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# AUDITING AND ATTESTATION

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## OVERVIEW OF AN ATTEST FUNCTION

The Attest Function

(1) In an attest engagement a CPA is engaged to issue or does issue an examination, a review, or agreed-upon procedures report on subject matter, or an assertion about subject matter, that is the responsibility of another party.

(2) To perform an attest engagement there must be suitable criteria to judge the fairness of the information being reported on.

(3) The attestation standards establish three forms of CPA attestation engagements—examinations, reviews, and the performance of agreed-upon procedures.

- (A) An **examination** referred to as an audit when it involves financial statements, normally results in a positive opinion, the highest form of assurance about whether the information follows the criteria.
- (B) A **review** is substantially less in scope than an audit and provides negative assurance (“nothing came to our attention”) rather than positive assurance.
- (C) For the third form of attestation engagement, a CPA and a specified party that wishes to use the information may mutually decide on specific **agreed-upon procedures** that the CPA will perform. Agreed-upon procedures engagements result in a report that describes the procedures performed and related findings

(4) **Statements on Standards for Attestation Engagements** provide guidance on how to perform attestation engagements.

(5) **Statements on Standards for Accounting and Review Services** provide guidance for work done for a nonpublic company that is less than an audit.

(6) An **independent audit** is made up of two separate steps.

- (A) First step is the examination of a set of financial statements that have been produced by the management of the reporting entity.
    - (1) Purpose of examination is to gather sufficient, competent evidence on which to form an opinion as to the fair presentation of the statements in accordance with generally accepted accounting principles.
    - (2) For each group of accounts and for the statements taken as a whole, management makes five **assertions**.
        - (a) **Valuation** - all accounts are shown at proper amounts based on generally accepted accounting principles.
        - (b) **Existence or occurrence** - all reported assets and liabilities actually exist; all other balances did occur. The account is not overstated.
        - (c) **Presentation and disclosure** - all accounts are properly classified and all relevant information is disclosed.
        - (d) **Completeness** - all transactions and accounts have been included within the financial statements. The account is not understated.
        - (e) **Obligations and rights** - all assets and liabilities are those of the reporting entity.
    - (3) Auditor attempts to corroborate these assertions in order to provide reasonable assurance that no material misstatements exist in any of the assertions.

(a) The term "**material**" means anything of a size or type that would influence the judgment of a reasonable person relying on the information. A preliminary judgment of the size component of materiality is set at the beginning of an audit but is continuously reassessed as new information is gathered.

(b) A **misstatement** is an **error** (an unintentional mistake), **fraud** (an intentional manipulation of the assets or the records).

(B) Second step is the report of the findings to outside parties, primarily to stockholders and other parties outside of the reporting entity. The report is intended to add credibility to the financial information being distributed.

(7) All of the auditor's work must follow **generally accepted auditing standards** (GAAS) which are currently established by means of **Statements of Auditing Standards** that are produced by the Auditing Standards Board. If the audit is of a public company, the audit must be performed in accordance with auditing standards adopted or issued by the **Public Company Accounting Oversight Board (PCAOB).**

(8) There are ten basic generally accepted auditing standards that provide the basis for an auditing engagement.

(A) **General Standards**

(1) The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor. The auditor should have sufficient education and experience in (1) auditing, (2) accounting, and (3) the industry in which the client operates in order to make the decisions necessary to evaluate whether any material misstatements exist in any of the management's five assertions.

(2) In all matters relating to the assignment, **independence** in mental attitude is to be maintained by the auditor.

(a) Independence in mental attitude cannot be regulated. However, to encourage independence in fact and to maintain the appearance of independence, the auditor can have no **direct financial interest** in the client. "Direct" includes the auditor and members of immediate family. "Financial interest" is ownership of equity shares, other client financial instruments, or any other potential financial benefit.

(b) In addition, there can be no material **indirect financial interest** such as ownership through a mutual fund.

(c) To ensure independence, auditor cannot render an opinion on statements of one year until all fees from the prior year audit have been paid.

(d) To emphasize independence from management, auditor is usually appointed by audit committee of the board of directors.

(3) **Due professional care** is to be exercised in the performance of the audit and preparation of the report.

(a) Auditor must do at least what any average auditor would do and never less.

(B) **Standards of Fieldwork**

(1) The work is to be adequately planned and assistants, if any, are to be properly supervised.

(a) Audit program is developed before substantive testing to ensure that adequate planning has occurred.

(b) All evidence is recorded on working papers that are reviewed by qualified personnel to ensure supervision. Even a partner other than the partner in charge of the engagement should review the working papers.

(2) A sufficient understanding of **internal control** is to be obtained to help determine the nature, extent, and timing of the substantive testing to be performed.

(a) Assessment is made of control risk. If that risk is high, the auditor will have to gather more evidence than anticipated or a better quality of evidence.

(3) Sufficient, competent **evidential matter** is to be obtained through inspection, observation, inquiries, confirmations, and the like to afford a reasonable basis for an opinion regarding the financial statements under audit.

(a) Evidence gathering is sometimes called **substantive testing**. Any testing that confirms the ending balance of an account is known as a test of a balance. Evidence gathered to support an account by looking at the various transactions that have affected it during the period is called a test of details.

(b) The actual amount and quality of evidence to be gathered depends on the judgment of the auditor.

(C) Standards of Reporting

(1) The report shall state whether the financial statements are presented in accordance with **generally accepted accounting principles**. (This assurance is stated explicitly.)

(a) The determination of what specific generally accepted accounting principle (GAAP) applies to a situation can be difficult because various sources can give conflicting guidelines. A **GAAP Hierarchy** has been established with five levels of authority. The higher levels have highest priority. In the top level (for businesses) are FASB Statements and Interpretations, APB Opinions, and AICPA Accounting Research Bulletins.

(2) The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period. (Assurance of **consistency** is implied.)

(3) Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in report. (Assurance of adequate disclosure is implied.)

(4) The report shall either contain an **expression of opinion** regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be rendered, the reasons should be stated. A clear-cut indication of the character of the auditor's work should be included along with the degree of responsibility that the auditor is taking.

## PROBLEMS AND SOLUTIONS
## OVERVIEW OF AUDIT FUNCTION

ONE – Because of the attest function, financial statements are the responsibility of the independent auditor. (True or False?)

*Answer – Financial statements are the responsibility of the management of the reporting entity. The independent auditor examines and reports on these financial statements. (Number One is False.)*

TWO – In an audit, the independent auditor attempts to corroborate five assertions made by the company's management in connection with each account or group of accounts found in a set of financial statements. These assertions are: valuation, timing, relevance, presentation, and completeness. (True or False?)

*Answer – The five assertions to be corroborated by the independent auditor are: (1) valuation, (2) existence or occurrence, (3) presentation and disclosure, (4) completeness, and (5) obligations and rights. (Number Two is False.)*

THREE – An independent auditor seeks to provide reasonable assurance that no material misstatements exist in any of the five assertions made by management. (True or False?)

*Answer – The role of the independent auditor is to gain sufficient, competent evidence so as to provide reasonable (not perfect) assurance that material misstatements do not exist in any of the assertions made by management. (Number Three is True.)*

FOUR – The term "materiality" refers to any factor of a size or type that would impact an outside decision-maker's decision about a set of financial statements. (True or False?)

*Answer – A material item is anything that – because of either its size or its type – would influence the judgment of a reasonable person relying on the information being presented. (Number Four is True.)*

FIVE – A misstatement is either due to error or fraud. (True or False?)

*Answer – A misstatement is an error (an unintentional mistake), or fraud (an intentional manipulation of the assets or the records. (Number Five is True.)*

SIX – The spouse of an auditor holds a small number of shares in a company. The auditor is not independent as to that particular company. (True or False?)

*Answer – To maintain the appearance of independence, independence is assumed to be lacking if the auditor has either a direct financial interest or a material indirect financial interest in the reporting company. Ownership of the shares by the spouse is considered a direct financial interest and would be prohibited. (Number Six is True.)*

SEVEN – According to generally accepted auditing standards, the standard audit report explicitly states that the financial statements are in accordance with generally accepted accounting principles applied on a consistent basis. (True or False?)

*Answer – The standard audit report must specify that the statements are in accordance with generally accepted accounting principles. However, consistency is not mentioned unless a problem exists. Thus, consistency is implied in the standard audit report. (Number Seven is False.)*

EIGHT – Auditing standards for audits of public companies are issued by the Auditing Standards Board. (True or False?)

*Answer – The AICPA Auditing Standards Board issues auditing standards for audits of nonpublic companies. The Public Company Accounting Oversight Board issues auditing standards for audits of public companies. (Number Eight is False.)*

## AUDIT OPINIONS

(1) An **unqualified opinion** (also called a standard auditor's report) is given when auditor's examination provides sufficient evidence that statements are presented fairly in accordance with generally accepted accounting principles (GAAP). It provides the users of financial statements with **reasonable assurance** that no material misstatements exist in any of the five assertions made by management.

(2) A **standard unqualified opinion** should contain several specific elements

- (A) The heading should state: Independent Auditor's Report.
- (B) The report is normally dated as of the final day of the auditor's field work and can never be dated prior to the final day of field work. Under normal circumstances, this concludes the auditor's responsibility for any type of evidence gathering.
  - (1) If an account has to be changed or a footnote added after the conclusion of the audit, management can request that the auditor return and audit that particular change. If that is done, the report must be dual dated ("March 22, 2005 except for Note Y as of April 2, 2005") to indicate that the auditor's work and responsibility have been extended for that one item.
- (C) The first paragraph is called the **introductory paragraph**.
  - (1) Indicates that an audit has been carried out (and not a preparation) of the financial statements
  - (2) Identifies the financial statements by name, by name of the company, and by the dates.
    - (a) Balance sheet is for a particular date; statements of income, retained earnings, and cash flows are for a period of time.
  - (3) Specifies that the statements are the responsibility of the company's management.
  - (4) States that the auditor's responsibility is to express an opinion on statements based on audit.
- (D) The second paragraph is called the **scope paragraph**.
  - (1) Specifies that the audit was conducted according to the auditing standards generally accepted in the United States.
  - (2) Indicates that audit was planned and performed to obtain reasonable assurance that the statements were free from material misstatements. Perfect assurance is not given for many reasons: not every transaction is examined, human error might occur in audit, fraud and illegal acts might be hidden, etc.
  - (3) Explains that evidence supporting amounts and disclosures has been examined but only on a test basis.
    - (a) This statement shows that not every transaction was examined
    - (b) Stresses reliance on auditor's judgment
  - (4) Indicates that an assessment was made of accounting principles, significant estimations, and statement presentation.
  - (5) States the belief that audit provides a reasonable basis for the opinion.
- (E) The third paragraph is called the **opinion paragraph**.
  - (1) Starts with the phrase "in our opinion" to show that this is not a guarantee but only an expert judgment

(2) Says that statements present fairly in all material respects the financial position, operations, and cash flows.
(3) States that financial statements conform to accounting principles generally accepted in the United States.

(3) An **explanatory fourth paragraph** should be added in several specific instances. In these cases, the extra paragraph is placed after the opinion paragraph and does not affect the wording of the other three paragraphs.
(A) **Emphasis of a matter** - the paragraph is added to draw attention to a matter of particular importance such as significant related party transactions or a subsequent event.
(B) Lack of consistency - the paragraph is added to draw attention to a footnote that explains a change in accounting principle. Paragraph mentions change but does not provide any judgment of it.
(1) If auditor does not concur that change is appropriate, the opinion should be qualified rather than relying on this explanatory paragraph.
(C) **Going concern problem** - the paragraph is added if substantial doubt exists as to company's ability to stay in business for 12 months from the date of the balance sheet. In this case, auditor does have the option to disclaim an opinion instead of adding an extra paragraph.
(D) **Other information attached to audited financial statements** - auditor is required to read all information attached to financial statements to determine if it is consistent with the information presented in the financial statements. If inconsistency is discovered and the financial statements are judged to be fairly presented, an extra paragraph is added to describe the problem. A qualified opinion is not rendered because the problem lies outside of the financial statements.

(4) If a problem arises and an unqualified opinion cannot be given, the appropriate wording depends on the type of problem. In each case, an additional paragraph is added to describe the problem but it always comes before the opinion paragraph and not after.
(A) There can be a **qualification because of a scope limitation**; the auditor fails to follow one or more of the generally accepted auditing standards. Frequently, the auditor is unable to obtain sufficient, competent evidence to provide reasonable assurance that a material misstatement does not exist in one of the assertions made by management
(1) Introductory paragraph does not change but scope paragraph indicates that GAAS was followed "except as discussed below" in the explanatory paragraph. As indicated above, explanatory paragraph describes problem and may direct the reader to a footnote where more information is provided.
(2) Opinion paragraph says that statements are fairly presented "except for adjustments, if any, that might have been found had we been able to . . ."
(3) If the lack of evidence is so material that auditor cannot add any credibility to financial statements, **disclaimer** (no opinion) should be given rather than a scope qualification.
(a) For a disclaimer, the last sentence in introductory paragraph about auditor's responsibility is removed.
(b) Scope paragraph is omitted completely.

(c) Opinion paragraph reiterates problem identified in explanatory paragraph and indicates that "the scope of our work was not sufficient to enable us to express and we do not express, an opinion on these statements.

(d) Even in a disclaimer, auditor must spell out any GAAP problems that were discovered

(e) If independence is lacking, auditor always issues a disclaimer but never gives the specific reason for the problem. In this case, the disclaimer is often just a single sentence: "I am not independent; I have no opinion."

(B) Statements can contain a departure from GAAP. For example, disclosure might not be adequate or a balance might not be capitalized properly. If the problem is material but some credibility can be given to the statements as a whole, the auditor issues an **opinion qualification**.

(1) The introductory and scope paragraphs are both left with standard wording. As always, an explanatory paragraph is added before opinion paragraph

(2) In opinion paragraph, the wording is changed to warn of the problem: "In our opinion, except for the effects of . . ."

(3) In severe cases, a departure from GAAP can have such an impact that the entire statements cannot be viewed as fairly presented in any capacity. An **adverse opinion** is appropriate. Again, the first two paragraphs are standard and the explanatory paragraph is added. The opinion paragraph states that "because of the effects . . . the financial statement referred to above do not present fairly . . ."

(C) Auditor can give different opinions for different statements (for example, an unqualified opinion on the balance sheet but a disclaimer on the other statements) but cannot give an opinion on specific accounts presented within a set of financial statements.

## PROBLEMS AND SOLUTIONS
## AUDIT OPINIONS

ONE – In a standard audit report, the responsibility of the management is stated in the first paragraph and the responsibility of the independent auditor is stated in the second paragraph.  (True or False?)

*Answer – The responsibility of the management for information in the financial statements is spelled out in the first paragraph.  In addition, the auditor's responsibility to express an opinion based on the audit is also stated in this first paragraph.  The second paragraph is used to detail the scope of the auditor's work.  (Number One is False.)*

TWO – In the second (scope) paragraph of a standard audit report, the auditor states that all appropriate evidence was examined. (True or False?)

*Answer – The auditor cannot possibly examine all evidence, too much would be available. Therefore, in the second (scope) paragraph of the report, the auditor states that evidence was examined on a test basis. (Number Two is False.)*

THREE – An auditor has examined a set of financial statements and is willing to provide reasonable assurance that the statements are free of material misstatements. However, the auditor wants to draw attention to a particular event that could be of special interest to readers of the statements. The auditor adds a separate fourth paragraph at the end of the report for this purpose. In addition, the opinion paragraph should begin with “in our opinion, except for the information spelled out in the following paragraph.” (True or False?)

*Answer – In this case, the auditor wants to emphasize a particular matter in the audit report. To do this, the auditor adds a paragraph at the end of the report, after the opinion paragraph. However, because the auditor is simply drawing the readers’ attention to this matter, no change should be made in the wording of the other three paragraphs. The “except for” wording seems to indicate a qualification of the opinion and should not be included. (Number Three is False.)*

FOUR – In each of the following cases, an auditor may add an extra paragraph at the end of an audit report but should not change the wording of the other paragraphs: a change in an accounting principle with which the auditor concurs, the emphasis of a matter, and where there is substantial doubt that the company can remain in business for 12 months from the balance sheet date. (True or False?)

