

EP 1-1

EP1-1 When the PA is hired by Hughes Corporation, he can no longer be considered independent with respect to the annual audit. The annual audit may then be unnecessary in a short-run view and unnecessary to the extent of services exclusive of the attest opinion. It is true that the in-house CPA can perform all the procedural analyses that would be required of an independent audit; however, it is extremely unlikely that he could inspire the confidence of users of financial statements outside the company. He cannot modify the perception of potential conflict of interest that creates demand for the independent audit. As a matter of ethics rules, this PA would be prohibited from signing the standard unqualified attest opinion.

EP 1-6

EP1-6 The neighbor appears to be uninformed on the following points:

- | | |
|---|---|
| 1- According to auditors' dogma, Price Waterhouse did not <u>prepare</u> the Dodge Corporation financial statements, and no auditor <u>prepares</u> a company's statements. | Inform your neighbor that Dodge management is primarily responsible for preparing the financial statements and deciding upon the appropriate accounting principles. |
| 2. An unqualified opinion does not mean an investment is <u>safe</u> . | Tell your neighbor that the financial statements are <u>history</u> . The value of his investment depends on future events, including the many factors that affect market prices. Tell him the opinion only means that the statements conform to GAAP (and you can add that the auditor knows of no material fraud or error). |

EP 1-9

EP1-9 Management certification means that, in the words of SOX, "The CEO and CFO of each issuer shall prepare a statement to accompany the audit report to certify the "appropriateness of the financial statements and disclosures contained in the periodic report, and that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the issuer." A violation of this section must be knowing and intentional to give rise to liability." Before SOX, management's responsibility was implicit, now it is made publicly explicit in writing. The primary effect on auditors is to reduce their legal liabilities by making it clearer that management takes on primary responsibility for financial reporting. Auditors are still needed because as the chapter discusses users may not trust management so any statements management makes does not really address this problem. Management however is now held more accountable. For example, management may no longer claim they didn't understand technical aspects of accounting and deferred to the auditor's judgment.

- EP2-1 a. PAs should not follow clients' suggestions about the conduct of an audit unless the suggestions clearly do not conflict with his professional competence, judgment, honesty, independence, or ethical standards. Where there is no disagreement about the results to be accomplished and the client's suggestion represents a good idea a PA can accept it. Within professional bounds, mutual agreement with the client is all right. The PA must never agree to any arrangement which violates generally accepted auditing standards or the Code of Professional Conduct.
- b. The reasons against dividing the assignment of audit work solely according to assets, liabilities and income and expenses include the following:
1. Work should be assigned to staff members by considering the degree of difficulty in relation to the technical competence and experience of individual staff members.
 2. Sequence of work performed on an examination should be in accordance with an overall audit plan.
 3. It is impossible to segregate work areas by major captions because often a close relationship exists among a number of accounts in more than one category, as for example where income is based on assets or expense is based on liabilities.
 4. Often a single audit work paper is desirable to substantiate balances in accounts of various types, such as an insurance analysis supporting premium disbursements, the expense portion and the prepaid balance.
 5. Duplication of staff effort would be more likely to occur if assignments were made on such a basis.
 6. Frequently, the scope of work regarding a single account requires simultaneous participation by the staff, such as in the observation of inventories.
 7. Many audit operations are not susceptible to division by category, as for example investigating internal control, testing transactions and writing the report.
- c. The PA's staff member whose uncle owns the advertising agency should not be assigned to examine Cooper's advertising account. The PA firm is responsible for avoiding relationships which might suggest a conflict of interest. Regardless of whether this staff member could be independent and unbiased in such a situation, outsiders probably will be influenced in their thinking by the fact that his uncle is the owner of the advertising agency. Even if a problem of ethics were not involved, it would be unwise for the PA to assign this staff member because the client's attitude could change significantly and the PA firm's position would be jeopardized if difficulties later arose in connection with the contract. Any situation in which bias exists or might arise should be avoided.

EP 2-6

EP2-6 Audit Report Language

- a. The auditor is reporting to the body that has engaged the auditing services. While the report may be read and used by others who are indirect beneficiaries of the audit, current custom is not to address the report to the unknown class of users.
- b. The scope paragraph should specifically identify the audited statements by name so that there can be no mistake about the subject of the report. The alternative language is not as precise.
- c. The standard language effectively bases the audit on an extensive body of written auditing standards that are known to others and can be cited in case of controversy. The alternative language, on the other hand, seems to break loose from profession-wide quality norms and make the audit quality depend more on "the circumstances," which introduces an element of mystery and lack of definition into the report.
- d. The alternative wording is similar to the typical British audit report, and they seem to be able to live with it, but Canadian auditors believe that "opinion" connotes belief or judgment stronger than impression but less strong than positive knowledge. Canadian auditors do not wish to appear to have full, positive knowledge about the statements on the grounds that it's not feasible to know all there is to know about the financial statements. Also, the standard language leans heavily on GAAP as the criteria for fair presentation whereas the alternative language contains no reference to authoritative accounting criteria.

EP 5-1

EP5-1 Analytical Review Ratio Relationships

- a. The current ratio was made larger than it should have been. The current asset numerator was made larger (fictitious accounts receivable larger than the inventory removed) while the current liability denominator did not change. (However, if the income tax effect of the error is included, the current liabilities change by a greater proportion than the current assets change, and it turns out that the current ratio was made smaller!)
- b. In this case the relative rate of change is important, because both the numerator and denominator of the current ratio are changed by the same amount.
 1. Current ratio (before) was greater than 1:1--the incorrect accounting makes the ratio larger than it should be.

| | |
|----------|-------------------------------------|
| Example: | Before \$100,000 / \$20,000 = 5.0:1 |
| | After \$ 90,000 / \$10,000 = 9.0:1 |
 2. Current ratio (before) was equal to 1:1--the incorrect accounting does not change the ratio.

| | |
|----------|------------------------------------|
| Example: | Before \$100,000 / \$100,000 = 1:1 |
| | After \$ 90,000 / \$ 90,000 = 1:1 |

3. Current ratio (before) was less than 1:1--the incorrect accounting makes the ratio smaller than it should be.

Example: Before \$ 20,000 / \$100,000 = 0.2:1
 After \$ 10,000 / \$ 90,000 = 0.11:1

- c. Effect of unrecorded purchase counted in physical inventory, assuming the accounts are adjusted to include the inventory on hand.

Inventory is not misstated.
Cost of goods sold is understated.
Gross profit is overstated.
Net income is overstated.

The question asks for the effect on the ratios compared to what they would have been without the error.

Current ratio:

Greater than 1:1 before.

The error of recording the inventory and not the current payable makes the ratio larger.

Equal to 1:1 before.

The error makes the ratio larger.

Less than 1:1 before.

The error makes the ratio larger.

Gross margin ratio: The error makes it larger.

Cost of goods sold ratio: The error makes it smaller.

Receivables turnover:

The error does not affect either the sales numerator or the receivables denominator, so the ratio is not affected.

- d. In this case the net receivables amount is correct. The proper adjustment should be to reduce gross receivables and the allowance for doubtful accounts by an equal amount.

Current ratio:

Not affected because the current asset and current liability totals are not affected.

Day's sales in receivables:

Not affected when the net receivables is used to calculate the ratio.

