafts over the years, Boritz's is still the most comprehensive analysis of going-concern contingencies in financial reporting. Boritz incorporates both the concepts

3 J. Boritz, "The Going-Concern Assumption," CICA Research Report, 1991.

4 J. Boritz, "Going, going, gone!" *CA Magazine,* Vo. 124, No. 4, April 1991, pp. 22–29.

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of "significant doubt" used in CAS 570.19, and "substantial doubt" used in PCAOB (2007) and FASB (2008). To facilitate discussion, here we reproduce Boritz's Table 5 as Exhibit 19–2, to summarize the issues.

EXHIBIT 19–2 Reproduction of Boritz's (1991, Table 5) Recommended Changes to (Then) Accounting and Auditing Standards

DEGREE OF DOUBT* ABOUT VALIDITY OF THE GOING CONCERN ASSUMPTION	CURRENT *CICA HANDBOOK* STANDARDS**	RECOMMENDED ACCOUNTING STANDARDS	RECOMMENDED AUDITING STANDARDS
Little or no doubt (less than 20%)	No guidance	No reference to going concern.	No reference to going concern.
Significant doubt (from 20% to 49%)	No guidance	Consider the need to disclose the existence of doubts, causes of doubts, management's plan and potential adjustments to recorded values.	No modification of auditor's report, if disclosure is adequate.
Substantial doubt (from 50% to 70%)	No guidance	Disclose the existence of doubts, causes of doubts, management's plans and potential adjustments to recorded values.	Explanatory paragraph in auditor's report, even if disclosure is adequate.
Very substantial doubt (from 70% to 95%)	Note disclosure; no audit reporting if disclosure is adequate	Disclose the information required under substantial doubt; accrue expected losses if they can be estimated, otherwise, disclose the impact on recorded values.	Explanatory paragraph in auditor's report, even if disclosure is adequate.
Total disbelief in the validity of the going concern assumption (greater than 95%)	Note disclosure; no audit reporting if disclosure is adequate	State that the going concern assumption is not valid; use alternative disclosed basis of accounting instead of generally accepted accounting principles applicable to a going concern.	If generally accepted accounting principles for a going concern are used, an adverse opinion should be given, even if there is note disclosure that the going concern is invalid.

* The degree of doubt is determined by examining the support for management's implicit or explicit assertion that an entity is a going concern.
** This is based on my interpretation of current standards since they are not explicitly related to degrees of doubt.

A good example of what we refer to as accounting risk is found in the extreme left-hand column (Degree of doubt) of Exhibit 19–2. This column lists the accounting risks, assuming that management does nothing to disclose the going-concern possibilities for each degree of doubt. Accounting risk is measured relative to a reported number (this reported number may be actual booked value or be assumed by the auditor for purposes of evaluating the associated accounting risk). Accounting risk for going concern is a function of what is reported (in the Exhibit 19–2 example, it is assumed that nothing is reported about going-concern problems) and the actual risk of failure (i.e., what is ultimately realized). One can see from this illustration that accounting risk corresponds to what is considered unreasonable ("total disbelief"). Note also from this example that accounting risk is addressed primarily by proper financial reporting. For example, in the instance of the bottom row of the exhibit, if management had used an appropriate financial reporting framework, a write down of assets to liquidation value, then the accounting risk could have been reduced to an acceptable level and the auditor could then have issued an unmodified opinion. Thus, the level of accounting risk based on management's estimates can highlight the need for adjusting entries. Without such adjusting entries, the auditee would appear to be in much better economic condition than it is, thereby making the unadjusted, reported numbers misleading and potentially fraudulent.

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According to this study, five types of audit reports may be used when going-concern problems exist. These different reporting situations illustrate the importance that accounting risk can have, and the extensive and complex judgments that may be required when dealing with accounting risk. The first is a standard report with no additional explanatory paragraphs, as long as doubts are, whether minor or significant, properly disclosed in the notes to the financial statements. Under current CAS 706, an emphasis of matter paragraph is now explicitly required even when there is appropriate disclosure of significant going-concern problems. The second type recommended by Boritz in Exhibit 19–2 is a standard report with an unmodified opinion paragraph and an additional explanatory paragraph(s) to direct attention to management's disclosures about the problems. This would be used when there are substantial doubts and the company has properly disclosed these problems in the notes. The third type of report is an adverse opinion that arises from a failure to disclose substantial doubts or when it is virtually certain that the company will fail to continue as a going concern and GAAP no longer applies (but management has used GAAP for its financial statements anyway). A fourth type of report is a qualification for a GAAP departure if the auditor believes the company's disclosures about financial difficulties and going-concern problems are inadequate. Such a report, shown in Exhibit 19–3, is based on the current CAS 706. The fifth type of report is one qualified for a scope limitation if evidence that might or might not exist is not made available to the auditors, leading to the "except for adjustments, if any" type of modified opinion explained in Chapter 4. These different reports arise from the refined classification scheme reflected by the going-concern study recommendations. Note that to be consistent, both accounting and auditing standards should use similar criteria. Unfortunately, on issues like going concern, these standards do not use the same terminology so it is unclear whether the same criteria are intended (compare CAS 570 with IAS 1.25). The auditor is left to rely on his or her professional judgment in resolving such incompatibility challenges in standards. This is when a systematic approach like critical thinking can help come up with the most appropriate decision in the circumstances.

In summary, the current *CICA Handbook* recommendation that applies is CAS 706, which effectively states that if there is a going-concern problem an unmodified opinion is given as long as the problem is adequately disclosed. If there is material uncertainty about

EXHIBIT 19–3 A Modified Report Explaining Going-Concern Problems

Departure from generally accepted accounting principles—inadequate disclosure of matters affecting the company's ability to continue as a going concern. When the auditor has determined that a qualification is the type of reservation required, the following wording may be appropriate.

AUDITOR'S REPORT

To the Shareholders of ....

The introductory, management responsibility, and auditor responsibility paragraphs are the same as in the unmodified report. A new paragraph is added after the scope paragraphs to provide more details immediately preceding the opinion paragraph as follows.

The accompanying financial statements, in my opinion, do not draw attention explicitly to doubts concerning the company's ability to realize its assets and discharge its liabilities in the normal course of business. These doubts arise because it is uncertain whether the company will be able to refinance long-term debt in the amount of $.................... due on ...., 20X2 in view of the existence of recurring operating losses in the past five years and the deficiency in working capital of $................ as at ...., 20X1. If refinancing cannot be arranged, it is not known whether the company can sell its hotel property for an amount sufficient to realize its carrying value of $...................., and to generate adequate funds to repay this debt.

In my opinion, except for the omission of the disclosure described in the preceding paragraph, these financial statements present fairly, in all material respects, the financial position of the company as at ...., 20X1 and the results of its operations and its cash flows for the year then ended in accordance with generally accepted accounting principles.

City (signed)....................

Date PUBLIC ACCOUNTANT

Source: © *CICA Handbook—Assurance,* 2012, CAS 706 (and section 5510.A, Example F).

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going concern, then an emphasis paragraph is also required even when the facts are adequately disclosed. If the facts are not adequately disclosed, the auditor should issue a reservation of the audit opinion. An illustration of an "except for" qualification reservation is shown in Exhibit 19–3.

The above discussion on accounting uncertainties and going concern suggests that the audit process can be viewed as having two stages. In stage one, the auditor gathers enough audit evidence to reduce audit risk to acceptable levels. This stage deals with what we can call audit evidence uncertainties, those related to the amount of evidence gathered. The significance of evidence uncertainties is that they distinguish between high, moderate, and no assurance engagements. If the purpose of the engagement is to obtain high assurance, then the PA needs to gather extensive detailed data to support the PAs audit report, and we get all the audit report issues discussed in this chapter. If, on the other hand, the purpose of the engagement is not to supply high assurance, then new evidence considerations come into play which we discuss in Chapter 21 (available on Connect). The accounting uncertainties discussed above have little to do with evidence gathering as they reflect the business risks of the client. Audit evidence-gathering procedures can do little to alleviate most client business risks. These are best dealt with by proper disclosure of them in the client's financial reporting. This brings us to stage two of the audit process.

In stage two, the auditor uses the evidence obtained in stage one to make a determination of the appropriateness of financial reporting relative to GAAP and fairness of presentation criteria. The two steps reflect the two major categories of audit report reservations: audit deficiency reservations based on stage one, and accounting deficiency reservations based on stage two. Thus, the distinction between audit and accounting uncertainties is critical for audit report reservations. One of the reasons critical thinking in professional judgment is important is that it focuses on the link between your study of auditing and your study of financial reporting in your accounting courses. Specifically, critical thinking helps integrate professional judgment in accounting and ethics with professional judgment in auditing and ethics.

REVIEW CHECKPOINTS

19-1 Why is the going-concern assumption of financial reporting important for auditors?

19-2 Why might "opinion shopping" be suspect? beneficial? (See Appendix 4B.)

Audit opinions on contingencies and going concern are examples of situations when the auditor may need to make an accounting estimate. The key CAS dealing with estimates is CAS 540, which we discuss in the next section.

REVIEW OF CAS 540

LO2 Describe the main concepts of CAS 540 and its relevance for financial reporting.

This is one of the most important of the CASs, especially with the adoption of IFRS which allows a much wider use of estimates. In addition, IFRS is considered more principles-based so that this greater leeway with estimates must be consistent with the principles.

As with any good theory, CAS 540.07 starts with some key definitions which identify the important concepts.

(a) **Accounting estimate**—An approximation of a monetary amount in the absence of a precise means of measurement. If the estimate involves only measurement at fair value, the term "fair value accounting estimate" is used.

(b) **Auditor's point estimate or auditor's range**—The amount or range of amounts, respectively, derived from audit evidence for use in evaluating management's point estimate.

(c) **Estimation uncertainty**—The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.

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(d) **Management bias**—A lack of neutrality by management in the preparation and presentation of information.

(e) **Management's point estimate**—The amount selected by management in the preparation and presentation of information.

(f) **Outcome of an accounting estimate**—The actual monetary amount which results from resolution of the underlying transaction(s), event(s), or condition(s) addressed by the accounting estimate.

There are a number of other key paragraphs:

CAS 540.11: The auditor shall determine whether in the auditor's judgment, any of those *accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks* (emphasis added).

A43–A44: These paragraphs note that not all differences between outcomes and estimates are due to misstatements, but this seems to depend on the financial reporting framework.

A47–51: These paragraphs point out that the amount of the estimate is not always an indicator of the estimation uncertainty. High estimation uncertainty situations include those in which the estimates are highly dependent on judgment, such as pending litigation and highly specialized, entity-developed models. Estimation uncertainty may be so high that a reasonable accounting estimate cannot be made (we call this the "nightmare" estimate situation as discussed below). The applicable financial reporting framework may not allow recognition or measurement of the item, or may require disclosure of the high estimation uncertainty.

A87–91: These paragraphs explain how auditors can develop either a point estimate or a range. For example, the auditor may initially develop a preliminary point estimate, and then assess its sensitivity to changes in assumptions to ascertain a range with which to evaluate management's point estimate. The ability of the auditor to make a point estimate, as opposed to a range, depends on several factors, including the model used, the nature and extent of data available, the estimation uncertainty involved in the accounting estimate, and the applicable financial reporting framework. A91 describes a number of ways to make a range or point estimate. (*Comment:* Note how they use models or assumptions as premises, or reasoning by analogy to a model that frames the problem appropriately.)

A92: A difference (in estimate) may arise because the auditor used different, but equally valid, assumptions as compared with those used by management. (The CAS is using the term "valid" very broadly here. What they really seem to mean is that the epistemic probability of the assumption is high, as is discussed in Appendix 3A). This may reveal that the accounting estimate is highly sensitive to certain assumptions and therefore subject to high estimation uncertainty, indicating that the accounting estimate may be a significant risk.

A93–95: When the auditor concludes that it is appropriate to use a range to evaluate the reasonableness of management's point estimate (the auditor's range), paragraph 13 (d) (ii) requires that range to encompass all "reasonable outcomes" rather than all possible outcomes. The range cannot be one that comprises all possible outcomes if it is to be useful, as such a range would be too wide to be effective for purposes of the audit. The auditor' range is useful and effective when it is sufficiently narrow to enable the auditor to conclude whether the accounting estimate is misstated. This usually means narrowing the range until its width is no larger than the materiality level set for the financial statements as a whole as suggested in CAS 540.A94. However, in some industries it may not be possible to narrow the range to below such an amount. This does not necessarily preclude recognition of the accounting estimate. It may indicate, however, that the estimation uncertainty associated with the accounting estimate is such that it gives rise to a significant risk. Then A95 considers ways to narrow the range to a position where all outcomes within the range are considered reasonable. (*Comment:* This guidance is unclear about how to determine a "reasonable" range. In particular, we will see in Part II, available on Connect, that there are two ways the ranges can be considered reasonable and they both can apply to this guidance. In addition, not all ranges have all the desired properties, and the auditor then has to decide how to report the estimate.)

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A116: Evaluating the reasonableness of the accounting estimates and determining misstatements. The difference between either the auditor's point estimate and management's estimate, or the nearest point of the auditor's range and management's point estimate is *at least the minimum of the misstatement* (emphasis added).

A118: There are three types of misstatements:

1. *factual*—misstatements about which there is no doubt
2. *judgmental*—management's judgments that the auditor considers unreasonable (i.e., forecast errors. This type also includes auditors' nonsampling errors.)
3. *projected misstatements*—projection of misstatements from samples to the entire population

DISCUSSION OF CAS 540

The above paragraphs outline the key concepts of CAS 540. The first thing to note about these concepts is that estimation uncertainties incorporate all three types of misstatements of paragraph A118. Factual and projected misstatements relate to sampling theory and the traditional audit risk model with its focus on planning audit evidence-gathering procedures. For example, factual misstatements are identical to the identified misstatements (IMs), and projected misstatements are identical to the likely aggregate misstatements (LAMs) concepts of Audit Guideline 41 (AuG-41) in the *CICA Handbook*. The ranges associated with these misstatements can be reduced to whatever level desired, because these are based on the amount of evidence gathered. Sampling theory has been used in auditing standards (e.g., the audit risk model) to model the evidence-gathering risks, and a sampling confidence interval is a good indicator of ranges when the only source of uncertainty is sampling risk. Sampling risk and confidence intervals can be reduced by increasing the sample size; that is, gathering more evidence.

Judgmental misstatements, on the other hand, are defined as "differences arising from management's judgments concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies the auditor considers inappropriate" (CAS 540.A118). It is evident from this definition that virtually all other misstatements are captured by this concept. This includes nonsampling errors, such as incorrectly applying testing procedures and incorrect evaluation of the findings of audit procedures as discussed, for example, in Chapter 10. More importantly from an accounting theory perspective, however, judgmental misstatements include inaccuracies in the forecasting of future events. The fundamental problem with future-event uncertainties is that ranges associated with future events do not behave the same way as ranges do in sampling theory. Future-event ranges are dependent on the broader economic environment of the reporting entity. If the volatility of the economic environment increases, then so do future-event uncertainties and the ranges associated with them. Thus, depending on the volatility of the business environment, more evidence on the volatility may actually increase the range associated with future events. Perhaps a good example of increased estimation uncertainty is the valuation estimates of level 3 fair values of IFRS 7.27A when there is a loss of market liquidity, as happened during the recent financial crisis. The recently issued "International Auditing Practice Note" (IAPN) 1000.38–40 (IFAC, 2011b) notes this as "increased measurement uncertainty." It appears that CAS 540 is primarily geared to dealing with such future-event uncertainties because of its emphasis on "forecasting outcomes" and "hypothetical" transactions (e.g., CAS 540.03). The "significant risks" of estimation uncertainties in CAS 540 thus, to a large extent, deal with the future-event risks such as going-concern problems as discussed in the preceding section. We refer to this future-event accounting for estimation uncertainty as accounting risk. In other words, the accounting risk is the risk of material forecasting errors in developing the accounting estimate.

Risks associated with forecasting future outcomes or events in accounting estimates are increasingly recognized as the biggest source of error in accounting estimates.[5]

5 For some recent examples, see M. E. Barth, "Including estimates of the future in today's financial statements" *Accounting Horizons,* Vol.20, No. 3, 2006, pp. 271–285; and B. E. Christensen, S. M. Glover, and D. A. Wood, "Extreme estimation uncertainty in fair value estimates: Implications for audit assurance," *Auditing: A Journal of Practice & Theory.* Vol. 31 No. 1, February 2012, pp. 127–146.

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W. H. Beaver, an outline of whose findings follows, was one of the first to stress that asset and liability definitions are based on future events, accruals are essentially a form of forecast, and future events pervade financial reporting.[6] Accruals are what distinguish cash basis accounting from GAAP. There are numerous events related to an asset or liability over its life, and the point at which an asset or liability is recognized in financial reporting is the critical event (123). Events up to and including the critical event are "past" events, and subsequent events are "future" events. However, future cash flows are the future events of ultimate interest in financial reporting, since they are the basis of the definition of assets as probable future benefits and liabilities as probable future sacrifices (123). Future events are characterized by uncertainty, and their probabilities are subjective or judgmental in nature. Accountants try to represent these uncertainties as deterministic, which creates a paradox. At minimum, it places a burden on the reporting of risks and uncertainties because a single number creates the appearance of certainty when that does not actually exist (125). Beaver calls this the deterministic principle (127). In reality, there is a range of outcomes and a probability of their occurring (126). What Beaver is suggesting here is that the range is like a confidence interval, except accounting ignores the confidence level associated with this range. Beaver contends that only contingency accounting explicitly uses probabilistic terminology; the financial reporting will differ, depending on which probabilistic category an item falls into. Probable loss contingencies are to be booked, while reasonably possible loss contingencies presumably require some form of disclosure, if material, and remote loss contingencies do not (127–128). (*Comment:* The reporting logic we use in the text, called risk-based reporting is consistent with this reasoning.)

Beaver also notes that market prices are a potential substitute for predictions, but the markets need to be perfect and complete—a condition frequently not met for a firm's assets and liabilities (129). Also, highly volatile markets or thinly traded markets may have reliability-of-valuation issues (129). The fundamental problem is in reducing uncertain future cash flows into a single number. (*Comment:* MBA students taking financial statement analysis and valuation classes often are surprised to learn how "soft" or imprecise accounting numbers can be in financial reporting because of this need to use a single-point estimate in financial reporting.) The reporting of future events is poorly articulated in accounting standards. It is not clear what is being "measured" in accounting and what the purpose of measurement is. Beaver proposes an "informational perspective" to help address this. The informational approach compares the ability of financial statements to provide information relative to other sources of firm-specific information available to users of financial statements. Financial statements should report information for which the firm has comparative informational advantage (129–130); that is, information that the user does not already know. The heart of the concept is that an information asymmetry potentially exists between the preparer of the accounting data and the user of accounting data. However, this also creates a risk for the user in that the preparer may have incentives (e.g., bonuses based on reported profit) to behave strategically by exploiting his or her information advantage, and so deceive the user. This is what we called the *financial reporting cheating principle* in Appendix 1B. Beaver thinks that such risks from information asymmetry help explain "conservatism" in financial reporting. From a strategic perspective, the concern over reliability is driven by the fact that, to the extent that it cannot be produced reliably, a number may be distorted in a strategic manner (131). This problem is not unique to accounting estimates, as the current scandal involving the banking industry's Libor rate estimates illustrates.[7] For those concerned about economic substance and economic consequences, the economic implications of misestimating Libor are gigantic. The $350 *trillion* global derivatives market is tied to Libor—a market 20 times larger than the U.S. economy and more than 200 times larger than that of Canadian. About 90% of U.S. commercial and mortgage loans are linked to Libor. Yet the estimated

6 As seen on pp. 122–3 in W. H. Beaver, "Problems and paradoxes in the financial reporting of future events," *Accounting Horizons,* December 1991, pp. 122–134. Subsequent page references in this discussion refer to this article.

7 For example, see Gillian Tetts, "Libor scandal betrays the basic principles of Adam Smith," *Financial Times,* June 29, 2012, p. 24.

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Libor rate that influences all of this activity is the result of a process similar to that of identifying and using a reasonable range to calculate an accounting estimate as discussed in Part II of this chapter (available on Connect). Hence in Part II, you learn about issues associated with, potentially, many crucial management estimates, not just accounting estimates.

Savage and Van Allen clarify how management can strategically exploit accounting standards' failure to address uncertainties associated with future-event predictions in accounting estimates through the portfolio effect.[8] Their article focuses on accounting estimates involving future events and shows how portfolio theory from finance illustrates how working with averages of a range of possible values can be misleading. Why is this important for financial reporting? Because accounting standards reference expected values as a general principle. For example, the IFRS Conceptual Framework, paragraph 4.4, defines an asset as, "a resource controlled by the entity as a result of past events and from which future economic benefits are *expected* to flow to the entity." Savage and Van Allen note that if two assets or two liabilities have the same expected value, then portfolio theory shows that the asset with the lower risk will have the higher market value. The concern is that management can exploit this to the detriment of the shareholders. For example, management can exchange two assets with the same accounting value thereby showing no gain or loss but different market values and thus allowing the difference in market values to go into management's pockets undetected by the accounting system. Accounting thus can legitimize theft from shareholders. (Note that this is another example of the Appendix 1B cheating behaviour, which auditors may be expected to detect.) Other problems associated with the portfolio effect relate to the accounting for contingent claims. By ignoring the portfolio effect, contingent claims can be ignored even when in aggregate they are virtually certain and material in amount. Using Monte Carlo simulations, Savage and Van Allen also demonstrate that even when average cash receipts equal average cash expenditures with sufficient uncertainty there is a 30% chance a business can become insolvent within 12 months. (Note the ramifications for bankruptcy prediction discussed above.)

In all the examples noted by Savage and Van Allen, problems arise from what they refer to as the "flaw of averages" in using the average or expected value of a distribution as a point estimate for a distribution of values. When there is sufficient estimation uncertainty, point estimates based on an average can lead to misleading results. In addition to examples already given, Savage and Van Allen note that pension accounting and percentage-of-completion accounting are other instances where the flaw of averages can lead to misleading results. They go on to argue that, as in the Continental Vending case, compliance with GAAP is not sufficient to demonstrate fair presentation. They argue instead that accounting for uncertainty should be required for fair presentation, even though GAAP does not require it.

The Savage and Van Allen article shows that uncertainty in accounting estimates should somehow be "accounted for," because otherwise the accounting numbers can be considered misleading. Since no materiality or risk considerations are introduced in the examples given in the article, it is difficult to say what the audit significance is, other than that the uncertainties Savage and Van Allen discuss can potentially result in significant risk from high estimation uncertainty of CAS 540.11.

There is another study, however, by Petroni and Beasley that reports an interesting empirical anomaly regarding audited accounting estimates of loss provisions by insurance companies.[9] Their results show that such estimates have an after-audit accounting risk of material misstatement higher than 0.9. They refer to the differences between estimated and realized losses as "accounting estimation errors" and clearly treat them as a form of misstatement.

8 S. Savage and M. Van Allen, "Accounting for uncertainty," *The Journal of Portfolio Management,* Fall 2002, pp. 31–39.

9 K. Petroni and M. Beasley, "Errors in accounting estimates and their relation to audit firm type," *Journal of Accounting Research,* 34 (1), 1996, pp. 151–171.

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These finding are consistent with the concerns about potential consequences of high accounting uncertainties expressed by Savage and Van Allen. All of these studies have a direct or indirect concern with accounting uncertainties associated with future events. Clearly, there are risk consequences for auditors, as is indicated by the Petroni and Beasley (1996), Savage and Van Allen (2002), and Christensen et al. (2012) results.

Accounting risk as defined earlier is thus a very specific and potentially very important type of judgmental misstatement of CAS 540, paragraph A118. In particular, accounting risk excludes the other types of misstatements of CAS 540 that can contribute to estimation uncertainty. It is important to maintain the distinction between accounting risk's future-oriented misstatements and the other types of misstatements for two reasons:

1. Accounting risks can be huge and are by far the biggest source of risks in financial reporting. This is perhaps why the first few paragraphs of CAS 540 focus on future events, suggesting them as the primary source of estimation uncertainties.
2. Accounting risks cannot be reduced by gathering more evidence. The risks associated with factual and projected misstatements are controlled the same way risks are in sampling theory: through more testing. For this reason, the factual and projected misstatements can be treated as part of audit risk. Accounting risks, on the other hand, can only be controlled through proper accounting disclosure and are a financial reporting judgment. For example, the left-hand column of Boritz, Table 5, (Exhibit 19–2) reflects the accounting risk (degree of doubt) assuming no disclosure of the going-concern scenarios listed there. This accounting risk can be reduced to an acceptable level only by taking the actions indicated in the recommended accounting standards column.