*Answer – In each of these three situations, the auditor should not qualify the report but should provide additional information at the end of the report. No change should be made in the wording of the other paragraphs. Information on these three situations should be added to provide adequate information for the readers of the financial statements. (Number Four is True.)*

FIVE – An auditor is not able to gather sufficient, competent evidence to corroborate an account balance. Because of this problem, the auditor is not willing to provide reasonable assurance that the statements are free of material misstatements. The auditor should give either a qualified opinion or an adverse opinion. (True or False?)

*Answer – Where the auditor is unable to gather sufficient, competent evidence on which to render an opinion, the auditor has not followed generally accepted auditing standards. Because of the failure to follow generally accepted auditing standards, the auditor must provide either a qualified opinion or a disclaimer of opinion. (Number Five is False.)*

SIX – An auditor discovers that the reporting company has not followed generally accepted accounting principles in the reporting of its lease obligations. The problem is considered to be material by the auditor. The auditor must provide either a qualified opinion or a disclaimer of opinion. (True or False?)

*Answer – When financial statements are not free of material misstatements, the auditor provides either a qualified opinion or an adverse opinion. (Number Six is False.)*

SEVEN - An auditor is unable to gather sufficient, competent evidence to corroborate an account balance. Because of this problem, the auditor is not able to provide reasonable assurance that the statements are free of material misstatements. The auditor is planning to provide a qualified audit opinion. In that report, the scope paragraph and the opinion paragraph must both be changed. In addition, an explanatory paragraph is added before the opinion paragraph to provide information and may direct the reader to a note to the statements for more information. (True or False?)

*Answer – When a qualified opinion is given because the auditor has not followed generally accepted auditing standards, the wording of both the scope paragraph and the opinion paragraph are affected. In addition, an extra paragraph is added before the opinion paragraph to provide the reader with more information. (Number Seven is True.)*

EIGHT – An auditor has discovered a material misstatement in the application of an accounting principle in a company's financial statements. Because of this problem, the auditor is going to provide a qualified audit opinion. In that report, the scope paragraph and the opinion paragraph must both be changed. Furthermore, an explanatory paragraph is added before the opinion paragraph to provide information and may direct the reader to a footnote for more information. (True or False?)

*Answer – When an audit report is qualified because of a departure from generally accepted accounting principles, a paragraph is added before the opinion paragraph to explain the problem. In addition, the wording of the opinion paragraph is altered. However, no change is made in the scope paragraph because the problem was not a result of the auditor's examination. (Number Eight is False.)*

NINE – An audit report is dated as of March 29, Year Two. That date indicates the last day of the audit fieldwork. (True or False?)

*Answer – An audit report is dated as of the last day of the auditor's fieldwork in order to indicate the point in time that standard audit procedures were completed. (Number Nine is True.)*

TEN – An audit report is dated as of "March 29, Year Two, except for Note Y as of April 17, Year Two." This report has been dual dated. The auditor apparently finished standard audit procedures on March 29 but returned to apply audit procedures to the information provided in Note Y. This later work was completed on April 17. (True or False?)

*Answer – The report here has a dual dated opinion. The earlier date reflects the completion of the audit. However, the client (or perhaps the auditor) decided that Note Y should be added (or modified) to provide more complete information. Since this change occurred after the auditor's fieldwork, the auditor must have returned to gain satisfactory information so that reasonable assurance could also be given in connection with this new material. (Number Ten is True.)*

## USE OF REPORT OF ANOTHER AUDITOR

(1) Most large companies are actually made up of many separate corporations. On occasion, one auditing firm will examine the statements of a portion of these companies while a different firm (an **other auditor**) audits the rest. Having two auditors may occur because a part of the company is in a separate geographical area.

- (A) Management designates a **principal auditor** to sign the audit report and be the auditor clearly visible to the public. The principal auditor is usually the firm that audits the parent company.
    - (1) Before accepting the role as principal auditor, firm must have knowledge of entire business and audit a large enough portion of the company to take responsibility as principal auditor.
- (B) If other auditor did only a small portion of the work, there often will be no division reported; opinion of principal auditor is standard with no mention made of the other auditor.
- (C) Principal auditor can also decide to indicate the presence of the other auditor (called "dividing the responsibility").
    - (1) If responsibility is divided, the introductory paragraph provides several pieces of information.
        - (a) Mentions existence of other auditor but rarely identifies other auditor by name. Can only mention name with permission of the other auditor.
        - (b) States the size of the division by giving the total assets and revenue of the part of the company that was examined by the other auditor.
        - (c) States that the opinion being rendered is based on principal's audit and the report of the other auditor.
    - (2) If responsibility is to be divided, the last sentence of the scope paragraph mentions that the principal's audit "and the report of the other auditor" provided basis for opinion.
    - (3) If responsibility is to be divided, opinion paragraph states that opinion is "based on our audit and the report of the other auditor."
    - (4) A qualification given by the other auditor does not necessarily lead to a qualification of the entire financial statements. Opinion depends on overall materiality of problem.
- (D) Principal auditor has responsibilities in connection with other auditor.
    - (1) Must always verify the professional reputation of the other auditor.
    - (2) Must always verify the independence of the other auditor.
    - (3) May possibly need to ascertain that other auditor understands applicable GAAP, SEC regulations, tax laws, etc. This step is most likely if other auditor is a very small firm or is located in a foreign country.
    - (4) May also want to review evidence gathered about intercompany balances.
    - (5) If responsibility is not divided, principal auditor should gain assurance of the quality of the work performed by the other auditor. In that case, principal may choose to do some or all of the following.
        - (a) Review other auditor's audit program.
        - (b) Review the evidence that was gathered and the handling of any problems that were discovered.

(c) Do some audit testing to confirm work of other auditor.

## PROBLEMS AND SOLUTIONS
## USE OF REPORT OF ANOTHER AUDITOR

ONE – The firm of ABC audits the Jones Company. The Jones Company has a wholly owned subsidiary that was audited by the firm of XYZ. Jones Company plans to release consolidated financial statements and ABC has agreed to serve as the principal auditor. In preparing its report, ABC has decided not to divide the responsibility for the audit with the firm of XYZ. For that reason, the work of XYZ will be noted in the audit report although the name of this other firm will probably not be mentioned. (True or False?)

*Answer – When another auditor is involved in an audit and the principal auditor decides not to divide the responsibility, all mention of the other auditor is omitted. Unless some other problem exists, the standard audit report is rendered. (Number One is False.)*

TWO – When another auditor has done a portion of an engagement and the principal auditor has decided not to divide the responsibility, the principal auditor must examine the other auditor's audit program and a portion of the evidence gathered. (True or False?)

*Answer – When no division of responsibility is being made, the principal auditor has to verify the professional reputation and independence of the other auditor. In addition, the principal auditor should consider determining whether the other auditor has adequate knowledge of applicable accounting principles and laws. The principal also needs to consider examining the other auditor's audit program and the evidence that was gathered. However, the principal is not required to do so. (Number Two is False.)*

THREE – The firm of ABC audits the Jones Company. The Jones Company has a wholly owned subsidiary that was audited by the firm of XYZ. Jones Company plans to release consolidated financial statements and ABC has agreed to serve as the principal auditor. In preparing its report, ABC has decided to divide the responsibility for the audit with XYZ. The report produced by ABC will have three paragraphs but each of these paragraphs will differ from the standard audit report. (True or False?)

*Answer – In order to divide the responsibility for an audit, the principal auditor must make changes in each of the three paragraphs of the audit report. In the first paragraph, the existence of the other auditor is noted by giving the size of the assets and revenue examined by this other group. Furthermore, in all three paragraphs, the principal auditor indicates its reliance on the report of the other auditor in arriving at its opinion. (Number Three is True.)*

FOUR - When another auditor has performed a portion of an engagement and the principal auditor has decided to divide the responsibility, the principal auditor must verify the other auditor's professional reputation and independence. (True or False?)

*Answer – Whether the principal auditor divides the responsibility for the engagement or not, the principal is relying on the work of this other party. Consequently, the principal auditor must verify the professional reputation of the other firm as well as its independence from the reporting company. (Number Four is True.)*

## COMPARATIVE FINANCIAL STATEMENTS

(1) A company may change auditors. Subsequently, in connection with **comparative statements**, the new auditor reports on current year statements but previous opinion is still applicable for the earlier set of financial statements.

- (A) Previous opinion can simply be included along with the current audit report. However, previous auditor must agree to inclusion of report. Before giving permission, previous auditor must make certain that original opinion is still appropriate.
  - (1) Previous auditor should review earlier financial statements to make certain that nothing has been changed since original examination.
  - (2) Must also read the current statements and compare to earlier statements to determine that no obvious discrepancies are present.
  - (3) Must obtain a representation letter from current auditors stating that nothing has been found to indicate that the previous statements require adjustment.
  - (4) Must also obtain an updated representation letter from management similar to the one that is required at the end of an audit.
- (B) The previous report can be omitted but then current auditor must refer to the earlier report. In that case, the introductory paragraph is changed to include several pieces of information.
  - (1) The statements being presented that were audited by the previous auditor must be identified but the name of that firm cannot be given.
  - (2) Date of the previous report must be included.
  - (3) Type of opinion given in previous report should be noted along with an explanation if the report varied from a standard unqualified opinion.

(2) For nonpublic companies, different levels of assurance may be appropriate for the statements of different years. For example, an audit may be performed in one year but only a review or compilation in another.

- (A) The report for the current year should be generated as is appropriate.
- (B) A separate paragraph at the end of the current report should be included to indicate the following about the previous statements.
  - (1) Identification of the previous statements.
  - (2) Indication of the type of engagement that was performed.
  - (3) Date and contents of the previous report.

(3) Auditor may decide to change an opinion given on an earlier set of financial statements that is being included for comparative purposes.

- (A) For example, statements may have been restated to conform with generally accepted accounting principles.
- (B) Within current report, an explanatory paragraph is added prior to the opinion paragraph.
  - (1) Should include date and opinion of previous report.
  - (2) Should indicate updated opinion on earlier statements and reasons for change.

## PROBLEMS AND SOLUTIONS
## COMPARATIVE FINANCIAL STATEMENTS

ONE – The audit firm of ABC prepares an audit report for the Year One financial statements of Smith Company. The audit firm of XYZ provides an audit report on the Year Two financial statements of that same company. Smith now wants to present the financial statements for these years together in comparative form. If both years are to be included, both audit reports must also be presented. (True or False?)

*Answer – Under certain conditions, Smith Company may present both audit reports along with its comparative financial statements. However, the report of the previous auditor (ABC) need not be included if the current auditor (XYZ) provides specific information about the previous report within its own audit report. (Number One is False.)*

TWO - The audit firm of ABC provides an audit report for the Year One financial statements of Wilson Company. The audit firm of XYZ provides an audit report on the Year Two financial statements of that same company. Wilson now wants to present the financial statements for these years together in comparative form. Wilson has asked ABC for permission to include its original report. ABC can grant permission as long as it has performed certain procedures including reading the current financial statements. (True or False?)

*Answer – In order to give permission to reissue a previous audit report, the previous auditor must take several actions: (1) review the original financial statements to make certain that nothing has been changed, (2) read the current statements and compare to earlier statements to ensure that no obvious discrepancies exist, (3) obtain a representation letter from the current auditors indicating that no adjustments are needed to the original financial statements, and (4) obtain an updated representation letter from the management of the reporting company. (Number Two is True.)*

THREE - The firm of ABC provides an audit report for the Year One financial statements of Aaron Company. The firm of XYZ provides an audit report on the Year Two financial statements of that same company. Aaron now wants to present the financial statements for these years together in comparative form. ABC performs the required activities and grants permission to include the original audit report. That report should have the same date as was used when it was originally issued. (True or False?)

*Answer – When a statement is reissued, the previous auditor must perform certain tasks. However, these procedures do not necessitate the dual dating of the audit report. Thus, the original date continues to be appropriate. (Number Three is True.)*

FOUR - The firm of ABC provides an audit report for the Year One financial statements of Harkins Company. The firm of XYZ provides an audit report on the Year Two financial statements of that same company. Harkins now wants to present the financial statements for these years together in comparative form. The report issued by ABC is not going to be included. Thus, the current audit firm (XYZ) must provide specific information about the previous report in the opening paragraph of its current report. (True or False?)

*Answer – When comparative statements are presented and the audit report of the previous auditor is not included, the current auditor must refer to that report. In the first paragraph of the current report, the auditor should identify the statements examined by the previous auditor, the date of that report, the type of opinion that was rendered, and an explanation if that report was not a standard unqualified opinion. (Number Four is True.)*

FIVE - The firm of ABC provides a review report for the Year One financial statements of Cheen Company (a nonpublic company). The firm of XYZ provides an audit report on the Year Two financial statements of that same company. Cheen now wants to present the financial statements for these years together in comparative form. The review report issued by ABC is not going to be included. Thus, the current firm (XYZ) must refer to this previous report in the opening paragraph of its audit report. (True or False?)

*Answer – Because the previous report is not being included, the audit report of the current auditors must refer to it. However, since different levels of assurance are being given (reasonable assurance for the audit and limited assurance for the review), readers might be confused. Therefore, to draw attention to the difference, relevant information about the previous report should be disclosed in a separate paragraph at the end of the current audit report. This paragraph should spell out (1) the identification of the previous statements,(2) an indication of the type of engagement, and (3) the date and contents of the previous report. (Number Five is False.)*

## COMPILATIONS AND REVIEWS

(1) Anytime that a CPA is associated with financial statements, a report must be issued to avoid any possible misunderstanding.
  (A) This report should indicate level of assurance, if any, that is being given.
  (B) A CPA is **associated with statements** when he or she prepares or assists in preparing statements or putting information into the form of financial statements.

(2) If CPA is associated with the statements of a publicly-held company but has not performed an audit, CPA must state so clearly ("I have not performed an examination and, therefore, have no opinion.")
  (A) No negative assurance should be given. For example, CPA cannot say "I did not perform an audit but I saw nothing wrong."
  (B) Each page should be stamped "Unaudited."
  (C) If CPA is aware of a problem with the application of GAAP, that information must be included in report.

(3) For the **interim financial statements** of a publicly-held company, CPAs perform **reviews**.
  (A) CPA carries out specified procedures and, if no problems are discovered, states that he or she is not aware of any material modifications that are needed to be in conformity with GAAP.
    (1) This wording is known as **negative assurance** or **limited assurance**.
    (2) Assurance being given is less than that of an audit (reasonable assurance) because no evaluation is made of internal control and insufficient evidence is gathered to form an opinion as to whether material misstatements exist in any of the five assertions made by management about the accounts and the financial statements.

(4) If a company is privately-held and an audit is not performed, CPA carries out either a **review** or a **compilation**. These services can be done on either interim or annual statements. The CPA's work must adhere to the **Statements on Standards for Accounting and Review Services**.
  (A) A review is essentially the same as a limited review performed on the interim financial statements of a public company.
  (B) There are specific procedures that CPA should do in a review.
    (1) Obtain a general knowledge of the company, its systems, its control structure, and the industry in which it operates.
    (2) Perform **analytical procedures**. Client balances, percentages, and ratios are compared to auditor's expectations for those same figures. Significant differences indicate areas where risk of misstatement is greatest.
      (a) Auditor expectations are usually stated within a range and the client figures would be expected to fall within that range.
      (b) Auditor expectations can be based on past years' figures, budgets, financial statements of competitors, industry averages, related nonfinancial information (the local economy has declined so that bad debt expense would be expected to increase), and related financial information (sales have gone up so cost of goods sold should have also gone up).

(3) Make inquiries of the client management looking for potential problems. Areas of inquiry would include the following.
(a) Method of preparing the statements
(b) Any changes in internal control
(c) Any changes in the application of GAAP.
(d) Outcome of problems found in previous engagements.
(e) Changes in the company, its systems, or its personnel.
(4) Read the financial statements and verify the math on those statements.
(5) Read **minutes of board of directors and stockholders' meetings** looking for discussion of unusual events or problems.
(6) Get **representation letter** from the management.

(5) A **review report** normally has three paragraphs.
(A) First paragraph states that a review was performed and identifies the statements.
(1) Also indicates that the work was in accordance with the Statements on Standards for Accounting and Review Services issued by the American institute of Certified Public Accountants (AICPA).
(2) Specifies that financial statements are the representations of the management.
(B) Second paragraph explains the steps and purpose of a review.
(1) Indicates that a review is mainly inquiries of company personnel and analytical procedures applied to financial data.
(2) Explains that a review is substantially less than an examination made in an audit.
(3) Specifies that no opinion is being expressed.
(C) Third paragraph provides **negative (limited) assurance**: "Because of my review, I am not aware of any material modifications that should be made . . . to be in conformity with GAAP."
(D) Each page of the financial statements must be stamped "see accountant's review report."
(E) If need for modification to be in conformity with GAAP is found, CPA discusses the problem with management and, if not resolved, with the audit committee. If still not resolved, CPA adds a fourth paragraph to explain. This extra paragraph is placed at the end of the report. The third paragraph (described above) makes mention of the problem and the inclusion of the additional paragraph.
(F) Situations (such as an emphasis of a matter) that lead in an audit to the inclusion of an **explanatory paragraph** are not mentioned in a review because the financial statements do not need modification.