Doubtful account ratio:

The improper accounting causes the ratio to be larger than it should be. (Proper accounting would cause the allowance numerator to be reduced to a greater extent, by a faster rate, than the receivables denominator.)

Receivables turnover:

Not affected when the net receivables is used to calculate the ratio.

Return on beginning equity:

Not affected because the income is measured properly with adequate allowance for doubtful accounts.

Working capital/Total assets:

Not affected because both terms are measured properly.

- e. The effect on the Altman (1968) discriminate Z score is a larger score because of the directional effect of all the changes mentioned:

Working capital/Total assets: The ratio is larger because WC is greater and TA is smaller.

Retained earnings/Total assets: The ratio is larger because retained earnings remained the same while TA is smaller.

Earnings BIT/Total assets: The ratio is larger, because EBIT is about the same as last year, and TA is smaller.

Market equity/Total debt: The ratio is larger because market equity is the same, while total debt is lower.

Net sales/Total assets: The ratio is larger because net sales have decreased less (5%) than the total assets have decreased (10%).

DC 5-4

DC5-4 Predecessor and Successor Auditors

Wells & Ratley need to initiate communications with both predecessor auditors. The situation is unusual, but W&R need to obtain complete information from all the predecessors involved since the last audit (2012 financial statements). Both Canby & Co. and Albrecht & Hubbard are predecessors. (If Canby & Co. had completed the 2013 audit, and W&R had been hired to perform the 2014 audit, then Canby & Co. would be the only Predecessor. A&H would be history.)

Inquiry of only one of the predecessors would not result in complete information because the circumstances surrounding each auditor change may be different. The two predecessors, having served at different times and for different lengths of time, may have different knowledge about Allpurpose Loan Company and its president.

If the company is public and subject to securities market reporting requirements, reports for both changes should have been filed with the regulator.

DC 5-6

DC5-6 Preliminary Analysis, Materiality, Assertions.

- a) To assess the risk of material misstatement, the auditor must understand the nature of the business on what needs to be accounted for, because it will affect what inherent risks exist in the business and thus its accounts. This illustrates the importance to the auditor of understanding how a business creates value and earns profits. The case requires one to apply one's knowledge of the business, given the facts provided in the case and other reasonable assumptions, to judge the relevant inherent risks for different financial statement components in relation to the five principle assertions: existence, completeness, ownership, valuation and presentation [ECOVF]
- b) To make a decision on materiality, we first identify the main users of financial statements – these are the minority shareholders who have asked for an audit for the first time this year. Also, the bank holding the long term loan shown in the trial balance likely will use the f/s to evaluate the risk of the company not paying back its loan. Other qualitative factors could be relevant, like contracts or covenants based on f/s balances, transaction volumes, indicators of fraud, etc. For quantitative assessment, apply appropriate benchmarks, e.g. 5-10% pre-tax normal income, 0.5-1% revenues or assets, and then also consider qualitative factors, to generate reasonable range. Select one level from range and justify the quantitative choice based on qualitative factors.
- c) Two possible ratios that could be calculated for analysis are:
 - i) current ratio/quick ratio
– may indicate liquidity problem, financial condition is poor, risk of business failure.
 - ii) gross margin percent
– may suggest performance of operation is inefficient, or price competition affecting viability
- for more meaningful ratios and analysis, further information is needed, e.g. past periods to compute turnover, efficiency ratios, industry average, to allow for more different comparisons. Other valid ratios, implications, and related further investigation are also acceptable if clearly explained and supported
- d) Assessment of the risk of material misstatement (RMM) takes into consideration both the inherent and control risks, at the assertion level. The inherent risk assessments are based on the nature of

the item and the risk that an error can have occurred in accounting for that item in the first place, regardless of controls. The general tendency is for high value items that are attractive to steal, like TVs, to have higher inherent risks related to the existence assertion. For Dawood, it is manufacturing the TV and monitors, so the valuation may be subject to errors in complex cost allocations, and the net realizable value may fall due to technological obsolescence, so the valuation assertion has high risk of misstatement. Several other accounts could also be noted as high risk, such as warranty provision (high valuation assertion risk as this is an estimate) or PPE because it is highly material and may become obsolete or inefficient over time, affecting its valuation. Another item that may have high inherent risk in Dawood is the accounts receivable balance if there is a concern about collectibility, as the valuation assertion would have a high risk of misstatement.

Two items that may have low inherent risk assessments are the bank loan - it is straightforward to value it and confirm its existence and completeness. Share capital might also be noted as a low risk account, since its ownership is well documented and since it is not complex to account for, its existence, valuation and completeness would not have high inherent risk.

Generally, assessing high inherent risk leads the auditor to expect management to have strong risk assessment processes, and strong controls in place to offset/reduce these risks. If this is the case, when inherent risk and control risk are combined as RMM, the assessed risk could be lower than the inherent risk alone. However, to rely on this assessment the auditor must test the relevant controls. In Dawood's case it may be feasible and efficient for the auditor to test these controls and get some assurance from them, and 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 a lot of substantive evidence to be able to get reasonable assurance to form an opinion about whether the f/ss are fairly stated.

- e) Inventory in manufacturing business will have raw material, WIP and finished goods
Assertions: (note - assessments of RMM below are for finished goods, WIP risk assessments may differ)
Existence: moderate
- The question is whether all the TVs and monitors recorded really are on hand. Since these items could be easily stolen, the risk is raised, but verification by physical inspection can provide very reliable evidence. Further, if controls in place appear strong over recording the purchases, it would be difficult to make an entry for an inventory purchase that doesn't exist. Thus the risk is moderated.
Completeness: moderate
- The question is whether all the inventory the company actually owns has been recorded. This depends on good controls over recording all purchases, and moving costs of WIP through the production accounting process properly. Since it is possible to miss recording unless controls are good, and inventory is key to the company's success, we can assume the controls over this are good and the risk is moderated.
Valuation: high
- The question is whether the dollar amount allocated to the finished goods is correctly calculated and complies with GAAP (i.e., the financial reporting framework selected by management, including the relevant inventory valuation policies and methods). There are a number of factors that can lead to risk of misstatement of the valuation assertions, such as: the TVs might not be able to be sold at expected prices; the raw materials and component used may not be of suitable quality; the costs of the components may not be correctly recorded; all production costs incurred in the process may not be captured accurately such overhead allocations.
Ownership: low
- The question is whether Dawood has proper title to the inventory. The risk is assessed as low since it is unlikely that Dawood will record inventory that is has not purchased and taken title to

upon delivery, or will include inventory once it is sold (under an assumption that the terms of sale for this type of business are not complex to follow, and title transfers when goods are delivered with little uncertainty about completing the sale)

Presentation: low

- The question is whether the inventory is properly classified in the financial statements and all disclosures required by GAAP are complied with. This is assessed as a low risk assertion since the classification not complex (as long as there are reasonable systems controls in place to measure the different classes of inventory: RM, WIP and FG), accounting policies for inventory valuation & disclosure are clear to apply, management is assume to have the required accounting skills.

Other valid risk assessments could be made based on different assumptions, or on different interpretations of the facts provided since these are fairly limited in the case.

DC 6-1

DC6-1 Audit risk model

Evaluation of risk assessment conclusions with $AR = IR \times CR \times DR$ as a model.