The difference between what was reported and what should have been reported, an auditor's traditional perspective of misstatement, is the basis of the concept of accounting risk. In the case of future events, the optimal value to report is that amount ultimately realized, and accounting risk takes this into account in the sense that the riskiness of an estimate with respect to what is reported is compared to what may be realized, considering possible future states of the world. Accounting risk reflects a risk-based approach to financial reporting that is consistent with current risk-based auditing standards. However, current reporting frameworks are not explicitly risk based (but perhaps they should be), and this failure of accounting standards to be risk based while audit standards are risk based creates a dilemma for auditors in the exercise of professional judgment on financial reporting. If the accounting risk is sufficiently high, Boritz proposes that the basis of accounting be changed to liquidation accounting.[10] This is an example of a switch to another reporting framework (CAS 200, paragraph 13). Note that the issue is really one of proper disclosure of a future event, fundamentally an issue of accounting theory and applicable reporting framework. This financial reporting aspect of critical thinking is especially important in professional judgment.

In summary, the estimation uncertainty of CAS 540 is a complex concept. It incorporates audit risk and accounting risk, and conceptually incorporates mistakes in carrying out audit procedures. The latter can be viewed as a qualitative characteristic and corrected by audit training, supervision, and quality control procedures. The risks that are more quantifiable and made more objective through modelling and math are audit risk and accounting risk. Both risks have models from other fields to assist in quantifying them (statistical sampling for audit risk, and actuarial and finance models for accounting risk). In fact, with increasing innovations in financial modelling and increased use of these models in fair value accounting, auditors will have little choice but to keep up with these trends if they are to remain relevant. This chapter gives but the barest attempt at a reasoning framework to assist auditors in this task.

10 Boritz (1991), p. 29.

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It is evident that CAS 540 has some degree of quantification or mathematical modelling in mind when it says in paragraphs A87–91 that auditors can develop either a point estimate or a range. A point estimate can be viewed as an ideal range in the sense that a point estimate is the most precise range of possible values. In other words, a number or quantification is possible. Both points and ranges involve making assumptions, and these assumptions introduce uncertainties, the distinguishing features of accounting estimates. The auditors' challenge then is to evaluate the assumptions for their "reasonableness" and to assess the associated uncertainties to see if they represent a "significant risk."

These concepts can be illustrated by looking at the Boritz Table 5 illustration. The "degree of doubt" column represents uncertainties. And reasonableness is effectively reflected in the table by how little doubt there is about the going-concern assumption; the table tells us that it is "reasonable" to assume the going-concern assumption for financial reporting when the degree of doubt is no higher than 20%. In other words, if you are 80% or more certain that the going-concern assumption is true for a particular auditee then you are entitled to say that it is a reasonable assumption for purposes of financial reporting. There is no need to add more disclosures to the financial statements regarding this issue. In particular, third-party financial statement users will find it a reasonable assumption for their needs, and they are unlikely to consider this assumption to be misleading. In terms of CAS 540, paragraph11, the going-concern assumption under Boritz's 20% degree of doubt is not considered to lead to a "significant risk" in estimates arising from use of it.

More illustrations of CAS 540 with point estimates are given in the application case at the end of this section as well as in the chapter questions. As you will see there, even in simplified point estimate situations the reporting issues can be controversial (as they are in Boritz, "*Going Concern*"1991, and the related CICA study regarding going-concern judgments).

AUG-41 (CICA AUDIT GUIDELINE 41)

LO3 Demonstrate an ability to apply CAS 540 in a qualitative way.

We now switch to the more complex estimates situations that involve ranges of possible values, not just point estimates. The issue is now further complicated by the need for the auditor to decide what is reasonable when working with ranges and how to measure estimation uncertainty when working with reasonable ranges. These judgments are required if CAS 540 is to be operational in all accounting estimates situations. We begin by considering the original concept of a reasonable accounting estimate as it is illustrated in CICA Audit Guideline 41 (AuG-41) (now part of the "Assurance Handbook Prior to the Isssuance of CASs"). This guidance has been superseded to some extent by CASs 320, 450, and 540, but we do not think the material in those CASs really covers what AuG 41 does.

Audit guidelines are intended to provide more detailed guidance for implementing the *CICA Handbook* recommendations, and several of them, such as AuG-41, were replaced by the CASs. For example, AuG-41, in part, deals with what a estimate. It is consistent with CAS 540, paragraph A116 as reviewed above but is more specific, and therefore more clear. The key illustration given in AuG-41.30 is as follows:[11]

> For example, the auditor's analysis of specific accounts receivable and recent trends in bad debt losses as a percent of sales may cause the auditor to conclude that the allowance for doubtful accounts should be between $130,000 and $160,000. If management's recorded estimate falls within that range, the auditor ordinarily would conclude that the recorded amount is reasonable, and no difference would be aggregated. If management's recorded estimate falls outside the auditor's range of acceptable amounts, the difference between the recorded amount and the amount at the closest end of the auditor's range would be aggregated as a misstatement. For example, if management has recorded $110,000 as the allowance, the amount by which the recorded estimate falls outside the range (i.e., $20,000) would be aggregated as a misstatement.

11 AICPA, 2005: AUI 312.07; CICA, 2007: AUG-41.30.

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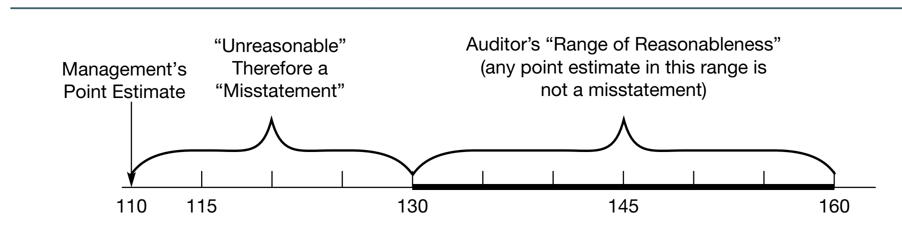
EXHIBIT 19–4 **Illustration of Logic of Audit Misstatements Concept**



The logic of this is presented graphically in Exhibit 19–4 above. Note that by this logic, a "reasonable" estimate has been defined as anything within the reasonable range. Misstatements are defined as the difference between management's point estimate (110k in the above example) and the nearest point of the reasonable range (130k in the above example) so that the misstatement is 130k − 110k = 20k. This misstatement is then treated like any other misstatements, and aggregated at the end of the audit; for example, on a summary worksheet ("scoresheet") as described in Chapter 16. Straightforward?

There are problems with the above fairly simple setup, and they are increasingly being recognized as the most challenging issues for auditor professional judgment (PJ) and in financial reporting. First, the misstatements that arise from estimates are often much bigger than the factual misstatements that an auditor finds in sampling or other audit procedures. Moreover, these misstatements will likely get bigger and more frequent with increasing use of estimates under IFRS. Second, as you can see from the review of CAS 540, paragraph A116 above, the standards are increasingly recognizing that the calculation of misstatements may only represent a minimum misstatement. The reason CAS 540 is becoming more cautious about defining misstatements is that the nature of the auditor's reasonable range is increasingly being questioned. This is likely why the concepts of estimation uncertainty and significant risks associated with them were introduced by CAS 540.

So, what does all this really mean for the auditor? How do we clarify our thinking on this? To answer these questions we will need to delve deeper into the meaning of estimates in financial reporting, and introduce some new concepts that clarify what is going on when auditors "verify" estimates based on future events. For example, take the concept of reasonable as used in AuG-41 above. Is this the same meaning as the way the word "reasonable" in the expression "reasonable assurance?" In the latter case, reasonable is synonymous with "high." Standards appear to use the word reasonable in the sense that a conclusion about an issue is highly likely to be true (i.e., there is a high epistemic probability to the conclusion, as discussed in Appendix 3A), whether we are talking about an auditor's opinion or the chance that no misstatement exists. Note that in both cases there seems to be an underlying argument or reasoning (see Appendix 3A) based on the degree of certainty. Quantified uncertainty is referred to as probability, or risk. The term "risk" is normally used when the probability involves an unfavourable event. The point is that it is important to be as clear and precise in the wording as the topic permits. All good theory and reasoning start with good definitions and clear concepts, something professional standard setters should keep in mind when developing standards and guidance.

We begin the process of clarification by reviewing D. J. Cockburn's 1992 article.[12] Cockburn seems to be the first auditor to recognize the potential significance of the problem associated with the AuG-41 concept of reasonableness and its close relationship with the limitations of accounting standards.

12 D.J. Cockburn, "At home on the range," *CA Magazine,* Vo. 125, No. 5, May 1992.

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Summary of Cockburn 1992

LO4 Explain the problems with existing standards.

This little two-page article is probably the most succinct you will find on issues related to auditor's reasonable ranges (from *CA Magazine,* not some academic journal). His key points can be summarized as follows (instead of auditor's reasonable range, he refers to auditor's zone of reasonableness—the same concept):

1. The key issue is factors to consider in determining the width of the range.
2. The auditor must accept the reality of the uncertainty that may be associated with the range.
3. Specialists, such as engineers, actuaries, and economists, may need to be consulted.
4. The range estimate must be at the date the auditor has gathered all the evidence.
5. A key issue is the length of the range compared to materiality.
6. Estimates with ranges that are too wide should be treated as contingencies (he is making a proposal about accounting theory at this point).
7. Ranges and their uncertainties should be disclosed (another accounting recommendation—an indication that auditing and accounting may not be separable in judgment; we can view this as his proposal to make fair presentation reporting more operational).
8. There are huge pressures on the auditor from management regarding recording of estimates (See his last point). This is because such estimates are essentially subjective in nature, and the major source of disagreement is likely the assumptions made about future-event outcomes. These assumptions and the related forecasts create the uncertainties associated with accounting risk.

We see from the above discussions that the key consideration when dealing with estimates is whether they are "reasonable." AuG-41 made the definition of this word very clear, but it was watered down by CAS 540 to mean only the minimum amount of misstatement to be assessed by the auditor. How should an auditor decide if the amount of misstatement or potential misstatement is reasonable? Moreover, neither of these guides really addresses Cockburn's concern about the width of the reasonable range. CAS 540 suggests that this width should be reducible to materiality, in which case Cockburn's problem disappears. But are such ranges really reducible in this way? The IFRS conceptual framework suggests not.

IFRS and CICA refer to the need for assets and liabilities to meet the "probable" criterion in order to be recognized in financial reporting.[13] The conceptual framework of IFRS, in paragraph 4.38, defines recognition of an element in the balance sheet or income statement as meeting two conditions:

1. It is probable that any future economic benefit associated with the item will flow to or from the entity.
2. The item has a cost or value that can be measured with reliability (i.e., measurement uncertainty of future economic benefits is acceptably low).

The first condition can be viewed as a categorical, random variable that establishes the existence of the element (yes or no). The second condition is the measurability criterion that can be reconciled with use of the reasonable ranges of CAS 540, with some additional assumptions. Possible assumptions are discussed in Part II of this chapter (available on Connect). There is no further guidance in the standards themselves and, therefore, this reconciliation is left as a matter of professional judgment for the practicing auditor—a judgment that the auditor must be prepared to defend in court, to oversight bodies, such as CPAB or PCAOB, or to a regulator, such as the OSC or SEC. Given the increased concerns about auditor, ability to verify complex estimates as expressed in the 2012 CPAB and PCAOB inspection reports, Part II provides additional guidance to help address such concerns, an advanced topic in audit of accounting estimates.

13 Part I IFRS, The conceptual framework for financial reporting, Ch. 4: 4.37–4.53, 2011.

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REVIEW QUESTION FOR PART I

MISSTATEMENTS IN ESTIMATES: BASED ON A FAMOUS CANADIAN TECHNOLOGY COMPANY

The auditors of Letron Inc. have set an overall materiality level of $900,000 and a performance materiality level of $800,000 for the current year audit, 20X2. They used the same materiality levels in their 20X1 audit. Letron is in the telecommunications equipment business, and its inventory value is subject to fluctuations due to changes in supply and demand as well as technological obsolescence, creating considerable measurement uncertainty. Management's point estimate of the inventories' value as of the end of 20X2 is $15.9 million, after reversal of a writedown that was taken in 20X1. The auditors have established a range of estimates for the inventory value of $14–16 million, so management's point estimate is within the auditor's range. In 20X1, poor market conditions prevailed and Letron wrote down its inventory to net realizable value, estimated to be $12.3 million. Management and the auditor had a disagreement regarding inventory valuation for 20X1, because it fell outside of the auditor's range of $13–15 million. However, this difference and the aggregated misstatements for 20X1 were less than the performance materiality, so these misstatements were not corrected. Letron initiated a bonus plan in 20X0 that would reward top management if the company reported positive profits. Letron reported losses in 20X0 and 20X1. In 20X2, Letron reported a small profit, giving rise to substantial bonuses for its management team.

Required:

Assume the role of Letron's auditor and explain the actions you would take in this situation, based on applying the requirements and guidance in CAS 450 and CAS 540.

Suggested Response:

When considering only quantitative materiality issues, these estimates are acceptable. In year 1 (20X1), the misstatement is not material and therefore acceptable. In year 2, there is no misstatement and is therefore also acceptable. (See AuG-41 in the *CICA Handbook*.) However, if we consider the qualitative aspects of this situation, the risks here seem high. First, these estimates allow management to get a big bonus, creating major incentives for manipulation. Second, there seems to be exploitation of the ranges of possible values for inventory. Third, what are the reasons for the inventory reversal in 20X2? This had the effect of creating a gain and increasing ending inventory for 20X2. It looks like each provided at least $0.7 million increase in profits in 20X2, resulting in the small positive profit for 20X2 on which the bonuses were based. There seems to be a great deal of what CAS 450 and 540 call *estimation uncertainty* here.

In Part II of this chapter (available on Connect), we provide some probability tools for more directly measuring the amount of risk arising from the uncertainty with using reasonable ranges. This will assist in auditor decision making. Note that in 20X2, no matter what concept of materiality is used, the result is acceptable because there is NO misstatement. To get around this problem, the risks need to be assessed more explicitly via probability modelling. Note that we have not even considered the problem of whether these ranges are too wide. Consideration of accounting risks associated with reasonable ranges also helps identify when a range is too wide, and what can be done about it.

PRINCIPLES-BASED REASONING WITH ACCOUNTING ESTIMATES USING RISK-BASED REASONING (RBR)

risk-based reasoning (RBR): reasoning using the following decision rule: If an actual estimation uncertainty associated with a recorded amount is greater than an acceptable level, then reject the recorded amount; otherwise, accept it.

This principle was introduced to you in Chapter 10 as the general principle of statistical reasoning and the audit risk model, both of which follow the logic of controlling beta risk at acceptable levels. If we extend this reasoning to other types of beta risk in estimation uncertainty then we get the above principle. In this way, we get consistency in the overall reasoning of the audit process, which is significant to the logic of audit reasoning. Inconsistency is not only illogical but is also the basis of lies (stated belief not consistent with actual belief). Thus consistency is very important for a rational thinking process.

However, it is possible to be consistent in several different ways. For example, an alternative, consistent reasoning system is to take the logic of accounting and extend it to auditing. This could result in quite different audit standards from what we have now. There are other logically consistent reasoning systems, but we leave it to others to use these to combine accounting with audit reasoning in a consistent way.

Since this is an audit textbook, we use the logic of audit theory and the standards as our starting points and develop a consistent way of reasoning about accounting issues. That is how we arrived at the RBR principle for dealing with all uncertainties in accounting estimates. Estimation uncertainty can be risks such as AccR or AudR or both, depending on the concept of risk the auditor wishes to focus on. If the uncertainty can be quantified then it is represented by a probability. Risk is the probability associated with an unfavourable event, such as a material misstatement.

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APPLICATION CASE WITH ANALYSIS

Illustration of Audit Risk and Accounting Risk Using Point Estimates of CAS 540

As noted in this chapter, the audit risk concept is a model for dealing with the risks associated with gathering sufficient, appropriate evidence. Risk-based auditing is predominantly evidence based and related to the audit risk model. The audit risk model is considered the heart of traditional auditing theory.

But as noted in Chapters 2 and 3, after deciding if there is sufficient, appropriate evidence, the auditor must decide how best to report the verified facts within GAAP. This interpretive decision based on evidence introduces an important new risk which we call accounting risk. Accounting risk is the uncertainty associated with the need to make forecasts for the many estimates used in GAAP, and is the main item in the estimation uncertainty concept of CASs 540–545.

Some people think accounting risk is already captured within the inherent risk component of audit risk because this seems to be suggested by the definition of inherent risk. Those who believe this have only a superficial grasp of the audit risk concept and are not critical thinkers, not understanding the limitations of the audit risk model and how to apply it properly in practice.

To illustrate why the above claims are true, consider this scenario:

- Your audit client has made an investment of $1 million with the following projected cash flows.

- $100 million, with probability 0.01
- $0 with, probability 0.99

A critical thinker would consider the following items. For each issue listed, offer your conclusion and, even more importantly, give reasons supporting your conclusion. In particular, respond to the question, "why is my answer to this question true?"

1. Is this $10 million investment an asset that should be reported in the financial statements? Why, or why not?
2. What is the business risk associated with this investment? Explain.
3. What is the audit risk associated with this investment? (You can assume that the auditor is convinced based on obtaining persuasive evidence, that the above facts are true.) Explain.
4. What is the inherent risk? Explain.
5. What is the accounting risk? Explain.
6. What is the information risk? Explain.
7. What is the amount that can be recorded under the assets definition of IFRS 4.38 (as quoted above) and *CICA Handbook* section 1000? Does this agree with your response to item 1? Why?
8. What is the best way to record this investment so that it "presents fairly" the economic reality of the investment? Explain why or why not this differs from your responses to 1 and 7.
9. What is the recorded amount for this investment that minimizes accounting risk? What is the information risk using this recorded amount? Do these values agree with your answer to item 8? Why, or why not?
10. If your client insisted on recording this investment at $10 million, would you approve this, as an auditor? What would you document in your working papers?

ANALYSIS

1. No, because of reasons given below.
2. The amount of the investment at risk here is 99% because there is only 1% chance this investment will recover its costs. Would you consider 99% a significant risk per CAS 540, paragraph11?
3. If the auditor is convinced the facts are true, that means he or she has all the evidence needed. Effectively, the audit risk is zero. Now it is a question of trying to decide how to record these facts relative to GAAP requirements. Note that this is the situation of a typical problem in your financial accounting courses: Audit risk is zero because the facts are presumed to be known with certainty, and the only issue is to how to properly report these facts in financial statements.
4. Inherent risk can be anything between 0 and 1 because that relates to evidence-gathering assessment, and we know from item 3 that CR and DR in the audit risk model must be compensated for so that audit risk is 0; specifically, either CR or DR, or both, are 0.
5. Accounting risk is dependent on what is recorded, as discussed below.
6. Since audit risk is 0, the accounting risk is the only source of information risk. Therefore, if we want to minimize information risk we now need to focus on minimizing, or at least bringing to acceptable levels, the accounting risk.
7. Under the HB 1000 (ASPE) and IFRS 4.38 conceptual framework discussed above, by definition an asset must have "probable" future benefits. Many interpret this as meaning "expected" future benefits, especially in the case of fair value accounting for financial assets. Thus, under this reasoning the expected value, which

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also happens to be the amount of the investment, is $1 million, and most accountants would probably say this is the amount to record. A skeptical auditor, however, would have problems with this reasoning, because a skeptical, risk-oriented auditor would realize that GAAP largely ignores accounting risk. Moreover, under CAS 540, paragraph 11 the auditor must assess whether the estimation uncertainties with respect to this expected value represent significant risks.

8. A risk-oriented auditor would consistently consider risks in accounting as well as in auditing. Otherwise, the auditor is not logical, violating a most basic rule of logic relating to consistency in reasoning. Inconsistency is the basis of lies and misleading financial reporting. To better understand the problems associated with handling risks inconsistently, consider the following. Would you accept recording the investment at $100 million and allow management to record a $99 million profit simply by paying out $1 million? Most of you would say no. Those who would allow this need to do a lot of explaining about the realization rules they are following, convincing the others that this is acceptable for financial reporting. Let us assume you say no to the question, probably based in large part on the fact that recording a $100 million asset means an accounting risk of 0.99 for this value. But if you think such a risk is too high, then you should also have problems with recording a $1 million asset, because its accounting risk is 100% (assuming you don't sell this investment in a complete, efficient market before the cash flows start coming in—you can think of this investment as a type of lottery ticket that can't be sold before the payoff date). If the auditor were sufficiently sure that it would be sold before the payoff date (this could be another way to make the "probable" concept of IFRS more consistent with CAS 540 requirements), then recording at $1 million makes sense. (Note, however, how important it is to make your assumptions clear when justifying your conclusion. Critical thinking reminds you of both this and the need to document your reasoning in the working papers.) In contrast, when the auditor assumes management will not sell the lottery ticket, the accounting risk is 0.01 at a value of $0 (and no estimate is recorded in the balance sheet).
9. The accounting risk is minimized when recording a value of zero for investment. To make this more concrete, assume materiality in this case is $ 1million. Anything outside of an immaterial range of zero has an accounting risk of 100% everywhere, except within a material amount of $1 billion, which has an accounting risk of 99%.

In light of the above, if the auditor wishes to control accounting risk to acceptable levels, recording a $1 million asset is unacceptable. To get the accounting risk down to an acceptable level, say, 1%, the auditor would insist on an adjusting entry crediting the investment asset $1 million and debiting either a loss or expense account. Further discussion of these possibilities along with any existing obligations to disclose this investment in the notes to the financials, are covered in Part II (available on Connect).

The above analysis can be summarized with its reporting implications, as follows. These results are so distinct from many allowable GAAP estimates that we shall assign a special term to the reasoning process: risk-based reasoning (RBR). RBR follows logic consistent with that used in statistical auditing. It is a form of principle-based reasoning using logic consistent with that in statistical auditing but now extended to reporting on future events via the accounting risk concept.

It is extremely important to note that the accounting risk is defined relative to the hypothesis of material misstatement. Thus, accounting risk is a type of beta risk as discussed in Chapter 10, but now it is related to a nonsampling error. So, using RBR accounting principles we get the following principles-based accounting for accounting estimates.

SUMMARY OF PART I

In this chapter, we introduced you to the major issues of professional judgment as they relate to the audit of accounting estimates.

- In Part I, we learned about the existing guidance in CAS 540 and AuG-41 and some of the limitations in that guidance. This guidance uses the concept of estimation uncertainty and ways to implement it. For point estimates, the auditor would need to assign probabilities associated with each reasonable outcome, and to make sure that these probabilities are reasonable. For example, the probability that the going-concern assumption will be violated should not be greater than one minus the probability that the going concern assumption will not be violated. If it were, the auditor would be violating basic axioms of probability and would then have to provide good reasons for doing so. This illustrates again that professional accounting standards operate within a broader context of social norms and their constraints.

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- The guidance also introduces the concept of reasonable range, which can be used to help make operational the reasonableness of an estimate by checking to see if it falls within the range the auditor considers reasonable. Any difference between the range and management's estimate would be identified as a misstatement if the estimate is used in the financial statements, because management's estimate is not reasonable. Thus, the guidance provides a key, logical step in identifying a misstatement for an accounting estimate. However, what is missing is guidance on how to get the reasonable range, and whether there should be some kind of constraints or properties associated with reasonable ranges in financial reporting.
- Cockburn seems to be the first to recognize that if the reasonable range is too wide then auditors should consider the financial reporting implications. What is "too wide" a range and how the range relates to estimation uncertainties is left to auditor judgment. To some extent, this approach is sufficient for practitioners because relating things like knowledge about the auditee's business to assessments about risks (see Chapter 5) will be a subjective exercise. Not everything about an auditee can be specified by professional guidance in advance. However, at some point the auditor's reasoning will need to rely on some general principles to link knowledge about the auditee to financial reporting. The reasonable range and estimation uncertainties concepts are good first steps, but as Cockburn suggests, the guidance is incomplete and may lead to unacceptably high diversity in audit judgments on financial reporting for the same fact situations. To help address this problem, Part II (available on Connect) introduces additional concepts and principles that go beyond the current professional guidance. An illustration of why such guidance might be helpful was given in the application case with analysis dealing with point estimates at the end of Part I.

KEY TERMS

accounting risk

mitigating factors

risk-based reasoning (RBR)

EXERCISES AND PROBLEMS

EP 19-1 LO1 Which part of estimation uncertainty concept deals with audit risk? Explain.

EP 19-2 LO2 How does CAS 540 define "reasonable" quantitatively? What are the problems with this definition?

EP 19-3 LO4 Explain the dilemma represented to the profession by the Petroni and Beasley study.

EP 19-4 LO3 Demonstrate with the Petroni and Beasley study data given in the text that AccR can be much bigger in practice than AudR.

EP 19-5 LO4 CAS 540, paragraph13(d)(ii) A93–A94 indicates that auditors can normally narrow a reasonable range until it is less than a materiality wide. Describe under what conditions the reasonable range is NOT likely to be reduced to materiality. Is this condition likely to be common?