(6) For a nonpublic company, the CPA can also perform a **compilation** which provides no assurance in connection with the statements.
(A) A compilation is sometimes referred to as write up work and means that the CPA took client information and put it into the form of financial statements.
(1) Footnote disclosure is often omitted in such statements but, in that case, an extra paragraph should be added to report to indicate that the statements are only intended for people aware of the missing disclosures.
(2) In performing a compilation, CPA should have a general knowledge of the company: its transactions, records, personnel, applicable GAAP, and the industry in which it operates.

(3) CPA must read the final statements and verify the math in order to catch any obvious errors. However, no evidence gathering is performed.

(4) A compilation is one service that can be performed by a CPA who is not independent of the reporting company although the lack of independence must be disclosed in the report.

(B) A compilation report normally has two paragraphs.

(1) The first paragraph identifies the financial statements that were compiled and indicates that the work was done in accordance with the Statements on Standards for Accounting and Review Services issued by the AICPA.

(2) The second paragraph describes the purpose of a compilation as presenting the representations of management in the form of financial statements. An indication is made that no audit or review was made and that no opinion or assurance is being given.

(3) If the CPA is aware of any departure from GAAP, a sentence is added to the second paragraph of the report to note that departure. Then, a third paragraph is added to describe the problem.

(4) Each page of the financial statements must be stamped “see accountant’s compilation report.”

## PROBLEMS AND SOLUTIONS
## COMPILATIONS AND REVIEW

ONE – A compilation and a review can only be performed for nonpublic companies. (True or False?)

*Answer – Either a compilation or a review can be performed on the financial statements of a nonpublicly-owned company. Normally, compilations and reviews are not appropriate for companies that are publicly owned. However, the interim financial statements of a publicly-owned company can be subjected to a limited review. (Number One is False.)*

TWO – In a review, the auditor can provide limited assurance. However, in a compilation, the auditor is not allowed to provide any assurance. (True or False?)

*Answer – Limited (sometimes called negative) assurance is appropriate in a review. When providing limited assurance, the CPA states that he or she is not aware of any material modifications that are needed for the financial statements to be in conformity with generally accepted accounting principles. For a compilation, the CPA provides no assurance of any type. A compilation is usually no more than the taking of client data and putting it into the form of financial statements. (Number Two is True.)*

THREE – In a review, the CPA does not assess control risk and does not gather corroborating information about particular accounts. The primary work done by the CPA is limited to performing analytical procedures and making inquiries of the client management. (True or False?)

*Answer – For a review, the CPA does not perform essential audit tasks such as assessing control risk and performing traditional audit tests of transactions and account balances. A review is an overview of the financial information in search of potential problems. The two main steps are analytical procedures and inquiries made of the client's management. In performing analytical procedures, the auditor arrives at estimations for significant client figures, ratios and the like. These auditor expectations are then compared to the client data looking for unusual variations that would indicate possible reporting problems. (Number Three is True.)*

FOUR – In a review, a large part of the work is carried out by making inquiries of the company's management. The CPA should ask about relevant issues such as the method of preparing the statements, changes in internal control and the application of generally accepted accounting principles, the composition of large account balances, and the outcome of problems found in previous examinations. (True or False?)

*Answer – For a review, numerous inquiries should be made of the company management. These questions address the financial reporting process in general. The CPA will be interested in changes that have occurred in the company and the statements as well as the settlement of any reporting problems previously noted. However, in a review, the CPA does not get involved with the composition of account balances. That is appropriate as an audit test of a specific account. (Number Four is False.)*

FIVE – A standard review report contains three paragraphs. The first paragraph indicates that a review is composed mainly of inquiries of company personnel and analytical procedures and is substantially less than an audit. (True or False?)

*Answer – The first paragraph of a review report indicates that a review was performed and identifies the financial statements. It also states that the Statements on Standards of the American Institute of Certified Public Accountants were followed and that the financial statements are the representations of the company management. The second paragraph explains that a review is primarily inquiries and analytical procedures and is substantially less than an audit examination. (Number Five is False.)*

SIX – In a compilation, the CPA need not be independent. (True or False?)

*Answer – A CPA normally has to be independent of all clients. One exception, though, is a compilation. Since no assurance is provided, independence is not required. However, disclosure must be made in the CPA's report of any lack of independence. (Number Six is True.)*

SEVEN – In performing a compilation, the CPA provides limited assurance for all information that was actually tested. No assurance is provided for the remainder of the financial information. (True or False?)

*Answer – In a compilation, the CPA provides no assurance. The CPA must read the finished statements and verify the math in order to catch obvious errors. However, no testing is done and no assurance is given. (Number Seven is False.)*

EIGHT – A CPA performs a compilation for a client. The compilation report should contain three paragraphs and describe any testing that was actually performed. (True or False?)

*Answer – A compilation report has only two paragraphs. The first paragraph identifies the financial statements and specifies that the CPA followed the Statements on Standards for Accounting and Review Services. The second explains that a compilation is the presentation of representations made by management in the form of financial statements and that no assurance of any type is being provided. (Number Eight is False.)*

## AUDIT RISK

(1) An independent auditor provides reasonable assurance that the five **assertions** made by management (and described earlier) are free from material misstatements. Misstatements result from errors, fraud, and direct illegal acts.

- (A) **Errors** are unintentional mistakes that affect the financial statements such as accidentally capitalizing a repair expense.
- (B) **Fraud** is an intentional action that leads to distortion of financial statements. Auditor may encounter two types of fraud.
  - (1) **Fraudulent financial reporting** is the manipulation of the financial records to make the reporting entity appear either better or worse than it really is.
  - (2) **Misappropriation of assets** (also known as **defalcation**) is the theft of assets, an action that causes the financial statements to be misstated.
- (C) Three conditions must be present for fraud to occur.
  - (1) Incentive/pressure.
  - (2) Opportunity.
  - (3) Attitude/rationalization.
- (D) A **direct-effect illegal act** is one that has an immediate impact on the financial statements. Income tax evasion is an example because the reported balances for income tax payable and income tax expense are wrong.
- (E) Auditor provides only reasonable assurance because (1) not every transaction is examined, (2) human error can occur in the testing, and (3) both fraud and illegal acts are usually hidden.

(2) **Audit risk** is the possibility that a material misstatement will occur and be reported within an entity's financial statements. For each group of accounts, the auditor is not satisfied until audit risk is reduced to an acceptable level. Acceptable audit risk is the amount of risk that the auditor is willing to assume and still provide reasonable assurance of no material misstatements. Audit risk has three components, each of which may be judged quantitatively (for example, a 20% risk of misstatement might be said to exist) or nonquantitatively (one account may be assessed as having maximum risk of misstatement whereas another has minimum risk).

- (A) The auditor estimates the severity of the first two components of audit risk based on an assessment of the client and the particular group of accounts. Auditor must evaluate the likelihood of a problem.
  - (1) **Inherent risk** is the possibility that a material misstatement will occur within the company's accounting system
  - (2) **Control risk** is the possibility that a material misstatement that has occurred will not be detected by the company's control system.
- (B) The final component of audit risk is based on the quality and quantity of evidence gathered by the auditor.
  - (1) **Detection risk** is the possibility that a material misstatement will not be caught by the auditor's testing (often referred to as substantive testing). Auditor continues testing an account group (thereby decreasing detection risk) until the three components taken together indicate that overall audit risk has been reduced to the level judged to be acceptable by the auditor.

(a) If inherent risk and/or control risk are assessed as high, auditor may have to reduce detection risk further than expected in order for overall audit risk to be acceptable.
(b) Detection risk decreases whenever auditor gathers more evidence or obtains evidence of a better quality. Evidence is considered to be of a better quality if it is gathered (1) closer to year end, (2) by more experienced auditors, or (3) using more sophisticated techniques (such as statistical sampling rather than judgment sampling).

(3) Early in the audit, the auditor should have a staff discussion (brainstorming session) regarding the risk of material misstatement due to fraud. The discussion should focus on how fraud might be perpetrated and emphasize the need for professional skepticism.

(4) Obtain the information needed to identify risks of material misstatement due to fraud through
(A) Inquiries of management and others within the organization.
(B) Considering the results of planning analytical procedures.
(C) Considering the existence of **fraud risk factors**.
(1) SAS 99 contains lists of fraud risk factors organized around the conditions of
(a) Incentive/pressure, (e.g., management or directors' financial situation threatened by significant financial interests in company).
(b) Opportunity (e.g., internal control deficiencies).
(c) Attitude/rationalization (e.g., known history of violations of securities or other laws).

(5) Identify fraud risks
(A) There is a presumption that misstatement of revenue will be a fraud risk.

(6) Responding to fraud risks
(A) Overall responses—assignment of personnel, careful consideration of accounting policies, and make audit procedures less predictable.
(B) Specific responses—alterations in the nature, extent, or timing of auditing procedures.
(C) Responses to further address the risk of management override of controls.
(1) Examination of journal entries and other adjustments.
(2) Retrospective review of prior accounting estimates for evidence of bias.
(3) Evaluation of the business rationale for significant unusual transactions.

(7) The auditor should document: the audit team discussion, procedures performed to identify fraud risks, specific fraud risks identified and the auditor's response, the reason why revenue was not identified as a fraud risk (if it was not), results of procedures to further assess the risk of management override of controls, and the nature of communications about fraud made to management, the audit committee, and others.

(8) At any time during an audit, auditor may discover evidence that indicates that a misstatement could possibly exist in the financial records.
(A) Auditor must assess whether the possible misstatement could be material. If not, the auditor need only inform members of management at least one level above those involved about the potential problem.
(B) If possible misstatement could be material, auditor gathers more evidence to determine if misstatement actually exists.

(C) If misstatement does exist, auditor assesses if it is material. If not, auditor tells management and has no other responsibility.
(1) If misstatement is material, auditor talks with management because the statements are the responsibility of management.
(2) Even if material problem is resolved, the audit committee of the board of directors must be informed because the issue had a significant impact on the financial reporting of the company.
(3) If material misstatement is not corrected, auditor gives an opinion qualification or an adverse opinion.

(9) Auditor's responsibility for detecting illegal acts.
(A) **Direct illegal acts** - auditor must provide reasonable assurance that no illegal acts have occurred that have a direct and material effect on financial statements. Auditor's responsibility is the same here as it is for errors and fraud.
(B) Other illegal acts such as insider trading and safety hazards only have indirect effects on the financial statements. No account is currently wrong but a contingency exists; if the act is discovered, company could be punished.
(1) Auditor has no responsibility to look for or find illegal acts that have an indirect impact on financial statements. These actions are outside scope of the audit; in addition, they may well be hidden.
(2) However, auditors must maintain skeptical attitude and, thus, may discover such illegal acts or situations pointing to illegal acts. Questionable events would include unauthorized transactions, improper or slow reporting, and large cash or unspecified payments
(C) Even for an indirect illegal act, if suspicious situation is encountered, auditor must investigate. If illegal act is discovered, auditor considers potential effect on the fair presentation of financial statements
(1) Must determine, by talking with management or through investigation, whether a contingency has been incurred that should be disclosed.
(2) If contingency has been incurred, auditor gathers evidence as to amount and proper presentation.
(D) If a material indirect illegal act is found and company will not disclose, auditor renders an opinion qualification. If an act is discovered but its legality cannot be established, the auditor can provide a scope qualification

## PROBLEMS AND SOLUTIONS
## AUDIT RISK

ONE – Audit risk is the possibility that a material misstatement will occur and be reported within an entity's financial statements. For each group of accounts, the auditor must carry out substantive testing until audit risk is reduced to zero. (True or False?)

*Answer – The auditor provides reasonable assurance of no material misstatements and not perfect assurance. Therefore, the auditor must continue to gather corroborating evidence until reasonable assurance can be given. Conveyance of reasonable assurance is possible when audit risk has been reduced to an acceptable level. (Number One is False.)*

TWO – Audit risk has three components: nonsampling risk, control risk, and sampling risk. (True or False?)

*Answer – Audit risk does have three components but they are inherent risk, control risk, and detection risk. (Number Two is False.)*

THREE – Inherent risk is the possibility that a material misstatement will occur within the reporting company's accounting system. The auditor examines the client's accounting system and assesses the amount of inherent risk that is present. (True or False?)

*Answer – Inherent risk reflects a characteristic found in a particular company. Therefore, an auditor cannot alter inherent risk but can only estimate how much risk is present based on assessing the people and systems in place within the company. (Number Three is True.)*

FOUR – Control risk is the possibility that a material misstatement that has occurred in a company's accounting system will not be detected by the internal control. The auditor examines the client's control components and may test certain control activities in order to assess the amount of control risk that is present. (True or False?)

*Answer – Control risk reflects a characteristic of a particular company. Therefore, an auditor cannot change control risk but can only estimate the amount of risk based on the testing that is performed. (Number Four is True.)*

FIVE – Detection risk is assessed by the auditor by examining the client company and the method by which it prepares its financial statements. (True or False?)

*Answer – Detection risk is the possibility that a material misstatement exists that will not be discovered by the independent auditor's own testing. It is not a characteristic of the company but is a function of the amount and quality of work performed by the auditor. (Number Five is False.)*

SIX – The auditor assesses both the inherent risk and control risk for a particular account or assertion to be high. The auditor must set the acceptable level of detection risk for that account or assertion at a relatively low level. (True or False?)

*Answer – The assessments of inherent and control risk will vary inversely with the level of detection risk that is considered to be acceptable. If inherent risk and control risk are estimated as being high for a particular account or assertion, detection risk will have to be reduced to a relatively low level in order to be acceptable. (Number Six is True.)*

SEVEN – The auditor assesses both the inherent risk and control risk for a particular account or assertion to be high. The auditor must set the acceptable level of detection risk for that account or assertion at a low level. In order to reduce detection risk to this acceptable level, the auditor must perform additional substantive testing. (True or False?)

*Answer – Detection risk can be reduced to an acceptable level by additional substantive testing or by obtaining evidence of a higher quality. Evidence is considered to be of a higher quality if it is gathered closer to the end of the year, is obtained by more experienced auditors, or is generated by more sophisticated techniques such as positive confirmations rather than negative confirmations. Additional substantive testing will reduce detection risk but obtaining a higher quality of corroborating evidence also decreases this risk. (Number Seven is False.)*

EIGHT – In assessing fraud risk, the auditor must be aware of management incentives to commit fraud. For example, a lack of internal control might provide the incentive. (True or False?)

*Answer – Management incentives to commit fraud include such factors as threats to financial stability or profitability, excessive pressure on management to meet requirements or third-party expectations, or management or director's financial situation threatened. A lack of internal controls provides an opportunity to commit fraud. (Number Eight is False.)*

NINE – The presence of an undisclosed direct-effect illegal act creates a misstatement. Because an auditor provides reasonable assurance that financial statements are free of material misstatements, the auditor's responsibility extends to direct illegal acts. In addition, the auditor provides negative assurance about the absence of indirect illegal acts. (True or False?)

*Answer – The auditor has no responsibility to search for or discover illegal acts that have an indirect impact on financial statements. Therefore, the auditor provides no assurance about the absence of such indirect illegal acts. However, the auditor must remain suspicious and follow up if events indicate the possible presence of an indirect illegal act. (Number Nine is False.)*

TEN – Income tax evasion is an example of a direct-effect illegal act and water pollution is an example of an illegal act that has only an indirect effect on financial statements. (True or False?)

*Answer – With a direct-effect illegal act, figures currently reported within the financial statements are stated incorrectly. Thus, income tax evasion is a direct illegal act because the Income Tax Expense account and the Income Tax Payable account are both misstated. Illegal acts are said to have an indirect effect on financial statements if they create a contingency for the company. If the act is discovered, the company may be fined or penalized in some way. Thus, water pollution creates an indirect impact; the financial statements will only be affected if the crime is discovered. (Number Ten is True.)*

ELEVEN – The procedures required to further address the risk of management override of controls include tests for unrecorded revenue and examination of the business rationale for significant unusual transactions. (True or False?)