- a) Ohlsen is not justified in acting upon a belief that $IR = 0$. He may have seen no adjustments proposed because (1) none were material or (2) Limberg's control system has functioned well in the past and prevented/detected/corrected material errors. If $IR = 0$, then $AR = 0$ and no further audit work need be done. Conservative auditing standards and practice do not permit this level of (non)work based on this little evidence and knowledge.
- b) Jones is not justified in acting upon a belief that $CR = 0$. She may well know that Lang's internal accounting control is exceptionally good, but (1) her review did not cover the last month of Lang's fiscal year and (2) control procedures are always subject to lapses, and management override is always a possibility. Therefore, CR can never equal zero. If $CR = 0$, that implies $AR = 0$ and no further audit work would need be done. Conservative audit practice does not permit assessment of control risk at zero to the exclusion of other audit procedures.
- c) Insofar as audit effectiveness is concerned, Fields' decision is within the spirit of audit standards. Even if $IR = 1$ and $CR = 1$, if $DR = 0.02$, the $AR = 0.02$. This audit risk (AR) seems quite small. However, Fields' decision may result in an inefficient audit.
- d) This case was deliberately left ambiguous, without putting probability numbers on the audit risks. Students will need to experiment with the model. One approach is to compare the current audit to a hypothetical last year's audit when "everything was operating smoothly." Assume:

Last Year: $AR = IR (0.50) + CR (0.20) \times DR (0.20) = 0.02$

Current year: $AR = IR (1.0) + CR (1.0) \times DR (0.25) = 0.25$

Features of the hypothetical comparison:

1. Inherent risk is greater than last year.
2. Control risk is greater than last year.
3. The audit was done in less time, and maybe the detection risk is a little greater.
4. Audit risk appears to be very high.

An alternative analysis is that Shad perceived higher inherent and control risk early, and he did not put audit time into trying to assess the risks at less than 100%. He proceeded directly to performance of extensive substantive procedures and worked a lesser total number of hours, yet still performed a high-

quality audit by keeping AR low by keeping DR low. In this case, however, Shad would still need to do at least a cursory examination of controls, and document the conclusion, to provide support in the audit file for the assessment of control risk as being very high, and the decision not to rely on internal control (see CAS 200, paragraph 7).

DC6-5

a) Key business factors in the CB case that its auditors must understand to assess the risks of material misstatement (RMM) include:

Industry, regulatory, other external risk factors

- global operations: risk of currency fluctuations, political risk e.g. expropriation of assets by government, unfavourable tax or duty imposed
- highly competitive industry, competing with powerful large companies, price cutting may threaten profitability
- materials are commodities with fluctuating world prices
- many laws and regulations are costs of operating, if violated can result in additional costs or shut down of operations

Nature of CB's business (operations, investments, financing)

- raw material prices may rise and competition may prevent CB from passing these on
- supplier contracts need to be renegotiated annually, may lose a key supplier or face unfavourable renegotiation terms.
- CB is dependent on a few large customers, loss of one customer can severely impact its profitability
- investment expansion of operations may overextend financial and management resources
- product liability for unsafe products is highly risky, may suffer significant costs of damages and loss of reputation and customer confidence may reduce sales
- may not be able to protect its intellectual property successfully, or prove that it has not infringed on other companies' property rights since beverage products are not very distinguishable
- breach of debt covenants can require disclosure of uncertainty regarding successful renegotiation

CB's objectives and strategy to address business risks

- expansion geographically and into new products and services to remain competitive
- cost cutting and rationalization to increase profitability/reduce losses
- new, experienced top management hired to start a turnaround by changing 'culture'

b) Linking business risks to RMM

Industry, regulatory, other external risk factors

- RMM: commodity prices and currency fluctuations are risk factors that may affect inventory valuation (LCM), contingent losses due to regulatory violations may be probable and require disclosure etc. (to be valid the points must be clearly linked to industry and external risk factors)

Nature of CB's business (operations, investments, financing)

- RMM: inventory valuation may be affected by changes in costs imposed by suppliers, marketability, beverages have limited shelf life, disclosure of economic dependence on large customers may be inadequate, valuation of PPE and intangibles may be affected negatively by poor investment management risk or inadequate capitalization to complete construction, or inability to protect intellectual property rights, contingent liability disclosures may be incomplete if unreported product liability or patent infringement issues occur (to be valid the points must be linked to operating/investing/financing risk factors)

CB's objectives and strategy to address business risks

- RMM: CB's strategies to address its risks may not succeed, if they fail the company may go bankrupt given the cut-throat nature of its competitive environment. (to be valid the points must relate to management's strategic risk assessment factors)

c)

Control risk appears to be high as some material weaknesses have been identified recently and the auditors don't know whether management has succeeded in fixing these problems yet. Assessment of internal control would require enquiries of management, observation and documentation of the control environment and control system, and identification of key control procedures in CB that may be effective, or significant deficiencies if they are not effective. (If any reliance on controls being effective is feasible, the controls identified would need to be tested by procedures such as observation, examination of documents, and reperformance - but this does not seem likely in this case.)

Applying the conceptual audit risk model:

- Inherent risk also would be assessed as high in the risk model, given the factors identified in part a). Thus the auditors will assess a very high risk of material misstatement (IR and CR combined).
- Facts suggest lowest audit risk should be accepted - it is a public company, with complex global operations, new management, financial difficulties, investors are unhappy - many factors indicate the auditor faces considerable risk of being sued for business and/or audit failure due to complex and risky operations.
- Overall the high RMM, combined with a low desired audit risk, will give a very low DR and the auditors will need to obtain a high level of highly reliable audit evidence to support their opinion.

DC 6-7

DC6-7 Management controls, impact on audit

The case presents a scenario where an integrated decision-oriented database system has been implemented and describes its features and how it is being used by senior management. It requires one to consider the impact of this system using computer-based management supervisor controls on the company's internal control:

The system can enhance internal control in several ways. The data used in the system are integrated from several databases, making them more accurate than if they had to be developed by manually combining data from different systems. The data come from the raw source directly to the senior managers so there is no opportunity for operating managers to manipulate the data, for example to obscure data that might indicate poor performance. Since the senior managers have the ability to customize, they can create more specific analysis that may enhance their ability to detect problems and potential misstatements that can affect the financial statements.

The case also requires one to consider whether this system has audit implications.

Two of the aspects that could be commented on are:

1. The higher potential effectiveness of management's supervisory control since the data are capable of being drawn on from source, with less interpretation by middle managers being required in the report generation stage, making possible a lower control risk assessment.
2. The availability of business data on a variety of operational aspects that are more independent and reliable for obtaining a knowledge of the business and for doing statistical analysis and other analytical audit procedures.