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CHAPTER 19

The Audit of Accounting Estimates

Part II: Advanced Issues in the Audit of Accounting Estimates

PROFESSIONAL JUDGMENT AND ITS PROBLEMS

Definition of Professional Judgment per CAS 200, Paragraphs 13(k) A23–A27

LO5 Explain how audit professional judgment differs from accounting professional judgment.

Professional judgment (PJ) is the application of relevant knowledge and experience to the facts and circumstances that are required for making informed audit decisions that are consistent with ethical requirements and CASs (CAS 200, paragraph 13[k]). This definition of professional judgment was introduced to you in Chapter 1. You have also been introduced to concepts of critical thinking and skepticism, as well as other concepts helpful to implementing PJ, as defined above. These additional concepts are needed because accounting and auditing standards in an increasing number of cases rely on defensible professional judgments that go beyond the standards. For example, the Securities and Exchange Commission (SEC) in the United States has proposed what it calls *objectives-oriented accounting standards* for financial reporting. With this new reporting framework, the SEC has specifically identified a needed change in the mindset of accountants: ". . . accountants would be required to focus on the economic substance of transactions and other covered events and exercise their judgment in a manner that maximizes the information conveyed to the market rather than directing their judgments on the question of which standard within the myriad of exceptions and contradictions should be applied. This could constitute a significant change in how many accountants think about and approach their work."[1]

LEARNING OBJECTIVES

After completing Part II of this chapter, you will be able to do the following:

- **LO5** Explain how audit professional judgment differs from accounting professional judgment.
- **LO6** Calculate and evaluate accounting risk for reasonable range.
- **LO7** Use a risk-based reasoning (RBR) matrix to decide if an accounting estimate should be accepted, rejected and disclosed in notes, or rejected and ignored for fairness of presentation of the estimate.
- **LO8** Calculate a benchmark range with insignificant judgmental misstatement risk.
- **LO9** Calculate the RBR summary of the different financial reporting possibilities.
- **LO10** Calibrate a range so that it is reasonable.

CHAPTER APPENDIX

Appendix 19A: A Quantitative Model for Information Risk

1 Securities and Exchange Commission (SEC), 2003, p. 45. Study pursuant to section 108(d) of the *Sarbanes-Oxley Act* of 2002 on the adoption by the United States financial reporting system of a principles-based accounting system July 25, 2003. www.sec.gov.

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As this passage makes clear, reference to GAAP rules will not be sufficient as far as the SEC is concerned. Instead, accountants are expected to decide what best reflects economic substance in each engagement, and to determine the extent to which reporting objectives are being met. This requires higher-level reasoning, an understanding of the different perspectives possible, and being able to interpret and evaluate events relative to these perspectives. In short, critical thinking will be increasingly required of all auditors.

In this part of the chapter, we provide an overview of the problems and their potential solutions, and of suitably implementing professional judgment, especially as it relates to the evaluation of the appropriateness of an accounting estimate. One thing to keep in mind is that all good theories begin with good definitions and clear concepts. We have attempted to do this using risk-based reasoning (RBR) and the principle for reasoning in accounting estimate judgments in Part 1. In this section, we review broader professional judgment issues, including major classes of problems in exercising judgment and the frameworks that have been developed to address these problems.

Before CAS 200, there was no authoritative definition of professional judgment. The CAS definition seems to be greatly influenced by the 1995 CICA professional judgment study.[2] This study was one of the first to use the clarity format, and its findings can be summarized as a framework for professional judgment using the following four elements.

1. CICA 1995 definition of professional judgment: Professional judgment in public accounting is the application of relevant knowledge and experience within the context provided by auditing and accounting standards and rules of professional conduct, in reaching business decisions where a choice must be made between alternative possible courses of action.
2. The goal in developing a framework for professional judgment is to assist auditors in properly exercising judgments in carrying out professional standards, in forming judgments on specific assertions and on financial statements as a whole, and in rendering an opinion as to whether the financial statements are presented fairly.
3. Key concepts for professional judgment are the *audit task environment, auditor characteristics, evidence, the decision-making process in auditing,* and *qualitative attributes of professional judgment.*
4. Principles: Assess the level of assurance needed, assess the materiality, identify the subject matter, assess the accountability relationships, identify the goals of the engagement, and justify the conclusion reached in terms of relevance of the conclusion to the goals and reliability of the conclusion.

Note that the definition of professional judgment in the CICA study is very similar to and has likely influenced the CAS 200 definition. The notable difference is the CICA's focus on business decisions, whereas CAS 200 is more focused on auditor accountability, which includes the accountability to third parties who do not pay the auditor. The above framework is also consistent with critical thinking as discussed in Chapter 3.

We next briefly discuss the five key concepts (*a*–*e*) of professional judgment identified in element three of the CICA study.

The *audit-task environment,* (*a*), relates not only to the needs of clients and users (the accountability relationships) but also to the competitive pressures, the professional standards the auditor must follow, and to specific features of the audit tasks. Specific features of audit tasks include how routine or unusual they are, their complexity, the existence of applicable authoritative guidance, the number of alternative actions, and the consequences of each task.

Auditor characteristics, (*b*), include knowledge, experience, objectivity, integrity, judgmental biases, and professional skepticism. These have been discussed in detail in various parts of this text already.

2 "Professional Judgment and the Auditor," CICA, Toronto, 1995, p. 127.

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Another concept in the professional judgment framework is *evidence* (*c*). There are two key elements to the evidence concept: sufficiency, which relates to the amount or quantitative aspect of evidence, and appropriateness, which relates to qualitative aspects of evidence.

The *decision-making process*, (*d*), is also part of the professional judgment framework. Decision making relates to choosing among alternative courses of actions. There is some overlap between this concept and that of audit-task environment. Decision making involves several key steps:

1. Identifying the crucial issues
2. Gathering information on all the significant assertions
3. Identifying possible alternative courses of action
4. Evaluating the alternative courses of actions
5. Deciding on the best alternative course of action

Note that step one especially involves consideration of the broader context of the audit-task environment, such as the type of accountability needed and who is the accountable party.

From the framework itself, one might get the impression the auditor just needs to follow its steps in a systematic, rational way. This view has been greatly influenced by economists' assumptions that economic decision makers are rational and selfish, and their tastes do not change. From these assumptions, economists have developed what is probably the most influential theory in the social sciences: expected utility theory, which is the foundation of the rational agency theory model introduced in Chapter 1.[3] Expected utility theory is also the theoretical ideal for PJ. From Chapter 3, you will recall that this is a major ethical assumption of economic theory. However, even if this ethical assumption is accepted, the problem in judgment, and not just for auditors but for all people, is that we are not always as rational as we think. This is where the auditor characteristics of PJ, referred to in the third of our five key concepts, can prove to be a major problem in fulfilling the goal of the framework. The issues of *qualitative aspects of PJ*, (*e*), can be summarized as laid out in the discussion below.

Auditors, like all people, are susceptible to judgmental biases because of the use of short cuts or heuristics in the reasoning process. A brief review of such biases from Kahneman follows. One example is the anchoring and adjustment heuristic, in which the first instance of an item or event that comes to mind has a disproportionate influence on judgment. Also, different starting points yield different estimates, each of which are biased toward the initial values. Typically, any adjustments are insufficient.[4] A good example of this bias is an experiment in which people were asked to estimate the percentage of African countries in the United Nations by first spinning a wheel of fortune to get a number between 0 and 100, and then adjusting upward or downward from this number to make their estimates. The median estimate for people getting a 10 on the wheel was 25, and the median estimate for people getting a 65 was 45. Note that this bias occurs because of ignorance or lack of knowledge; if someone actually knew the number of African countries in the U.N, they would not be influenced by such an irrelevant factor as a wheel of fortune result. (How many of you would be influenced to adjust your age based on the spin of a wheel of fortune?) This suggests that if an auditor is truly knowledgeable about a client's business, industry, and economic factors then that auditor is much less likely to be influenced by irrelevant factors.

Another example of a judgmental bias is that first impressions of any new situation tend to have disproportionate influence on subsequent judgments. Behavioural studies have shown that the impression someone makes in the first few minutes of an interview or initial meeting has a lasting impact in the subsequent relationship—an especially significant consideration for job interviewing. For auditors, the anchoring bias that can be created by the client's proposed accounting estimate is a significant concern! It is one good reason why auditors need to be skeptical and to practise critical thinking while being aware of potential judgment errors.

3 See Daniel Kahneman's useful survey of the literature in *Thinking, Fast and Slow,* (New York: Farrar, Straus and Giroux, 2011).

4 Kahneman, *Thinking,* p. 427.

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Another example of a judgmental bias is that the representativeness heuristic is that of estimating a probability that event A originates from process B. Such probabilities are typically built on an evaluation of the degree to which A is representative of B; that is, by how much A resembles B. To illustrate, imagine that "a person named Steve is described as shy, withdrawn, and helpful, but as having little interest in people or the world of reality," and then, "assess the probability that Steve is a farmer or librarian."[5] Chances are you would guess that Steve is a librarian. But the fact that there are many more farmers than librarians in the population should be considered in estimating the probability that Steve is a farmer. For this reason, it is more likely that Steve is a farmer. In other words, the base rates or prior probabilities can be ignored when using the representativeness heuristic. This phenomenon also explains why many diagnostic medical procedures result in so many "false positive" results. Even when a diagnosis is, say, 90% accurate it does not mean a positive result indicates you have a 90% chance of having the disease. The 90% statistic applies to people actually having the disease. With a relatively rare disease, a positive result still means that you have a low (but higher chance than without the result) risk of actually having the disease.[6] The representativeness heuristic illustrates that stereotypes can affect your probability judgments, such as inherent risk assessment based on assessments of people's capabilities using erroneous stereotypes (e.g., stereotypes about occupations in the Steve problem). Even the concept of audit risk assumes the worst possible state—that there is material misstatement and that the auditor fails to detect it. There is a reason for this. Most audits do not involve material misstatements, so to prevent auditors from being overly optimistic when there are material misstatements, the audit risk model is used to help compensate for this optimism bias. The concept of skepticism has also been introduced to help counteract auditor overconfidence. Later in this chapter, we learn about calibration techniques to counter overconfidence in assessing accounting estimates.

Yet another judgment bias is the availability heuristic: the prediction that people estimate frequency or probability by the ease with which instances or occurrences of the event can be brought to mind. The ability to do this may depend not only a historical frequency but also on such factors as familiarity, saliency, interval since occurrence, imagery, and the effectiveness of a search test. Events that are familiar, salient, easy to imagine, and so on are likely to be judged as occurring more frequently than are events that do not possess these characteristics.[7] As a result, auditors may base their conclusions on data that are easy to access rather than the most appropriate data for the decision at hand. You saw a prime example of this in the Hall et al. article in Chapter 10 on the dangers of haphazard sampling: the influence on auditors of accessibility, flashiness, and size of judgmentally selected items.

A related example is that of giving more weight to vivid information, such as on meeting a person, rather than on pallid information that may be more relevant, such as a letter of reference from someone who is better able to evaluate that person's performance on the job. Note that the key issue here is the relevance of the information as opposed to the vividness of it. The expression "a picture is worth a thousand words" captures this effect. Vividness can overwhelm relevance, as studies reviewing court decisions illustrate. For example, there is much social psychology data showing that the attractiveness of people, such as celebrities, influences not only the chances that they will be found guilty but also the severity of the punishment when they are found guilty; the more attractive the person, the less likely they are to be found guilty, and the less severe would be the punishment. (Think of the celebrities who have been taken to court recently—did they get harsh sentences?)

Keep these heuristics in mind as we go through the rest of this book, and try to understand where audit reasoning can fail. For example, a common "anchor" in auditing is last year's audit file. Too many auditors use last year's file in a mechanical, unthinking way to

5 Kahneman, *Thinking,* p. 7.

6 Ian Hacking, *An Introduction to Probability and Inductive Logic,* (Cambridge: Cambridge University Press, 2001).

7 Kahneman, *Thinking,* p. 425.

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get them through the current year. The professional judgment problem this may cause is that auditors may not adjust their audit plan sufficiently for their client's changed circumstances. Auditors may tend to ignore negative evidence that does not conform to their (last year's) expectations. This is why constantly checking one's assumption (a form of skepticism and critical thinking) is a good way of maintaining one's professional skepticism. Also, making the assumptions more explicit by documenting them will remind auditors to reconsider their assumptions in light of changed circumstances.

Other biases include the hindsight bias, which is the tendency to exaggerate the inevitability of causal sequences, and the endowment effect, which is the tendency to value what we have because it is ours, regardless of its intrinsic value. Judgments are also greatly influenced by the framing effect: an unjustified influence of the beliefs and preferences on which a problem is formulated. For example, the positive approach to statistical hypothesis testing discussed in Chapter 10 will not automatically provide the assurance the auditor may expect from a test. A more subtle and pervasive version of this problem is the burden of proof concept introduced in Chapter 3. For example, do auditors need to proactively prove that the going-concern assumption is true? The going-concern assumption is a working assumption of GAAP (like the monetary unit assumption which assumes the inflation rate is not sufficiently high to significantly distort financial reporting). Traditionally, auditors accepted the going-concern assumption (and other accounting assumptions underlying accounting principles) as true, and worried about it only if audit evidence indicated to the contrary (i.e., a type of negative assurance was thus provided). However, more recent standards (CAS 570, paragraph 06) require auditors "to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern." (This more proactive approach was evident in the Boritz exhibit [Exhibit 19–2] in Part I.)

The words and accounting chosen to describe a reporting situation have what is called a framing effect. For example, calling an avoidable loss an expense makes this use of auditee resources seem more legitimate. Another example is the distinction CAS 200 now makes between compliance reporting framework and fair presentation frameworks, indicating that there is a difference. However, further clarification that would result from an actual definition of the meaning of "present fairly," as used in the auditor's report, could have a big impact on audit practice. In the meantime, we will use acceptable accounting risk and the RBR principle to help decide when an accounting estimate can be considered to present fairly.

Other judgment errors that research in psychology has identified and auditors should be aware of include confirmation bias, which is the tendency of people to seek data compatible with their beliefs, and the halo effect, which is the tendency to like or dislike everything about a person, including things not observed.[8] Confirmation bias is particularly important for auditors because it makes them less skeptical. To counteract this bias, auditors should consider alternative explanations for their findings and actively search for evidence that may not support their conclusions. Note that such a thorough approach would require considerable independence on the auditor's part, something akin to the independence public sector auditors have over their auditees.

A fundamental source of error in human judgment is emotion, but emotions are also what make us human. They are important in reasoning because they help shape the basic goals of reasoning and influence intuition. The primary role of the emotions seems to be in the ranking of objectives that trigger thinking and actions.[9] Emotions are indispensable in coordinating the various mental modules that make up human reasoning.[10] This helps explain why the mind does not always seem to follow rules of logic.

Formal logic can result in trivial truths and yet miss consequential ones. Kahneman discussed how we might not even be conscious that most of the heuristics and influences

8 Kahneman, *Thinking,* pp. 81–83.

9 S. Pinker, *The Stuff of Thought,* (New York: Viking, 2007).

10 Ibid, *Stuff,* p. 70.

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affecting us.[11] Emotions influence the meaning of words and language and the understanding of them in specific contexts. Our minds link emotions with words, gestures, memories, and ideas, which, in turn, trigger other ideas in a coherent way, and we make sense of the world through combinations of ideas that create a coherent story. Our minds maintain and update a mental model of our personal world consisting of various types of associative links in a vast network of various types of ideas. Our remembered selves take the form of stories about ourselves. Everyone cares about the narrative that their lives represent and whether it makes for a good story. All this can impact how we process information, including audit evidence! But we do have a more rational and conscious side that makes it possible to reason with others even when we disagree with them. This rational side helps us stay in touch with reality and aligns our preferences with our interests and values. This more deliberate system requires effort; for example, deciding the right way to frame a problem rather than just following our intuition, as sometimes our intuition can be wrong, as many visual and mental illusions demonstrate. The need to complement intuition with a more systematic approach is why individuals and organizations make use of models, procedures, and checklists in making decisions. It is also the reason professional standards exist and why we introduce RBR, including how to apply it to point estimates as well as reasonable ranges. The next section introduces further refinements for professional judgment frameworks.

The judgmental biases are important because they affect all professional judgment as well as everyday practical reasoning. In fact, the study of logic probably began in the first place when ancient philosophers became aware of the existence of judgmental biases more than 24 centuries ago. Con artists and fraudsters are intuitively aware of these biases and exploit them to deceive people, including auditors. There are four main ways to counteract these biases: (1) being aware of them, (2) consulting with others (e.g., several people being involved in an interview help achieve a more objective interview process (the brainstorming process of CAS 240 allows auditors to more objectively assess fraud risks), (3) documenting one's reasoning so that the hidden assumptions become more apparent, and (4) being knowledgeable about the subject matter (e.g., industry specialization and good knowledge of the client's business). Another audit decision aid is to use models or theories relevant to the audit, such as statistical sampling, to counter the problems of haphazard sampling. Or, as the Hall et al. reference in Chapter 10 recommends, obtain de-biasing training before applying haphazard sampling. Hall is now arguing, based on his research findings, that such training be required by audit standards.

The five steps in the CICA professional judgment study essentially involve arguing for a conclusion. How do we know the best conclusion (best course of action) has been reached? That is the purpose of justification in decision making. Justification via argumentation has been covered in Appendix 3A.

The next section reviews a more specialized judgment framework for accounting estimate decisions, which is intended to further assist auditors in avoiding judgment biases and errors.

Tentative PCAOB and CIFiR Frameworks for Auditing and Accounting Professional Judgments

The SEC established the Advisory Committee on Improvements in Financial Reporting (CIFiR) in June 2007 to "examine the U.S. financial reporting system with the goals of reducing unnecessary complexity and making information more useful and understandable to investors." In February 2008, an advisory panel of the PCAOB discussed a proposal of CIFiR relating to accounting and auditing judgments. The key excerpts from the meeting are given in the box that follows.

11 The following discussion is based on concepts found in Kahneman, *Thinking*, 2011.

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FINANCIAL REPORTING ISSUES THAT A FRAMEWORK MAY HELP ADDRESS, AS SUGGESTED BY CIFIR'S PROGRESS REPORT

- Investors' lack of confidence in the use of judgment
- Preparers' and auditors' concern regarding whether reasonable judgments are respected
- Lack of agreement in principle on the criteria for evaluating judgments
- Concern over increased use of "principles-based" standards

CIFiR's progress report states that "[t]here are many categories of accounting and auditing judgments that are made in preparing financial statements, and a framework should encompass all of these categories, if practicable." The framework describes the following categories of *accounting judgment:*

- Selection of accounting standard
- Implementation of an accounting standard
- Lack of applicable accounting standards
- Financial statement presentation
- Estimating the actual amount to record
- Evaluating the sufficiency of evidence

Accounting Judgments

CIFiR's progress report proposes a framework for accounting judgments consisting of two components, (1) a *critical and good faith thought process* and (2) *documentation.* The report describes those components as follows:

Critical and Good Faith Thought Process

Professional judgment should be based on a critical and reasoned evaluation made in good faith, prior to the exercise of the judgment, of an identified issue, including the nature and scope of the issue based on the following:

1. An analysis of the transaction, including the substance and business purpose of the transaction
2. The material facts reasonably available at the time that the financial statements are issued
3. A thorough review and analysis of relevant literature, including the relevant underlying principles
4. Alternative views or estimates, including pros and cons for reasonable alternatives
5. The rationale for the choice selected, including reasons for the alternative or estimate selected and linkage of the rationale to investors' information needs and the judgments of competent external parties
6. Linkage of the alternative or estimate selected to the substance and business purpose of the transaction or issue being evaluated
7. Known diversity in practice regarding the alternatives or estimates
8. The consistency of application of alternatives or estimates to similar transactions
9. The appropriateness and reliability of the assumptions and data used

The critical thought process should include input from personnel with an appropriate level of professional expertise and should include a sufficient amount of time and effort to properly consider the judgment (see Chapter 3 for other aspects of critical thinking).

Material issues or transactions that were analyzed pursuant to the application of the framework should be disclosed in accordance with existing disclosure requirements. This disclosure should be transparent so that the investor understands the transaction and assumptions that were critical to the judgment. When evaluating professional judgment, auditors, and/or regulators should take into account the disclosure relevant to the judgment.

Documentation

The alternatives considered and the conclusions reached should be documented contemporaneously. The lack of contemporaneous documentation may not mean that a judgment was incorrect, but it would complicate an explanation of the nature and propriety

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of a judgment made at the time of the financial statement release. This guidance is intended to discourage unnecessary diversity in judgments by requiring the justification of the judgments.

CIFiR also proposed that PCAOB adopt a similar framework for auditing judgments. PCAOB suggested that this framework focus on determining and evaluating whether sufficient appropriate evidence was gathered in order to render an audit report. Overlapping with accounting judgments reference is made to, "evaluating judgments made by management in determining accounting estimates." In this part of the chapter, we treat estimates as an accounting judgment, and it is according to this definition, that auditing judgments are essentially covered in the rest of the text.

Accounting judgments are increasingly coming into prominence in 21st-century auditing. This is made clear in an article by J. Schmutte and J. R. Duncan.[12] This article builds on the CIFiR framework for professional judgment in auditing, with a focus on evaluating the reasonableness of accounting judgments. Accounting standards provide the general framework but audit standards determine the adequacy of evidence "to support the estimates and reach a conclusion on the actual valuation amount."[13] To make this more operational in practice is one goal of this chapter. To do that we will need to introduce some new concepts and clarify existing ones used by Schmutte and Duncan. The article puts great stress on documentation—the key criterion is documentation that an "experienced auditor" could follow. This includes a complete record of the judgment process and factors considered. Use of a novel form of conceptual analysis that the average experienced auditor could not follow should be explained and documented. The article covers the need for documentation to be persuasive in case it is challenged (auditor accountability), the importance of reasoning by analogy, the importance of what we called *moral imagination* (here restricted to visualizing alternative accounting treatments, to prevent the existing treatment from creating an availability heuristic bias as discussed above); and the importance of review for consistency of treatment of prior, similar transactions—there must be good reasons for the deviation (e.g., a logical barrier is needed, such as the RBR acceptability of risk criterion to prevent a slippery slope fallacy allowing ever more deviations from the existing treatment).[14] The factors in accounting PJ are summarized and illustrated in the article's Exhibit 2, which is reproduced in part below as Exhibit 19–5.

EXHIBIT 19–5 Illustrative Example

The CEO of a medium-sized, privately held corporation informs the controller that she has just agreed with a shareholder to repurchase the shareholder's stock at a fixed price over a four-year period. The CEO states that she does not want the agreement to negatively affect the company's financial position due to the company's debt covenants. Below are the proper factors the controller must consider in making a sound judgment.

JUDGMENT DOCUMENT FACTOR	CASE EXAMPLE
1. Does the transaction make sense?	The motivation behind the transaction is the shareholder's desire to convert his investments into more liquid assets for estate planning purposes and the CEO's desire to limit new shareholders.
2. Do we have all the facts?	Obtain a copy of the agreement to determine the specifics related to the planned transaction, and ascertain from the CEO whether there are any "side agreements" related to the transaction. Determine the planned subsequent treatment of the reacquired shares (i.e., is the intent to retire the stock or hold it as treasury stock?).

12 J. Schmutte and J. R. Duncan, "A model for accounting and auditing decisions, *CPA Journal,* Sept. 2009, pp. 32–35.

13 Schmutte and Duncan, "Model," p. 33.

14 Schmutte and Duncan, "Model," p. 35.

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EXHIBIT 19–5 Continued

3. What does the literature say?	Review authoritative literature, such as SFAS 150–debt/equity, ARB 43–treasury stock, SFAS 47–disclosure of long-term obligations, and FASB Concepts Statement 5. Use the search capabilities of the FASB Accounting Standards Codification.
4. Are there any alternative treatments?	Consider possible accounting treatments, such as: 1. A treasury stock transaction 2. A forward purchase agreement 3. A stock retirement 4. A reverse stock subscription 5. No financial statement recognition, but disclosure as a commitment
5. Are there any alternative or unique industry practices?	There do not appear to be any alternative or unique industry practices.
6. Did we consult with any experts?	As the legality of stock repurchase and treasury stock transactions varies across jurisdictions, the agreement should be reviewed by legal counsel. In addition, the company's auditors may be consulted after preliminary research.
7. Why was this alternative selected?	The agreement appears to fall under the guidance of SFAS 150 (as amended by FSP 150-3). A liability is required to be recorded with an offsetting charge to stockholder's equity.
8. Have we made all the relevant assumptions, and how reliable are they?	As the proposed treatment requires measuring the liability at the present value of the future cash flows, the rate of interest needs to be assumed. Propose using the corporation's incremental borrowing rate.
9. Does it all make sense?	Regardless of the desired reporting impact, the corporation has, in fact, incurred a liability. The primary users (creditors) have an interest in the corporation's obligations. The equity account charged must be consistent on both an accounting and legal basis.
10. Is the proposed treatment consistent with similar past transactions?	There have been no similar prior transactions between the corporation and its shareholders.
11. Have we put enough time into this issue?	All of the previous steps likely employ significant time and effort. The documentation reflects the time and analysis devoted to the issue.