*Answer – The procedures required to further address the risk of management override of controls include examination of journal entries and other adjustments, retrospective review of prior year accounting estimates for biases, and evaluation of the business rationale for significant unusual transactions. (Number Eleven is False.)*

TWELVE **–** The risk of fraudulent misstatement of revenue generally must be presumed to be a fraud risk on every audit. (True or False?)

*Answer – SAS 99 indicates that revenue recognition should be considered a fraud risk unless the auditor can justify otherwise. (Number Twelve is True.)*

## INTERNAL CONTROL

(1) **Internal control** is a process set up by board of directors and management to provide reasonable assurance that company goals will be achieved as to (1) the reliability of financial reporting, (2) effectiveness and efficiency of operations, and (3) compliance with laws and regulations.

- (A) **Control risk** is the chance that a material misstatement will not be prevented or detected by the company's internal control.
- (B) An inverse relationship exists between assessed level of control risk and the acceptable level of detection risk that has to be achieved through auditor's substantive testing. Thus, assessment of control risk affects nature, extent, and timing of substantive testing.

(2) Auditor must always come to an understanding of five components of client's internal control. Knowledge of components must be documented. Documentation can be by questionnaire, flowchart, memorandum, or a combination of these.

- (A) **Control environment** - company's commitment to integrity, ethical values, and competence; management's philosophy and style (the amount of risk that the company is willing to take, for example, or conservative nature of reporting); delegation of authority and responsibility; and human resource policies.
- (B) **Risk assessment** - company's ability to anticipate potential misstatements and work to prevent them before they occur. Control system should recognize that risk increases because of new people, new operating systems, rapid growth, change in company or environment, new technology, new products, geographical separation and the like.
- (C) **Control activities** - policies and procedures installed by company to reduce risk of misstatements to an acceptable level. Can be separated into several classifications.
  - (1) **Performance reviews** (such as comparing reported figures to budgets, standards, forecasts, past year figures, etc.) to highlight differences and indicate to officials the possible need for investigation and corrective action.
  - (2) **General controls** to help ensure the accuracy of all data processing activities.
  - (3) **Application controls** applied to individual transactions to ensure that all transactions are valid, authorized, and properly processed.
  - (4) **Physical controls** to safeguard assets.
  - (5) **Segregation of duties** within the organization so that different individuals/departments (1) authorize transactions, (2) record transactions, and (3) maintain custody of assets.
- (D) **Information and communication** - ability of the accounting system to generate reliable information. System must be able to identify and record all transactions in a timely manner and convey information to those parties who can make use of it.
- (E) **Monitoring** - regular assessment of internal control over time so that it does not become outdated or lose its dependability.

(3) While assessing control risk, auditor must watch for factors, such as the following, that indicate a particular **risk of fraud**.

- (A) Failure of management to monitor significant controls.

- (B) Failure to screen new employees who will be in positions to steal.
- (C) Inadequate recording of assets that could be easily stolen.
- (D) Lack of proper segregation of duties.
- (E) Lack of system for authorizing and approving transactions.
- (F) Poor physical safeguards.
- (G) Failure to record transactions in a timely fashion.
- (H) Lack of mandatory vacations.
- (I) Failure to correct problems found in internal control system.

(4) After coming to an understanding of control components, auditor makes a **preliminary assessment of control risk** based on the quality of these components, evaluations made in previous audits, discovery of fraud risk factors, competence and objectivity of internal audit department, review of client control documentation, observation of employee performance, and by tracing a sample of transactions through various systems to note proper application of control procedures.

- (A) Based on this preliminary assessment, significant problems may be apparent and the auditor will assess control risk at a maximum level. Auditor then relies solely on substantive testing to reduce detection risk so that overall audit risk is reduced to acceptable level. Auditor has no reason to perform tests of controls.
- (B) Based on preliminary assessment, control risk for some assertions may appear to possibly be below maximum. If control risk is eventually assessed as being below the maximum level, auditor will be required to do less substantive testing or can rely on tests of a lower quality.
- (C) To finalize a preliminary assessment that control risk is below the maximum, the auditor performs **tests of specific control activities**.
  - (1) Must determine **design of internal control** within individual accounting systems. Once again this understanding can be documented by a questionnaire, flowchart, and/or memorandum.
  - (2) **Control activities** are identified within these systems that should help to reduce control risk. Auditor anticipates types of misstatements that could occur and then searches for control activities that would prevent these problems.
  - (3) The identified control activities are tested to verify that they are actually operating effectively and efficiently as intended. Auditor can take several actions.
    - (a) Talk with personnel about procedures that they follow.
    - (b) Observe employees as they perform critical tasks.
    - (c) Trace the processing of transactions through the system to see if control activities were properly performed. In most cases, control activities are designed to leave some physical proof such as a check mark.
    - (d) Reperform the activities to ensure that all problems were caught.
- (D) Even if control risk appears low after preliminary assessment of the five components, further testing of specific controls may take more effort than the potential savings in substantive testing. In those cases, it is more efficient for auditor to assume maximum control risk and move directly to substantive testing.
- (E) If control risk is assessed at the maximum, auditor must document understanding of the control components and specify the conclusion. If control risk is assessed

below the maximum, auditor must also provide basis for this conclusion and understanding of the control activities relied on in the individual systems.

(F) In a system where information is transmitted, processed, or maintained electronically, auditor may be unable to carry out enough substantive testing to reduce detection risk to an acceptable level. Auditor should perform additional tests of controls to gather evidence that might provide adequate assurance.

(5) **Inherent limitations** exist for all systems of internal control. Some amount of risk will always exist; internal control cannot provide perfect assurance.

(A) Collusion by employees can get around most control activities.

(B) Management can override control activities.

(C) Human errors can prevent control activities from working properly.

(D) At some point, the cost of additional control is not worth the additional benefits that accrue.

(E) Internal control as well as the company itself can change quickly over time. Even though control may be excellent at one point in time, that is no assurance that it will continue to be sufficient.

(6) **Internal audit department** is responsible for monitoring internal control within a company. It appraises the design and helps assure compliance with all controls (as compared to independent auditor who just assesses financial controls). Fair presentation of financial statements is only an indirect interest of the internal audit department.

(A) Independent auditor determines the actual function of the internal audit department by looking at job descriptions, status in the company, audit plans, etc.

(B) If internal audit department is competent and objective (independent), assessed level of control risk might be reduced so that less substantive testing is needed.

(1) **Competence of internal audit department** is judged by looking at education, certification, and experience of the individuals. Auditor should also review some of the work of the internal audit department as it relates to financial reporting

(2) **Objectivity of internal audit department** is judged by determining whether reporting is done directly to audit committee and/or board of directors. It is also important to make sure that no limitations are placed on work of internal audit department.

(C) If risk of material misstatements is very low for certain assertions (value of prepaid expenses, for example), the work of the internal audit department alone may provide sufficient evidence for the independent auditor.

(7) If auditor discovers a **reportable condition** (a significant deficiency) in a company's internal control, auditor must inform the audit committee.

(A) Communication can be written or oral.

(B) If problem has been previously reported and acknowledged by board but not fixed, auditor has no responsibility to communicate again.

(C) If problem constitutes a **material weakness in internal control** (high level of risk), communication should be made immediately. Otherwise communication can wait until end of the audit.

## PROBLEMS AND SOLUTIONS
## INTERNAL CONTROL

ONE – An auditor is assessing a company's control risk and determines that less risk exists than was anticipated originally. Consequently, the auditor will probably reduce the amount of substantive testing to be performed. (True or False?)

*Answer – When the assessment of control risk is reduced, the level of detection risk that is considered acceptable can be increased. Because the acceptable level of detection risk is higher, the auditor will be required to do less substantive testing (or can gather evidence of a lower quality than was originally expected). (Number One is True.)*

TWO – Regardless of the anticipated level of control risk, the auditor must gain an understanding of the components of a reporting company's internal control. There are five such components. (True or False?)

*Answer – In following generally accepted auditing standards, an auditor must come to an understanding of five components of internal control. These components are (1) the control environment, (2) risk assessment, (3) control activities, (4) information and communication, and (5) monitoring. (Number Two is True.)*

THREE – The auditor seeks to determine whether a company has the ability to anticipate and prevent potential misstatements. This component of internal control is known as the control environment. (True or False?)

*Answer – Assessing whether an accounting system and its related controls can anticipate potential misstatements and take actions to prevent them is a component of internal control known as risk assessment. The term "control environment" refers to factors such as the company's commitment to integrity and management's philosophy toward financial reporting. (Number Three is False.)*

FOUR – A company's accounting system is able to identify all transactions and report them in a proper and timely fashion to the people within the organization who need the information. The auditor is assessing the company's control activities, one of the five components of internal control. (True or False?)

*Answer – The auditor does assess whether the reporting company can gather all essential information in a timely manner and report it to the appropriate individuals. However, this component of internal control is known as "information and communication." Control activities relate to policies and procedures used by the company to reduce misstatements within its accounting system. (Number Four is False.)*

FIVE – During the assessment of control risk, an auditor must watch for fraud risk factors that may be present. For example, the failure of the company to require mandatory vacations would be one such fraud risk factor. (True or False?)

*Answer – Factors that might indicate the presence of fraud within the internal control of the reporting company would include: failure of management to monitor significant controls, lack of proper segregation of duties, poor physical safeguards, failure to correct problems in internal control, and lack of mandatory vacations. An employee's failure to take a vacation may indicate that the individual is hiding either theft or a manipulation of the accounting records and is afraid to take time off because of the chance of discovery. (Number Five is True.)*

SIX – After making a preliminary assessment of the five components of internal control, the auditor believes that control risk is high because of weaknesses that are discovered. The auditor should test those controls further before beginning substantive testing in order to reduce detection risk to the level that is considered acceptable. (True or False?)

*Answer – If control risk is high because of identified weaknesses, there is no reason to do additional testing of those controls. The auditor should move directly to substantive testing. Control risk will be assessed at the maximum level. As a result, the auditor has to set the acceptable level of detection risk relatively low. Increased substantive testing will be performed or evidence of a better quality must be obtained. (Number Six is False.)*

SEVEN – After making a preliminary assessment of the five components of internal control, the auditor believes that control risk might be low for one or more assertions. The auditor may then choose to test those controls but may also decide not to test those controls. (True or False?)

*Answer – Where control risk appears to be below the maximum level, the auditor must decide whether to test those controls or not. If a reduction in control risk is expected to cause a decrease in overall audit time and effort, the controls should be tested further. However, if the effort needed to reduce control risk will not lead to a drop in overall audit time and effort, control risk should be set at the maximum level. The auditor then immediately begins substantive testing procedures. (Number Seven is True.)*

EIGHT – A preliminary assessment has been made of the five components of internal control. If the auditor decides to perform tests of controls, the design of specific systems and the control activities within those systems should be determined. A flowchart must be created in order to reflect the auditor's understanding of those systems and controls. (True or False?)

*Answer – In performing tests of controls, the design of the internal control within individual systems must be determined and documented. For that purpose, a flowchart, a memorandum, or a questionnaire can be used. (Number Eight is False.)*

NINE – If an auditor has decided to perform tests of controls, the auditor must determine the design of internal control within the various accounting systems, identify control activities that could reduce control risk, and verify that those activities are operating effectively and efficiently. The auditor performs substantive testing procedures to determine whether specified control activities are operating as intended. (True or False?)

*Answer – Testing of controls does consist of three steps: determining the design of the systems and the internal control within those systems, identifying control activities that would reduce risk, and testing to see if those activities are actually functioning as intended. To verify that the designated activities are operating effectively and efficiently, the auditor can make inquiries, observe employees performing the controls, look for physical proof that the activities have been performed, or reperform some of the activities to ensure that all problems are being detected. These actions are considered tests of controls and not substantive tests. (Number Nine is False.)*

TEN – Collusion among employees is an inherent limitation of internal control. (True or False?)

*Answer – Internal control can only provide reasonable assurance that material misstatements are prevented or detected. It cannot provide perfect assurance because certain inherent limitations are impossible to overcome completely. These inherent limitations include (1) overriding the system of control by members of the management, (2) human errors, (3) changes in the company that occur over time, and (4) collusion among company employees. (Number Ten is True.)*

ELEVEN – If an independent auditor discovers a significant deficiency (a reportable condition) in a company's internal control, the auditor must inform the management and the audit committee immediately. (True or False?)

*Answer – In assessing control risk, an auditor may discover a significant deficiency in internal control which is known as a "reportable condition." This information must be communicated to management and to the audit committee. This communication can be orally or in writing and can be made immediately or delayed until the end of the audit. (Number Eleven is False.)*

## EVIDENCE GATHERING

(1) The **audit program** is a list of substantive testing procedures to be performed. It is required in an audit; it shows that the work has been adequately planned.
- (A) Preliminary draft is often written at the beginning of the audit.
- (B) Audit program is finalized after assessment is made of inherent risk and control risk. At that point, auditor knows the level of detection risk that has to be achieved which affects the nature, extent, and timing of the substantive tests to be carried out.

(2) In the year that an auditing firm takes a new engagement, information should be sought from the **predecessor auditor**. Predecessor auditor is one who did previous audit but who has been terminated or resigned or has been told that termination may occur.
- (A) Current auditor must always get the client's permission before talking with past auditor (or anyone else). If client refuses to give permission, auditor normally resigns because of fear that management cannot be trusted. However, resignation is not required; auditor should assess reason for refusal.
- (B) **Successor auditor** is required to communicate with predecessor before accepting engagement but should not seek this discussion until after engagement has been offered. If predecessor's response is limited (if, for example, because of litigation), the limitation should be indicated. Required communications include the following:
  - (1) Information as to the integrity of management.
  - (2) Disagreements with management on either accounting or auditing issues.
  - (3) Communications with audit committee regarding fraud, illegal acts, and internal control related matters.
  - (4) The predecessor's understanding of the reason for changing auditors.
- (C) After accepting an engagement, the successor is urged (but not required) to communicate with predecessor again so as to review prior **working papers**.
  - (1) This review can help the auditor identify accounting methods that were used in the past so that consistent application can be substantiated.
  - (2) Successor also needs to substantiate the opening balances of the balance sheet accounts. Successor does not rely on the predecessor's working papers but rather the review of those working papers is one method of gathering the needed evidence.

(3) Auditor is required to establish an **understanding with the client about each engagement** (an audit as well as other attestation services).
- (A) This understanding must include four areas:
  - (1) Objective of the work (for an audit, it is the expression of an opinion on the financial statements).
  - (2) Management's responsibilities - the financial statements, effective internal control, compliance with laws and regulations, making all records available, and a representation letter to the auditor.
  - (3) Auditor's responsibilities - following generally accepted auditing standards and letting the audit committee know of any reportable conditions.
  - (4) Limitations of the engagement - reasonable assurance is given and not absolute assurance, a disclaimer will be rendered if no opinion can be

given, and that internal control is only evaluated in order to determine the nature, extent, and timing of audit testing.

(B) Other matters can also be included in the understanding: the use of a specialist, the use of internal auditors, discussions with predecessor auditors, etc.

(C) Understanding with client must be documented. An **engagement letter** is recommended for this purpose but not required. A signed memo describing an oral discussion will be adequate as will a formal contract.

(4) **Representation letter** is obtained by auditor, usually on the last day of fieldwork. Can be dated later than the audit report but no earlier.

(A) It is a letter from representatives of the management (signed by both the CEO and CFO and anyone else with sufficient knowledge of financial statements).

(B) If representation letter is not received, auditor must give qualified opinion because of the scope limitation. Auditor also has the right to give a disclaimer or withdraw from the engagement.

(C) The letter requires management to acknowledge responsibility for financial statements. Management must also state its belief that the financial statements are presented fairly according to generally accepted accounting principles. Management indicates that it is also responsible for correcting any material misstatements and that any uncorrected misstatements are not material. In addition, letter confirms and documents the representations made to the auditors during the audit. It also helps to reduce misunderstandings between the parties.

(D) Can include a number of representations such as the following:

(1) Management acknowledges responsibility for financial statements and states belief that they are presented fairly.

(2) States that all records, data, and minutes have been made available.

(3) States that all material transactions have been properly recorded.

(4) States that no fraud has occurred involving management with a significant role in internal control and that no fraud has occurred that has a material effect on the financial statements.