EP 8-4

EP8-4 Audit Procedure Terminology

1. Scanning for debit balances in accounts payable
Recalculation of amounts on supporting documents
Vouching of account entries to supporting documents
2. Vouching of policies from expense and prepayment entries
Recalculation of expiration of insurance premium
Analysis of interrelationships--compare insurance coverage to assets owned and leased
3. Scanning inventory records for "old" last-issue dates
Verbal inquiry--question inventory control personnel about slow-moving inventory
Vouching--examine journal entries for evidence of actual book writedown of the specific inventory items
4. Tracing--trace remittance amounts to appropriate customer's account
Recalculation--recalculate amount of discounts and allowances
Vouching--examine authoritative documents supporting unusual discounts and/or allowances
5. Observation and examination by the auditor--of the inventory and the inventory-taking procedures
Confirmation by letter--of inventory held in outside warehouses
Recalculation--of the accuracy of cost-flow calculations

EP 8-5

EP8-5 General Audit Procedures and Financial Statement Assertions

The related assertions are taken from the textbook explanation of the procedures.

| General Audit Procedures | Related Management Assertions |
|-----------------------------|--|
| 1. Recalculation | Existence, Valuation |
| 2. Physical observation | Existence, Valuation |
| 3. Confirmation | Existence, Rights (Ownerships) Valuation (sometimes) Cutoff (sometimes) |
| 4. Verbal inquiry | All assertions: however, responses typically yield more assertions, in turn subject to audit with corroborating evidence |
| 5. Examination of documents | Existence (vouching direction) Completeness (tracing direction) Valuation or allocation Rights and obligations Presentation and disclosure |
| 6. Scanning | Raises questions that may be relevant to all objectives, but may not produce actual "evidence." Since it is performed on recorded amounts, it works best for Existence, Valuation, Rights, and Presentation/Disclosure. When applied to |

source documents, it might work for the completeness assertion.

7. Analytical Procedures

Existence or occurrence
Valuation
Completeness

DC 8-3

DC8-3 Appropriateness of Evidence and Related Parties

- a) Do you perceive any problems with related party involvement in the evidence used by M. Johnson? Explain.

Yes, there are problems. Verbal assurance of collectibility from Bumpus, the S&L officer with an investment in the Smith Street property, is the weakest type of self-serving information.

Bumpus is a related party and information from him ought to be regarded as biased.

Another problem lies in the appraisal company. With the name of Guaranteed Appraisal Partners, Inc., the appraisers may be related, even owned by, the auditee--Guaranteed Savings & Loan Company. An auditor's general knowledge of financial institution difficulties in real estate lending and the widespread problems with appraisers should alert Johnson to the possible relation of the appraisers to the auditee. Further investigation should be carried out to identify the appraisers.

- b) Do you perceive any problems with M. Johnson's reasoning or the competence of evidence used in that reasoning?

Yes, there are problems. In addition to the dubious related party sources of information just mentioned, Johnson's "assumption" about the collectibility of the Baker Street loan is unwarranted. Auditors are not entitled to "assume" collectibility on any grounds with supporting evidence. The fact that a loan is new or construction is still in progress is no reason to "assume" collectibility.

EP 9-3

EP9-3 Key control, control test evaluation

- a) The auditor would consider this a key control because it is an important procedure to make sure all invoices that were issued were for real sales. If it was not performed well non-existent sales could be entered and not detected.
- b) The control test will indicate how well the company's control procedures actually worked during the period under audit. If the test provides evidence that this control operated effectively during the audit period, the auditor can assess a low control risk for the controls relating to the existence assertion in receivables and sales. Since the auditee has a large number of customers, a large number of accounts would need to be audited at year end to get sufficient evidence that accounts receivable balance exists (is not overstated). This control test provides evidence that can allow the

auditor to reduce the amount of substantive testing that needs to be done on the audit of year-end accounts receivable balance. This may be efficient. Also, this control test can be designed in a way to provide evidence on both control effectiveness and substantive evidence on existence of the sales transactions - if the test includes tracing the sale to the sales journal in the accounting records. This dual purpose test can be even more efficient than just testing the control itself.

- c) A control test has two parts. Part 1 is an identification of the data population from which a sample of items will be selected for audit. Here the sample will be selected from the population of sales invoices issued during the year. The sample should include invoices from throughout the year so the test will provide evidence for the whole audit period. Part 2 is a description of the action taken to produce relevant evidence. Here the action is to determine whether the selected invoices agree with information in another data population, the Shipper's Receipts filed in the warehouse office for the whole year.

- d) At 95% or 100% the auditor would probably be able to conclude that this control is operating effectively. The larger the sample of invoices tested, the more confidence the auditor would have in this conclusion. For example, if 20 invoices were tested and one was wrong, compliance is 95%. If 100 invoices were tested and 5 were wrong the compliance rate is still 95% but the auditor has more confidence that this is the compliance rate for the whole population. Similarly, if 2 invoices were tested and neither was wrong, compliance is 100% but unless more invoices are examined the auditor would not have a lot of confidence assuming 100% compliance for the whole population. And as long as the auditor only looks at a sample and not the entire population of invoices, he or she can never have 100% confidence that the control is always operating. If the control test finds the control only operates 60% of the time, this is probably too low a compliance rate to indicate the control is reliable, regardless of how many invoices are tested. As an example, if 10 invoices are sampled and 4 are wrong, compliance is 60% - this finding may be due to very bad luck in choosing a sample that has a much higher rate of non-compliant transactions than actually exists in the population, and the auditor should discuss this finding with the auditee to see if there is some other reason that can explain it - maybe the auditee's filing procedures changed during the year and the auditor's test is not designed properly to find the documentation of the control. Once the control test design is fixed, it may make sense to do further testing to see if it indicates a higher compliance rate. If the auditee has no convincing explanation for such a low compliance rate in the sample, the auditor has to assume that compliance is too low. In this case there is probably no point in doing more control testing - the auditor should assume the control risk is high and do more substantive tests that can determine directly if there are misstatements (overstatements in this case) in sales and accounts receivable.

EP 9-5

EP9-5 Tests of control procedure and audit programs

1. Credit approval

Control Objective: Authorization of credit sales transactions.

Test of Control Procedure: Select a sample of recorded sales invoices from the sales journal. Note the date, number, amount and customer name. Find the Copy 2 in the accounts receivable department chronological (date) file and read (vouch) the customer order to see if credit was approved according to company policy.

2. Sales transaction recording

Control Objective: Validity of recorded sales.

Proper period recording of sales.

Test of Control Procedure: Select a sample of recorded sales invoices from the sales journal (same sample as in a). Note the date, number, physical quantity and customer name. Find the Copy 3 in the billing department file for the recording date. Compare (vouch) the quantities noted in Copy 3. Note the shipping document number. Find the bill of lading in the shipping department numerical file. Compare (vouch) the quantity shipped, date and customer name.

3. Pricing and mathematical accuracy

Control Objective. Mathematical accuracy of recorded sales.
Authorized prices used on invoices.

Test of Control Procedure: Select a sample of recorded sales invoices from the sales journal. (Same sample as in a and b). Note the date, invoice number, amount and customer name. Find Copy 2 (because it is the copy used in the accounting entry) in the accounts receivable department file (same copy as found in a). Look up the correct unit price in the catalog and recalculate the invoice arithmetic.

4. Classification of sales.

Control Objective. Classification of sales.

Test of Control Procedure. Select a sample of recorded sales from the sales journal (same sample as in a, b, and c). Find Copy 2 (same as a and c). Knowing the names of the subsidiary companies, determine whether Copies 2 with those names are coded "9" and so entered in the sales journal, and that none are not coded "9" and entered as sales to outsiders.

EP9-7 Part A
a. b. c.

Control 1

Purchase Requests from operating departments are authorized by the appropriate person in the requesting department.

Type: authorization procedures

Objective: authorization

Test: examine the PR documents to verify they have been signed

Control 2

The Purchasing Clerk verifies that there is a signature on the Purchase Request and then issues a pre-numbered Purchase Order for the items required. The Purchasing Clerk retains copies of the PR and the PO and files them by PO number.