Source: J. Schmutte and J. R. Duncan "A model for accounting and auditing decisions, *CPA Journal,* Sept. 2009, Exhibit 2.

CAS 540 and the judgment frameworks appear to need the most guidance in linking concepts, such as significant risks and fairness of presentation to probabilities and other measures of uncertainties. This is reflected in item 8 of the judgment document factors in the exhibit. If, as in statistical audit sampling applications, a more formal model and theory is used, then it is better to start with a quantitative model because that would clarify all the underlying assumptions; the model thus "frames" the problem. Since the assumptions of such quantified models are explicit, the auditor can more easily evaluate whether the assumptions are reasonable. In addition, after using the model to identify the quantitative effects of a decision, it is easier for the auditor to then add the qualitative considerations in order to facilitate an overall, combined consideration of qualitative and quantitative factors. This was illustrated in Chapter 10, with the statistical sampling applications, and in the critical thinking of Appendix 3A. Note that most of the factors above are qualitative, and this may explain why standards and this text are largely qualitative in nature. But this should not undermine the fact quantitative models can assist in more objectively evaluating qualitative factors and in indicating where existing concepts may need clarification. In Part I, you already saw how this can work for accounting point estimates, and next you will see how quantification of uncertainties can be made feasible when working with ranges. But first, it is important to understand the unique nature of accounting uncertainties when dealing with reasonable ranges of CAS 540.

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MODELLING THE ESTIMATION FROM REASONABLE RANGES

LO6 Calculate and evaluate accounting risk for reasonable range.

Beaver[15] and others, reviewed above, indicate that the problem of reasonable ranges Cockburn (Part I)[16] wrestles with can, at least in part, be attributed to the fact there is no probability associated with the reasonable range. In other words, reporting with reasonable ranges is not risk based like auditing is risk based. More generally, accounting is not risk based like auditing is risk based. While there are several ways of resolving this to avoid the inconsistency, since this is an auditing text we do so by extending risk-based auditing logic to risk-based reporting logic.

To do this with reasonable ranges, we have to make some assumptions about the probability associated with them. The case of point estimates has already been discussed using the lottery ticket example (Part I). The general problem of probabilities with ranges can be summarized via confidence intervals. You can think of a confidence interval as a range (the interval) and its associated probability (the confidence level). Note that this concerns the risk of failure to predict future outcomes correctly, which is quite different from the risk of failing to detect factual misstatements about past events in a population, the objective of evidence-gathering procedures covered in earlier chapters of this text. To keep track of this distinction, we refer to evidence risk of introductory auditing as *AudR* (i.e., *audit risk*) and the risk associated with material forecast errors (material difference between an estimate involving future events and its outcome) as *accounting risk (AccR)*. As in the application case exercise in Part I of the chapter, it is important to remember that audit procedures, and the risks associated with them, are not likely to affect client business risks, whereas AccR is largely geared to reflect business risks of the auditee (e.g., think of the going-concern issue discussed near the beginning of this chapter). Thus, at first approximation, we can treat AudR and AccR as largely independent, and the assessments of them can be done independently. Another good reason for thinking of them independently is that when discussing accounting estimates with the auditee, the auditee management will be viewing estimates in terms of AccR only. Why? Because the auditee most likely presumes to know the facts about their organization and its business risk, and the issue for them is how to properly report it. For example, see the application case at the end of Chapter 4 for a discussion of fairness of presentation. AudR is something that is relevant to you the auditor but not to your auditee.

You have to be aware of these different perspectives in order to understand how your auditee is likely to frame the reporting problem. Of course, you as the auditor have to consider both AudR and AccR and somehow combine them using your professional judgment, as is required by the CAS 540 concept of estimation uncertainty. As they are largely independent of each other, AudR and AccR can be dealt with separately. In fact, most audit textbooks deal only with AudR and totally ignore AccR because they effectively presume AccR is a financial reporting issue to be covered in financial accounting. So, when talking and negotiating with your client about accounting estimates, you are likely to agree about the facts (assuming you have gathered sufficient appropriate audit evidence to make AudR acceptably low) and the contentious issues are likely the assumptions and predictions made about the future outcomes in developing the accounting estimates. This is why this chapter focuses on AccR.

The AccR for the AuG-41 example discussed in Part I can be summarized using a probability distribution as in Exhibit 19–6 which assumes the familiar normal distribution as a starting point.

The first thing to notice about Exhibit 19–6 is that it has a lot more complexity than Exhibit 19–4 in Part I of this chapter. The reasonable range of 130–160k from the AuG-41 illustration is now represented as the shaded rectangle. If we want to see the probability associated with this range, we have to make an assumption about the distribution of all possible future outcomes (e.g., possible present values that might be realized, depending on future events such as cash flows). Exhibit 19–6 assumes a normal-based distribution

15 W. H. Beaver, "Problems and paradoxes in the financial reporting of future events," *Accounting Horizons,* December 1991, pp. 122–134.

16 D. J. Cockburn, "At home on the range," *CA Magazine,* Vo. 125, No. 5, May 1992.

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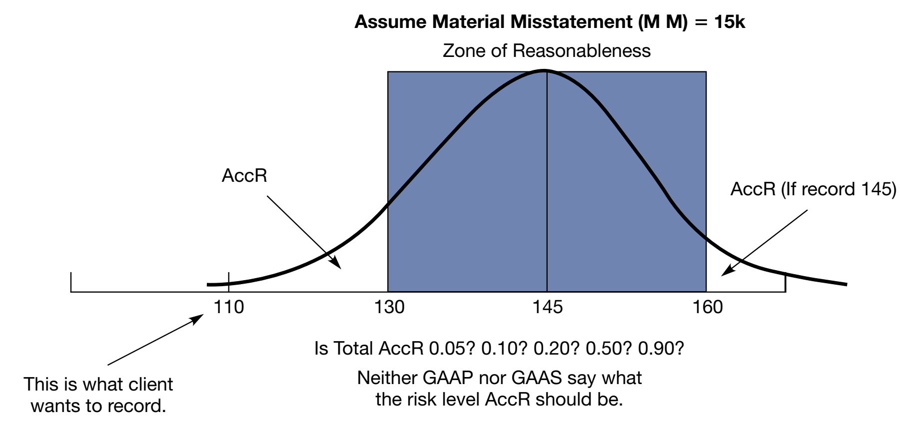
EXHIBIT 19–6 Uncertainty Made Explicit in the AuG-41 Example



that is centred at the midpoint of the reasonable range. The shaded part of the distribution in the rectangle represents the probability associated with the range. If this was a sampling distribution, this shaded part would be the confidence level associated with the range. If, in addition, you were willing to make an assumption about materiality, as in Exhibit 19–6, then you could also calculate the probability of a material misstatement for any number. Since these probabilities relate to differences between future outcomes and current estimates, they relate to AccR, as we defined it above.

Exhibit 19–6 also graphically illustrates what is involved in the calculation of AccR, assuming that the client wants to record 145k as the estimate. Note that with the normal distribution, the possible future amounts extend infinitely in both directions, but the chances of actually realizing any of the values far from the mean of 145k drops off rapidly. It is the area under the distribution that represents the probability. Thus, just by glancing at Exhibit 19–6, you can see that the probability of material misstatement (area under the two tails outside of the shaded rectangle) is small relative to the probability of no material misstatement (shaded area under the curve). Keep in mind that these probability calculations assume the client records at 145k. This 145k point estimate is an example of what Beaver means by "a format that is deterministic in appearance . . . because a single number creates the appearance of certainty when it does not exist."[17] If the client had recorded any other value as the estimate, if the normal distribution had a different variance or mean, if you used a different materiality, or if you used a different probability distribution (e.g., the discrete distribution in the lottery ticket example) the probability calculations would change as well. We are talking about a potentially complex environment here, which is why the profession seems to be having problems with this issue, even at the most general conceptual basis.

You may wonder whose distributions these are. CAS 540 now suggests they are the auditors, either directly modelled by the auditor or relied on through use of specialists, such as actuaries. How else can the auditor decide if estimation uncertainties represent significant risks? (But then the auditor has the responsibility to tell the actuary or other specialist how to calculate the AccR associated with the estimates coming from their models.)

Let us take a point in Exhibit 19–6 where we can get a reasonable approximation of AccR. Assume that the client is willing to take an adjustment to 130k, the auditor is interested in determining what the AccR for the adjusted amount of 130(k) is. Again, just glancing allows you to guess the approximate value of AccR at 130k. If you answered 0.5, then you are correct. To estimate AccR, ask yourself what the probability is that future outcomes would be materially different from the proposed estimate of 130k. To answer this, mentally

17 W. H. Beaver, "Problems and paradoxes in the financial reporting of future events," *Accounting Horizons,* December 1991, pp. 122–134.

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add and subtract materiality (15k) and see how much of the distribution is outside this materiality rectangle. For a two-sided risk, you consider the parts of the distribution on both ends of the rectangle. Thus, the main concern is with the right-hand side. Material differences from 130k start at 145k, which is the midpoint of the distribution. And since the normal distribution is symmetrical, we know that this region is 0.5; that is, half of the total distribution. The AccR is then roughly 0.5, and somewhat larger than 0.5. (Using the table for the standardized normal distribution, for values below 130k − 15k, we can see that a very small part of the total area under the curve is in the left-hand tail. In fact, it is so small that even a standard normal distribution table to 4 decimal places gives a value of zero.) The normal is widely used in practice; for example, the Black-Scholes option pricing model in finance is based on it. However, for our purposes of illustrating the basic RBR principles, this method of calculating AccR is unnecessarily complex and we will be using a much easier method as discussed a little later on. Before we get there, we need to dig a little further into the concepts underlying the reasonable range idea of AuG-41 and CAS 540.

We want to briefly examine how an auditor gets a reasonable range, as in AuG-41 and CAS 540. It is done through knowledge of the auditee's business and research on the auditee's industry and broader economic environment, considering such things as interest rate, inflation rate, price of inputs such as commodities, and exchange rates in currencies. Note that a lot of these things are totally out of the auditor's and auditee's control. This is why we can fairly safely say that AudR and AccR are independent of each other, at least as a first approximation. By the way, if you did not acknowledge that AudR and AccR are largely independent of each other then you could just model AccR as part of inherent risk making AccR part of AudR already and we would not need this chapter! But since auditors do not control such things as interest rates and commodity prices, we need to continue.

Assume that you, as an auditor, were auditing an auditee who had to make an accounting estimate closely tied to the future price of oil. Your auditee provided one-year guarantees to its clients to provide oil at a specified price, and the client had to estimate the cost of this guarantee in order to recognize the revenue from it. The price of oil today is $105/barrel and the guarantee was sold at $120/barrel. You estimate based on predictions as of May 6, 2012, that oil can range from $50 to $150 per barrel. How did you get this range? You checked industry, economic, and political forecasts, as is suggested in Chapter 5 regarding obtaining knowledge about the auditee's business, and found that they varied. Note that you as an auditor have no impact whatsoever on the future price of oil no matter how many audit procedures you perform. All you can do is try to accurately predict the future oil price (or, more realistically, the range of prices). Your auditee client does the same.

If you are as mathematically inclined as the people in finance, you might try to develop a probability distribution as in Exhibits 19–6 or 19–7 (i.e., a math model of the estimation uncertainty, which will get you the reasonable range. You might want to call on a knowledgeable specialist in the field, but even with just one of the specialist's probability distributions, there are many possible ranges. You the auditor, not the specialist, must still decide what is the "most reasonable" range given what you know about audit and accounting theory. In other words, you must do some critical thinking!

Without digressing too much, note that the word "reasonable" as used in CAS 200, paragraph 13 (m) should be logically consistent with the "high" level of assurance provided by an audit. Let us set a specific number to be absolutely clear; say, reasonable is 95%. This means your reasonable range should capture 95% of the probability distribution. For example, if this represented the distribution of the price of a barrel of oil looking one year ahead, then you expect that 95% of all future outcomes of oil prices will fall within this range. This distribution is the "economic reality" of the effects of potential future oil price changes, at least as it would be represented financially (which is what matters to the auditor). Furthermore, to be consistent with the IFRS's new conceptual framework, paragraphs 4.37 to 4.38, the range must be a "faithful representation" of the distribution and must be "neutral." This would be best accomplished for a symmetric distribution like the normal distribution in Exhibit 19–6 by centring the reasonable range at the middle of the distribution (i.e., at the mean of the normal distribution). Further discussion of these issues is left for the questions at the end of this chapter.

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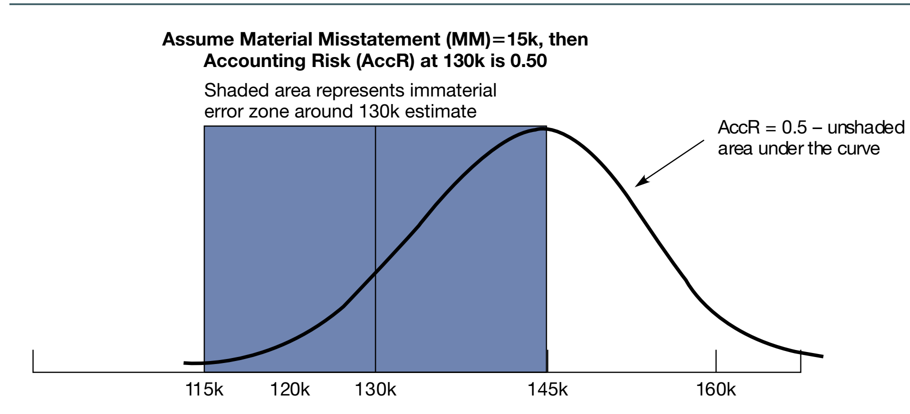
EXHIBIT 19–7 Uncertainty Made Explicit in the AuG-41 Example



Although you may be most familiar with the normal distribution from your statistics course, in this chapter we will focus for a variety of reasons on using the uniform distribution to calculate AccRs associated with reasonable ranges.

The Uniform Distribution Assumption for the Reasonable Range

The distribution we will focus on here is the uniform distribution. There are two reasons for this:

1. It requires no tables or formulas other than working with relative lengths of line segments (the ranges of future outcomes).
2. It is consistent with current standards concerning reasonable ranges.

Let us start with the second reason. CAS 540, paragraphs A93–A95 state, "When the auditor concludes that it is appropriate to use a range to evaluate the reasonableness of management's point estimate (the auditor's range), paragraph 13 (d) (ii) requires that range to encompass all "reasonable outcomes" rather than all possible outcomes. The range cannot be one that comprises all possible outcomes if it is to be useful, as such a range would be too wide to be effective for purposes of the audit." The quote indicates that the auditor only needs to consider reasonable outcomes; that is, reasonable assumptions about the future. All other possible assumptions can be ignored, as implied by CAS 540. Further reinforcing this approach is the wording in AuG-41, paragraph 29: "In determining the amount of the misstatements to be aggregated with respect to a management estimate. The auditor considers the "closest reasonable estimate," which may be either a range of acceptable amounts or a point estimate, if that is a better estimate than any other amount." This quote suggests point estimates be used if they are clearly better than any other amount. But this implies that if no point estimate is better than any other amount, then all the values in the reasonable range should be equally likely. This combined with the range needing to encompass all reasonable outcomes rather than all possible outcomes suggests use of a uniform distribution that has these properties. Finally, the nature of audit evidence and audit estimates is such that it may be cost effective for an auditor to only get an idea of the reasonably high and reasonably low values for a range of possible estimates. In this case, the uniform is the ideal distribution to represent the estimation uncertainty from accounting risk.

The uniform distribution is a symmetrical distribution with mean at its midpoint but discontinuous distribution at its endpoints. It can be represented as a rectangular-shaped distribution over the length of the reasonable range. The calculation of AccR with a uniform distribution and an endpoint value of 130k from the original Figure 1 example in AuG-41 is illustrated in Exhibit 19–8.

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EXHIBIT 19–8 Accounting Risk (AccR) Made Explicit in the AuG-41 Example

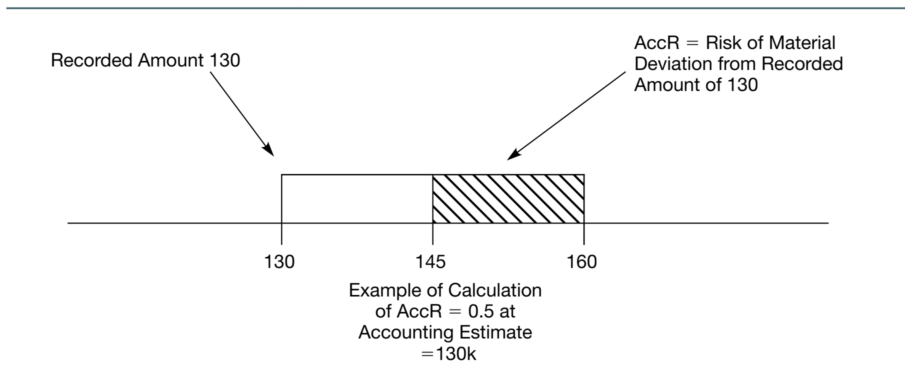

Exhibit 19–8 illustrates the calculation of AccR at 145k if the uniform distribution is used to calculate the AccR at 130k. We see that the results are very similar to the normal distribution discussed above, even though this simplified uniform is easier to work with it. In a uniform distribution, the probabilities are presented as easy-to-calculate areas of rectangles. But an even greater simplification is possible. Note height, h, of a rectangle is constant. To get the probability of the shaded area in Exhibit 19–6, one simply calculates the probability mass as follows: area of shaded area = h × (160 − 145) and probability of total reasonable outcomes is h × (160 − 130). Thus, the AccR probability calculation for 130k is (h × [160 − 145])/(h × [160 − 130]), and after eliminating common terms we get (160 − 145)/(160 − 130) = 0.50. Thus, the AccR calculation is a fairly straightforward task of comparing relative lengths of line segments. All you need is some high school algebra to get a quantitative measure of the AccR.

We next present a more complete review of AccR calculations using the uniform distribution. These are given as a series of exercises below.

Illustrations of Accounting Risk Calculations

The following examples have been developed to give you a better intuition on how RBR can be used with "reasonable ranges" that help address the concerns of Cockburn 1992. We progress from the simple to the more complex issues using the AuG-41 example in paragraph 30 as our base. (This same example was used in U.S. standards, indicating that it is representative of the fundamental problem facing auditors in verifying the "reasonableness" of accounting estimates.)

Key assumptions from AuG-41: the auditor identifies a reasonable range of 130–160k; considers nothing inside the range to be a misstatement, only numbers outside the range are; ignores accounting risk (uncertainty due to forecast errors) and misstatements are treated as factual.

Additional assumptions include that the auditor assesses materiality of 15k and uses RBR reasoning. Using RBR means that the auditor has to make an additional assumption about the forecast error distribution. The definition of reasonable range in AuG-41 allows that all future realizations can take place only in the range 130–160k, and all values in this range are equally likely. Thus, the uniform distribution defined over 130–160k is a reasonable assumption to make, both regarding the future values that will actually be realized and as a basis for calculating AccR for any recorded amount.

With the above assumptions made explicit, we can now calculate the various accounting risks (AccRs) discussed in this section. The list that follows is a series of exercises in calculating the AccRs using the above assumptions. The exercises are listed in order of increasing difficulty. At the end, you are given the answers to all the exercises. If you do not understand them, then you have not yet mastered the basic concepts of thinking with reasonable ranges using RBR.

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Exercise 1: What is AccR for the client-recorded amount of 110k? What is the misstatement of this recorded amount under AuG-41? Note that the misstatement at 110k is material under AuG-41 definition of misstatement.

Exercise 2: What is AccR for a recorded amount of 125k? What is the misstatement of this recorded amount under AuG-41? Note that the misstatement at 125k is not material under AuG-41 definition of misstatement.

Exercise 3: What is AccR for a recorded amount of 130k? What is the misstatement of this recorded amount under AuG-41?

Exercise 4: What is AccR for a recorded amount of 140k? What is the misstatement of this recorded amount under AuG-41?

Exercise 5: What is AccR for a recorded amount of 145k? What is the misstatement of this recorded amount under AuG-41?

Solutions to exercises:

Exercise 1: AccR = 30k/30k = 1.0. AuG-41 misstatement = 20k, which is greater than materiality (15k) and, therefore, unacceptable. Note that if the client would refuse to make the correcting entry, then this 20k misstatement could be considered intentional and, thus, potentially fraudulent under CAS 240.

Exercise 2: AccR = 20k/30k = 2/3. Aug-41 misstatement = 5k, which is immaterial.

Exercise 3: AccR = 15k/30k = 1/2. AuG-41 misstatement is zero.

Exercise 4: AccR = 5k/30k = 1/6. AuG-41 misstatement is zero.

Exercise 5: AccR = 0/30k = 0. AuG-41 misstatement is zero.

The calculations above, with the uniform distribution, show that the AccRs can get quite high, at least in theory. This illustrates that there can be significant risks in estimation uncertainties of CAS 540, paragraph 11, as discussed above. They also indicate that AccR for estimates using reasonable ranges can be controlled the same way as for point estimates in the application case for Part I: Make an adjusting entry to an estimate that results in acceptable AccR. For example, in the above exercises, if the client wants to use an estimate of 125k and the auditor aims for an acceptable AccR of 1/6, then the auditor should insist on an adjusting entry crediting the allowance account at least 15k and debiting bad debt expense by the same amount. Crediting the allowance account 15k will increase it from 125k to 140k, and this will have the effect of reducing AccR from 2/3 to 1/6 (see calculations in exercises above). With this particular set of assumptions, the auditor can even reduce AccR to zero by crediting the allowance with 20k.

This illustrates how dealing with AccR based on reasonable ranges is done through appropriate adjusting entries and, more generally, through proper financial statement disclosures. You are now equipped to understand how RBR principle can be used to help identify the different types of appropriate disclosures of financial reporting, specifically the three generic alternatives first identified in Beaver (1991). This is covered through the concept of the RBR matrix discussed next.

THE RBR MATRIX

LO7 Use an RBR matrix to decide if an accounting estimate should be accepted, rejected, and disclosed in notes, or rejected and ignored for fairness of presentation of the estimate.

Up to this point, you may have been finding it somewhat confusing to keep track of the many potential probabilities that exist regarding AccR. From the auditor's perspective, what ultimately matters for fairness of presentation of accounting estimates are AccR and its acceptability. AccR is addressed through what can only be proper disclosure. This proper disclosure is a financial reporting issue so the next task is to set up a reporting system for better disclosing AccR; that is, create operational fairness of presentation of estimates with estimation uncertainties due to AccR. We do this by what is called the RBR matrix. The RBR matrix is an attempt to summarize all the possibilities of accounting uncertainties that an auditor may encounter and classify them by reporting types. It really is a generalization of Beaver's observation of classification of contingencies uncertainties reporting. From the auditor's point of view, these uncertainties also include the evidence-gathering uncertainties in AudR, but since the auditor controls AudR at a low level, the major uncertainty is AccR.

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Also, from the client's point of view, since the client presumably knows all the facts of the situation, the real issue is dealing with various levels of AccR. For these two reasons our RBR matrix focuses on AccR levels.

So, if we extend the logic of risk-based auditing to risk-based accounting using AccRs as our measure of risk, we get the following perspective. First, the fundamental principle in RBR is the decision rule: If AccR less than or equal to acceptable, then accept the estimate; otherwise, reject it. Assuming acceptable level is .05, and we have an investment with payoff of $10 million at probability of 0.97, with zero payoff otherwise, can we record it? (*Note:* This is a point estimate.) The answer is yes. Why? Because if we record $10 million, then AccR = 0.03, which is acceptable (i.e., it is less than or equal to 0.05).

Now, assume the payoff probability is 0.03 in the above illustration. Should we record it under RBR? This time the answer is no, because AccR is now 0.97 and that is much greater than acceptable risk of 0.05. Therefore, we record an asset of value zero, which effectively means not recording it.

The next question is, should we disclose the 0.03 probability payoff? Answer: Going back to statistical decision making and trying to be consistent with it, which is like accepting a sample result with beta risk of 0.03 when we planned a beta risk of 0.05. In sampling, do we bother disclosing the beta risk in financial reporting after accepting a reported amount for a population? No! This case is similar. If we do not record the asset, there is less than acceptable risk of being materially misstated, so we can ignore disclosing this payoff for fairness of presentation purposes. Note what we have just done: We picked a lower threshold of disclosure, just like Beaver did, for the term "remote" regarding contingencies, and concluding remote contingencies did not require disclosure.[18] But we have picked this lower threshold to be directly dependent on the acceptable risk. And "one minus the acceptable risk" is the minimum probability for recording the payoff at the payoff amount. This is equivalent to what Beaver called "probable" probability threshold.