(5) States that the following have been properly disclosed and reported: related party transactions, guarantees, significant estimates, unasserted claims, contingencies and the like.

(E) Can include information on materiality, in either qualitative or quantitative terms.

(5) **Audit committee** is composed of independent members of the board of directors (members who are not part of management).

(A) Committee oversees the internal audit function and serves as liaison with independent auditors.

(B) Independent auditor should ensure that committee knows of anything that has a significant effect on financial statements including: accounting policy decisions by management, method of deriving estimates, and proposed adjustments discovered by auditor.

(C) Auditor must also tell audit committee about any misstatements not corrected by management even though the misstatements were not considered to be material, either individually or in the aggregate.

(D) For an SEC client, an auditor must talk with the audit committee about the quality (as well as the acceptability) of the company's accounting principles and estimations.

(6) **Analytical procedures** are used in reviews and they are also required in an audit engagement.

- (A) Analytical procedures must be performed in the planning stage of an audit to help auditor assess inherent risk. They also must be carried out in the final review stage of the audit to make certain that no suspicious changes occurred during the audit that were overlooked. Analytical procedures can be used as substantive tests but this use is optional.
- (B) Auditor anticipates client figures, ratios, and relationships such as sales, current ratio, age of inventory, gross profit percentage, etc. These estimations are made within a range. If client figures lie outside of this range, the risk of misstatement increases.
- (C) Expected figures come from budgets, figures of previous years, industry averages, reports by competitors, changes in environment or in the company and the like.
- (D) The credibility of auditor expectation is improved if information was derived from (1) several sources, (2) outside of company, (3) an independent party inside of company, or (4) audited data.

(7) In every engagement, auditor must maintain an attitude of **professional skepticism**. During substantive testing, auditor should watch for factors that might indicate a particular risk of fraud. **Fraud risk factors** in this stage of the audit include the following.

- (A) Transactions that were not recorded in a complete and timely manner or were recorded incorrectly.
- (B) Discovery of unsupported or unauthorized balances or transactions.
- (C) Significant adjustments made by the client near the end of the year.
- (D) Missing documents or only photocopies available when the originals should exist.
- (E) Unexplained items appearing on reconciliations.
- (F) Inconsistent or vague responses from management to auditor inquiry.
- (G) Unusual discrepancies found in financial records.
- (H) Auditor denied access to certain records.
- (I) Missing assets.
- (J) Unusual delays in getting requested information from management.

(8) If auditor has reason to suspect fraud, certain actions may be needed.

- (A) Surprise inspection of assets.
- (B) Requiring a count of assets closer to year’s end.
- (C) Oral confirmations of balances as well as written ones.
- (D) Detailed review of large transactions and adjustments.
- (E) Analytical procedures on a more detailed basis (sales by location, for example).
- (F) Interviews with employees in high risk areas.

(9) Auditor can make use of an outside **specialist** in gathering evidence.

- (A) In some areas, an auditor will not have the expertise necessary for making required judgments. In those cases, auditor may hire and rely on a specialist. For example, this may be done in inventory valuation (diamonds), estimations (percentage of completion), litigation analysis, etc.
- (B) Before relying on specialist, auditor must verify the reliability of that party’s work.
  - (1) Auditor checks specialist’s professional reputation by examining licenses, certifications, references, client list, etc.

(2) Auditor checks independence. Specialist does not have to be independent but that would weigh on credibility of evidence

(C) Auditor is responsible for making certain that specialist understands what is needed and how the information will be used.

(D) If there is a difference between client figures and the results of a specialist, auditor should seek a resolution or get opinion of a second specialist or consider qualifying opinion.

(1) Using the name of specialist in audit opinion is allowed but only if the work of the specialist lead to an opinion that was other than the standard unqualified opinion.

(10) Material **related party transactions** must be disclosed in the footnotes. Auditor must make sure that all have been found and disclosed.

(A) Related parties include affiliates of the company, substantial owners, management and their immediate family, and anyone who exerts significant influence over the company

(B) Auditor first gets a list of all related parties by asking client, looking at SEC reports and annual reports, getting a list of management and stockholders, and looking at information found in previous audits.

(C) Auditor attempts to find all related party transactions by asking client, giving staff a list of related parties, reading minutes, scanning accounts for unusual amounts or familiar names, and watching for transactions with unusual terms especially if they occur near the end of the year.

(D) If related party transactions have occurred, the nature of the relationship and the terms of the transactions must be disclosed

(1) Client can also state that transactions were at same terms as transactions with an outside party but only if that assertion can be substantiated.

(11) Auditor has special problem in corroborating **estimations** because there is usually a lack of objective evidence.

(A) Estimates are found throughout statements: collectibility of receivables, outcome of lawsuits, life of equipment, etc.

(B) Auditor evaluates (a) management’s system of identifying need for estimates and (b) the method used in making specific estimations.

(C) Auditor must also evaluate reasonableness of each significant estimate by (a) looking at past results (for example, how long equipment is normally used), (b) having an independent estimation made possibly by using an outside specialist, and (c) reviewing subsequent events to determine if they confirm estimations.

(12) Auditor must evaluate whether substantial doubt exists that company can remain in business for one year from balance sheet date. Auditor looks for indications of possible evidence that warn of **going concern problems**.

(A) Indicators of possible problems include recurring losses, negative cash flows from operations, a negative working capital position, restructuring of debt, default on loans, lawsuits, unpaid dividends, loss of key customers, etc.

(B) If problems are discovered, auditor seeks management’s plans as to how problem will be resolved so that the company can continue to operate.

(C) If auditor is not satisfied with management’s plans, an **explanatory paragraph** is added after the opinion paragraph to warn readers that substantial doubt exists as to whether company can remain as a going concern. As an alternative, a disclaimer is allowed.

(13) The evidence that is gathered in an audit is recorded in **working papers** (audit documentation). **Audit documentation** serves mainly to provide support for the auditor's report and aid the auditor in the conduct and supervision of the audit. It should be sufficient to show that the standards of fieldwork have been observed.

   (A) Audit documentation should be sufficient to enable reviewers to (1) determine the nature, timing, and extent of the work performed and the results, (2) indicate who performed and reviewed the work, and (3) show that the accounting records agree or reconcile with the financial statements. Significant findings and issues and actions taken to address them should also be documented.

   (B) **Current file** includes (a) the audit program to indicate planning, (b) all evidence gathered to substantiate opinion, (c) indication of proper supervision, and (d) an explanation of all problems encountered and their resolution.

      (1) Quality of evidence affects need for quantity. Best quality evidence is any direct personal evidence acquired by auditor (inspection, observation, computation) especially if it is based on information derived from outside of client. Poorest evidence is anything produced by client and given directly to auditor (bill of lading, receiving reports, etc.).

   (C) **Permanent file** includes client data that will stay the same for a number of years: account numbers, bond contracts, the company charter, organizational chart, etc.

(14) In an audit, the **subsequent period** is the time between the end of the client's fiscal year and the last day of the auditor's fieldwork.

   (A) Auditor's investigation during this period should provide evidence about the possibility of misstatements in year-end balances. Such testing would include reviewing (a) cash payments as a search for unrecorded liabilities, (b) cash receipts to verify collectibility of receivables, (c) sales to prove reported value of inventory, (d) sales returns to substantiate reported Sales figure, etc.

   (B) Some subsequent events have no impact on year-end balances but are so significant that they should be disclosed in the footnotes. Examples would include the issuance of capital stock, a large casualty loss, or the incurrence of a large debt.

(15) After issuance of an opinion, auditor may discover new information about the financial statements or the audit examination.

   (A) After audit is finished, auditor has no further responsibility to do any further investigation. However, information may come to the auditor's attention that indicates a potential problem. In that situation, the auditor's concern is whether the original opinion can still be justified.

   (B) Auditor should determine if original opinion continues to be appropriate. If necessary, client should be contacted and asked for help in the investigation.

## PROBLEMS AND SOLUTIONS
## EVIDENCE GATHERING

ONE – An audit program is a requirement of an audit. It is normally not finalized until after the auditor's assessments of inherent and control risks have been made. (True or False?)

*Answer – An auditor is required to create an audit program to demonstrate that the work was planned properly. Frequently, a tentative program will be developed in the early stages of the audit. However, until the auditor has assessed both inherent risk and control risk, the acceptable level of detection risk is unknown. Since this determination will impact the amount of substantive testing to be done, the audit program cannot be finalized until those assessments have been made. (Number One is True.)*

TWO – A new auditor will seek permission from a client to talk with the audit firm that did the engagement in previous years. To avoid burdening the predecessor, the new auditor should wait until the client has offered the engagement. In the initial conversation with the predecessor, the new auditor is most interested in asking about accounts that are likely to contain material misstatements. (True or False?)

*Answer – When talking with the predecessor auditor prior to accepting an engagement, the new auditor is most interested in information about the integrity of the company's management. This information helps the new auditor determine whether to take the engagement. For this reason, the new auditor should ask about disagreements that arose with the management and communications made with the audit committee because of matters such as fraud or illegal acts. The new auditor should also seek information about the reason for the change being made in auditors. (Number Two is False.)*

THREE – An auditor must write up an engagement letter and have it signed by the management of the client company. (True or False?)

*Answer – The auditor has to establish an understanding with the client company about the objective and limitations of the work as well as the responsibilities of both parties. This understanding must be documented. An engagement letter can be used for this purpose but is not required. (Number Three is False.)*

FOUR – An auditor fails to obtain a representation letter from the client company at the end of an audit engagement. The auditor cannot give a standard unqualified audit opinion. (True or False?)

*Answer – According to generally accepted auditing standards, a representation letter is required in order to have sufficient, competent evidence on which to base an opinion. Failure to receive a representation letter will prevent the auditor from giving a standard unqualified audit opinion. (Number Four is True.)*

FIVE – A representation letter has to be signed by the president of the reporting company as well as the head of the board of directors. (True or False?)

*Answer – A representation letter should be signed by the chief executive officer of the reporting company as well as the chief financial officer and any other person with sufficient knowledge of the financial statements. (Number Five is False.)*

SIX – A representation letter should have the same date as the audit report. (True or False?)

*Answer – A representation letter should be received (and dated) as of the last day of the audit fieldwork. That is the same date that is applied to the audit report. In the representation letter, the management acknowledges its responsibility for the financial statements and states its belief that they are presented fairly in accordance with generally accepted accounting principles. The letter also serves to document specific representations made during the audit by the management. (Number Six is True.)*

SEVEN – The auditor only needs to inform the audit committee of issues that will lead to an opinion that is other than a standard audit report. (True or False?)

*Answer – The auditor must make certain that the audit committee is aware of anything that will have a significant effect on the financial statements. Disclosure to that group should include accounting policy decisions, methods of deriving important estimations, and proposed adjustments (even if agreed to by management). (Number Seven is False.)*

EIGHT – Analytical procedures must be performed by the auditor in both the planning stage and review stage of the audit. (True or False?)

*Answer – Analytical procedures are carried out in the planning stage of the audit to highlight areas of particularly high risk. The procedures are done in connection with the assessment of inherent risk. Analytical procedures are also required during the final review stage of the audit to help make certain that no suspicious changes have been missed. Analytical procedures can also be used for substantive testing purposes although that is an optional method of gathering evidence. (Number Eight is True.)*

NINE – In performing analytical procedures, auditor expectations of account balances, ratios, and the like are compared to client records. The auditor is looking for any large or unusual differences. The amounts anticipated by the auditor are normally based on the budgets and forecasts prepared by the client company for the period. (True or False?)

*Answer – The amounts, ratios, and the like anticipated by the auditor are derived from numerous sources such as historical figures, budgets and forecasts, industry averages, figures reported by competing companies, and other financial and nonfinancial information. (Number Nine is False.)*

TEN – The firm of XYZ is auditing a mining company that has based its depletion expense for the year on an estimation that 10,000 tons of ore are located in a particular mine. The audit firm hires an outside specialist who indicates no material difference with this estimation. The audit firm must render a qualified opinion because of reliance on this outside expert. (True or False?)

*Answer – An auditing firm will occasionally need to corroborate information through the use of an outside expert. As long as certain procedures are followed, such testing is acceptable and normal. Because the specialist found no evidence of a material* *misstatement in the company's estimation, the audit firm can provide a standard unqualified audit report. (Number Ten is False.)*

ELEVEN – An auditor notes that a company did not pay its normal dividend during the past year because of cash flow problems. The auditor is not certain that the company can remain in business for the next five years because of such problems. The auditor should qualify the audit opinion because of this concern. (True or False?)

*Answer – The auditor must be aware of any indications that substantial doubt might exist that the reporting company will not remain a going concern for at least 12 months from the balance sheet date. Such factors as unpaid dividends, default on debt, and major litigation can all point to this type of concern. If the company cannot show how it will stay in operation for at least 12 months, the auditor should add a paragraph at the end of the audit report to draw attention to this uncertainty. As an alternative, the auditor can give a disclaimer of opinion. (Number Eleven is False.)*

TWELVE – A company's balance sheet is dated December 31, Year One. The date of the audit report is March 4, Year Two. On February 8, Year Two, a major fire creates a material loss for the company. Even though the fire occurred after the balance sheet date, the loss should be disclosed in the Year One financial statements. (True or False?)

*Answer – Any significant event that occurs between the end of the fiscal period and the date of the audit report must still be disclosed even if the entire impact relates to the subsequent time period. This information is considered useful to the users of the financial statements. (Number Twelve is True.)*

## ACCOUNTS RECEIVABLE AND REVENUES

(1) In auditing accounts receivable and related revenue balances, several potential problems exist that could create material misstatements. Some of these would be errors whereas others would indicate fraud.

- (A) Reported receivables and sales could be false. Amounts were recorded to manipulate reported amount of income. **False sales** are especially likely if (a) income to be reported is down for the period, (b) employee compensation or bonuses are based on profits, or (c) company plans to issue capital stock or borrow money in the near future.
- (B) Incoming cash is stolen and theft is hidden by writing off the receivable as a bad debt.
- (C) **Lapping** is being carried out. Cash from one receivable is stolen and covered with cash received from a second customer during the following day or two
- (D) The **year-end cut-off** of transactions is incorrect. Transactions occurring before the end of year could be recorded in the subsequent period (thus, reporting for the initial year is not complete). Transactions after the end of year could be recorded prematurely in the initial year (reported transactions in initial year did not actually exist at the time of the financial statements).
- (E) Customer is billed incorrectly (because of math errors, wrong quantity, wrong price, wrong items) or customer is just not billed at all for goods that were actually shipped (inventory is gone but no collection is ever made)
- (F) Transaction is with a related party so that disclosure is needed

(2) Company should have a system in place to record sale, make proper shipment, and control and collect receivable balance.

- (A) A customer order is received. May be by mail or over telephone or given directly to company employees.
- (B) On a pre-printed, pre-numbered **sales order** form, the **sales department** lists all relevant information: quantity, description, terms, buyer, address, method of payment, etc.
- (C) **Credit department** reviews **credit file** (which can hold credit report, references, financial statements, payment history of client, etc.). Approval or disapproval of credit is then indicated on the sales order form.
- (D) If approved, sales order goes to finished goods **warehouse** where goods are gathered and sent to **shipping department**. Separate departments are maintained so that goods being removed must be documented. Since asset is being transferred, shipping department should verify description and quantity against sales order form. Condition of goods should also be checked. Shipping then signs and returns a copy of sales order which is kept by warehouse as a receipt to prove that transfer was made.
- (E) Shipping department sends goods to customer and prepares a shipping document, often known as a **bill of lading**. One copy goes with merchandise and a second copy is sent directly to customer.
- (F) Copy of bill of lading is sent to **inventory accounting department** which should maintain a perpetual listing of all inventory. An entry is made to remove item from records. Entries are accumulated and forwarded to **general accounting department** for posting of the overall reduction of Inventory account.

(G) Copies of all documents go to **billings department**. Comparison is made of quantity and description. If all information agrees, a **sales invoice** is prepared and sent to client. It is also recorded in **sales journal**. Summary of sales journal is forwarded to general accounting for recording.

(H) Copy of sales invoice is sent to **accounts receivable department**. Amount is recorded in **accounts receivable master file** by customer name.

(I) Periodically, an **aged accounts receivable trial balance** is prepared which lists each account by age. Old accounts are turned over to a **collection department**.

(J) If balance still proves to be uncollectible, both collection and accounts receivable departments file documentation to indicate actions taken. Independent party reviews information before final write-off of balance is approved.