Type: documentation and records created to support transaction

Objective: completeness, accuracy

Test: examine the PR/PO documents to verify they match
test numerical continuity,

Control 3

The Purchasing Manager reviews Purchase Order to see whether the Purchase Request is authorized, and if so, approves it and forwards it to the Buyer.

Type: authorization is verified independently by segregation of duties

Objective: authorization

Test: examine the PR documents to verify they have been approved by Purchasing Manager

Control 4

The Buyer must select a vendor from a pre-approved list for all Purchase Orders over \$5,000. For POs under \$5,000 the Buyer can select any vendor.

Type: authorization control procedure to ensure company is receiving the best price and suppliers are at arm's length from Buyer

Objective: authorization, validity

Test: examine the PO documents to verify those over \$5000 are sent to a preauthorized vendor, scrutinize POs for signs the Buyer is sending these disproportionately to certain vendors, enquire of Purchasing Manager and Buyer about preauthorized vendors to assess their validity

Control 5

The Receiver who accepts the goods into the warehouse verifies that the quantity received matches the Bill of Lading, and signs on behalf of IMS for receipt of the goods listed on the Bill of Lading. If there is a discrepancy in the quantity received, the receiver does not sign the Bill of Lading; the Bill of Lading is sent to the Buyer to resolve the problem with the vendor.

Type: documents and records are used to record transaction information and allow for independent verification

Objective: accuracy, completeness

Test: examine the BL documents for evidence of quantities being verified, follow up of documents showing discrepancies to verify they have been signed for approval

Control 6

The Purchasing Clerk matches the signed BL with the filed copies of the PO and PR
Type: documents and records to allow independent verification of details
Objective: accuracy, completeness
Test: examine the PO/PR documents to verify they agree to BL.

Part B

d. e. f.

Control Weakness 1

The Purchasing Clerk does not verify that the Purchase Requests are authorized by an appropriate person in the operating department, but only checks that there is a signature on the document.

Risk: unauthorized expenses may not be detected

Possible error: none in the financial statements (This is a subtle point, but if even if expenses are improper, as long as they are correctly recorded as debits in the income statement accounts the net income is still correctly stated - effectively, these are a cost of doing business and should be recorded as such. This can, however, be seen as a type of misclassification misstatement in that the improper expenses should be shown as such in the income statement, not buried in with properly classified expenses. If improper expenses are detected by the auditor, this would indicate a fraud risk that needs to be followed up.), but management's control objective of safeguarding company assets is not being met

Impact on audit: Inform management of internal control weakness, and potential fraud risk.

Control Weakness 2

Access to the warehouse is not controlled and anyone can enter and leave anytime.

Risk: Theft of goods after received

Possible error: If inventory is recorded then stolen, perpetual inventory will be overstated. The inventory count should pick up and record any shrinkage, so the year-end financial statements would be corrected (This point is subject to the same consideration as noted above for Control Weakness 1 - the 'loss' due to theft is real cost to the business so needs to be recorded, but it should not be classified as part of Cost of Sales, and the implications for the auditor's assessed risk of fraud need to be followed up.), but management's control objective of safeguarding assets is not being met.

Impact on audit: Do not rely on perpetual inventory records. Increase substantive tests of inventory completeness. Inform management of weakness.

Control Weakness 3

The receiver does not match the BL to an authorized PO.

Risks: 1) unauthorized goods or incorrect quantities may be accepted, increase possibility of errors in recording accounts payable and purchases

Possible error: Incorrect purchases and account payable recorded (as above, if unauthorized inventory is then stolen, it will be a cost of doing business and not an error if loss is picked up by inventory count and adjustment for shrinkage)

Impact on audit: Increase substantive tests of payables, purchases, and expenses. Inform management of control weakness.

EP 9-10

EP9-10 Control tests and errors/irregularities

1. Controlled access to blank sales invoices.
 - a) Observation. Visit the storage location yourself and see if unauthorized persons could obtain blank sales invoices. Pick some up yourself to see what happens.
 - b) Someone could pick up a blank and make out a fictitious sale. However, getting it recorded would be difficult because of the other controls such as matching with a copy from the shipping department. (Thus a control access deficiency may be compensated by other control procedures.)
2. Sales invoices check for accuracy.
 - a) Vouching and Recalculation. Select a sample of recorded sales invoices and vouch quantities thereon to bills of lading, vouch prices to price lists, and recalculate the math.
 - b) Errors on the invoice could cause lost billings and lost revenue or overcharges to customers which are not collectible (thus overstating sales and accounts receivable).
3. Duties of accounts receivable bookkeeper.
 - a) Observation and Inquiry. Look to see who is performing bookkeeping and cash functions. Determine who is assigned to each function by reading organization charts. Ask other employees.
 - b) The bookkeeper might be able to steal cash and manipulate the accounting records to give the customer credit and hide the theft. (Debit a customer's payment to Returns and Allowances instead of to cash, or just charge the control total improperly.)
4. Customer accounts regularly balanced with the control account.
 - a) Recalculation. Review the auditee's working paper showing the balancing/reconciliation. Do the balancing yourself.
 - b) Accounting entries could be made inaccurately or incompletely and the control account may be overstated or understated

DC 9-5

DC9-5 Cash Receipts Control

- a) See the System Flowchart in the Figure on the next page.
Students could be asked to prepare a bridge working paper for parts b and c.
- b) The main "material weakness" lies with Sue Kenmore's cash handling duties. She could allow more discount than the customer actually took or approve a credit for a return that was not made in order to (1) take cash for herself, and (2) keep the customer's account properly stated. This weakness is magnified by the fact that no one reviews the amount or pattern of discounts and return allowances for accuracy or reasonableness.

An auditor might suspect that Sue has taken cash in this manner from a review of the sales statistics. Observe the following percent relationship of discounts and allowances:

Recorded

| | Percent of Sales | Amount | @ 3% | Difference |
|------|------------------|--------|--------|------------|
| 2006 | 3.03% | \$ 500 | \$ 495 | \$ 5 |
| 2007 | 2.96 | 550 | 557 | (7) |
| 2008 | 2.95 | 520 | 528 | (8) |
| 2009 | 3.10 | 570 | 551 | <u>19</u> |
| 2010 | 3.97 | 950 | 719 | 231 |
| 2011 | 5.02 | 1,480 | 884 | 596 |
| 2012 | 5.99 | 2,230 | 1,117 | 1,113 |

The normal discount of 3% is exceeded by 2010 (when Sue was first employed). The increasing amount of return credits could account legitimately for the difference, but it looks like \$1,940 may have been stolen since 2010.

Also, Sue seems to enjoy an expensive automobile, which might be considered beyond the normal means of someone who can't afford to go to college.

- c) This is a small business, a fact that should be considered when making recommendations.
1. Sue Kenmore has an improper combination of duties--custody of cash plus a major record-keeping responsibility. Someone else (Janet Bundy) should receive cash in the store, prepare the remittance list and prepare the bank deposit, especially if Sue continues to keep the cash receipts journal.

Sue can post the cash receipts journal from a copy of a remittance list or daily cash report (including sales not on account) prepared by Janet. Then Sue will not have access to the cash. Sue also has authority to approve discounts and allowances. There may be a question of whether she is competent (qualified, experienced) to do so. This function may be left with Sue so long as Janet is responsible for the remittance list. If Sue is embezzling money, her motivation to approve erroneous discounts will be removed because she no longer can handle the money.