So, have we covered all possible probabilities? No! We still have the range of intermediate probabilities, specifically from acceptable AccR to "one minus acceptable AccR" that we have not yet decided how to deal with. Beaver gives us a clue through the "reasonably possible" concept, where he refers to such probabilities of contingencies that require disclosure but are not recorded (booked). But under RBR, we apply this consistently to contingent gains as well as contingent losses, and we also relate everything to the acceptable AccR level. This makes it the simplest reporting system possible. There may be good reasons to not have such symmetry, such as to get a more refined system of disclosures, but for our purposes, we will not introduce this added complexity here. When we say "disclose," we mean note the disclosure in the financial statements and/or modifications in the auditor's report.

To summarize, under the RBR system of risk-based reasoning for accounting estimates, there are three possible ranges or regions of probabilities of payoffs to consider. We start with the idea of acceptable risk of AccR. Who decides that? Optimally, accounting standards should decide that, as indicated by Beaver. Accounting standards should, in turn, be guided by a more general principle, such as our decision rule for accepting recorded amounts based on the acceptability of AccRs. The simplest reporting system based on acceptable AccR has the following three areas or regions of probabilities that indicate what should be done:

1. The record region (payoff is recorded): Probability of payoff is 1.00 to (one minus acceptable AccR)
2. The disclose region (payoff is disclosed): Probability of payoff is (one minus acceptable AccR) to (acceptable AccR)
3. The ignore region (payoff can be ignored): Probability of payoff is (acceptable AccR) to zero.

Note that these regions are mutually exclusive and exhaust all probabilities. If accounting standards, or the financial reporting framework of CAS 200, do not specify these

18 Beaver, "Problems," pp. 127–128. Remainder of the references in this discussion are taken from this article.

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regions, then auditors need to decide based on whether the estimation uncertainty represents a significant risk or not. We effectively equate significant risk with anything above the acceptable AccR level. If nothing is said in the accounting standards, then the auditor decides on the acceptable AccR that represents fairness of presentation for a line item amount in the financial statements. Obviously, this is a key professional judgment made by the auditor. The many articles that are consistent with this reasoning should help convince you that this is a reasonable approach, especially within an IFRS reporting environment. Next, the regions are depicted in more detail using a specific value of acceptable risk, AccR = 0.05.

The RBR matrix shown in Exhibit 19–9 summarizes all the actions the auditors should take under RBR logic. If the client's reporting practices conform to this logic, then there is no basis for claiming they are misleading. The presumption here is that acceptable AccR is a main feature of fairness of presentation, just as acceptable AudR is. AudR deals with the fairness of

EXHIBIT 19–9 RBR Framework Summary

Assume acceptable risk = 0.05

(Where risk is dependent on perspective: Probablility of Material Mistatement, PMM, from auditor's perspective, but only AccR from management's perspective, which is used below.)

Column 1 Probability of Payoff (or Payout in the case of Liability) = AccR If Recorded at Zero = Probability of No Material Misstatement If Recorded at Payoff (Payout)	**Column 2 Probability of No Payoff (or No Payout in the case of Liability) = AccR If Recorded at Payoff (Payout) = Risk of Material Misstatement If Recorded at Payoff (Payout)**	
1.00	0	**Region I** Recognize the payoff (payout) as asset (liability) because probability of material misstatement with recognition is less than acceptable risk. For example, if a related cost is involved, then the related cost is capitalized.
0.99	0.01	
0.98	0.02	
0.97	0.03	
0.96	0.04	
0.95	0.05	
0.94	0.06	**Region II** Do not need to recognize asset or liability but should disclose in footnotes. For example, if a related cost is involved, then the related cost is recorded as an expense.
:	:	
:	:	
0.54	0.46	
0.53	0.47	
0.52	0.48	
0.51	0.49	
0.50	0.50	
0.49	0.51	
0.48	0.52	
0.47	0.53	
:	:	
:	:	
:	:	
0.06	0.94	
0.05	0.95	**Region III** Do not need to recognize or disclose becasue failure to do so means that probability of material misstatement is less than acceptable risk. For example, if a related cost is involved, then the related cost is recorded as loss or waste.
0.04	0.96	
0.03	0.97	
0.02	0.98	
0.01	0.99	
0.00	1.00	

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presentation of past events, whereas AccR deals the fairness of presentation of future events. Both need to be at acceptable (but not necessarily the same) levels. In essence, this is the way auditors avoid both auditing- and accounting-deficiency reservations in their reports. We, thus, have an audit theory that is aimed at identifying when such deficiencies are avoided.

The main use of the RBR matrix is to provide a convenient decision aid for any reporting situation involving future events. It does so by structuring the decision process so that you do not need to keep track of all probabilities, just the main regions and their reporting consequences. This matrix is so general it can be used for either point estimates (as in the lottery ticket example in Part I), in reasonable ranges (as in the AuG-41 example and the exercises just preceding), or in both simultaneously.

The summary steps in the decision making are as follows:

1. You need to know the various payoff states and their probabilities, acceptable AccR, and materiality (all these would be given to you on a test). In the real world, these are obtained from evidence gathering audit procedures and through use of calibration techniques for assessing ranges for estimates, as discussed in the next subsection. The auditor then may add a more sophisticated distribution (based in increasingly available industry studies of accounting uncertainties or by simply assuming that the uniform distribution holds over the reasonable range of identified high and low estimates, based on audit evidence and calibration of ranges).
2. Calculate the three probability regions for the RBR matrix from step 1.
3. Identify the client (auditee) reported amount or estimate that is being proposed and its probability of realization.
4. Based on the probability of realization (or equivalently, the AccR associated with the reported amount), see what should be reported, based on the region the payoff probability falls.
5. Compare to what client actually reports.
6. Identify an adjusting entry to what should be reported in step 4. Remember, the only way to control AccR is through proper disclosure, and this adjusting entry should help achieve that.

IMPORTANCE OF BENCHMARKS ("RISK ADJUSTED"—REASONABLE RANGES) AND KEY FORMULAS IN THEIR DERIVATION: THIS IS CRUCIAL FOR FULLY UNDERSTANDING AUDITS OF ACCOUNTING ESTIMATES (CAS 540)

LO8 Calculate a benchmark range with insignificant judgmental misstatement risk.

As we saw in the review of AuG-41 paragraphs 29–30 and CAS 540 (e.g., see CAS 540 A48, A116), reasonable ranges (RRs) are crucial for deciding if there is a misstatement in accounting estimates (including estimates used in fair value accounting). CAS 540, paragraphs 11, A47–A51 go one step further and specifies that auditors must consider the riskiness of the estimate; specifically, if there is a "significant" risk associated with the estimate. This is consistent with Cockburn's (1992) concerns about RRs getting too wide. Cockburn indicates that if they are too wide, then contingency accounting logic might be used. It seems he is suggesting that a potential writedown of an asset should follow contingent loss treatment of *CICA Handbook* Accounting Part II, section 3290. Under IFRS, contingencies are only disclosed in notes, not recorded. However, with fair value accounting under IFRS, write-ups of assets and liabilities will be allowed as well as writedowns, and with 540, paragraph 11 we need to consider the risks of all related estimates, not just whether contingencies need to be disclosed. All of these situations are covered in the RBR matrix Exhibit 19–9. RBR and the accounting risk (AccR) concepts have been introduced to this text in large part to help address these issues.

The RBR principle with accounting estimates uses the following as its principal reason for justifying an estimate, but it is now made more specific with respect to AccR and AudR:

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> If an actual risk (such as AccR or AudR, or both depending on which risk the auditor wishes to focus on—these risks are measured with the assistance of appropriate models such as the uniform distribution) associated with a recorded amount is greater than an acceptable level, then reject the recorded amount; otherwise, accept it.

Accounting risk (AccR) is the risk associated with an estimate that makes assumptions about the future. This is a potentially big risk of financial reporting because, as Beaver (1991) notes, future events pervade accrual accounting and distinguish it from cash-basis accounting, and this is even more so under fair value accounting principles. In the past, auditors put great stress on controlling AudR in financial statement auditing but have tended to ignore AccR. The adoption of CAS 540, however, changes the picture. CAS 540 makes auditing as well as financial reporting more risk based. The readings above should make evident the riskiness of audited financial reporting in today's environment. In this chapter, we clarify through calculations how the risks related to financial reporting can be made more objective, and their control made more operational.

Reasonable ranges (RRs) are supposed to be based, as much as possible, on facts and reasonable assumptions. It is the assumptions that allow us to make specific forecasts of the future. Knowledge of the client's business and business risk approaches to auditing covered in earlier chapters of this text (specifically Chapters 5, 6, and 9) are what help auditors to evaluate the reasonableness of the assumptions. Reasonableness in this context refers to how likely the assumptions are to be true. At this point, it also refers to how accurately the assumptions and their effects on RR capture the reality of the business uncertainties facing the client. If the RR correctly captures the range of realistic possibilities, then RR can be viewed as a type of model about the future, accurate to the best of our ability to forecast the future. (*Note:* CAS 540, paragraph A93 recognizes that RR must be limited to "reasonable outcomes rather than all possible outcomes," and that the "range cannot be one that comprises all possible outcomes if it is to be useful.") This assessment of an RR can involve much work: acquiring an understanding the business risks of the client, the industry, and the economy. Gaining this understanding and gathering the necessary evidence and can be viewed as step one in the estimation process. The role of step one is to capture as realistically as possible, based on the information currently available, the range of values likely to occur in the future for an amount in the financial statements. You can view this as a reasonable representation of the future that captures some "reasonable" (= high, such as 95%) proportion of future outcomes. For example, estimating the range of oil prices, interest rates, and gold prices one year into the future could be key inputs to many accounting estimates.

This reasonable representation of the future involves proper calibration of future-event probabilities. The reasonable range realistically reflects the uncertainty about future events; for example, if the range is supposed to reflect 95% of all future events it actually does so, and not some much lower percentage, such as 20%. This is also referred to as *proper calibration of the range* in risk management research.[19] A well-calibrated 95% range captures close to 95% of all future events related to the estimate; a 95% range that captures more than 95% is conservative, and a 95% range that captures less leads to the famous, pervasive overconfidence (underestimation of risk) bias first identified by Kahneman and Tversky, as noted by Hubbard.[20] This can be a major problem in financial reporting because as risk management and forecasting literature also note, risky events tend to have a wide range of possible outcomes as noted by Hubbard.[21] Well-calibrated, auditor *reasonable ranges* help identify inappropriate management assumptions and can be a key component of implementing auditor skepticism (see CAS 200, paragraph A19 and IFAC, 2011 paragraphs 71–72). In addition, the IASB and IFRS conceptual framework concepts of "verifiability" as "consensus of knowledgeable observers" would appear to depend on the consistency of well-calibrated ranges of the observers when applied to future-event predictions (IFAC, 2011 paragraph 25). Calibration is improved with training and experience, and it can be viewed as a new skill auditors need in order to develop principles-based financial reporting,

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19 D. Hubbard, *The Failure of Risk Management,* (John Wiley & Sons, 2009) pp. 201–208.

20 Hubbard, *Failure,* p. 102.

21 Hubbard, *Failure,* p. 129.

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of which RBR is an example. Example exercises of calibration and further discussion are provided in the last section of this chapter.

But what is reasonable financial reporting about the future? That is what RBR tries to answer. For example, if your reasonable representation about the future tells you that the future is highly volatile, that does not necessarily mean the accompanying highly volatile future cash flows allow you to record an asset or liability. This is what fairness of presentation of GAAP is all about, according to RBR. This brings us to step two.

Step two in the reporting process is quite distinct from step one. In step two, you are to decide how to best report the uncertainties reflected in your model from step one (so that the reported numbers "present fairly'). Note that step two is a reporting and disclosure issue, and, thus, really relates to accounting theory and standards. The problem is that accounting standards are not currently risk based, whereas CAS 540, paragraph 11 requires us to assess the significance of the risks associated with the accounting estimates, and, depending on the estimation uncertainty, determine which reporting framework to use; that is, whether an asset or liability even exists for financial reporting purposes. (See CAS 540, paragraphs A49, A120–A123.) This is when modelling the estimation uncertainty, accounting risk (AccR), and RBR can play an important role in improving professional accounting judgments involving estimates.

In step one, a decision must be made about the type of probability distribution associated with the RR. Specialists, such as actuaries and valuators, can play an important role here, but to be most useful to auditors, these they should be guided as to the type of information most relevant to the auditor. This is where the concepts of accounting risk (AccR) and estimation uncertainty become relevant. As we noted in above, CAS 540 paragraph A118 indicates a three-way classification of estimation uncertainties: factual errors, judgmental errors, and projections. The risks associated with failing to detect factual errors and projections are captured in auditing via the AudR concept. AudR follows from sampling risk of statistical theory. Judgment errors are essentially nonsampling errors, and they include a broad range of mistakes auditors can make in implementing audit procedures and the audit risk model, along with its components (IR, CR, and DR), underlying the AudR concept.

In the end, all the risks need to be combined in an overall evaluation of information risks associated with audited financial reporting. The risks can be combined to represent the auditor's perspective when considering total information risk. We refer to this total risk as the probability of material misstatement. Some refer to it as financial reporting risk (IFAC, 2011). Our focus in this part of the chapter is on the accounting risk (AccR)v for the following reasons: First, AudR tends to be small relative to AccR in audited financial reporting; and, second, from the client's point of view, there is only AccR, since presumably the client already knows all the relevant facts about their business. Thus, when the auditor is discussing reporting issues with a client, the issues will tend to focus on AccR related to the reported amounts. For these reasons, the focus of RBR is on AccRs associated with the pervasive need to make forecasts in financial reporting (see discussion of Beaver, 1991, and others in the preceding sections if you have not already done so).

AccRs are a type of nonsampling error and, thus, a type of judgmental error risk of CAS 540, paragraph A118. AccRs can only be controlled through proper accounting and disclosures, and they relate to judgments by both auditors and management about appropriateness of the financial reporting. Specifically, the acceptable level of AccR and the RBR matrix are central to deciding how to report a RR once an auditor has determined that for a specific estimate.

In the most general case, there are many possible probability distributions that can be associated with a reasonable range (RR), and the auditor can work with specialists from various fields, as described earlier, to help identify the most appropriate distribution. However, in most situations, it appears that the uniform distribution already discussed is a reasonable proxy for the uncertainties associated with RRs (see AuG-41, paragraphs 29–30, and CAS 540, paragraphs A93–A95). This is so because of the wording that a point estimate be used "if that is better than any other amount" (AuG-41, paragraph 29), and the fact that auditors might have only an idea of the range of possible values, as indicated by highest and lowest realistic estimates. The other common distribution in audit practice is the discrete distribution consisting of point estimates (AuG-41, and CAS 540, paragraphs A87–A95). You have already seen examples of working with point estimates in the lottery ticket example in Part I. Both kinds of distributions work with the basic RBR decision rule and the RBR matrix in deciding how a payoff should

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be reported; that is, comparing that to what the client is proposing to report, and making any adjustments as appropriate to arrive at what should be reported. Note that everything is driven by what the auditor concludes should be reported. In turn, what should be reported is determined by the auditor's definition of materiality and acceptable AccR levels.

By now, you should be familiar with how the RBR logic and matrix work for point estimates. The rest of this section deals with how this works with reasonable ranges (RRs). Complications with RRs arise from the fact that AccRs are more complex to calculate with RRs. What the previous exercises, under the heading "Illustrations of Accounting Risk Calculations," do not tell you is how to mathematically derive an RR that meets the auditor's risk criteria for acceptable AccR levels. Instead, they indicate a trial-and-error method, but we can be more precise about finding acceptable AccR ranges. We continue using the uniform distribution for the reasons given above. For other distributions, auditors may need to work with specialists and/or use of specialized probability management software, such as that advocated in the Savage and Van Allen (2002) discussed in Part I.

The key point to remember is that the RR with the uniform represents "reality" about the future as far as the auditor is concerned. The auditor must work within this reality to decide on the best way to report it. To support this, we introduce the concept of the benchmark (B), which is a "risk adjusted" range of future values that controls AccR within levels acceptable to the auditor for financial reporting (as determined by the auditor or possibly future GAAP). Note the distinction: RR is the "reasonable range" in reflecting future realizations, whereas B is the set of values from within that range that is "acceptable" (to the auditor) for reporting. B is necessary in addressing Cockburn's (1992) concerns about too wide a RR and in controlling AccR so these do not become a "significant" risk of estimates that is the concern of CAS 540, paragraph 11. In what follows, significant risk is effectively equated with unacceptable AccR. (Keep in mind though, that estimation uncertainty of CAS 540 deals with all sources of error in CAS 540, paragraph A118, and when significance of uncertainty is assessed all these sources should be combined. Ultimately, the auditor needs to use an aggregate risk concept combining AccR with AudR. We discuss such a model in the appendix. In this section, however, we focus on RR, the key component of estimation uncertainty relating (or how it should relate) to accounting theory—AccR.

Assuming a uniform over RR greatly simplifies risk calculations for AccR, as you have already seen from the exercises already referred to. We now exploit this simplicity to develop an algebraic formula for calculating a B (when it exists, as is explained below) for any acceptable AccR and materiality combination. The simplest approach appears to take advantage of the fact that, with the uniform distribution, over a RR the maximum AccR is at its endpoints, the AccR is minimized at the midpoint of the RR, and the B range is symmetrical and always centred at the midpoint of the RR. Also, the uniform distribution is defined by the RR (i.e., not by any other range! This is because the RR is supposed to reflect what the auditor considers the reality about the future). The benchmark (B) calculations below work with this uniform.

Thus, to approach this, take advantage of the fact the maximum AccR for the benchmark range (B) is always at the edges of the desired B. The steps in the algorithm are as follows:

1. You must decide on an acceptable AccR and the materiality (MM) that goes with it. Acceptable AccR is a planning risk concept like planned audit risk. Similarly, MM is assessed for overall MM as discussed in earlier chapters. Some writers think acceptable AccR should be part of accounting principles, but accounting is not (yet) risk based.
2. Calculate AccR at the midpoint of your RR. If AccR at midpoint is greater than acceptable, then you have Cockburn's nightmare because there is no B with acceptable AccR (i.e., there is no value such that AccR is acceptable). In terms of the RBR matrix, there is no value in RR that has an acceptable AccR. But depending on what the AccR is at the midpoint, you may need to disclose the value of RR at the midpoint (i.e., you are in region II of the RBR matrix), or you can ignore any mention of the amount (i.e., you are in region III). In terms of CAS 540, paragraphs A93–A94, there is no way to shorten the RR to get an acceptable range because of the inherent uncertainty in predicting future events.
3. If AccR is less than or equal to acceptable at midpoint of RR, then there are two possibilities. These are considered in the next two steps.

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4. If MM is less than the RR, solve for x in the following formula:
   Acceptable AccR = (upper endpoint of RR − (lower endpoint of RR + MM + x))/(length of RR)
   The arrived at value of x defines B as follows:
   B = (lower endpoint of RR + x, upper endpoint of $RR - x$)

   You should confirm that the edges of this B have AccR at exactly the acceptable value. If not, then you did something wrong. Note that B is a risk-adjusted range in the sense that no value of AccR within it is greater than acceptable.
5. If MM equals or is greater than RR, then you have the opposite of Cockburn's nightmare. You have what we can call Cockburn's nirvana: every value in RR has an AccR of zero! Interestingly, CAS 540, paragraphs A87–A94 suggest that auditors can usually get to this point, but this ignores the fact that RR should reflect the business risks of the client's environment. Auditors cannot control client business risks but they can insist that these risks be appropriately disclosed in financial reporting via recorded amounts and/or appropriate note disclosures. This is the rationale behind the calculations given above.

AccR Calculation Exercises with RBR Benchmarks

Exercise 6: Assume that the auditor decides that the AccR associated with the AuG-41 reasonable range is too high, judging that acceptable risk for AccR in this situation should be 1/6. Calculate the new reasonable range that results in acceptable risk.

Solutions to AccR Exercises

Exercise 6: Using the formula for B above, calculate the new reasonable (benchmark) range, 140–150k. This new range is 1/3 the size of the original and is smaller than materiality because the auditor is willing to tolerate less risk. This illustrates that RBR can address Cockburn's (1992) concerns about having a reasonable (well-calibrated) range that is too wide. The original RR is reasonable because it captures a reasonable number of future outcomes for the assurance engagement, and it is too wide because it is supposed to capture reality about the future. For example, reasonable assurance = high assurance per CAS 200, paragraph 11. This also means the reasonable range is well calibrated. (See the last section about calibrating ranges.) A well-calibrated range, however, does not guarantee that an estimate is reliable enough to be treated as an appropriate measurement for financial reporting. The acceptable AccR determines what is reliable enough to be used in financial reporting of accounting estimates that "present fairly." This is further discussed in the next section.

SUMMARY COMMENTS ON RBR PRINCIPLE FOR ACCOUNTING ESTIMATES

LO9 Calculate the RBR summary of the different financial reporting possibilities.

The above algorithm, and similar ones using probability distributions other than the uniform, can be easily programmed into a software package by an accounting firm. Such software can become part of the auditor's toolkit. It is already used in probability management for other business applications. Various collaborative methods have been developed, such as prediction markets or ranges of estimates as with multiple pricing services for financial instruments (see Chapter 14), so that subjective estimates from multiple individuals can be taken into account. Stochastic modelling methods, such as the Monte Carlo method, often use subjective estimates from "subject matter experts."

The really important thing you should take from this discussion is the implication of Cockburn's nightmare for financial reporting: A range cannot be arbitrarily reduced with the expectation that this will solve the "significant risk" estimation uncertainties of CAS 540. The underlying uncertainty represented by the uniform distribution does not disappear by arbitrarily reducing the range. The problem with CAS 540 is that it tends to assume the auditor can reduce AccR by gathering more evidence, and that this evidence will reduce the RR. When a B does not exist, the auditor has to seriously consider whether an asset or liability exists in the accounting sense (e.g., see CAS 540, paragraphs A49, A120–A123). This situation is captured in regions II and III of the RBR matrix. In other words, if the client's

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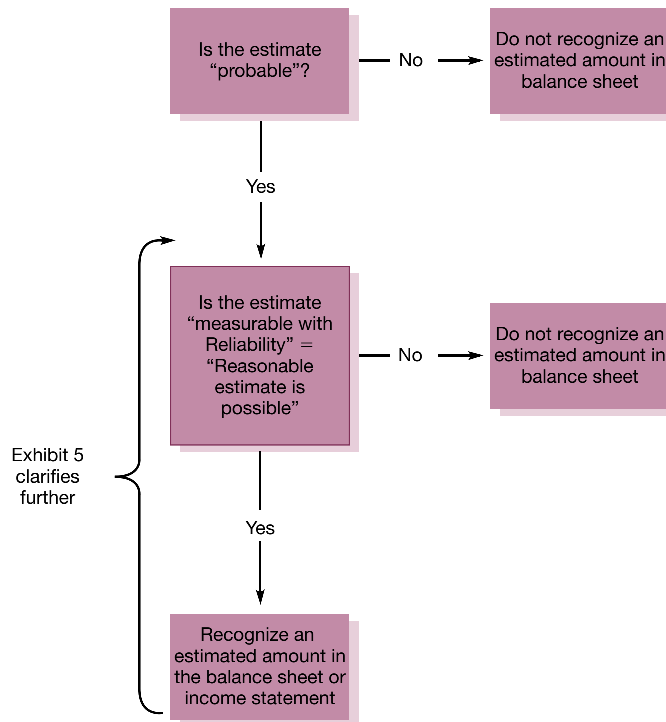
EXHIBIT 19–10 **Conceptual Framework for Financial Reporting under IFRS (Paragraphs 4.37–3.48): Recognition of the Elements of Financial Statements**



estimate falls in these ranges, the accounting risk is higher than acceptable, and the auditor needs to consider adjustments. This distinction is perhaps further clarified by looking at standards related to audits of future-oriented financial information (FOFI) covered in Chapter 21 (available on Connect). The audit of FOFI forecasts requires the auditor to assess the reasonableness of the assumptions used in developing FOFI. This is equivalent to assessing the RR. But FOFI audit standards do not require that a B be found with acceptable AccR for the forecasted estimate, indicating that the distinguishing feature of GAAP forecasts, versus those in FOFI, is that some degree of acceptable AccR is required in GAAP accounting.

The criterion of the acceptability of AccR connects logically with the measurability concept of IFRS reviewed earlier. Basically, we can reconcile acceptability of AccR with reliability and measurability of an accounting estimate, and that is what we propose as a clarification of the gaps left from Part I of this chapter.

Exhibit 19–10 summarizes the current conceptual framework of IFRS. Note that it makes use of both "probable" and "measurable" IFRS criteria, although both these concepts incorporate accounting risk, whereas there is little guidance on the acceptable levels. However, it is an important, if implicit, assumption of all appropriate financial reporting frameworks that falsehoods regarding factual information are not acceptable. Thus, the controversies will tend to centre on the acceptability of accounting risks for various estimates.