(3) A number of substantive testing procedures should be performed to verify the five assertions made by client about accounts receivable and related balances.

(A) Perform **analytical procedures** to identify areas where client figures differ from auditor expectations. Look at: overall balance of each account, age of receivables, gross profit percentage, sales returns as a percentage of sales, write off of accounts as compared to previous years, etc.

(1) Analytical procedures are required in planning stage of audit to help assess inherent risk. They are also required in final review stage of audit as a last check. Use as a substantive test of an account balance is optional.

(B) Trace one or more transactions through the entire system to see if recording is appropriate at each step. Start with customer order and check all steps until account and collection are recorded. Auditor is especially interested that all shipments are properly billed.

(1) Whenever auditor starts with transactions at their inception, the **completeness assertion** is being tested.

(C) Vouch one or more entries in the T-account back through system to see if there is adequate support. Whenever auditor starts with a reported balance and seeks corroboration, the **existence assertion** is being tested.

(D) Check math and accuracy of client work where applicable. Re-add accounts receivable master file and compare it to the general ledger account. Verify that aged accounts receivable trial balance is added correctly and individual amounts agree with master file. Re-add sales journal.

(E) For 3-4 days before and 3-4 days after year end, verify client cut-off procedures to make sure transactions were recorded in correct period. Use the bill of lading and sales invoice to determine when receivable and sale should be recorded. Cash receipts listing provides date for removal of receivable.

(F) Auditor reviews any evidence generated in **subsequent period** (the time from the balance sheet date until the end of fieldwork). For example, cash collections prove the balance and collectibility of a receivable, sales returns should be matched with sales, and bad debts written off may have been uncollectible at year's end.

(G) Look for **related party transactions** that have to be disclosed. For example, the **representation letter** asks about their existence.

(H) **Confirm balances directly with customers** to prove **existence assertion**. Usually done early in audit unless inherent and/or control risks are high. In that case, confirmation is carried out closer to year's end.

(1) All confirmations are signed by client but controlled, mailed, and responses received by auditor

(2) **Negative confirmations** ask customer for a response only if reported balance is wrong. It is less costly but provides a poorer quality of evidence since nothing tangible is received unless a problem exists. Normally used for small balances, balances that are not old, and where risk appears low.

(3) **Positive confirmations** ask for response from customer whether balance is correct or incorrect. Because an actual response should be received in all cases, this is viewed as a better technique. Normally used for old balances, large balances, or where risk is high.

(a) If no response to positive request is received, a second confirmation can be sent or a direct call made. If auditor still does not get a response, alternative testing must be expanded. All documents should be compared and cash receipts should be reviewed for subsequent payment.

(b) In either type of confirmation, reported discrepancies should be investigated to determine whether a problem exists.

(4) Accounts which have been written off or which have a zero balance can be confirmed just to make certain that reported facts are accurate.

(5) If a confirmation is returned by e-mail or by fax, the auditor may need to call the customer or request that the confirmation be mailed to the auditor in order to get adequate support.

(I) Method of estimating bad debt expense should be examined. Auditor wants to make sure that no evidence exists to indicate that client's estimation is not justified. Auditor must be aware of changes that may affect client's previous experience.

(J) Auditor must ensure balance sheet presentation and disclosure is appropriate. For example, pledged accounts must be noted.

## PROBLEMS AND SOLUTIONS
## ACCOUNTS RECEIVABLE AND REVENUES

ONE – The shipping department of a company should be a department separate from the warehouse. (True or False?)

*Answer – The warehouse has custody of assets (inventory) and is, thus, in a position to steal. To add control and to prevent theft, a separate shipping department should be in operation. Thus, the assets must pass through a different department (shipping) before they can be taken from the company. This organizational separation reduces the potential for theft. (Number One is True.)*

TWO – A company's billings department produces a sales invoice. Immediately after preparation, the document should be sent to the accounts receivable department for recording purposes. (True or False?)

*Answer – To avoid possible misstatements within a system, all documents are normally reviewed and authorized before any other step occurs. After that, a record should* *be made of the document and a copy should be kept in case of loss. (Number Two is False.)*

THREE – Company X has a receivable from a customer that is never collected. The collection department attempts to force payment but no amount is received. The account is now to be written off as uncollectible. Before this account is removed from the records, the cashier must give final approval. (True or False?)

*Answer – Accounts being written off are a concern because the balance may have been collected and then stolen. As a second problem, perhaps the sale should not have been made to this particular credit risk. Therefore, before any account is declared uncollectible, it should be reviewed and authorized by an independent party. The cashier is not considered independent because that person may have stolen the incoming money. Therefore, some other party unrelated to the transaction needs to review the documentation and approve the write off. (Number Three is False.)*

FOUR – A company has an account receivable from a customer with a balance of $11,000 as of the end of the year. The auditor finds documentation such as a sales order and a shipping document to support that balance. The auditor is testing the existence assertion. (True or False?)

*Answer – Typically, when an auditor selects a balance found in the financial records and seeks to corroborate or support it by looking for documentation, the auditor is attempting to make sure the balance did exist and was not falsified. (Number Four is True.)*

FIVE – An auditor randomly selects a sales order that is from a customer who wants five large pieces of furniture. The auditor finds a shipping document that matches this sales order. The auditor also locates a copy of the sales invoice for this transaction. Then, the auditor discovers that the appropriate amount is included in the accounts receivable subsidiary ledger. The auditor is testing the completeness assertion. (True or False?)

*Answer – Whenever an auditor starts with the origination of a transaction and traces it through the system into the financial statements, the auditor is seeking to verify the completeness assertion. The auditor is making certain that information is not changed or lost while the documents make their way through the system. All relevant information is supposed to get into the financial statements. (Number Five is True.)*

SIX – A company makes several sales and records them just before the end of Year One. The auditor examines the appropriate documentation to be sure that the transactions should have been recorded in Year One and not Year Two. The auditor is testing the completeness assertion. (True or False?)

*Answer – These accounts have been recorded in the current year. The auditor is interested in ascertaining whether they actually existed prior to the end of the year. Thus, the auditor is testing the existence assertion. Whenever the auditor is* *concerned that an account may be overstated by the inclusion of extra transactions, the existence assertion will be tested. If the auditor is worried that accounts are understated by the omission of transactions, the completeness assertion is tested. (Number Six is False.)*

SEVEN – Confirmations are signed by the client but mailed by the auditor with all responses directed back to the auditor. (True or False?)

*Answer – To avoid the chance for the client to manipulate the information, confirmations remain in the custody of the auditor. However, because of confidentiality, they must be signed by a representative of the client. (Number Seven is True.)*

EIGHT – If control risk is assessed as high, the auditor is more likely to rely on negative rather than positive confirmations of account receivable balances. (True or False?)

*Answer – When control risk is viewed as high, the acceptable level of detection risk will have to be relatively low to compensate. In order to reduce detection risk, the auditor has to carry out more substantive testing or gather evidence of a higher quality. Positive confirmations provide a better quality of audit evidence since a response is requested in all cases. Thus, positive confirmations are more likely when control risk is assessed at a high level. (Number Eight is False.)*

NINE – An auditor sends a first and a second positive confirmation to a client of the reporting entity but receives no response. The auditor will likely look at cash receipts in the period subsequent to the end of the year in hopes of corroborating the balance. (True or False?)

*Answer – The confirmation process has failed to support the balance. This lack of response may indicate that the receivable is false. One alternative auditing procedure is to examine subsequent cash receipts to determine if the receivable is collected and, if so, if the receipt corresponds with the reported balance. A subsequent collection will provide evidence of the existence of the receivable. (Number Nine is True.)*

## STATISTICAL SAMPLING

(1) Sampling is used in virtually every aspect of auditing. The term refers to making a decision about a whole (a population) by testing only a part of that group (called a sample).
 (A) Sampling creates a problem; because auditor does not look at every piece of evidence, a chance exists that a material misstatement could be missed. Thus, some risk always remains that the audit opinion will be wrong.
 (B) There are two reasons why auditor only provides reasonable assurance and not perfect assurance.
  (1) **Sampling risk** is the chance that auditor's conclusion will be wrong because only a portion of the population was examined. A sample may not be representative of the population.
  (2) **Nonsampling risk** is the chance that auditor's conclusion will be wrong for reasons that would happen even if every item had been tested. Includes human errors such as the failure to recognize a misstatement and the misinterpretation of results.
 (C) **Judgment sampling** estimates the amount of sampling risk that the auditor faces purely by human guess.
 (D) **Statistical sampling** determines sampling risk mathematically
  (1) Auditor sets an acceptable level of sampling risk before beginning a test and statistical sampling computes the number of items to be tested to reduce risk to that desired level.
  (2) Auditor can also perform a test and then use statistical sampling to determine the amount of sampling risk that is present. For example, the auditor might use statistical sampling in making the following evaluation: "Based on the results of this test, there is a 10 percent chance that the client figure is not fairly presented."

(2) In general, there are two types of statistical sampling.
 (A) **Attributes sampling** estimates a percentage and is often used in the **tests of controls** because the auditor is interested in the **error rate** that has occurred in connection with a particular control activity. Auditor is attempting to determine if activity is functioning as intended.
 (B) **Variables sampling** estimates a total and is often used in substantive tests where the auditor is attempting to corroborate a reported account balance.

(3) Auditor carries out several steps in following an attributes sampling plan.
 (A) Anticipates the **deviation rate** for the control activity (or other application) being tested. Expected rate is based on difficulty of activity, experience of person performing the control, results found in previous audits, etc. The more deviations that are anticipated the larger the sample must be.
 (B) Sets a **tolerable deviation rate**. This is the maximum error rate that the auditor could tolerate and still believe the control activity was operating effectively and efficiently. As the rate that the auditor can tolerate gets smaller, sample size must get larger.

- (C) Sets allowable level of risk that the sample will be misleading. For this particular testing, auditor is especially worried that the sample will look better than the actual population. In that case, auditor may think that the control activity is functioning properly and will set control risk too low and do less substantive testing than is needed. To reduce the level of risk that the sample will be misleading, the size of the sample must be increased.
- (D) Based on these three figures, a calculation or a chart is used to determine proper sample size. Except with very small populations, the number of items in the population has little or no effect on the sample size.
- (E) The appropriate number of items is selected from the population. Items must be picked randomly, each item should have an equal chance of selection.
- (F) Sample items are examined and the number of deviations (usually errors) is determined. That number is restated as a percentage based on sample size.
- (G) Another chart is used to convert the actual deviation rate of the sample to the potential **upper deviation rate of the population**. Difference between the actual rate and upper deviation rate is called the **allowance for sampling risk**.
- (H) Upper deviation rate is compared to maximum tolerable rate. If upper deviation rate is lower, auditor assumes control activity is functioning as intended and will probably set control risk at a low level. If upper deviation rate is more, auditor assumes activity is not functioning as intended; control risk is high
- (I) Auditor also examines both the cause and size of the errors that were found. Even if rate is low, the type of deviation may indicate a serious problem.

(4) Auditor carries out several steps in a variables sampling plan. There are several variations but following is an example of classical mean-per-unit sampling.

- (A) Sets the level of a **tolerable misstatement**. This is the size of the largest misstatement in the account being examined that (when combined with misstatements in all other accounts) would still not cause the financial statements to be materially misstated. If auditor reduces the size of a misstatement that can be tolerated, a bigger sample will be required.
- (B) Sets allowable risk levels that sample will be misleading. To reduce these risk levels, a larger sample size must be selected.
  - (1) A misleading sample can cause **incorrect acceptance**. There is a risk that a sample will substantiate client figure when the population is actually materially misstated. This problem leads to an unqualified opinion being given on statements that are not fairly presented.
  - (2) A misleading sample can cause **incorrect rejection**. There is a risk that a sample will not substantiate the client figure even though the population is not materially misstated. This problem leads to additional (unnecessary) testing being performed.
- (C) Estimates the amount of misstatement in the population. This figure is usually affected by the efficiency of the accounting system and staff. The bigger the expected misstatement the larger the required sample size.
- (D) Again, population size has only a little impact on sample size.
- (E) Auditor takes a preliminary sample to estimate the variability of the items in the population. If the items are all about the same amount, variability is low. Variability is measured by estimating the **standard deviation**. The higher the variability, the more items that have to be selected to get a representative sample.

(F) The various factors are entered into mathematical formulas to determine the appropriate sample size.

(G) Auditor randomly selects items for the sample and measures the average value of these items. The average of the sample is then extended to the entire population to give a total. Difference between this total and client figure is the **projected misstatement**. If projected misstatement is less than tolerable misstatement, the test has provided evidence that reported balance is fairly presented. If projected misstatement is more, the test has not provided evidence that balance is fairly presented.

(5) In variables sampling, the variability of the items in the population can often be so great that sample size has to be large, causing the auditor to do extensive testing.

(A) One alternative is to stratify the population. Items are divided into two or three separate populations based on size. Because they are grouped by size, the variability of each population will be relatively small and the required sample will be reduced.

(B) Two other alternatives are **ratio and difference estimations**. These methods do not estimate the average item in the population but rather the average of differences between book values and audited values or the ratio of book values to audited values.

(6) **Probability proportional to size sampling** (PPS sampling) is another way of estimating a total while keeping sample size small. The sampling unit is each dollar in the population and not each document. This approach is also called monetary unit sampling and dollar unit sampling.

(A) Instead of selecting every Nth item (every 50th invoice, for example), auditor picks every Nth dollar (every $5,000th, for example, in a list of invoices). Although the Nth dollar is selected, the entire document is tested.

(1) Bigger items have more dollars so they are more likely to get picked. Stratification and the degree of variability are not important.

(2) Sample size is determined mathematically based on tolerable misstatement, expected misstatement in population, allowable risk of incorrect acceptance, and expected number of errors.

(3) Total dollar figure of population is divided by sample size to get sampling interval (such as every $5,000th dollar).

(B) If sample has no errors, population total is accepted. If misstatements are found, the size of a projected misstatement must be determined.

(1) For items that are larger than the interval (in this example, an invoice that is over $5,000), the amount of the misstatement is just used in arriving at the projected misstatement.

(2) For items that are smaller than interval, the percentage of the misstatement (called the tainting percentage) is determined and multiplied by the interval. If a $500 item has a 2% error, 2% is multiplied by sampling interval to get figure to include in projected misstatement.

## PROBLEMS AND SOLUTIONS
## STATISTICAL SAMPLING

ONE – When control risk is assessed as being high, an auditor is more likely to use statistical sampling. (True or False?)

*Answer – If control risk is high, the level of detection risk that must be achieved to be acceptable will have to be low. To lower the achieved level of detection risk, the auditor must do more substantive testing or gather evidence of a higher quality. Substantive testing provides higher quality evidence if it is performed closer to the end of the year, uses more experienced audit personnel, or incorporates more sophisticated audit techniques. Statistical sampling is viewed as a more sophisticated audit technique than judgment sampling so its use is more likely when control risk is viewed as being high. (Number One is True.)*

TWO – The benefit of using statistical sampling is that it reduces the amount of risk that the auditor faces in performing a test. (True or False?)

*Answer – Two audit benefits are associated with statistical sampling. First, it can be used to determine mathematically the size of the sample that should be selected to achieve the desired amount of reliability. Second, after the testing has been conducted, statistical sampling can be applied to evaluate mathematically the results that have been found. It does not reduce risk; it helps the auditor determine the amount of risk that is present. (Number Two is False.)*

THREE – In auditing, most statistical sampling can be divided into two different general types. (True or False?)

*Answer – When applying statistical sampling, the auditor is usually attempting to estimate either a rate or a balance. If a rate is being estimated, the auditor is sometimes said to be sampling for attributes. When estimating a balance, the auditor is said to be sampling for variables. (Number Three is True.)*

FOUR – When using statistical sampling to estimate a rate (sampling for attributes), the auditor is frequently assessing control risk. When using statistical sampling to estimate a balance (sampling for variables), the auditor is frequently attempting to gather evidence about a particular account. (True or False?)

*Answer – In assessing control risk, an auditor often wants to estimate the error rate that is associated with a particular control activity. In order to reduce detection risk, an auditor may want to estimate a balance that is being reported by the client. Hence, estimation of a rate (sampling for attributes) is associated with the assessment of control risk whereas estimation of a balance (sampling for variables) is more often used in the substantive testing done to reduce detection risk. (Number Four is True.)*

FIVE – Whether an auditor is estimating a rate or a balance, assume that the sample size is determined to be 100 out of a population size of 10,000. If the population size had been 20,000 instead of 10,000, the sample size would have been 200. (True or False?)