2. David Roberts should be assigned the duty (supervisory) of reviewing discounts and allowances for reasonableness and proper approval. He is experienced and is in charge of supervising the record keeping.
3. The cash receipts journal appears to be a superfluous record. A daily cash report of over-the-counter sales and collections on account (mail and in the store) could serve in its place.

| |
|---------|
| EP 10-2 |
|---------|

EP10-2 Test of Controls Audit Procedures Objectives and Deviations

1. Credit Approval:
 - a) Objective- Determine whether credit is approved in accordance with company policy
 - b) Deviation- Absence of notation of approval or disapproval on customers' orders

2. Validity of Sales and Proper Period Recording
 - a) Objectives-
 - (i) Determine whether recorded sales invoices are supported by written notices of shipment,
 - (ii) Determine whether the sales record date is the same as the shipment date.

- b) Deviations- (i) Absence of written shipment notice, (ii) Sales record date and shipment date are not the same.
- 3. Accuracy of Sales Invoices
 - a) Objectives- Determine whether (i) Quantities on shipping notices and invoices are the same, (ii) Unit prices on the invoices are correct (catalog), and (iii) Invoice arithmetic is correct.
 - b) Deviations- (i) Quantities do not match, (ii) Wrong prices, (iii) Mathematical mistakes.
- 4. Classification of Sales
 - a) Objective- Determine whether invoices are properly coded "9" for intercompany sales.
 - b) Deviation- (i) Invoice to an affiliated company not marked "9" and (ii) Invoice to an outside customer marked "9".

DC 10-4

- DC10-4 a) The sample sizes using the formula (with k=0): $n = R/P$ are as follows.
 Case 1, n=50. Case 2, n=100. Case 3, n=29. Case 4, n=60. Case 5, n=12. Case 6, n=16.
 Anything larger than these discovery sample sizes reduces alpha risk, while beta risk (1 – confidence level) remains constant.
- b) The achieved P or UELs are as follows. Case 1, UEL = .063. Case 2, UEL = .03. Case 3, UEL = .065. Case 4, UEL = .089. Case 5, UEL = .181. Case 6, UEL = .2.
- c) Unacceptable for cases 1,4, and 6. The auditor can extend testing, insist on an adjustment, re-consider the extent of reliance on controls.
- d) Sources of error helps auditor assess whether error is intentional or unintentional, and to assess qualitative aspects of internal control (for example, whether a particular individual, department, or time period is affected).
- e) 1. auditor estimate
 2. auditor decision
 3. auditor decision
 4. auditor decision, or by formula
 5. sample result
 6. sample result
 7. sample result: achieved P or UEL is the maximum error rate at the stated confidence level.

EP 10-5

EP10-5 Stratified Calculation of Projected Likely Misstatement Using the Ratio Method

| Stratum | Recorded Amount | Sample | Sample Results | | PLM (ratio) |
|---------|------------------|-----------|-----------------|---------------|---------------|
| | | | Recorded Amount | Error Amount* | |
| 1 | \$100,000 | 6 | \$100,000 | - \$ 600 | - \$ 600 |
| 2 | \$ 75,068 | 23 | \$ 21,700 | - \$ 274 | - \$ 948 |
| 3 | \$ 75,008 | 22 | \$ 9,476 | - \$ 66 | - \$ 522 |
| 4 | \$ 75,412 | 22 | \$ 4,692 | - \$ 88 | - \$1,414 |
| 5 | <u>\$ 74,512</u> | <u>23</u> | <u>\$ 1,973</u> | <u>\$ 23</u> | <u>\$ 869</u> |
| | \$400,000 | 96 | \$137,841 | - \$1,005 | - \$2,615 |

- 1: $-600/100,000 \times 100,000 = -600$
 2: $-274/21,700 \times 75,068 = -948$
 3: $-66/9,476 \times 75,008 = -522$
 4: $-88/4,692 \times 75,412 = -1,414$
 5: $23/1,973 \times 74,512 = 869$

EP 10-6

EP10-6 Determining the Risk of Incorrect Acceptance

Fred puts inherent and control risk together and calls them a "50-50 proposition," so inherent risk can be taken to be 1.0 and control risk to be 0.50.

Jack says it's too bad analytical procedures do not reduce the audit risk in this situation, so analytical review risk seems to be 1.0.

Fred says the firm policy is to set audit risk very low. Students may think "very low" means different things. The solution below takes audit risk to be 0.01.

$$TD = \frac{\quad}{AR (=0.01)} = 0.02$$

$$IR (=1.0) \times CR (=0.50) \times AP (=1.0)$$

This test of detail risk seems to be quite small, suggesting a large sample size. If the risk were larger, the sample size would be smaller. If it were smaller, the sample size would be larger.

DC10-3 projected likely misstatement = $((162.83)/80) \times 1740 = (3541.56)$. This is a little over half of what is considered material (tolerable) and would likely be acceptable by AUG-41.

See below for AUG-41 excerpt.

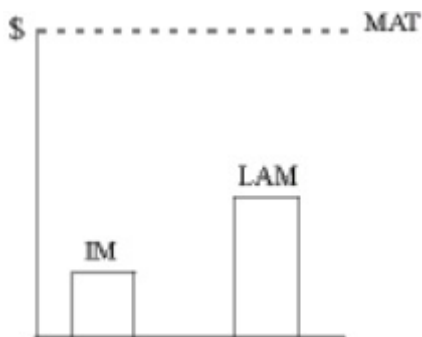
The non-statistical measurements described in Chapter 10 leave only one avenue for "accounting for further misstatement": Apply experience and professional judgment to decide if further misstatement could be large enough to prevent an acceptance decision. If the projected likely misstatement is a great deal less than the amount considered material, an auditor could judge that further misstatement, if known, would not affect acceptance. If projected likely misstatement is close to the amount considered material, maybe acceptance is not warranted. This is essentially a summary of the AuG-41, appendix which is reproduced below.

(With statistical calculations, the further misstatement can be measured directly)

ABBREVIATIONS

| | |
|-----|-------------------------------|
| IM | Identified misstatements |
| LAM | Likely aggregate misstatement |
| MAT | Threshold of materiality |

Situation 1



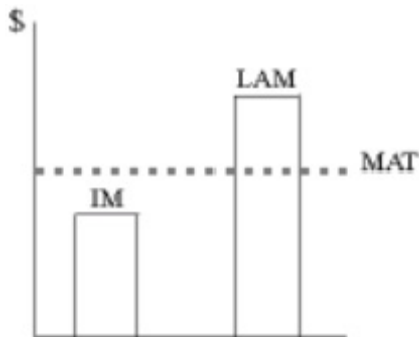
In this situation (the one most frequently encountered in practice), the level of likely aggregate misstatement is substantially less than materiality. Because of this, it is extremely unlikely that the level of maximum possible misstatement would be quantitatively material. Accordingly, the auditor would need to consider the effect of the qualitative factors set out in paragraph 24 to assess whether the misstatement should be considered material. Depending on the outcome of that assessment, either an unqualified opinion or a qualified opinion might be given.