The problem for auditors is that the current guidelines for fair presentation are rather vague given that current accounting standards do not specify acceptable levels of accounting risk for various line items in the financial statements. Each auditor must, in effect, develop his or her own principle of acceptability, for every item, for every engagement. This seems to be causing many of the problems for auditors in the current reporting environment, as noted in the readings discussed earlier.

Exhibit 19–11 gives an overview of the decision logic summarizing the above discussion and incorporating the logic of IFRS concepts of Exhibit 19–10.

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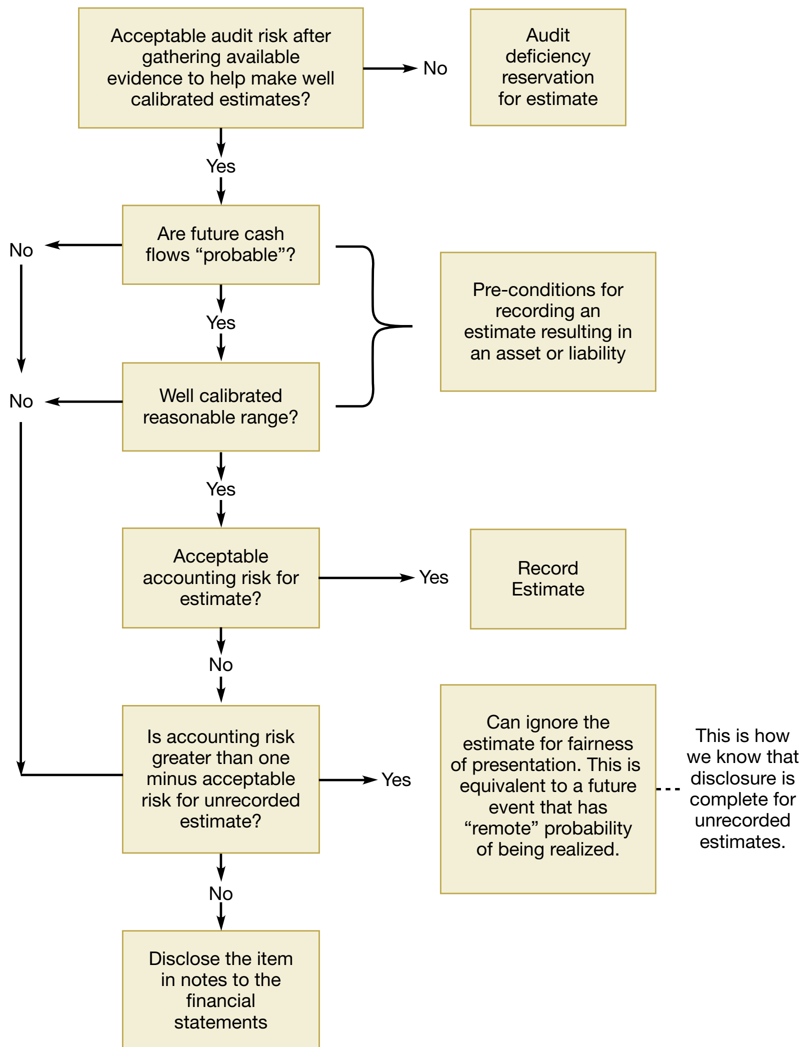
EXHIBIT 19–11 Reasoning Steps in Risk-Based Reporting for an Asset or a Liability Line Item



The nature of any adjustment depends on how wide the range is, as was first noted by Cockburn (1992). Whether the RR is sufficiently narrow is determined by the level of acceptable accounting risk (AccR). We can develop some generic rules of thumb for high assurance engagements involving reasonable ranges that capture high probabilities of future outcomes. These rules, using MM to represent material misstatement, are as follows:

- **Accounting estimate nirvana:** The width of RR is less than or equal to MM, which means that there is no significant risk for any estimates within RR.
- **Accounting estimate problem (i.e., Cockburn's problem):** The width of RR is greater than MM but not greater than two times MM, which means an estimate with no significant risk can be found within RR.
- **Accounting estimate nightmare:** The width of RR is greater than two times MM, which means all values in RR may have significant risk of CAS 540, paragraph 11

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(and also that all estimates outside RR have significant risks). In other words, there is no estimate with an insignificant estimation risk possible in a nightmare situation.

If we use the Part I AuG-41 example about the allowance for bad debt in which there is no mention of materiality, we can illustrate the effects of varying materiality.

- **Accounting estimation nirvana:** The situations occur when MM is $30,000 or more.
- **Accounting estimation problems:** This occurs when MM is between $15,000 and $30,000.
- **Accounting estimation nightmare:** Situations can occur in which MM is less than $15,000 and they are increasingly more likely the smaller MM becomes.

The nightmare accounting estimate situation is equivalent to having to switch to a different financial reporting framework because the current one leads to unacceptably high estimation risks (i.e., the reporting framework is misleading and does not fairly present in the circumstances—CAS 200, paragraph 13 and 540, paragraph 18). Frequently, this takes the form of the need to write down an asset.

The existence of the benchmark range helps address the question of what is a reasonable estimate to use in financial reporting given well-calibrated ranges. We propose making this concept operational through accounting risk control, and link fairness of presentation to this control. The fairness framework tells us that the legitimate way to identify a benchmark range within the reasonable range is through the acceptable accounting risk criterion for an estimate. Under this approach to fairness of presentation the accounting estimate situations can be characterized as follows:

- **Nirvana:** The benchmark range is larger than or equal to and contains the reasonable range, and therefore, the entire reasonable range results in fairly presented estimates.
- **Accounting estimate problem:** Find a benchmark range, when it exists, within the reasonable range. The acceptable estimate, when it exists, must be within a well-calibrated reasonable range because the accounting risks of estimates outside the range are always higher than those inside. You can prove this to yourself with the exercises using the AuG-41 example.
- **Nightmare:** No benchmark range can be found (not even a point estimate) for the desired acceptable accounting risk level.

All the above rules of thumb for working with the reasonable ranges are equivalent. To make feasible the calculation of the benchmark range, the auditor needs to define an acceptable accounting risk-level based on user needs and cost-benefit factors, similarly to identifying materiality for financial reporting. The next step is to model the uncertainty in the reasonable range more explicitly via calibration of the range and use of formal probability models, such as the uniform distribution, with appropriate data when those are available.

The reasonable range should realistically reflect the uncertainty about future events; for example, if the range is supposed to reflect 95% of all future events it should actually do so, and not some much lower percentage such as 20%. This is also referred to as *proper calibration of the range* in risk management research.[22] A well calibrated 95% range captures close to 95% all future events related to the estimate, a 95% range that captures more than 95% is conservative, and a 95% range that captures less leads to the famous, pervasive overconfidence (underestimation of risk) bias first identified by Kahneman and Tversky.[23] This can be a major problem in financial reporting because the risk management and forecasting literature also notes that risky events tend to have a wide range of possible outcomes.[24] Well-calibrated auditor reasonable ranges help identify inappropriate management assumptions and can be a key component of implementing auditor skepticism (CAS 200, paragraph A19 and IFAC, 2011, paragraphs 71–72). In addition, the IASB concept of "verifiability" as "consensus of

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22 Hubbard, *Failure,* pp. 201–208.

23 Hubbard, *Failure,* p. 102.

24 Hubbard, *Failure,* p. 129.

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knowledgeable observers" would appear to depend on the consistency of well calibrated ranges of the observers when applied to future event predictions (IFAC, 2011, paragraph 25).

There are a number of ways individually or in combination to do this, and this is an example of some of the new types of training auditors may need to get in order to more effectively audit accounting estimates.

Now that you have seen the crucial importance of realistic and well-calibrated reasonable ranges in implementing fairly presented accounting estimates using GAAP, the next section gives an overview of what is involved in calibration. The questions at the end of this part provide exercises illustrating the above logic and its ramifications for financial reporting of estimates. We next consider some general techniques for calibrating an auditor's reasonable range of estimates.

GETTING YOUR RANGES CALIBRATED

LO10 Calibrate a range so that it is reasonable.

Kahneman notes that there is a very important distinction between evidence and predictions.[25] This is another reason to distinguish the risks associated with audit evidence (AudR) and predictions used in accounting estimates (AccR). The AccR is influenced by the reasonable ranges and how well they are calibrated. Based on research by Douglas Hubbard, it is thought that calibration training may measurably improve an expert's ability to assess odds, and it forms the basis of and intuition for understanding probabilistic models in general.[26]

If a person has no idea whatsoever of the validity of two competing estimates, he or she will be only 50% confident. With absolute certainty of the correctness of one, he or she will be 100% confident. But most people will answer somewhere in between those two levels. A calibrated person is one who, when asked a large number of such questions, will get about as many correct as he or she expected. On the other hand, an uncalibrated person who is systematically overconfident may be 90% confident of the correctness over a large number of questions, where in the end only 60% or 70% of them will be correct. Calibration training generally involves taking a number of such tests, where feedback is provided between tests and the subjects refine their probabilities.

Calibration is achieved through repetition and feedback, which improves the quality of expert's estimates. If the environment is predictable and an expert has learned through training to identify the situations where their intuition misleads them, then the feedback will have corrected their intuitions. This is the basis of calibration training for assessing reasonable ranges of accounting estimates in new or changing conditions. According to Hubbard (2009), calibration can be summarized in the following steps:

1. *Repetition and feedback.* Take several tests in succession, assessing how well you did after each one and attempting to improve your performance in the next one. Continue to track performance after training is complete. For example, an expert can be asked to estimate the return on the TSE over a stated period of time. Two estimates can be asked: a value he or she is 95% sure is too high, and once he or she is 95% sure is too low. The range between these two estimates is the "90% confidence interval" and outcomes outside this interval can be viewed as "surprises." A well-calibrated expert who assesses such confidence intervals multiple times can expect 10% of the outcomes to be surprises. As Kahneman notes, however, managers can be grossly overconfident in their ability to predict markets or even their own company's performance.[27] Actual surprises might be three times higher than estimated. This indicates that perhaps auditors should be encouraged to develop their own reasonable ranges and get their ranges better calibrated through estimation exercises involving repetition and feedback, for example, answers to trivial pursuit–type questions involving ranges, or imagine an equivalent bet or critical thinking exercise.

25 Kahneman, *Thinking,* p. 188.

26 Hubbard, *Failure*, Chapter 6.

27 Kahneman, *Thinking,* Chapter 23.

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2. *Equivalent bets.* For each estimate, set up the equivalent bet to test whether that range or probability really reflects your uncertainty.
3. *Consider two pros and cons.* Think of at least two reasons why you should be confident in your assessment and two ways you could be wrong.
4. *Avoid anchoring.* Think of range questions as two separate binary questions of the form "Are you 95% certain that the true value is over/under (pick one) the lower/upper (pick one) bound?"

The questions at the end of this chapter illustrate calibration techniques.

Kahneman, however, prefers to base predictions on distributional information as much as possible. He chooses to use the steps of something called reference class forecasting to overcome the major problems associated with judgment errors in forecasting:[28]

1. Identify an appropriate reference class (large building construction projects, new technology information systems, prior bad debt experience under similar economic conditions, etc.)
2. Obtain statistics of the reference class (in terms of percentage of expenditure exceeding the budget, actual write-offs of bad debt exceeding changes in prior estimate). Use the statistics to generate a baseline prediction.
3. Use specific information about the case to adjust the baseline prediction, if there are particular reasons to expect the optimistic bias to be more or less pronounced in this project (audit) than in others of the same type.

If we replace "project" with "audit of an accounting estimate" we can see the relevance of this guidance for auditing. In fact, this guidance indicates how very specific to the auditee context critical thinking can get. There is a good chance that calibration of reasonable ranges will be getting considerable attention from CASB, standard setters, and regulators in the 21st century. These developments also may indicate that auditing and verifiability of financial reporting is getting so complex that it will become a specialization area for all PAs.

REVIEW QUESTION FOR PART II

LETRON REVISITED

Now that you know about AccRs and how they can be modelled under the uniform distribution, you can apply this knowledge to the Letron situation of the review question presented earlier in this chapter. The applicable materiality there was 800k and both beginning and ending inventory had what we now call reasonable ranges for estimates of 2000k. We now do some AccR calculations. Make sure you understand the rationale behind each calculation!

Assuming Letron would have recorded at the edge of its reasonable range for beginning inventory, what is the AccR at 13 million?

Answer: (2 minus 0.8)/2 = 1.2/2 = 0.60 = AccR at $13 million.

What is AccR for the estimate of 12.3 million that the client wants to record for beginning inventory?

Answer: (2 minus 0.1)/2 = 1.9/2 = 0.95

What is AccR for the estimate of 15.9 million that the client wants to record for ending inventory?

Answer: (2 minus (15.1 minus 14))/2 = 1.1/2 = 0.55

4. What is the AccR for the combined impact of inventory forecast errors on net income (NI)?

Answer: Since COGS = BI + Purchases − EI, then both beginning inventory (BI) and ending inventory (EI) estimates impact NI. To calculate AccR in this situation, it is easier to first calculate that there is no AccR due to inventory in NI and then subtract that probability from one. So the probability of both inventory estimates being materially correct is (one − AccR due to BI) × (one − AccR due to EI) = (1 − 0.95) × (1 − 0.55) = (0.05) × (0.45) = 0.0225. Thus, total AccR from estimates in inventories is 1 − 0.0225 = 0.9775. In other words, there is about a 98% chance that Letron's numbers are materially misstated. Surprise! NI is not an exact number. But how exact should it be if it is to "present fairly"? That is the point of learning about AccR and RBR. And if this number was audited, would you consider this misleading? Would you consider the auditor competent?

The above numbers are based on those of a formerly dominant company in Canada's technology sector: Nortel.

28 Kahneman, *Thinking,* p. 251.

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SUMMARY OF PART II

- In Part II, we identified the specific concept of accounting risk as an important type of estimation uncertainty of CAS 540 and related quantitative models to help clarify the estimation uncertainty concept and its role in GAAP. As we have seen in this part, the acceptability of estimates is largely driven by the acceptability of the risks associated with forecasting uncertainty. For any well-calibrated reasonable range of accounting estimates, the acceptable level of accounting risk determines whether a benchmark range exists from which fairly presented estimates can be selected (see Exhibit 19–4 for an illustration). The higher the acceptable level of accounting risk, the wider the benchmark range will be. It can even be wider than the original reasonable range, that is, the entire reasonable range of possible future event values would be acceptable for financial reporting. This shows that it is the acceptable level of accounting risk that determines if a range is too wide. The authority for acceptability now comes from CAS 540 with its significant risk concept. Effectively, the RBR principle of acceptability and CAS 540 can be linked by the following relationship: An insignificant level of risk for accounting estimates is equivalent to acceptable level of accounting risk.
- The above reasoning can be made clear quantitatively with the use of probability models such as the uniform distribution over the reasonable range. The quantitative models are needed primarily to quantify risk so that the CAS 540 concept of significant risk can be implemented. But we have also shown via the RBR matrix that quantitative models can provide insights on broader issues of appropriateness of financial statement disclosure of future events affecting the auditee. This is very important to auditors in addressing the financial reporting challenges facing auditees and maintaining the relevance and effectiveness of audits in the 21st century.
- The chapter illustrates the advantage of taking a particular perspective by framing a problem in terms of quantitative reasoning about beta risks in financial reporting and auditing. Without such an approach one cannot get very far: Reasonable ranges without risk quantification can lead to vaguer reasoning about acceptability of estimates and problems of dealing with reasonable ranges that are too wide, as we saw in Part I. Essentially, use of models in auditing and accounting turns qualitative issues into more objectively addressable quantitative issues. Of course, such quantification must have good reasons to support it and we hope we have provided convincing arguments for our RBR approach in this chapter. However, we can never completely eliminate qualitative issues in audit judgment and the qualitative issues always dominate in the sense they are needed in justifying a quantitative model. In this sense quantitative models help guide what is essentially qualitative professional judgment.
- Appendix 19A further illustrates how a quantitative model may help auditors better understand the ways different estimation uncertainties can aggregate to an overall estimation uncertainty for accounting estimates.

EXERCISES AND PROBLEMS

EP 19-4 Accounting Risk with Point Estimates. LO6 A horse-business example that deals with point estimates.

Part 1: A horse business example (55% of university students get this wrong)

- A man bought a horse for $600 and sold it for $700. Then he bought it back for $800 and again sold it, this time for $900. How much money did he make in the horse business? Was it $100, $200, $300, or none of these?

  Calculate the profit (pre-tax) according to GAAP.

Part 2: The horse business example with accounting risk added:

- Assume the same facts as in Part 1 except now the horse is sold the first time for a lottery ticket having the following payoffs: $2800 at probability of 0.25 and $0 at probability of 0.75. How much was earned in the horse business this time, assuming the profit needs to be calculated before the lottery payoff date?

Requirement 1: Calculate the profit according to GAAP.

Requirement 2: Calculate the profit using the RBR principle for estimates assuming the acceptable accounting risk is 0.2.

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Requirement 3: Calculate the profit using the RBR principle for estimates assuming that acceptable accounting risk is 0.3. Is there any difference in financial reporting from that of requirement 2?

Part 3: Assume the same facts as in Part I except that now the horse is sold the first time for a lottery ticket having the following payoffs: $2800 at probability of 0.75 and $0 at probability of 0.25. How much was earned in the horse business this time, assuming the profit needs to be calculated before the lottery payoff date?

Requirement 1: Calculate the profit according to GAAP.

Requirement 2: Calculate the profit using the RBR principle for estimates assuming acceptable accounting risk = 0.2.

Requirement 3: Calculate the profit using the RBR principle for estimates assuming acceptable accounting risk = 0.3. Is there any difference in financial reporting from requirement 2?

Part 4: Assume the same facts as in Part 1 except that now the horse is sold the first time for a financial instrument (asset 1) having payoffs in the relevant range $600–$800. You assume a uniform distribution applies to this range and that the auditor's materiality is $100. For the second time, the horse is sold, and the client gets a lottery ticket (asset 2) with a payoff of $3600 at probability of 0.75 and $0 at probability of 0.25. How much was earned in the horse business now, assuming the profit needs to be calculated well before the payoff dates for both asset 1 and asset 2? Give at least two alternative profit calculations under GAAP, clearly indicating the values of asset 1 and asset 2 separately, and clearly explain the *CICA Handbook* reasoning.

Assuming acceptable accounting risk is 0.30, calculate a profit in part 2 under RBR and any related disclosure decisions. Assuming acceptable accounting risk is 0.20, calculate a profit in part 2 under RBR and any related disclosure decisions. Which of the four alternatives in parts 2 and 3 do you prefer and what are the warrants in your reasoning?

EP 19-5 Critical Analysis of Standards and RBR. LO7
Working with Reasonable Ranges

Assume that an auditor assesses a well-calibrated reasonable range (RR) of 25–35k and uses the uniform distribution to model the accounting risk (AccR) over the RR. The auditor judges that acceptable AccR is 0.2 in this situation.

i. Give a numerical example of a materiality that results in a nirvana accounting estimate situation for the above RR. Is your materiality a specific materiality or overall materiality?
ii. Give an example of a materiality for which there exists a benchmark range with acceptable AccR = 0.2 at least at one point, but not at all points within RR, thereby solving Cockburn's problem.
iii. Give an example of a materiality that results in nightmare accounting estimate situation.
iv. What should the auditor do about an auditee company's reported estmate in its financial statements that happens to be in a nightmare situation?

EP 19-6 LO9 Explain the dilemma represented to the profession by the Petroni and Beasley study.

EP 19-7 LO9 Demonstrate with the Petroni and Beasley study data given in the text that AccR can be much bigger in practice than AudR.

EP 19-8 Basic Calibration Exercises. LO10 The following sets of questions are designed to encourage you to develop estimates. You may not know the exact value, but try to develop a range, thinking analogously to situations with which you might be more familiar. Perform these exercises based on your background knowledge alone; do not conduct any outside research. The answers for these exercises follow Calibration Exercise 3; they will give you feedback to sharpen your calibration skills. Good luck!

CALIBRATION EXERCISE 1

QUESTION	LOWER BOUND (95% CHANCE VALUE IS HIGHER)	UPPER BOUND (95% CHANCE VALUE IS LOWER)
1. What was the average market risk premium of Canada in 2011?		
2. What was the gross domestic product (GDP) growth in Canada in the third quarter of 2011 over the previous quarter?		
3. How much was RIM's (Research in Motion Limited) second quarter revenue of fiscal 2012? (The company's second quarter of fiscal 2012 is the three-month period ended August 27, 2011).		
4. What was the last reported unemployment rate in Canada in November 2011?		
5. What was Bank of Canada's target for the overnight rate as of October 25, 2011?		
6. What was the estimated percentage of those 65 years of age and over in Canada in 2011?		

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CALIBRATION EXERCISE 1 Continued

7. What was Apple's current ratio as of September 2011?		
8. What was the value of Lehman Brothers Holdings' total assets when it filed for Chapter 11 bankruptcy protection on September 15, 2008?		
9. How much were the estimated oil reserves of Canada in 2007?		
10. What was the latest USD–CAD closing rate as of December, 2011?		

CALIBRATION EXERCISE 2

QUESTION	LOWER BOUND (95% CHANCE VALUE IS HIGHER)	UPPER BOUND (95% CHANCE VALUE IS LOWER)
1. How much was GAP's merchandise inventory valued at the lower of cost or market in the audited 2010 consolidated balance sheets?		
2. Best Buy recognizes revenue from gift cards when (i) the gift card is redeemed by the customer or (ii) the likelihood of the gift card being redeemed by the customer is remote (gift card breakage). How much was Best Buy's gift card breakage income in fiscal 2011?		
3. Best Buy's revenue from merchandise sales and services is reported net of sales returns, including an estimate of future returns based on historical return rates. How much was their sales returns reserve, which represents the gross profit effect of their sales returns at February 26, 2011?		
4. What was the WTI Cushing crude oil spot price on November 30, 2011?		
5. How much was Apple's 2011 Q3 revenue?		
6. Olympus is being investigated for an accounting fraud of covering up its investment losses during the 1990s. What was the media's estimated amount of the losses based on investigation up to November 30, 2011?		
7. How much was AMR's listed liabilities when it filed for Chapter 11 bankruptcy protection?		
8. For the IPO of Facebook, how much capital was the company exploring to raise in its IPO?		
9. S&P downgraded several of the largest banks in the world this week including Goldman Sachs. How much was its exposure to European sovereign debt, as estimated by Fitch?		
10. How much was Bank of Canada's prime business rate as of December 1, 2011?		

CALIBRATION EXERCISE 3

Identify a 90% reasonable range for each of the following values:

1. What is the estimated net economic effect of BP's oil spill?
2. How does BP's oil spill compare to those of other companies?
3. What was the financial impact to Exxon due to the oil spill?
4. How many public companies are in Canada?
5. What was the amount of Enron shareholders' loss from the scandal?
6. What was the estimated amount of off-balance sheet debt in the Enron scandal?
7. What is the risk-free rate in Canada?
8. By what percentage did Apple's stock price rise after Steve Jobs returned to the company in 1997?
9. How many countries require IFRS?
10. What is the expected real GDP growth for Canada in 2012?

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ANSWERS TO CALIBRATION EXERCISES

EXERCISE 1

1. 5.9%
2. 0.9%
3. $4.2 billion (in U.S. dollars)
4. 7.4%
5. 1%
6. 15.9%
7. 1.61
8. $639 billion
9. 179 billion
10. $1 USD for $1.0168 CAD

EXERCISE 2

1. $1561 million
2. $53 million
3. $15 million
4. $100.36/bbl
5. $28.57 billion
6. $1.4 billion
7. $29.55 billion
8. $10 billion
9. $38.5 billion
10. 3.00%

EXERCISE 3

If 9 out of 10 of your ranges include these, then your ranges are well calibrated; anything lower than 90% indicates an optimism bias.

1. As high as $23 billion.
2. BP spilled 30 million gallons of oil, three times that of the Exxon Valdez; for example, $11 million.
3. In 1994, the court ordered Exxon to pay $287 million in actual damages and $5 billion in punitive damages. However, the punitive damage was reduced to $507.5 million after 14 years.
4. 5731
5. In the four years before the company's bankruptcy, the investors lost $74 billion, of which $40–45 billion was estimated to be due to fraud.
6. Approximately $19 billion; Enron revealed that the actual debt is closer to $36.4 billion, rather than the reported amount of $17 million.
7. The average yield over 10 years for Government of Canada marketable bonds is 2.59% at November 29, 2011.
8. It rose by more than 9000 percent.
9. Approximately 120 countries permit or require IRFS for domestic-listed companies.
10. 1.8%

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APPENDIX 19A

A Quantitative Model for Information Risk

How common are significant risks of estimation in practice? The Beaver, Savage and Van Allen, Petroni and Beasley, Christiansen et al. and even the Cockburn studies indicate that significant estimation uncertainties may be quite common in practice and not necessarily adequately dealt with by auditors. Identifying the specific effects of AccR is even more problematic, because there is little direct empirical evidence as individual outcomes from estimates are not normally recorded in the financial statements. However, there are exceptional circumstances where estimation of AccR is feasible, but it requires a slightly more sophisticated model than that of audit risk in order to detect the effects of AccR. In this appendix, we use the probability of material misstatement (PMM) model to isolate the effects of AccR on financial reporting.