*Answer – Except in very small populations, the size of the population has little impact on sample size. Doubling the population size might increase the sample size from 100 to 103 but would not have come close to doubling the required sample size. (Number Five is False.)*

SIX – Whether an auditor is estimating an error rate or an account balance, assume that the auditor determines that more errors (or attributes) exist in the population than was originally expected. This discovery will necessitate a smaller sample size. (True or False?)

*Answer – In either method of sampling, the presence of more errors (or attributes) will cause the auditor to select a larger number of items in order to get a representative sample. (Number Six is False.)*

SEVEN – An auditor carries out a test of a population and comes to the wrong conclusion. The auditor may have come to the wrong conclusion for either of two different reasons. (True or False?)

*Answer – In testing, an auditor may arrive at the wrong conclusion for either of two reasons. First, the auditor faces sampling risk – the chance that the sample did not look like the population as a whole. There is always some possibility that any sample will not have the same characteristics as the population and, hence, the auditor will be lead into making the wrong conclusion. That risk is always present whenever an auditor chooses to sample rather than look at every item. Second, the auditor has some amount of nonsampling risk – the chance that a human error will lead the auditor into making the wrong conclusion. Perhaps the auditor incorrectly looked at a document or the auditor's judgment was simply incorrect. (Number Seven is True.)*

EIGHT – Whether an auditor is estimating an error rate or an account balance, the auditor must set an acceptable level of sampling risk. For some reason, the auditor decides to reduce the acceptable level of sampling risk for a particular test. The auditor will have to select a larger sample. (True or False?)

*Answer – In order to reduce sampling risk, the auditor will always have to sample a larger proportion of the population. (Number Eight is True.)*

NINE – An auditor is attempting to estimate a balance. The auditor must estimate the amount of variability of the items in the population. For example, if one item is $12 and the next item is $989, there appears to be a high degree of variability among the items. If variability is high, the auditor will have to select a larger sample. (True or False?)

*Answer – When variability is high, the auditor must sample more items in order to get a representative sample. (Number Nine is True.)*

TEN – When an auditor is attempting to estimate a balance, if the variability of the items in the population is high, the sample size will be quite large. In order to reduce this problem, the auditor may choose to stratify the population so that the sample size will be lower. (True or False?)

*Answer – Stratifying a population means that the larger items are pulled out and tested separately. The items that remain in the population will have a much smaller variability and, therefore, will necessitate a smaller sample size. The same effect can be achieved by using alternative methods of statistical sampling such as difference estimation, ratio estimation, and probability proportionate to size sampling. (Number Ten is True.)*

ELEVEN - Whether an auditor is estimating an error rate or an account balance, the auditor must set the highest amount of problem that can be tolerated. In other words, a tolerate error rate must be set or a tolerable amount of difference from the client balance must be established. As the rate or the amount that an auditor can tolerate rises, the sample size must go up. (True or False?)

*Answer – If the auditor can tolerate a higher error rate, or if the auditor can tolerate a bigger misstatement in the client balance, the auditor will need to sample fewer items. (Number Eleven is False.)*

TWELVE – The auditor performs a test to estimate an error rate. The sample indicates that the error rate is 2 percent but statistical sampling indicates that the population rate could be as high as 3 percent (the upper deviation rate). The auditor had previously established a tolerable error rate of 2.4 percent. Because the sample error rate (2 percent) is below the tolerable rate (2.4 percent), the auditor will assume that this particular control activity is operating effectively. (True or False?)

*Answer – Because the upper deviation rate (3 percent) is above the tolerable rate (2.4 percent), the auditor concludes that the control activity is not being performed effectively. The assessment of control risk will probably be set at a higher level. (Number Twelve is False.)*

THIRTEEN – The auditor performs a test to estimate an error rate. The sample indicates that the error rate is 2 percent but statistical sampling indicates that the population rate could be as high as 3 percent (the upper deviation rate). The 1 percent difference between the sample rate (2 percent) and the upper rate estimated for the population as a whole (the 3 percent upper deviation rate) is known as the allowance for sampling risk. (True or False?)

*Answer – Because only a sample is being selected, a difference will exist between the rate determined for the sample and the upper deviation rate that is estimated for the population. That difference (1 percent in this case) is known as the allowance for sampling risk. (Number Thirteen is True.)*

## INVENTORY AND ACCOUNTS PAYABLE

(1) Auditor should anticipate certain potential problems in auditing **inventory**, **accounts payable**, and related accounts.
- (A) Inventory may include **damaged or obsolete items** so that recorded value must be reduced to net realizable value. This possibility relates to valuation assertion.
- (B) Inventory might be miscounted either accidentally or intentionally. Overcounting inflates currently reported earnings; undercounting reduces reported income. If overcounted, problem is with existence assertion. If undercounted, problem is with completeness assertion.
- (C) End of year cut off could be recorded incorrectly in connection with receipt and shipment of inventory. Again, possible overstatement relates to existence assertion whereas understatement affects completeness assertion.
- (D) End of year liabilities may have been omitted because invoice has not been received or because company wants to improve its reported debt position. Problem relates to completeness assertion.
- (E) Inventory being held by client is on **consignment** or inventory owned by client is out on consignment.

(2) Company should have a system in place to record purchase of inventory (or fixed assets) and the related liability as well as subsequent payment.
- (A) For example, assume that a department or individual within company needs an item. A **requisition** (sometimes referred to as a material requisition) is completed. A person with appropriate authority reviews and authorizes requisition.
  - (1) Whenever any document is created, it should be reviewed, authorized, recorded, and a copy kept.
- (B) Copy of approved requisition goes to **warehouse** (or store room).
- (C) If item is available, order is filled. If not, **purchase requisition** is created and sent to **purchasing department**.
- (D) Purchasing department verifies request by checking against budget. Should also check that all documents have been properly authorized. A **purchase order** should be created after going through a set of prescribed steps such as getting bids (for expensive items) or checking with a number of vendors (for cheaper items).
  - (1) Should only buy from vendors listed on a **preapproved vendor list**.
- (E) Copy of purchase order goes to **receiving room** to alert that a shipment is to be expected. On this copy, quantity is blanked out to ensure that goods will be counted.
- (F) Goods are received by receiving room and compared to copy of purchase order to verify make, model, description of item, and condition. If there is a discrepancy or if goods are damaged, they are not accepted. If accepted, a **receiving report** is prepared giving all information about goods.
  - (1) Copy is sent to **inventory accounting department** to update **perpetual inventory records**.
  - (2) Receiving room is separate from warehouse in order to ensure adequate documentation of goods that are received.
- (G) Goods are transferred to warehouse. Warehouse employees verify quantity, description, and condition and then return a signed copy of the receiving report so that the receiving room has a receipt to verify transfer of goods.

(H) **Purchase invoice** is eventually received from vendor. The price charged, terms of payment, and math need to be verified.
(I) Copies of all documents (requisition, purchase requisition, purchase order, receiving report, and purchase invoice) are forwarded to **accounts payable department** (also referred to as **vouchers payable department**). Agreement and authorization of all documents is verified.
(J) A **voucher** is prepared by accounts payable to indicate approval to make payment. It is reviewed and authorized. Liability and purchase are recorded in **voucher register**. Summary of voucher register is forwarded periodically to general accounting to record in general ledger.
(K) Voucher and back-up documentation (sometimes referred to as a voucher package) are sent to **cash disbursements department** and filed by due date.
(L) On due date, voucher is reviewed for reasonableness and compared one final time to documentation. **Check** is written.
(M) Second party compares check and voucher and signs check. Amount is recorded in **cash disbursements journal** as a reduction in cash and liability. Again, a summary will be made and forwarded to general accounting for recording. Voucher is defaced in some manner to avoid repayment. Check is mailed to vendor.

(3) A number of substantive testing procedures should be performed to verify the five assertions made by client about inventory, accounts payable, and any related balances.
(A) **Analytical procedures** are performed, both at beginning and end of audit. Auditor expectations are compared to client figures such as the age of inventory, gross profit percentage, balance of year-end inventory and liabilities, cost per unit, percentage of inventory that is recorded below cost, etc.
(B) Trace one or more transactions through the entire system to see if recording is appropriate at each step. Start with requisition and check all steps until liability is recorded and paid. Whenever auditor starts with initiation of a transaction and follows it through system, the **completeness assertion** is being tested.
(C) Vouch one or more entries in the T-account back through system to see if there is adequate support. Whenever auditor starts with a reported balance and seeks support, the **existence assertion** is being tested.
(D) Check math as well as client work where applicable. Re-add voucher register and cash disbursements journal and compare totals to the general ledger account. Application of LIFO/FIFO should be checked. For manufacturing company, inventory cost figures should be verified.
(E) For the 3-4 days before and 3-4 days after the end of the year, verify client **cut-off procedures** to ensure that transactions were recorded in correct period. Use receiving report and purchase invoice to determine when inventory and payable should be recorded. Need to know FOB point and location of inventory on last day of year. Cash disbursements journal provides date for removal of payable.
(F) Auditor reviews any evidence generated in **subsequent period** (the time from the balance sheet date until the end of fieldwork). For example, auditor investigates the following.
(1) Inventory that does not sell in subsequent period should be examined for obsolescence or damage.

(2) Cash payments in subsequent period are reviewed to see if they indicate an unrecorded year-end liability.
(3) Invoices received should be reviewed to see if an unrecorded liability existed at year's end.
(4) Accounts payable can be confirmed but that is not usually done since invoice is received from vendor.

(G) **Representation letter** should ask about presence of obsolete inventory.

(H) Auditor looks for evidence that inventory might be out on **consignment** or that goods are being held on consignment.
(1) Contract file should be examined for evidence of consignment transactions.
(2) Preparation of a **bill of lading** without a subsequent sales invoice may indicate consignment-out transactions. Receipt of goods without a subsequent purchase invoice may indicate consignment-in transactions.
(3) Collections and payments made at irregular intervals may indicate that cash is transferred whenever a sale is made.
(4) Confirmations may expose inventory out on consignment that has been recorded by company as a receivable.
(5) Auditor should confirm consignment-out balances and may want to make a test count.

(I) Auditor should observe client's taking of a **physical inventory**. If company uses a periodic system, count will be at year's end. If it has a perpetual system, count can be any time during year unless risk levels are high. Auditor performs a number of tasks.
(1) Makes sure that counters know what they are doing.
(2) Looks for damaged or obsolete items.
(3) Makes and records a number of test counts.
(4) If tag system is used, records last tag number so no additional inventory can be added at a later time.

(J) Client adds cost to ending list of inventory items and arrives at a final total of the inventory cost. Auditor must verify this listing.
(1) Makes sure that quantity listed for the items that were test counted agrees with recorded amounts.
(2) Verify that last tag number is the same.
(3) Checks a sample of cost figures.
(4) Checks a sample of extensions and footings.

## PROBLEMS AND SOLUTIONS
## INVENTORY AND ACCOUNTS PAYABLE

ONE – When examining the Accounts Payable account, the auditor is most concerned with corroborating the existence assertion. (True or False?)

*Answer – For most liabilities, the auditor wants to ensure that the balance is not understated. Omitting liabilities improves the company's debt to equity ratio and can often increase net income. In addition, initial documentation for many liabilities (such as an invoice) may come from outside of the company and not be* *generated internally. Whenever an auditor fears that a balance may be understated, special emphasis will be placed on the completeness assertion. (Number One is False.)*

TWO – The auditor finds a receiving report for 25 refrigerators. However, the related purchase invoice is for 28 refrigerators. The problem is never caught and payment is made based on the invoice. The accounts payable account will be understated. (True or False?)

*Answer – The payable was recorded for 28 refrigerators and then paid so that the balance in the liability is now reported as zero. Since no further liability exists, that balance is correct. However, the company appears to be due a refund for the extra three refrigerators so that accounts receivable is understated by that amount. (Number Two is False.)*

THREE – Company A ships inventory costing $300,000 to Company Z on consignment. The total sales price of this merchandise is $390,000. Company A incorrectly reports a $390,000 balance as an account receivable. The auditor may discover this problem by confirmation. (True or False?)

*Answer – The confirmation process is intended primarily to ascertain that a reported balance does exist. Here, the auditor will need to seek evidence that the $390,000 amount does exist as a receivable. Obviously, when the confirmation arrives, Company Z will respond that there is no debt between the companies until the merchandise is sold. (Number Three is True.)*

FOUR – When merchandise is received by a company's receiving department, the goods should be counted and inspected before being accepted. In addition, receiving department personnel should verify that the proper merchandise was delivered. For that purpose, the Receiving department should have a copy of the approved purchase order. (True or False?)

*Answer – Normally, whenever any asset is conveyed, the receiving party should make a count, inspect the asset, and verify its description. For inventory, that is especially important since a large amount of merchandise may be received on a regular basis. Thus, the receiving department should have a copy of a purchase order to ascertain that the appropriate merchandise is being accepted. Furthermore, the quantity should be deleted on this copy of the purchase order to encourage a careful count of the goods. (Number Four is True.)*

FIVE – A voucher is an approval to pay a liability and is recorded in the voucher register. (True or False?)

*Answer – After ensuring that a debt is legitimate, a voucher is prepared as approval for the company to make payment. It is then reviewed and authorized. If appropriate, the voucher is entered in the voucher register which serves to record the debits and credits created by the debt. (Number Five is True.)*

SIX – A voucher is prepared in the cash disbursements department. (True or False?)

*Answer – As an approval to pay a liability, the voucher is prepared in the accounts payable (or vouchers payable) department. It is then forwarded to cash disbursements for payment. (Number Six is False.)*

SEVEN – Accounts payable balances are usually confirmed. (True or False?)

*Answer – Confirmations are primarily used to gather information about the existence assertion. With liabilities, the auditor is most concerned that the balance is understated (the reported balance is too low or the debt has been omitted entirely). Therefore, the completeness assertion is of primary interest. Because confirmations are not viewed as a good test of the completeness assertion, they are rarely utilized in connection with accounts payable. However, they can be used if the existence of a particular balance is in question. (Number Seven is False.)*

EIGHT – In testing accounts payable, the auditor is more likely to look at cash payments just after the end of the year than at payments made before the end of the year. (True or False?)

*Answer – Payments made after the end of the year might well signal liabilities that had been improperly omitted on the balance sheet date. However, if a payment is made before the end of the year, the liability will probably have been recorded as a step in the system that led to the payment. (Number Eight is True.)*

NINE – An auditor has assessed control risk at the maximum level in connection with inventory. As a result, the auditor is more likely to ask for a physical count of inventory to be held as early in the audit as possible. (True or False?)

*Answer – When control risk is high, the acceptable level of detection risk will be relatively low. To reduce detection risk to this desired level, the auditor must carry out a substantial amount of substantive testing or perform tests that generate a better quality of evidence. Evidence resulting from tests performed closer to the balance sheet date is viewed as having a better quality. When control risk is high, the auditor is likely to insist that the physical inventory count be carried out nearer to the end of the year in order to reduce detection risk to the acceptable level. (Number Nine is False.)*

TEN – An auditor fails to observe the taking of the client's physical inventory but is satisfied by other testing that the reported balance is fairly presented. The auditor must render either a qualified opinion or a disclaimer of opinion. (True or False?)

*Answer – If a legitimate reason exists for the failure to observe the physical inventory and if alternative procedures can be applied to gain satisfactory evidence, the auditor may still give a standard unqualified audit report. (Number Ten is False.)*

## AUDITING WITH TECHNOLOGY[1]

(1) The auditor's responsibility with regard to internal control over information technology (IT) systems remains the same as with a manual system. However, the auditor's consideration may be affected by the fact that IT systems
  (A) Result in transaction trails that exist for a short period of time or only in machine readable form.
  (B) May allow data to be altered without any visible evidence.
  (C) Include computer controls that may not be tested by observation.

(2) IT specialists may be needed to assist the auditor with the audit of complex systems.