Situation 2



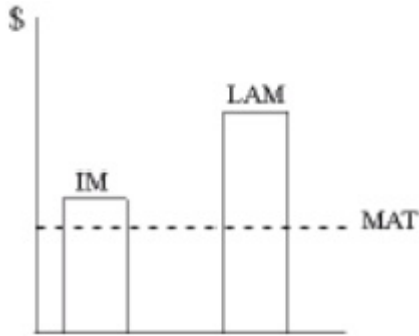
The level of likely aggregate misstatement is close to materiality. In this situation, on the one hand, the auditor's best estimate (based on likely aggregate misstatement) is that the financial statements are not materially misstated. On the other hand, the existence of further possible misstatements that might cause the financial statements to be materially misstated cannot be ignored. Usually, the auditor would recommend that misstatements be corrected to reduce the level of likely aggregate misstatement to the point where, clearly, an unqualified opinion could be given. The auditor might also consider attempting to reduce his or her assessment of further possible misstatements through the performance of additional auditing procedures. If these approaches do not resolve the matter, the auditor will have to exercise his or her professional judgment in deciding whether an unqualified opinion is appropriate.

Situation 3



Identified misstatements are less than materiality but the level of likely aggregate misstatement exceeds materiality. When the level of likely aggregate misstatement exceeds materiality, although it is not conclusive, the auditor's best estimate is that the financial statements are materially misstated. Before concluding that a reservation of opinion is necessary, however, the auditor would urge management to correct misstatements to reduce the level of likely aggregate misstatement sufficiently below materiality to enable an unqualified opinion to be given.

Situation 4



Levels of both identified and likely aggregate misstatement exceed materiality. In this situation, if a reservation of opinion is to be avoided, management will have to correct misstatements to reduce the level of likely aggregate misstatements sufficiently below materiality to enable an unqualified opinion to be given.

DC 11-3

DC11-3 Cash receipts weaknesses and recommendations

Memorandum

TO: Board of Directors, The Pottstown Art League
FROM: (Student's name)
DATE:
SUBJECT: Control weaknesses related to Cash Admission Fees

You requested a report which identifies the weaknesses in the existing system of cash admission fees and my recommendations. Below are the weaknesses that exist and my recommendations for procedures that overcome these weaknesses. I will be pleased to discuss these at the next board meeting and offer further explanations that may be necessary.

Weakness: There is no segregation of duties between persons responsible for collecting admission fees and persons responsible for authorizing admission.

Recommendation: One clerk (hereafter referred to as the collection clerk) should collect admission fees and issue prenumbered tickets. The other clerk (hereafter referred to as the admission clerk) should authorize admission upon receipt of the ticket or proof of membership.

Weakness: An independent count of paying patrons is not made.

Recommendation: The admission clerk should retain a portion of the prenumbered admission ticket (admission ticket stub).

Weakness: There is no proof of accuracy of amounts collected by the clerks.

Recommendation: Admission ticket stubs should be reconciled with cash collected by the treasurer daily.

Weakness: Cash receipts records are not promptly prepared.

Recommendation: The cash collections should be recorded by the collection clerk daily on a permanent record that will serve as the first record of accountability.

Weakness: Cash receipts are not promptly deposited. Cash should not be left undeposited for a week.

Recommendation: Cash should be deposited at least once each day.

Weakness: There is no proof of accuracy of amounts deposited.

Recommendation: Authenticated deposit slips should be compared with daily cash collection records.

Discrepancies should be promptly investigated and resolved. In addition, the treasurer should establish a policy that includes an analytical review of cash collections.

Weakness: There is no record of the internal accountability of cash.

Recommendation: The treasurer should issue a signed receipt of all proceeds received from the collection clerk. These receipts should be maintained and should be periodically checked against cash collection and deposit records.

EP 11-4

EP11-4 Alternate accounts receivable procedures

The auditor can consider alternative confirmation methods to test the accounts receivable balance, such as confirming individual invoices in the balance.

Auditing procedures other than confirmation which may be used to verify an account receivable include:

1. Examination of evidence of subsequent payment of the account including:
 - a) The customer's remittance advice accompanied by the payment.
 - b) The cheque sent in by the customer.
 - c) An authenticated bank deposit ticket listing a deposited cheque for the outstanding account.
 - d) An entry in the cash receipts book.
 - e) A credit posted to the customer's account.
2. Examination of other evidence including:
 - a) Shipping department's notice of shipment, accompanied possibly by a receipted copy of the bill of lading, the customer's purchase order, sales invoices, and any correspondence referring to the shipment of the goods.
 - b) Entries removing the goods from inventory.
 - c) Time records and work orders, if appropriate.
3. External inquiries as to the existence and credit rating of the debtor.
4. Discussion of the account with the auditee's credit manager, examination of credit department records, and records of merchandise returned, and such other investigation as may lead to better understanding of the nature of the account and its collectibility.

DC 11-6

DC11-6 Receivables audit procedures

The procedure followed appears to be appropriate except that the examination of detail transactions for three months might be considered to be excessive in view of the exceptionally good internal control. A lighter test of such transactions, designed to test the effectiveness of the control procedures, might be devised.

The procedures followed should be supplemented by the following:

1. Review the company's method of sales cutoff at year-end and test billings and shipments (including returns) for an adequate period before and after year-end to establish that cut-off procedures have been adhered to.
2. Examine collections in early part of subsequent period to determine if a substantial portion of the receivables has been collected.
3. Examine agreements entered into with the distributors. If price protection clauses are included, review the current price position and distributor inventory positions to determine whether a reserve for such protection is needed.
4. When a company deals with a limited number of customers, it is dependent upon the continued solvency of all such customers.
5. Obtain a representation letter from appropriate company officials covering the receivables.

DC 11-10

DC11-10 Substantive testing for sales

Procedures that would be appropriate include:

- a. 1. Select a sample of sales from the sales journal and vouch to the sales invoice and then to the shipping document. Any credit sale not shipped is not a valid sale.
2. Trace cash sale invoices to cash receipts journal or bank deposit. Any sale recorded as a cash sale but not paid for would likely not be a valid sale.
- b. 1. Select a sample of shipping invoices and trace to sales invoice and then to sales journal, to find any sales shipped but not recorded in the sales journal.
2. Trace cash deposits for last week before year end to sales journal to find unrecorded sales.

(Source: CGA-Canada AU1 Examination, June 2011)

EP 4-1

EP4-1 Association with Financial Statements

The consequences of being associated with financial statements: "In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking."

- a. Associated Issue audit report.
- b. Not associated Tax returns are an exception.
- c. Associated Issue disclaimer (public company)
Issue compilation report (nonpublic).
- d. Not associated PA is associated with accounting records but not with financial
statements.
- e. Associated Issue a disclaimer (public company).
- f. Associated Issue interim information review report. (Should have requested client
not mention review procedures this way.)
- g. Not associated Nothing need to be done so long as client doesn't mention PA in the
interim statement document.

EP 4-2

EP4-2 Reports and the Effect of Materiality

If the amounts involved are immaterial, the report can be unqualified, otherwise materiality affects the report choice as follows:

| | Materiality | |
|--|--|--|
| | Lesser | Greater |
| | Amounts are material but not pervasive or overwhelming | Amounts are very large, pervasive and overwhelm the presentation |

| | | |
|--|--|---|
| a. Scope limitation on accounts receivable audit. | "Except for" language used to express no opinion on the accounts receivable. Reference to "adjustments, if any." | Disclaimer, with separate paragraph describing the restricted scope. |
| b. Departure from GAAP (failure to accrue revenue), but not a departure from a pronouncement. | "Except for" language used to qualify the opinion for the GAAP departure. | Adverse opinion. |
| c. Departure from an CICA pronouncement that requires capitalization of leases. | "Except for" language used to qualify the opinion for the GAAP departure. | Adverse opinion. |
| d. Uncertainty related to the amount of damages that might eventually be confirmed by an appeals court ruling. | Added paragraph used to warn users and to take no responsibility for failure to accrue the loss. (Otherwise a standard unqualified report) | Disclaimer, if auditor thinks the amount that might be awarded seriously threatens the going-concern status of the company. |

EP 4-4

EP4-4 The question involves distinguishing between a review and an audit.