We cannot use the term risk of material misstatement here because in the CASs it now has a very specific technical meaning which has nothing to do with AccR (by the way, this illustrates the importance of language and definitions in specifying concepts). Thus, we make do with PMM and also make some simplifying assumptions, as discussed in the chapter, such as that audit procedures and evidence will normally not affect client's business risk, thereby making audit risk (AudR) and accounting risk (AccR) independent of one another. With such assumptions it can be shown that

$$\text{PMM} = \text{AudR} + ((1 - \text{AudR}) \times \text{AccR}).$$

PMM is, thus, our way of quantitatively modelling estimation uncertainty of CAS 540 for a specific accounting estimate of interest. An advantage of this quantitative modelling is that it allows a measure of the risk of fraud that is now required by CAS 240. This modelling is further discussed in Chapter 21 (on Connect).

Note several interesting properties of PMM:

1. If there were no accounting risk (i.e., AccR = 0), then PMM = AudR. This shows us that audit risk assumes there is no accounting risk.
2. If there were no audit risk (i.e., AudR = 0, meaning the auditor has gathered all the evidence possible, such as in 100% sampling), then PMM = AccR. This shows us that accounting risk exists even though we have all the facts about the past, because there is still the unavoidable uncertainty associated with the future, per Beaver (1991). So, in a sense, the PMM concept is an attempt to make Beaver (1991) more operational for auditors so that they can meet the new requirements of CAS 540 regarding significant risks associated with estimation uncertainties.
3. Finally, note that PMM is a true probability in the sense that if AccR and AudR are true probabilities then so is PMM (in the sense that probabilities only take values within the range [0,1]). In particular, consider the special cases of AudR = 1, and AccR = 1: if either equals 1 or both equal 1, then so does PMM.

Property 1 is especially significant in that it means auditors have to consider a special perspective, consistent with Beaver (1991). This perspective is summarized in Exhibit 19A–1 below.

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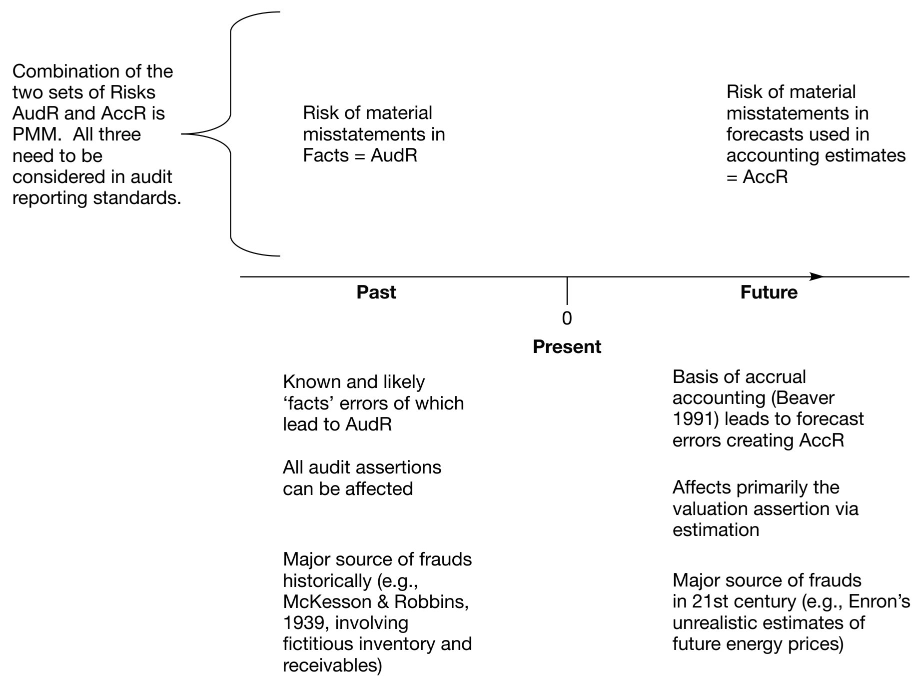
EXHIBIT 19A–1 Overview of AudR and AccR Concepts



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CHAPTER 20

Legal Liability Cases

Chapter 20, available on Connect, continues the coverage of legal liability begun in Chapter 3. Since common law has been the main source of auditor liability in the past, most of this chapter is devoted to legal liability under common law. However, we also introduce you to the increasingly important liability arising from statutory law. The U.S. Sarbanes-Oxley Act (SOX) is an example of statutory law. This law is proving to be very influential in shaping legislation in Canada and around the world in the current environment, as we saw through some of the effects of SOX discussed in Chapter 1. In Canada, we have nothing like the Securities and Exchange Commission (SEC) Acts that were passed in the U.S. in the 1930s, but, as we will discuss in this chapter, we may be moving toward that. Other statutory laws affecting accountants include the legislation prohibiting money laundering and payment of bribes. Under this legislation, public accountants (PAs) have responsibilities to disclose such activities once they are aware of them. These responsibilities are covered in this chapter and in Appendix 20A on Connect. Appendix 20A Chapter 20 introduces you to the SEC Acts and some influential court cases, all of which affect auditor liability. We review the U.S. experience because it is useful for providing some perspective on the likely future impact of recent Canadian securities legislation.

Legal liability has been increasing for all professionals, not just PAs. "Tort reform" has been a hot topic in the business and popular press. Record-setting damages have been awarded, professional liability insurance premiums have increased dramatically, and in some cases, insurance has become difficult to obtain at all. The problems affect everyone, from manufacturers to rock concert promoters and PAs. Payments for litigation have become several times greater than 20 years ago. Payments in the United States now run into the billions.

PAs are potentially liable for monetary damages and even subject to criminal penalties (e.g., under SEC rules), including fines and jail terms, for failure to perform professional services properly. They can be sued by clients, clients' creditors, investors, and the government. Exposure to large lawsuit claims is possible through class actions permitted under federal rules in Canada and the United States. In a class action suit, any number of plaintiffs with small individual claims can bring suit for large damages in the name of an extended class. After a bankruptcy, for example, 40 bondholders who lost

LEARNING OBJECTIVES

After completing this chapter, you will be able to do the following:

LO1 List some examples of potential civil and criminal litigation facing PAs.

LO2 Apply and integrate the chapter topics to analyze a practical auditing situation/case/scenario.

LO3 Recognize U.S. SEC, SOX, and other (statutory) law liability issues. (Appendix 20A)

CHAPTER APPENDIX

Appendix 20A: Liability under SEC (Statutory) Law *(online)*

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$40,000 might decide to sue, and they can sue on behalf of the entire class of bondholders for all their alleged losses (say, $40 million). In some jurisdictions, lawyers will take such suits on a contingency fee basis (a percentage of the judgment, if any). The size of the claim and the zeal of the lawyers make the class action suit a serious matter. In the United States, class action suits have become such a problem that they threaten the existence of many firms.

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CHAPTER 21

Other Professional Accounting Services and Reports, Including Fraud Auditing

Chapter 21, available on Connect, discusses the assurance services of public accountants (PAs) on information other than the standard historical financial statements. These services grow out of business, government, and public consumer demand for the objective expert association offered by PAs. However, PAs need to be careful that they do not suggest more credibility than is warranted in their reports on the information.

As you study the topics in this chapter, you will see the standards for PA engagements other than audits of financial statements. The CICA has decided to adopt only the international *audit* standards at this time and will consider at a future date what, if any, other international standards it will adopt. Existing Canadian standards for other PA services and reports, as they were outlined at the beginning of Chapter 2, will remain in effect for the time being. In this chapter, we cover some of these other types of association in more detail: some non-asssurance engagements involving financial information, some assurance engagements other than financial statements, public sector assurance engagements, and the assurance engagement conceptual framework.

LEARNING OBJECTIVES

After completing this chapter, you will be able to do the following:

Part I of this chapter deals with other types of professional accounting services and reports.

LO1 Define the various financial presentations and levels of service involved in association with special reports and compliance reporting prospectuses, MD&A, and financial statements for use in other countries.

LO2 Explain the various financial presentations and levels of service involved in association with future-oriented financial information (FOFI), prospectuses, MD&A, and financial statements for use in other countries.

LO3 Describe the umbrella standards for assurance engagements, and relate them to an acceptable reporting framework.

LO4 Explain public sector auditing concepts.

LO5 Explain environmental auditing issues.

Part II of this chapter deals with advanced issues regarding fraud auditor responsibilities.

LO6 Explain the auditing standards related to external, internal, and governmental auditors' responsibilities to detect and report frauds, errors, irregularities, and illegal acts.

LO7 Describe ways and means to prevent frauds.

LO8 Explain the use of extended audit procedures for detecting fraud.

LO9 Summarize how PAs can assist in prosecuting fraud perpetrators.

CHAPTER APPENDIX

Appendix 21A: Other Advanced Assurance Topics *(online)*

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The standards in this chapter are covered under the original *CICA Handbook* system of numbered recommendations and, thus, do not refer to CASs. However, we also reference the most closely related international standards. As we will see, Canadian standards have had a significant influence on international standards for assurance engagements.

Part II of this chapter introduces some key issues related to auditor responsibilities for detecting fraud, especially when a client asks for a special forensic investigation beyond auditor responsibilities to detect fraud under the CASs. The issue of whether such engagements constitute an assurance engagement is also discussed. The chapter concludes with the increasingly important topic of identifying fraudulent accounting estimates, integrating Chapter 19 (available on Connect) coverage of the audit of accounting estimates with Chapter 7 coverage of the responsibility to detect fraud in order to assess the risk of fraud associated with accounting estimates in financial reporting. This is likely to become an increasingly important issue for the profession in this age of Ponzi schemes and the fraudulent financial reporting which allow them.

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Key Terms

account balance a control account made up of many constituent items *(Chapter 10)*

accountability relationship a relationship in which at least one of the parties needs to be able to justify its actions or claims to another party in the relationship *(Chapter 1)*

accounting the process of recording, classifying, and summarizing into financial statements a company's transactions that create assets, liabilities, equities, revenues, and expenses *(Chapter 1)*

accounting deficiency reservation reservation based on a known GAAP departure *(Chapter 4)*

accounting process transactions streams and related account balances used to capture financial data about a business process in the accounting information system; also referred to as an *accounting cycle (Chapter 6)*

accounting risk the part of information risk due to incorrectly predicting future events, especially in accounting estimates *(Chapters 1 and 19)*

accounts receivable lapping a manipulation of the accounts receivable entries to hide a theft or fraud *(Chapter 11)*

accounts receivable subsidiary ledger a detailed listing of outstanding accounts receivable balances by individual customer that adds up to the total balance in the general ledger accounts receivable "control" account; reconciliation of the subsidiary ledger and the control account is an important control procedure and a key audit test *(Chapter 11)*

acting in the public interest acting in the interest of the users of financial statement; also, more generally, fulfilling the social role expected of the professional *(Chapter1)*

adverse opinion states that financial statements are not in accordance with GAAP *(Chapter 2)*

aged A/R trial balance a list of all outstanding accounts receivable balances organized by how long they have been outstanding; used to manage collection and assess the accounting requirement to provide an allowance for possible uncollectible accounts *(Chapter 11)*

alpha risk (type I error risk) the risk that the auditor will incorrectly reject an account balance that is not materially misstated; a type of sampling risk *(Chapter 10)*

American Institute of Certified Public Accountants (AICPA) the professional organization of independent external auditors in the United States *(Chapter 2)*

analysis audit procedures that involve evaluations of financial information by a study of plausible relationships among both financial and nonfinancial data to identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount and need to be investigated in order to assess risk of material misstatement, obtain substantive evidence, or form an overall opinion at the end of the audit *(Chapter 8)*

analytical procedures specific methods and tests used to perform analysis on client account balances *(Chapter 5)*

analytical procedures risk (APR) the probability that analytical procedures will fail to detect material misstatements (beta risk associated with APR) *(Chapter 10)*

anchoring preconceived notions about control risk that auditors carry over when they perform an audit on a client year after year, a potential pitfall if conditions have changed *(Chapter 6)*

application controls control procedures performed at the application level relating to input, processing, and output of the accounting information system *(Chapter 6)*

articles of incorporation a corporation's legal documents that set out its purpose, classes of shares that can be issued, etc. *(Chapter 14)*

assertions claims that management makes on financial statements *(Chapter 5)*

associated with financial statements any involvement of a public accountant with financial statements issued by a client *(Chapter 4)*

association a term used within the profession to indicate a public accountant's involvement with an enterprise or with information issued by that enterprise *(Chapter 4)*

assurance engagement an engagement in which the auditor adds either reasonable (high) or moderate (negative) levels of assurance *(Chapter 1)*

attest engagement when a public accountant is hired to perform procedures and issue a report resulting from those procedures that affirms the validity of an assertion; also known as an *attestation engagement (Chapters 1 and 21)*

attribute sampling in control testing this is the type of audit sampling in which auditors look for the presence or absence of a control condition *(Chapter 10)*

audit committees monitor management's financial reporting responsibilities, including meeting with the external auditors and dealing with various audit and accounting matters that may arise *(Chapter 2)*

audit deficiency reservation reservation based on insufficient audit evidence (scope restriction) *(Chapter 4)*

Audit Guidelines (AuGs) the part of the *CICA Handbook* that provides procedural guidance on implementing GAAS *(Chapter 2)*

audit of internal control over financial reporting the engagement that results in an audit report on the effectiveness of a client's internal control over financial reporting *(Chapter 17)*

audit plan the set of audit programs to be executed in an audit engagement (*Chapter 2*)

audit procedures the general audit techniques of recalculation/reperformance, observation, confirmation, enquiry, inspection, and analysis *(Chapter 10)*

audit program a list of the audit procedures auditors need to perform to produce sufficient, competent evidence as the basis for good audit decisions *(Chapters 2 and 5)*

audit risk (account level) the probability that an auditor will fail to find a material misstatement that exists in an account balance *(Chapters 1, 2, and 6)*

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audit sampling testing less than 100% of a population (items in an account balance or class of transactions) to form a conclusion about some characteristic of the balance or class of transactions *(Chapter 10)*

audit societies the term coined by Michael Power for societies in which there is extensive examination by auditors of economic and other politically important activities *(Chapter 1)*

auditee the entity (company, proprietorship, organization, department, etc.) being audited; usually it refers to the entity whose financial statements are being audited *(Chapter 1)*

auditing the verification of information by someone other than the one providing it *(Chapter 1)*

auditing standards the subset of assurance standards dealing with "high" or "reasonable" levels of assurance in assurance engagements *(Chapters 1 and 2)*

auditor's risk from taking the engagement possibility that negative consequences will arise for an auditor's professional practice as a result of taking on a particular audit engagement, such as damage to reputation, litigation, or financial loss *(Chapter 5)*

authorization ensuring that transactions are approved before they are recorded *(Chapter 9)*

balance audit program lists the substantive procedures for gathering direct evidence on the assertions (i.e., existence, completeness, valuation, ownership, presentation) about dollar amounts in the account balances and related discourses *(Chapter 8)*

balanced scorecard a tool used to analyze business performance that measures resources (learning and growth), processes (internal business), and markets (customer relations), relating all three to financial performance; an approach that the auditor can use for comparing the client firm with others in its industry *(Chapter 6)*

bank transfer schedule an audit analysis summarizing all the transfers between the auditee's bank accounts in the days just before and after the period end, to verify each amount transferred is included in only one account at the period end, not double counted *(Chapter 11)*

beta risk (type II error risk) the risk that the auditor will incorrectly accept an account balance that is materially misstated; it can result in audit failure and so is considered to be a more serious problem for the audit than incorrect rejection; a type of sampling risk *(Chapter 10)*

block sampling choosing segments of contiguous transactions; undesirable because it is hard to get a representative sample efficiently *(Chapter 10)*

bridge working papers audit documentation that connects (bridges) the control evaluation to subsequent audit procedures by summarizing the major control strengths and weaknesses, listing test of controls procedures for auditing the control strengths, and suggesting substantive audit procedures related to the weaknesses *(Chapter 9)*

business risk the probability that significant conditions, events, circumstances, or actions might arise that will adversely affect the entity's ability to achieve its objectives and execute its strategies *(Chapter 1)*

business risk–based audit approach the requirement for the auditor to understand the client's business risks and strategy in order to assess the risks of material misstatement in the financial statements and design appropriate audit procedures in response to those risks *(Chapter 6)*

business-to-business (B2B) when commercial transactions are conducted over the Internet between business entities, such as a manufacturer and its suppliers (*Appendix 6D*)

business-to-consumer (B2C) when commercial transactions are conducted over the Internet between business entities and their end customers, such as online book sales (*Appendix 6D*)

Canadian Auditing Standard (CAS) the audit standard in Canada, using the equivalent International Standard on Auditing (ISA) and the same numbering system as the ISAs *(Chapter 1)*

Canadian Coalition for Good Governance a group of the largest pension and mutual funds, whose purpose is to monitor executives and boards of directors to comply with good corporate governance and financial reporting practices (*Chapter 2)*

Canadian Institute of Chartered Accountants (CICA) the professional body of chartered accountants in Canada *(Chapter 1)*

Canadian Public Accountability Board (CPAB) the board organized to monitor the auditors of public companies in Canada *(Chapter 2)*

Canadian Securities Administrators (CSA) organization of Canadian provincial securities market administrators and regulators *(Chapter 3)*

certified internal auditors persons who have met the Institute of Internal Auditors' criteria for professional CIA credentials *(Chapter 21)*

cheating principle principle proposed to represent the main concerns of third-party users of financial statements *(Appendix 1B)*

cheque kiting the practice of building up apparent balances in one or more bank accounts based on uncollected (float) cheques drawn against similar accounts in other banks *(Chapter 11)*

class of transactions groups of accounting entries that have the same source or purpose; credit sales, cash sales, and cash receipts are three different classes *(Chapter 10)*

classical attribute sampling when a sampling unit is the same thing as an invoice or population unit *(Chapter 10)*

clean audit an audit of a client where the accounting records are accurate and easy to verify and there are good controls *(Chapter 9)*

clean opinion the highest level of assurance with an opinion sentence that reads, "In our opinion, the accompanying financial statements present fairly, in all material respects" *(Chapter 4)*

client the person or company who retains the auditor and pays the fee *(Chapter 1)*

combined audit approach an approach to performing an audit that involves obtaining assurance from reliance on internal controls based on testing their effectiveness, combined with assurance from substantive procedures *(Chapter 9)*

commission a percentage fee charged for professional services for executing a transaction or performing some other business activity *(Chapter 18)*

company-level controls internal control framework components that permeate the organization and affect the quality of its financial reporting and disclosures, consisting of the control environment; entity's risk assessment process; the information system, including the related business processes, relevant to financial reporting, and communication; and monitoring of controls *(Chapter 6)*

completeness ensuring that valid transactions are not missing from the accounting records *(Chapter 9)*

compliance assertion management's claim that it has disclosed any non-compliance with laws or regulations that affect the entity and its business *(Chapter 5)*

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compliance auditing when an audit engagement is being done for the sole purpose of reporting on compliance with laws, regulations, or rules *(Chapter 21)*

comprehensive governmental auditing auditing that goes beyond an audit of financial reports to include economy, efficiency, and effectiveness audits *(Chapter 1)*

conflict of interest a situation faced by a professional accountant in which there may be a divergence between the interests of two (or more) parties for whom the professional accountant undertakes a professional activity (e.g., clients), or between the interests of the professional and the interests of such parties, that could create a threat to the professional's objectivity or other fundamental ethical principles *(Chapter 1)*

consequentialism a moral theory that the choice of action is made based solely on the consequence; that is, that it maximizes utility; note that economics and business are based on this theory *(Chapter 3)*

continuity schedule a working paper that shows the movements in an account balance from the beginning to the end of the period under audit; used to analyze the account balance changes and the other financial statement items related to them *(Chapter 11)*

contrived sham transactions fictitious transactions created for illegal purposes, such as evading taxes *(Chapter 14)*

control activities specific company procedures designed to control processes, transactions, and applications that affect accounting information; consisting of general control activities and application-based control activities *(Chapter 6)*

control risk (CR) the risk that the client's internal controls will not prevent or detect a material misstatement *(Chapter 6)*

control risk assessment process the auditor uses to understand the client's internal control that will be sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and to design and perform further audit procedures; required to comply with the second examination standard of generally accepted auditing standards *(Chapter 11)*

control strengths specific features of effective controls that would prevent, detect, or correct material misstatements *(Chapter 9)*

control testing (compliance testing) performing procedures to assess whether controls are operating effectively *(Chapter 6)*

control weaknesses the lack of controls in particular areas that would allow material errors to get by undetected *(Chapter 9)*

corporate governance the ways in which the suppliers of capital to corporations assure themselves of getting a return on their investment; more generally, under the corporate social responsibility view, corporate governance is the system set up to hold a corporation accountable to employees, communities, the environment, and similar broader social concerns, in addition to being accountable to the capital providers *(Chapter 2)*

COSO (Committee of Sponsoring Organizations of the Treadway Commission) an organization that investigated corporate fraud and developed a control framework that has become the standard for the design of controls by companies and evaluation of controls by auditors; the COSO control framework is cited by the PCAOB in its auditing standards on internal control as an acceptable framework against which control design and effectiveness should be evaluated *(Chapter 17)*

cost of goods sold includes costs such as materials, labour, overheads, freight, and so on, that are necessary to get goods to the stage when they can be sold; calculated as the beginning inventory, plus costs added during the period, less the ending inventory; offset against sales revenues, it indicates the gross profit or gross margin on sales on which analytical expectations can be based *(Chapter 13)*

critical thinking the process of justifying one's conclusion or decision by providing good or acceptable reasons *(Chapters 1 and 3)*

critical-thinking framework principles and concepts to help structure your thinking so that your conclusions will be better justified *(Chapter 3)*

current file the administrative and evidence audit working papers that relate to the audit work for the year being audited *(Chapter 8)*

cutoff bank statement a complete bank statement, including all paid cheques and deposit slips for a 10- to 20-day period following the reconciliation date *(Chapter 11)*

cutoff error when transactions are recorded in the wrong period, either by postponing to the next period or accelerating next period transactions into the current period *(Chapter 12)*

dangling debit a false or erroneous debit balance that exists because one or more accounts are misstated *(Chapter 5)*

debt instruments legally documented obligations between a borrower and a lender, such as a bond payable, lease, or mortgage payable *(Chapter 14)*

defalcation fraud in which an employee takes assets (money or property) from an organization for personal gain; may be due to corruption or asset misappropriation *(Chapter 7)*

deontological (Kantian) ethics the moral theory that an action is right if it is based on a sense of duty or obligation *(Chapter 3)*

detailed audit plan an audit planning document outlining the nature, timing, and extent of audit procedures to assess risk of financial statement misstatement and obtain the necessary audit evidence for each assertion for all significant transactions, balances, and disclosures, including staffing decisions and time budgets *(Chapter 11)*

detection rate the ratio of the number of misstatements reported to auditors to the number of actual account misstatements *(Chapter 11)*

detection risk (DR) the risk that the auditor's procedures will fail to find a material misstatement that exists in the accounts *(Chapters 6 and 10)*

direct-effect illegal acts violations of laws or government regulations by the company, its management, or the employees that produce direct and material effects on dollar amounts in financial statements *(Chapter 7)*

direct reporting engagement a type of assurance engagement in which the assertions are implied and not written down in some form *(Chapters 1 and 21)*

direction of the test description of the nature of an audit test procedure in terms of whether it involves vouching from the accounting records back to source documents ("grave to cradle") or tracing from the source documents up to the accounting records ("cradle to grave") *(Chapter 9)*

disclaimer of opinion auditor's declaration that no opinion is given on financial statements and the reasons why this is so, usually due to a scope limitation; also called a *denial of opinion (Chapter 2)*

dual dating refers to instances of dating the audit report as of the date that financial statements are approved by the auditee's responsible parties; includes an additional date indicating that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements described in the relevant note to the financial statements, which outlines the effects of the subsequent event or events causing that amendment *(Chapter 16)*

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dual-direction testing audits both control over completeness in one direction and control over validity in the other *(Chapter 11)*

electronic commerce (e-commerce) any trade that takes place by electronic means *(Chapter 6)*

embezzlement fraud involving employees or non-employees wrongfully taking money or property entrusted to their care, custody, and control; often accompanied by false accounting entries and other forms of lying and cover-up *(Chapter 7)*

employee fraud the use of dishonest means to take money or other property from an employer *(Chapter 7)*

engagement letter sets forth terms of engagement, including an agreement about the fee when a new audit client is accepted *(Chapter 5)*

engagement partner one of the most experienced members of the audit team who makes the final decision on the audit opinion *(Chapter 15)*

engagement quality review review of working papers and financial statements by a partner not responsible for client relations; ensures that quality of audit work is in keeping with the standards of the audit firm *(Chapter 15)*

enterprise resource planning systems (ERPS) an information system in which inputs and outputs from many or all the business processes will be processed in an integrated manner, so the accounting component of the information system will be closely related to many other functional areas such as sales, inventory, human resources, cash management, etc. *(Chapter 6)*

entity's risk assessment process management's process for identifying business risks that could affect financial reporting objectives and for deciding on actions to address and minimize these risks; understanding this process helps auditors to assess the risk that the financial statements could be materially misstated *(Chapter 6)*

error in financial statement auditing, unintentional misstatement or omission of amounts or disclosures in financial statements *(Chapter 7)*

error analysis qualitative evaluation of control risk *(Chapter 10)*

ethical dilemma a problem that arises when a reason to act in a certain way is offset by a reason to not act that way *(Chapter 3)*

evidence collection steps 4, 5, and 6 of the sampling method, which are performed to get the evidence *(Chapter 10)*

evidence evaluation final step of the sampling method; to evaluate the evidence and make justifiable decisions about the control risk *(Chapter 10)*

expectation about the population deviation rate an estimate of the ratio of the number of expected deviations to population size *(Chapter 10)*

expectations gap the difference that can arise between what the public expects of the auditor's social role and what the professional standards and practice deliver *(Chapter 1)*

expected dollar misstatement a preliminary estimate of expected monetary misstatements in a total monetary value recorded for a population *(Chapter 10)*

expenditure analysis comparing the suspect's spending with known income *(Chapter 21)*

extending the audit conclusion performing substantive-purpose audit procedures on the transactions in the remaining period and on the year-end balance to produce sufficient competent evidence for a decision about the year-end balance *(Chapter 10)*

extent the amount of audit work planned, such as sample size for an audit test *(Chapter 8)*

external auditor an auditor who is an outsider and independent of the entity being audited *(Chapters 1 and 21)*

fairly present in financial reporting, that management's financial statements achieve the properties of being a faithful representation of the economic realities they purport to portray, and of not being misleading to users *(Chapter 5)*

fidelity bond a type of insurance policy that covers theft of cash by employees *(Chapter 11)*

financial error an unintentional misstatement of the financial statements; in contrast, fraud (or fraudulent financial reporting), is defined as intentional misstatement *(Chapter 9)*

financial reporting broad-based process of providing statements of financial position (balance sheets), statements of results of operations (income statements), statements of results of changes in financial position (cash flow statements), and accompanying disclosure notes (footnotes) to outside decision makers who have no internal source of information like the management of the company has *(Chapter 1)*

FOB destination terms of sale indicating that title to goods sold transfers from seller to buyer when the goods reach the buyer's destination; can give rise to an amount of inventory-in-transit at year-end that is owned by an auditee company (the seller) that is not physically on hand at the auditee's premises *(Chapter 11)*

FOB shipping terms of sale indicating that title to goods sold transfers from seller to buyer when the goods are handed over from the seller to the shipping company that will ultimately deliver them to the buyer; can give rise to an amount of inventory-in-transit at year-end that is owned by an auditee company (the buyer) that is not physically on hand at the auditee's premises *(Chapter 11)*

forensic accounting application of accounting and auditing skills to legal problems, both civil and criminal *(Chapters 1 and 21)*

fraud an attempt by one party (the fraudster) to deceive someone (the victim) for gain; in financial statement auditing, an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage *(Chapters 1 and 7)*

fraud audit questioning (FAQ) a non-accusatory method of asking key questions during a regular audit to give personnel an opportunity to supply information about possible misdeeds *(Chapter 21)*

fraud auditing a proactive approach to detect financial frauds using accounting records and information, analytical relationships, and an awareness of fraud perpetration and concealment efforts (ACFE) *(Chapter 1)*

fraud incentive when management is under pressure, from sources outside or inside the entity, to achieve an expected (perhaps unrealistic) earnings target or financial outcome, particularly as the consequences to management for failing to meet financial goals can be significant; also, when individuals are tempted to misappropriate assets because, for example, they are living beyond their means *(Chapter 7)*

fraud opportunity when an individual believes internal control can be overridden to allow a fraud to be perpetrated; for example, when the individual is in a position of trust or has knowledge of specific deficiencies in internal control *(Chapter 7)*

fraud rationalization when individuals possess an attitude, character, or set of ethical values allowing them to knowingly and intentionally commit a dishonest act, or when otherwise honest individuals are in an environment that puts sufficient pressure on them to commit a fraudulent act *(Chapter 7)*

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fraud risk in financial statement auditing, the possibility that fraud has resulted in intentional misstatement in the financial statements; two types of intentional misstatements are relevant to the auditor: those resulting from fraudulent financial reporting and those resulting from misappropriation of assets *(Chapter 7)*

fraud triangle a model of the three factors that make fraud likely: incentive, opportunity, and rationalization (or similar concepts) *(Chapters 6 and 7)*

fraudulent financial reporting intentional manipulation of reported financial results (by manipulation of accounting records or supporting documents, misrepresentation or omission of significant information, or intentional misapplication of accounting principles) to portray a misstated economic picture of the firm by which the perpetrator seeks an increase in personal wealth gain through a rise in stock price or compensation *(Chapter 7)*

further possible misstatements those that could exist over and above the total of known and likely misstatements because of the limitations of the testing concept of auditing *(Chapter 15)*

general controls organizational features that have a pervasive impact on accounting processes and applications and the effectiveness of application-level control procedures *(Chapter 6)*

generally accepted accounting principles (GAAP) those accounting methods that have been established in a particular jurisdiction by formal recognition by a standard-setting body, or by authoritative support or precedent such as the accounting recommendations of the *CICA Handbook (Chapter 1)*

generally accepted auditing standards (GAAS) those auditing recommendations that have been established in a particular jurisdiction by formal recognition by a standard-setting body, or by authoritative support or precedent such as the auditing and assurance recommendations of the *CICA Handbook (Chapter 2)*

haphazard selection unsystematic way of selecting sample units *(Chapter 10)*

horizontal analysis comparison of changes of financial statement numbers and ratios across two or more years *(Chapters 5 and 21)*

hypothesis testing when auditors hypothesize that the book value is materially accurate regarding existence, ownership, and valuation *(Chapter 10)*

illegal act in financial statement auditing, non-compliance with a domestic or foreign statutory law or government regulation attributable to the entity under audit, or to management or employees acting on the entity's behalf; this does not include personal misconduct by the entity's management or employees unrelated to the entity's business activities *(Chapter 7)*

imperatives universal principles assumed by monistic moral theories *(Chapter 3)*

indirect-effect illegal acts violations of laws and regulations that are far removed from financial statements *(Chapter 7)*

individually significant items items in account balances that exceed the material misstatement amount; in audit sampling these should be removed from the population and audited completely *(Chapter 10)*

information risk the possible failure of financial statements to appropriately reflect the economic substance of business activities *(Chapter 1)*

information technology (IT) the hardware and software needed to process data *(Chapter 1)*

inherent risk (IR) the probability that material misstatements could have occurred *(Chapter 6)*

initial public offering (IPO) first time offering of a corporation's shares to the public *(Chapter 2)*

interim audit work covers procedures performed several weeks or months before the balance sheet date *(Chapter 5)*

interim date a date before the end of the period under audit when some of the audit procedures might be performed, such as control evaluation and testing *(Chapter 2)*

internal auditing verification work performed by company employees who are trained in auditing procedures, mainly used for internal control purposes but external auditors can rely on internal audit work if certain criteria are met *(Chapter 1)*

internal control the system of policies and procedures needed to maintain adherence to a company's objectives; especially the accuracy of recordkeeping and safeguarding of assets *(Chapter 2)*

internal control program an audit planning document summarizing the auditor's understanding of internal control and the control testing procedures to be performed to assess control risk and control effectiveness *(Chapter 8)*

internal control questionnaire checklist to gather evidence about the control environment *(Chapter 9)*

International Federation of Accountants (IFAC) an organization dedicated to developing international auditing standards *(Chapter 1)*

international harmonization international convergence of national accounting and auditing standards with IFRSs and ISAs, including going concern, fraud, and the audit risk model *(Chapter 1)*

International Standards on Auditing (ISAs) the auditing standards of IFAC *(Chapter 1)*

joint and several liability a legal liability regime in which one party found to be liable can be required to pay the full amount of the damages even if there are other parties that are partially liable but bankrupt or otherwise unable to pay a proportionate share of the damages *(Chapter 20)*

key controls important control procedures; auditors should identify and audit only these controls *(Chapter 9)*

known misstatement the total amount of actual monetary error found in a sample *(Chapters 10 and 15)*

legal responsibilities auditor responsibilities imposed by the legal system *(Chapters 3 and 20)*

levels of assurance the amount of credibility provided by accountants and auditors *(Chapter 4)*

likely misstatement the projection of a known misstatement identified in a representative sample to the whole population *(Chapters 10 and 16)*

limited liability partnership (LLP) a company whose partners' liability is limited to the capital they have invested in the business *(Chapters 1 and 20)*

lower-of-cost-or-net-realizable-value (LCNRV) an accounting rule that requires inventory to be reported at its cost, or, if the amount that could be obtained by selling it net of any selling costs is less than its cost, at that lower amount; the lower amount is achieved by recording a writedown *(Chapter 13)*

management letter written communication to management of control deficiencies uncovered by the auditor; also called a *management control letter (Chapter 9)*

management representation letter the written statements by management provided to the auditor to confirm certain matters or to support other audit evidence as required by CAS 580 *(Chapter 15)*

management's discussion and analysis (MD&A) a section of the annual report that includes management's analysis of past operating and financial results; can also include forward-looking information; the financial statement auditor reviews the information to ensure there is nothing that is inconsistent with the audited financial

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statements but the MD&A itself is not audited *(Chapter 21)*

materiality amount of misstatement that would likely affect a user's decision *(Chapter 1)*

materiality for financial statements as a whole (overall materiality) largest amount of uncorrected dollar misstatement that might exist in financial statements that still fairly present the auditee's financial position and results of operations under an acceptable financial reporting framework *(Chapter 5)*

minutes notes taken to summarize key decisions made in a formal meeting, such as a corporate board meeting *(Chapter 5)*

misappropriation of assets the theft or misuse of an organization's assets (a type of defalcation) *(Chapter 7)*

mitigating factors elements of financial flexibility (saleability of assets, lines of credit, debt extension, dividend elimination) available as survival strategies in circumstances of going-concern uncertainty, which may reduce the financial difficulty problems *(Chapter 19)*

modified opinion report an audit report that contains an opinion paragraph that does not give the positive assurance that everything in the financial statements is in conformance with GAAP; includes qualified opinion, adverse opinion, and disclaimer of opinion reports *(Chapter 2)*

monetary-unit sampling (MUS) a modified form of attributes sampling that permits auditors to reach conclusions about monetary amounts as well as compliance deviations *(Chapter 10)*

money laundering engaging in specific financial transactions in order to conceal the identity, source, and/or destination of money resulting from an illegal act, which may involve organized crime, tax evasion, or false accounting *(Chapter 11)*

monistic theories ethical theories that assume universal principles apply regardless of the specific facts of a situation *(Chapter 3)*

moral imagination part of ethical reasoning where one has the ability to imagine others' feelings about the consequences of a decision *(Chapter 3)*

moral responsibilities auditor responsibilities to conform to broad social norms of behaviour *(Chapters 3 and 18)*

nature (of audit procedures) the six general techniques of an account balance audit program: recalculation/reperformance, confirmation, enquiry, inspection, observation, and analysis *(Chapters 8 and 10)*

negative assurance (moderate assurance) statement that, having carried out a professional engagement, nothing has come to the public accountant's attention that would give reason to believe that matters under consideration do not meet specified suitable criteria *(Chapter 4)*

no assurance the PA provides zero assurance credibility because there is no independent verification of the data provided by the client; for example, a compilation engagement *(Chapter 4)*

non-excludability a product of audited financial statements, that the auditor is unable to prevent any user from consuming the good *(Appendix 1B)*

non-rival consumption a product of audited financial statements, that one person's consumption of a good prevents another person from consuming it *(Appendix 1B)*

nonsampling risk the possibility of making a wrong decision, which exists in both statistical and nonstatistical sampling *(Chapter 10)*

nonstatistical (judgmental) sampling choosing items in a population for audit testing and evaluating the findings based on the auditor's own knowledge and experience rather than statistical methods *(Chapter 10)*

off the balance sheet refers to how certain obligations and commitments do not have to be reported on the balance sheet, such as purchase commitments and operating leases *(Chapter 14)*

operational auditing (performance auditing or management auditing) auditors' study of business operations for the purpose of making recommendations about economic and efficient use of resources, effective achievement of business objectives, and compliance with company policies *(Chapters 1 and 21)*

overall audit strategy an audit planning document that sets the scope, timing, and direction of the audit, and that guides the development of the audit plan, including the reporting objectives; the nature, timing, and extent of resources necessary to perform the engagement; and the nature of the communications required *(Chapter 5)*

peer review study of a firm's quality control policies and procedures, followed by a report on a firm's quality of audit practice *(Chapter 2)*

performance materiality amount(s) set by the auditor at less than materiality for the financial statements as a whole, to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole; if applicable, also the amount(s) set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances, or disclosures *(Chapter 5)*

permanent file audit working papers that are of continuing interest from year to year, including the client company's articles of incorporation, shareholder agreements, major contracts, minutes, etc. *(Chapter 8)*

pervasive materiality GAAP departures so significant that they overshadow the financial statements or affect numerous accounts and financial statement relationships *(Chapter 4)*

physical representation of the population the auditor's frame of reference for selecting a sample; for example, a journal listing of recorded sales invoices *(Chapter 10)*

planning memorandum where all planning activities are recorded and summarized *(Chapter 8)*

pluralistic theories ethical theories that assume that there are no universal principles and that the best approach is to use the principles that are most relevant in a particular case *(Chapter 3)*

population the set of all the elements that constitute an account balance or class of transactions *(Chapter 10)*

population unit each element of a population *(Chapter 10)*

positive assurance a high, but not absolute, level of assurance; also referred to as reasonable assurance in the context of audit reporting *(Chapter 4)*

possible misstatement the further misstatement remaining undetected in the units not selected in the sample *(Chapter 10)*

practice inspection the system of reviewing and evaluating practice units' audit files and other documentation by an independent external party *(Chapter 2)*

pre-audit risk management activities procedures auditors perform before accepting an audit engagement to ensure the client and the engagement do not pose an unacceptably high risk of audit failure *(Chapter 5)*

predecessor the auditor that held the engagement previously, before a new successor auditor took on the engagement *(Chapter 5)*

primary beneficiaries third parties for whose primary benefit the audit or other accounting service is performed *(Chapter 20)*

pro forma financial data the presentation of financial statements as if the event had occurred on the date of the balance sheet; for example, perhaps the best way to

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show the effect of a business purchase or other merger *(Chapter 15)*

problem recognition the first three steps of the sampling method *(Chapter 10)*

professional judgment the application of relevant training, knowledge, and experience, within the context provided by auditing, accounting, and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement *(Chapter 1)*

professional responsibilities the rules and principles for the proper conduct of an auditor in her work; necessary to obtain the respect and confidence of the public, achieve order within the profession, and to provide a means of self-policing the profession; also known as *professional ethics* *(Chapters 3 and 18)*

professional skepticism an auditor's tendency to question management representations and look for corroborating evidence before accepting them *(Chapter 3)*

projected misstatement the estimated amount of likely misstatement in a population based on extrapolating a misstatement discovered in a sample (known/identified misstatement) over the whole population *(Chapter 10)*

proportionate liability a legal liability regime where a party found to be partly liable is only responsible for paying a part of the damages in proportion to their share of the blame *(Chapter 3)*

prospectus set of financial statements and disclosures distributed to all purchasers in an offering registered under Securities Law *(Chapter 2)*

providing assurance the "adding of credibility" to financial information by objective intermediaries *(Chapter 1)*

public accountant (PA) individual doing audit work with a public accounting firm; includes Chartered Accountants (CA), Certified General Accountants (CGA), Certified Management Accountants (CMA) *(Chapter 1)*

Public Company Accounting Oversight Board (PCAOB) a five-member board created through the *Sarbanes-Oxley Act* (SOX) to oversee the auditors of public companies in the United States *(Chapter 2)*

public sector activities of all levels of government *(Chapter 1)*

purchase cutoff recording purchase transactions in the proper period, including accruals of payments not due until the following period *(Chapter 12)*

qualified reports audit reports that contain an opinion paragraph which does not give the positive assurance that everything in the financial statements is in conformity with GAAP *(Chapter 4)*

quality inspection examination and evaluation of the quality of the overall practice *(Chapter 2)*

quality of earnings extent to which the reported earnings number represents actual economic performance, rather than selective accounting policy choices or management manipulation *(Chapter 6)*

random sample a set of sampling units so chosen that each population item has an equal likelihood of being selected in the sample *(Chapter 10)*

reasonable assurance a high, but not absolute, level of assurance; also referred to as *positive assurance* in the context of audit reporting *(Chapter 6)*

recalculation audit procedure that involves redoing calculations already performed by auditee personnel to determine if the result is accurate *(Chapter 8)*

reliance letter where accountants sign that they have been notified that a particular recipient of the financial statements and audit report intends to rely upon them for particular purposes *(Chapter 20)*

reperformance audit procedure in which the auditor executes a procedure that is part of the auditee's internal control to assess its effectiveness *(Chapter 8)*

replicate re-perform a selection procedure and get the same sample units *(Chapter 10)*

reportable matters significant deficiencies in the design or operation of the company's internal control structure, which could adversely affect its ability to report financial data in conformity with GAAP *(Chapter 17)*

representational faithfulness when information presented in an entity's financial statements closely corresponds to the actual underlying transactions and events affecting it, conveying their economic substance rather than simply their legal form *(Chapter 5)*

representative sample sample that mirrors the characteristics of the population being studied *(Chapter 10)*

reservations major variations on the standard audit report *(Chapter 4)*

response rate the proportion of the number of confirmations returned to the number sent *(Chapter 11)*

revenue recognition problems techniques used by financial statement preparers to manipulate reported revenues resulting in low-quality earnings *(Chapter 11)*

risk assessment program an audit planning document listing the specific procedures for gaining understanding of the auditee's business transaction processing systems and controls, as well as for assessing the inherent risks and the control risk for the assertions in financial account balances and transaction streams *(Chapter 8)*

risk-based reasoning (RBR) reasoning using the following decision rule: If an actual estimation uncertainty associated with a recorded amount is greater than an acceptable level, then reject the recorded amount; otherwise, accept it *(Chapter 19)*

risk of assessing the control risk too high probability that the compliance evidence in the sample indicates high control risk when the actual (but unknown) degree of compliance would justify a lower control risk assessment *(Chapter 10)*

risk of assessing the control risk too low probability that the compliance evidence in the sample indicates low control risk when the actual (but unknown) degree of compliance does not justify it *(Chapter 10)*

risk of incorrect acceptance (RIA) decision to accept a balance as being materially accurate when the balance is materially misstated *(Chapter 10)*

risk of incorrect rejection the decision to accept a balance as being materially misstated when it is not *(Chapter 10)*

risk of material misstatement assessed on the financial statements overall and based on pervasive factors such as fraud, going concern, or other significant business-level risks; the auditor's assessment of combined inherent and control risk *(Chapters 5 and 6)*

rollforward period the period between the cutoff and year-end *(Chapter 12)*

sales cutoff recording sales transactions in the proper period *(Chapter 11)*

sample a set of sampling units *(Chapter 10)*

sampling error the amount by which a projected likely misstatement amount could differ from an actual (unknown) total as a result of the sample not being exactly representative *(Chapter 10)*

sampling risk the probability that an auditor's conclusion based on a sample might be different from the conclusion based on an audit of the entire population *(Chapter 10)*

sampling unit unit used for testing a client's population, for example, a customer's account, an inventory item, a debt issue, or a cash receipt *(Chapter 10)*

scanning audit procedure in which the auditor quickly reviews a whole report, account, journal or other listing in the auditee's records to look for any unusual

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items that require further investigation *(Chapter 8)*

scope the entity and the financial statements that will be covered by the audit engagement, and the client documents and records to be examined to provide the necessary audit evidence *(Chapter 11)*

scope limitation conditions where auditors are unable to obtain sufficient appropriate evidence *(Chapter 4)*

search for unrecorded liabilities set of procedures designed to yield audit evidence of liabilities that were not recorded in the period following the audit client's balance sheet date *(Chapter 12)*

Securities and Exchange Commission (SEC) the main U.S. government agency regulating the securities markets in the United States *(Chapter 2)*

self-regulation a situation where a professional group is given the power to monitor and discipline its members by the government *(Chapters 2 and 18)*

significant control deficiency when the auditor believes that an identified control deficiency or combination of deficiencies exposes the entity to a serious risk of material misstatement *(Chapter 9)*

significant risks identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration *(Chapter 5)*

skewness the concentration of a large proportion of the dollar amount in only a small number of the population items *(Chapter 10)*

specific materiality materiality level(s) to be applied to those particular classes of transactions, account balances, or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements *(Chapter 5)*

specific performance materiality amount(s) set by the auditor at less than the specific materiality level(s) to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds specific materiality *(Chapter 5)*

standard deviation a measure of population variability *(Chapter 10)*

statistical sampling audit sampling that uses the laws of probability for selecting and evaluating a sample from a population for the purpose of reaching a conclusion about the population *(Chapter 10)*

Strategic Systems Auditing (SSA audits) an auditing approach that has a top-down focus, starting with an in-depth understanding of the auditee's business; enables the auditor to understand the strategic objectives of the auditee, the risks the auditee faces in relation to these objectives, and the controls necessary for the business to respond to these risks; obtaining an understanding of the business as a whole, then proceeding to look at the details of the risky transactions in the context of the knowledge gained at the broader level *(Chapter 6)*

stratification subdividing the population in an audit sample by, for example, account balance size *(Chapter 10)*

substantive audit approach an approach to performing an audit that involves obtaining assurance only from substantive procedures, with no reliance on internal control effectiveness *(Chapter 9)*

substantive audit procedures designed to detect material misstatements at the assertion level; comprised of tests of details (classes of transactions, account balances, and disclosures) and substantive analytical procedures *(Chapter 6)*

substantive tests of details auditing the performance of procedures to obtain direct evidence about the dollar amounts and disclosures in the financial statements *(Chapter 10)*

successor a new auditor who takes over the engagement from the predecessor *(Chapter 5)*

systematic random selection using a predetermined population and sample size and random starting places *(Chapter 10 and Appendix 10B)*

those charged with governance person(s) or organization(s) (may include management) with responsibility for overseeing the strategic directions of the entity and obligations related to the accountability of the entity; includes overseeing the financial reporting process *(Chapter 5)*

three-party accountability an accountability relationship in which there are three distinct parties (individuals): an asserter, an assurer, and a user of the asserted information *(Chapter 1)*

timing when the planned audit procedures are to be performed, either before, at, or after period end *(Chapter 8)*

tolerable deviation rate rate of deviation that can exist without causing a minimum material misstatement in a test of controls procedure *(Chapter 10)*

tort legal action covering civil complaints other than breach of contract; normally initiated by users of financial statements *(Chapter 3)*

unaudited—see Notice to Reader note accountant places on each page of financial statements in performing write-up or compilation work *(Chapter 17)*

unmodified opinion report an audit report in which the auditor is not calling attention to anything wrong with the audit work or the financial statements *(Chapter 2)*

unrestricted random sample sample obtained by means of unrestricted random selection *(Appendix 10B)*

unrestricted random selection using a printed random number table or computerized random number generator to obtain a list of random numbers *(Chapter 10)*

utilitarianism a moral theory that the right choice is the one which results in the greatest good for the greatest number of people *(Chapter 3)*

validity ensuring that the recorded transactions are ones that should be recorded; that is, that they exist *(Chapter 9)*

value-for-money (VFM) audit audit concept from public sector that incorporates audits of economy, efficiency, and effectiveness *(Chapter 1)*

vertical analysis analytical procedure of comparing all financial statement items to a common base; for example, total assets or total sales *(Chapters 5 and 21)*

walk-through following one or more transactions through the accounting and control systems to obtain a general understanding of the client's systems *(Chapters 10 and 11)*

white-collar crime misdeeds committed by business and government professionals, typically non-violent *(Chapter 7)*

window dressing in financial reporting, the inappropriate manipulation of account balances by management, usually at the end of a period, to make the financial position or performance reported in the financial statements appear more attractive to users; often involves using accounting policies, journal entries, or actual cash transactions between related parties that have no real business purpose, resulting in artificial embellishment of the company's results or liquidity to obtain some benefit. (i.e., salaries and bonuses that depend on how well the company performed) *(Chapter 11)*

working paper reference index table of contents listing all the index numbers used to identify sections of the audit working paper files *(Chapter 15)*

year-end audit work audit procedures performed at and shortly after the balance sheet date *(Chapter 5)*

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