A review report provides only negative assurance that the financial statements are fairly presented in the form a misstatement that nothing has come to the accountants attention that would indicate that the financial statements are not fairly presented. The accountant is only required to apply analytical procedures in a review engagement and is only permitted by the standards to state that nothing has come to the accountants attention to suggest that the financial statements are not fairly stated as a result of performing these review procedures. An audit report provides positive assurance in the form of the auditors opinion. The auditor is required to obtain independent evidence, via procedures such as confirmation and re-performance, to support the opinion that the financial statements are fairly presented.

Since an audit provides higher assurance, the banker will believe that the audited information is more reliable and credible. The banker must manage the overall risk that the bank is taking by lending out money. Lending a larger amount of money presents a higher level of risk to the bank, higher assurance that the information reported by the borrower is reliable. Two of the ways that the audit reduces the bank's risk are that 1) the probability of errors and omissions in the information is lower because more extensive verification procedures have been performed, 2) the auditor can be held liable for losses the bank may incur as a result of relying on the audited financial statements if they contain misrepresentations.

The bank's policy seems reasonable. Banks are lending out depositors money so they have a duty to ensure that they don't take unreasonable risks. Requiring audit on larger loans is a responsible way of reducing the risk of making bad loans and also sharing the risk with auditors.

EP 4-18

EP4-18 a) The case facts suggest considerable risk that the company is not a going concern.

Preparation of financial statements in accordance with GAAP makes the assumption that the company is a going concern, that is, it will be able to realize its assets and discharge its obligations under normal conditions and terms, without undue duress.

when issuing the audit report, the auditor needs to be satisfied that presenting financial statements in accordance with GAAP is not misleading and that's disclosure regarding the going concern issues is adequate.

In this case, the long term debt coming due in the following year would make difficult for the auditor to agree to financial statements prepared in accordance with GAAP unless assurances can be obtained that the terms of repayment will be altered or extended so that the company has reasonable probability of meeting them. If there's a high probability that the company will go bankrupt, preparing financial statements on liquidation basis is more appropriate than GAAP.

- b) If the long term debt were not due until 2025 there may be more probability that the company can survive through the current year, making presentation of financial statements under liquidation basis unnecessary.

DC 18-1

DC18-1 Rules of Professional Conduct

Rule 301.2, which prohibits CA's from soliciting professional engagements entrusted to others, has been violated. There are circumstances under the rules where the mailing of brochures to non-clients is not considered solicitation. However, the mailing of these brochures to "all the top candidates" and then contacting them to discuss their accounting and auditing needs is considered solicitation. It is likely that these companies already have CA's performing these duties.

Rule 217.1 prohibits advertising in a manner which is false or misleading, contravenes professional good taste, reflects unfavourably on other CA's or includes unsubstantiated statements. Describing the firm "as the CA firm where clients come first" reflects unfavourably on CA's because it implies that other CA's do not put their clients first. Also, this statement cannot be substantiated. The firm is allowed to issue brochures provided that the wording is appropriate and proper.

Rule 215 prohibits CA's engaged in public practice from representing that they perform a professional service without a fee. The only exception to this rule is for work of a charitable or benevolent nature. Since the brochure states that new audit clients will not be charged fees for management, consulting services in the first year, rule 215 has been violated.

DC 18-3

DC18-3 The case involves issues of independence, and the responsibilities of management and the public accountant. Some of the points that can be discussed include the following

- the impact on independence of the client lacking the management expertise to make its own decisions, which the PA can then provide assurance on. A key principle here is that people cannot objectively assess their own work. If the company management lacks the expertise to make accounting decisions it is not possible for them to take responsibility for the statements and therefore it is not possible for PA to provide assurance on them

- the PA has recently become aware that he/she is probably not acting independently enough to perform a review. Independence requirements are even higher for an audit so it would be difficult to accept the audit engagement under the current circumstances. If Pinto were to hire a qualified CFO this situation would probably change.

DC 18-6

DC18-6 Sample Response

From the situation in the question the following ethical issues have been identified and are discussed in the context of the ICAO rules of professional conduct.

- actual audit strategies should not be disclosed to the client since one is looking for errors and does not want the client to “pre-audit” material.
- “lowball” bids and “fixed fee quotes” should not be used since fees should be based on the time required to perform the service

One of the factors an auditor should consider before accepting an audit is whether they have adequate knowledge and expertise in a field. If the auditors were ‘apprehensive’, then they perhaps should not have accepted the job

- Stan Biggs may lack independence and objectivity, real and apparent. He may have loyalty to his old company especially since he was the controller and will be auditing his own work. The fact that he still has investments in the company further creates independence problems
- the auditor’s objectivity may further appear to be impaired if he agrees to appear in the ad, particularly the type of ad suggested by Edgar
- to accept gifts and fringe benefits from clients beyond what employees receive - further impinges on the auditor’s apparent independence
- it is the responsibility of all members of the profession to report any incompetent work to the Institute. The auditor should determine if the quality of work of the previous auditor is bad enough to warrant reporting them to the professional conduct committee.

DC18-2 Conflict of Interest

Observations: Conflict of Clients' Interests

If Jack and Jill gang up on Bill, Jon may lose the work that goes to Phil. Despite the bad poetry, this situation raises a typical "Who's the client?" question.

Unfortunately, the relevant relationships are Jon's individual engagements with Jack and Bill--because Jon would have essentially the same problem if Oneway Corporation were not a client. The situation is "unfortunate" because **Jon is in a no-win situation**. If he keeps Bill informed, he might save the Oneway engagement and Bill's friendship (not to mention the well-being of little Otto, his godchild), but he will suffer the guilt of having engaged in industrial espionage and might face an ethics complaint for having thumbed his nose at the rule of accountants' confidentiality. If Jon keeps quiet, he might lose the engagement and a significant portion of his personal income at least temporarily, Bill will probably suffer and life just won't be the same.

If Jon believes rules are the most important element of ethical behavior and the consequences of action or inaction must fall where they may, he will refuse Bill's request with an eloquent and sympathetic explanation of the professional reasons for not discussing other clients' business affairs. A happy outcome for this approach depends upon Bill's understanding the difficult situation he has created for Jon. (After all, Bill created the situation by asking Jon to give him the information. Friendship runs both ways, and in this case Bill has unintentionally been "unfriendly.")

If Jon believes in weighing the "good and evil consequences" of ethics-related choices, he will need to decide which ultimate outcome is most desirable: Bill's well-being (and his own income) or Jack's and Jill's well-being, whatever it may be. Choosing to tell Bill about Jack's plans could be construed as a selfish act on Jon's part. Professional "selfishness" may not be against the rules, but in this case, different avenues of analysis seem to suggest the rule is a good one, even in this difficult personal situation.