(3) **Computerized audit tools (CAATs)** and other automated audit tools
  (A) Program analysis
    (1) **Code review**—actual analysis of the logic of the program's processing routines.
    (2) **Flowcharting software**—automatically flowcharts the logic of programs.
    (3) **Program tracing and mapping**—trace or map the logic of programs.
    (4) **Snapshot**—"takes a picture" of the status of program execution and results at a specified point.
  (B) Program testing techniques.
    (1) **Test data**—a set of dummy transactions used to test computer controls.
    (2) **Integrated test facility**—processes dummy (test) transactions with live processing.
    (3) **Controlled program—**auditor testing of a copy of the company's program at the auditor's facility.
  (C) Techniques for continuous testing.
    (1) **Embedded audit modules and audit hooks—**embedded audit functions.
    (2) **Systems control audit review files (SCARF)**—embedded audit modules that capture unusual transactions.
    (3) **Transaction tagging—**used to follow a transaction through processing.
  (D) The auditor may use a **generalized computer audit software package**.
    (1) It is designed with considerable flexibility so that it can be adapted to the client's computer.
    (2) It provides auditor with independent access into computer so that the data can be gathered without having to rely on client personnel and programs.
    (3) Programs can serve as a **controlled program** so that a **parallel simulation** of data can be carried out and compared to the output of client's programs.
    (4) Can test data stored within computer. Can do mechanical testing such as selecting old accounts, internal comparisons, verification of year-end cut-off, and the like.
  (E) Spreadsheets can be developed to do many audit tasks. Data can then be entered into the spreadsheet to verify calculations such as depreciation and interest. Analytical procedures as well as statistical sampling tests can be performed using such spreadsheets.

[1] *You should also review the Information Technology chapter in the Business Environment and Concepts section of this Guide.*

(F) Working papers can be placed on diskettes for easy storage. Items such as flowcharts, questionnaires, representation letters, and engagement letters can be kept on file and printed out when needed.

(G) Testing typically done to control computer such as the use of test data, code comparison programs, and integrated test facilities an also be applied by external auditor.

## PROBLEMS AND SOLUTIONS
## AUDITING WITH TECHNOLOGY

ONE – A major problem with auditing sophisticated IT systems is that transaction trails do not exist. (True or False?)

*Answer – In IT systems transaction trails may exist on-line for only a short period of time. In addition, the trails are often only machine readable. This requires the auditor to adopt different approaches to auditing transactions. However, the trails exist in all systems. (Number One is False.)*

TWO – In testing computer program controls auditors often rely on computerized audit tools. A program testing technique that is commonly used is the test data approach. (True or False?)

*Answer – An audit difficulty with respect to auditing IT systems is the fact that many controls exist in the software and often can only be tested using computerized audit tools. A commonly used technique is the test data approach. (Number Two is True.)*

THREE – A continuous testing technique that is often used by internal auditors and may also be used by external auditors is embedded audit modules and audit hooks. (True or False?)

*Answer – Techniques for continuous testing of computer systems include embedded audit modules and audit hooks, systems control audit review files, and transaction tagging. (Number Three is True.)*

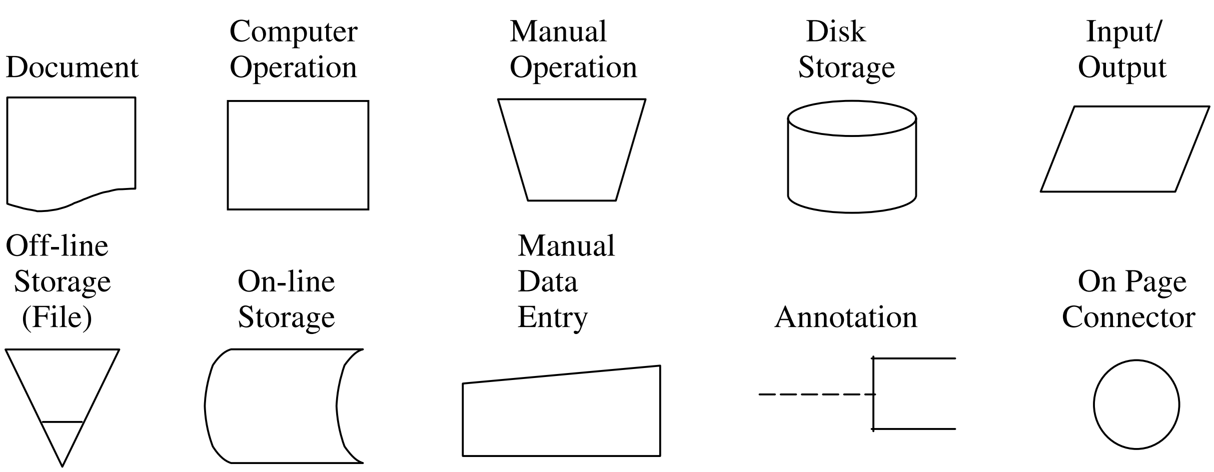
FOUR – Generalized computer audit software is most often used to perform substantive tests directly on the company's computerized records. (True or False?)

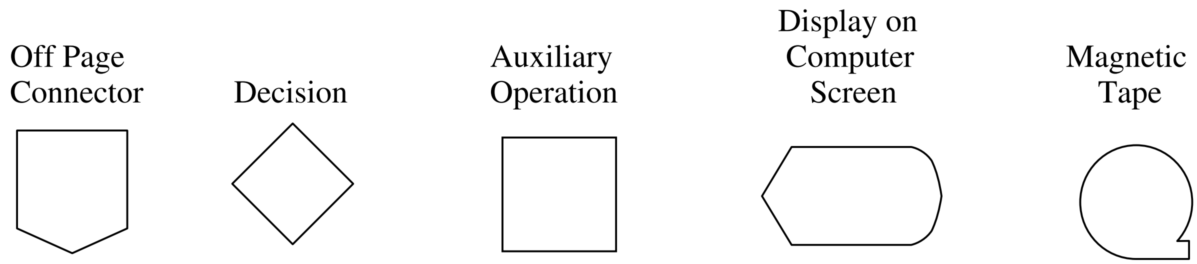
*Answer – Generalized computer audit software can test data stored within the IT system. It can do mechanical testing such as selecting old accounts, internal comparisons, verification of year-end cut-off, and preparation of confirmations. Generalized computer audit software is most often used for substantive testing of client records. (Number Four is True.)*

## FLOWCHARTING

(1) In assessing control risk, the auditor evaluates five **internal control components**. Auditor must also decide whether to perform tests of controls such as investigating the design of individual accounting systems and the control activities in use. Three approaches can be used in achieving an understanding of controls and systems.

- (A) **Internal control questionnaire** is a list of questions about internal control with "yes" answers indicating good control and "no" being a problem.
  - (1) Auditor anticipates problems that might happen and the control activities that should be in use, both general controls and controls specifically for the system being studied. Each question is designed to ascertain whether a particular control exists and is functioning appropriately.
  - (2) Thus, a "no" answer would indicate that a control is not functioning properly and, if a misstatement occurs, it may not be caught.
  - (3) The advantages of using a questionnaire are that this is a very thorough technique and problems are noted immediately. The disadvantage is that company personnel often know the appropriate response and may not be completely truthful.
- (B) Using a **memorandum** means that auditor physically writes out a description of a system and its control activities.
  - (1) The advantages are that anyone can produce a memo and it requires auditor to gain a good knowledge of a system. The disadvantages are that it takes a long time, problems are not always apparent, and changes are difficult to record.
- (C) **Flowcharting** is the symbolic presentation of a system in a sequential order. It is designed to show what each department does as well as the creation and disposition of all documents.
  - (1) The advantages are that it provides an excellent depiction of the system and problems may be easier to spot. The disadvantage is that creating and reading a flowchart both take a particular skill.
  - (2) Numerous flowchart symbols are used. Below are some of the most common.






## PROBLEMS AND SOLUTIONS
## FLOWCHARTING

ONE – A flowchart is a symbolic representation of an auditor's understanding of the design of a system or of particular control activities. Because of the increased sophistication of accounting systems, a flowchart must be used whenever an auditor anticipates that control risk will be assessed at below the maximum level. (True or False?)

*Answer – A flowchart is one method by which auditors can depict their understanding of the design of a company's various systems or particular control activities within those systems. However, a memorandum can be written for this same purpose or a questionnaire may also be used as an alternative. A flowchart has some advantages in that it provides a visual display of all documents, departments, and activities. Unfortunately, control weaknesses and strengths may not be obvious to a person without experience in working with flowcharts. (Number One is False.)*

TWO – In flowcharting, the auditor is especially interested in the activities of each department and the source and disposal of documents within a system. (True or False?)

*Answer – Flowcharts should follow all documents within a system or process from their creation to disposal. In addition, the activities of each department should be clearly marked. (Number Two is True.)*

THREE – The flowcharting symbol for a computer operation or process is the diamond. (True or False?)

*Answer – The diamond symbol is used to indicate that a decision must be made. A computer operation or process is represented by a rectangle. (Number Three is False.)*

FOUR – A document symbol is shown on a flowchart and is followed by a triangle. The document has been sent to a different system within the company or to a recipient outside of the company. (True or False?)

*Answer – A triangle represents a file; thus, the document has been filed. A connector (as might be used to show that a document has been sent to another part of a company or to a party outside of the company) is shown by the use of a five-sided symbol. (Number Four is False.)*

FIVE – On a flowchart, a square symbol indicates an auxiliary operation.  (True or False?)

*Answer – An auxiliary operation is any procedure or process that is helpful but not essential to an activity.  On a flowchart, it is symbolized by a square.  (Number Five is True.)*

## CASH RECEIPTS AND CASH BALANCES

(1) For auditor, **cash receipts** and resulting cash balances provide several concerns. Most problems deal with the theft of company's cash and ability of company's internal control to prevent such theft.

(2) Company should have a system to record the inflow of cash into company.

- (A) As with any transaction, there should be an immediate recording. However, because of the possibility of theft, this step is especially important in connection with cash receipts. The use of a cash register is quite common for this purpose. Cash register tape can be used to make sure money is deposited correctly.
- (B) If checks are accepted, they should be required to be in the name of the company and immediately endorsed "For Deposit Only."
- (C) Periodically, all cash is delivered to **cashier** and a signed receipt is used to document conveyance of asset.
- (D) Cashier prepares a daily cash summary of all incoming cash with a copy going to general accounting for journal entry purposes.
- (E) Money should be deposited in the bank on a daily basis for security purposes and to provide an additional record of the cash amounts.
- (F) Cashier prepares **bank deposit slip** listing individual items. This document is reviewed and approved by second party who makes deposit.
- (G) **Validated bank deposit slip** is mailed by bank directly back to independent party in company who compares total and individual items with daily cash summary to make certain that appropriate cash was deposited each day.
- (H) Independent party in company performs **reconciliation of bank account** on a regular basis. Second party reviews reconciliation, especially looking at deposits in transit, outstanding checks, and other items included to get balances to reconcile.

(3) If money is mailed into company (for sales or on account), additional control steps should be taken to prevent theft.

- (A) Ask for payment by check (not cash). Request that checks be made out in the name of the company.
- (B) Have customer return a **remittance slip** with the payment which includes information about account. Customer should enter amount of the payment being made.
- (C) One person opens mail, counts money, and takes custody. A second person records names and amounts, collects remittance slips, and prepares a cash remittance list (which can be used to make certain that money is deposited correctly and that proper reductions are made to accounts receivable).
- (D) As in any cash system, checks are immediately endorsed "For Deposit Only" and money is conveyed to cashier for inclusion on daily cash summary.
- (E) Remittance slips go to accounts receivable department to update master file of customer balances.

(4) A number of substantive testing procedures should be performed by the auditor to verify the five assertions made by client about cash and cash receipts.

- (A) Carry out **analytical procedures**. For example, compare expected cash inflows to actual cash inflows, compare cash inflows by month looking for any unusual amount, compare items on bank reconciliation to previous reconciliations.

(B) Trace a sample of all documents through system to test for completeness: remittance slips, cash remittance list, cash register tape, daily cash summary, bank deposit slip, and journal entries.

(C) Vouch entries in Cash account to find support to test for existence. Look for documentation that substantiates entries.

(D) Cash remittance list and daily cash summary should be re-added on a test basis.

(E) Request a bank cutoff statement for all items clearing account for the first 7 to 10 days after the end of the year for all checking accounts. As with any confirmation, it is signed by client but controlled by auditor.

(F) Year-end **bank reconciliation** should be reviewed. Math is checked. Items from bank cutoff statement are used to verify outstanding checks and deposits in transit.

(G) Test year-end cut-off by looking at receipts and disbursements for a few days before and a few days after the end of the year to make certain transactions are recorded in proper time period.

  (1) One of the big concerns at year-end is the chance of **kiting**. In kiting, money is transferred from one account to another with deposit recorded in first period and withdrawal recorded in second period.

  (2) Kiting is used to inflate cash in order to (1) allow for recording of false sales or (2) cover stolen funds.

  (3) Auditor reviews **bank cutoff statement** to uncover transfers at year-end which are then scheduled to ensure that they have been recorded correctly.

(H) Cash is only counted if a significant amount is held by client. Should count marketable securities and any other liquid assets at the same time so that funds cannot be moved around to cover a cash shortage.

(I) Request a **bank confirmation** from all banks with which the company has dealt. Confirmations should even be sent to banks where accounts have been closed to make certain that balances have not been hidden. It asks for information about checking accounts, savings accounts, loans and other debts, etc. Confirmation will ask for all balances and terms including interest rates and security arrangements.

(J) Look in subsequent time periods for any unusual cash receipts or cash disbursements. Also watch for any returned checks

## PROBLEMS AND SOLUTIONS
## CASH RECEIPTS AND CASH BALANCES

ONE – Kiting is a process by which employees can steal money from a company by using funds collected from one receivable to cover a theft of an earlier cash collection. (True or False?)

*Answer – The term "lapping" refers to the misappropriation of funds collected from one customer to cover a balance stolen from an earlier receipt. Kiting is a practice whereby money is transferred from one bank account to another with the receipt being recorded in one period and the disbursement in the following period. In this way, cash balances can be inflated for a short period of time or a shortage can be camouflaged. (Number One is False.)*

TWO – A bank cutoff statement is used to corroborate balances shown on a bank reconciliation. (True or False?)

*Answer – A bank reconciliation will include balances such as deposits in transit and outstanding checks that appear in the financial records but have not yet been recorded by the bank. To support such figures, the auditor requests a cutoff statement directly from the bank. This statement includes all account activity for a few days after the end of the year to enable the auditor to determine that reconciling items actually did exist. (Number Two is True.)*

THREE – A variety of information can be gathered by means of a bank confirmation: checking, savings, and debt balances, interest rates, security agreements and restrictions, and the like. The auditor mails the confirmation and the bank is requested to send the information directly to the auditor. (True or False?)

*Answer – The client must sign any confirmation to authorize release of the information. However, the auditor retains custody of the confirmation and all information should be sent directly to the auditor to prevent any possible manipulation by the client. (Number Three is True.)*

FOUR – During the current year, the reporting company closes out a checking account with a particular bank. No other activity was carried out with that bank. At the end of the year, the auditor should still send a confirmation request to that bank. (True or False?)

*Answer – Company officials may say that a bank account has been closed out but then use that particular account to steal money from the company or make illegal payments. Therefore, even if an account has been apparently closed during the year, the auditor will normally mail a bank confirmation simply for additional corroboration. (Number Four is True.)*

FIVE – A company receives cash payments in the mail. One employee should take immediate custody of the cash while another lists each payment. If this control procedure is not in place, the auditor will be especially concerned with corroborating the existence assertion. (True or False?)

*Answer – With cash, the auditor realizes that the risk of theft is particularly high. Thus, at every point within the cash receipts system (and the cash disbursements system), a clear separation should be maintained between the party responsible for custody of the asset and the party in charge of the recordkeeping function. If this segregation of responsibilities is not maintained, the risk of theft increases. In this case, the money could be stolen when the mail is opened with no record being made of the cash receipt. Since the auditor is concerned about the balance being understated or omitted, the completeness assertion will need to be corroborated. (Number Five is False.)*

SIX – A company requires that its cashier prepare a bank reconciliation for each account on a monthly basis. Because of this responsibility, the auditor will probably set control risk at a particularly high level. (True or False?)

*Answer – Every reconciliation should be prepared by a party who is independent of both the custody of the asset in question and the recordkeeping function. The cashier is an employee directly connected to the custody of cash and would, therefore, not be an independent party. (Number Six is True.)*

## SPECIAL REPORTS AND OTHER REPORTS

(1) Several types of **special reports** exist where auditor can examine information not in the form of financial statements presented according to US generally accepted accounting principles.
- (A) One common form of special report is prepared to report on statements produced using a comprehensive basis of accounting other than US generally accepted accounting principles. One example would be reporting on statements prepared on the cash basis.
  - (1) An additional paragraph is inserted before the opinion paragraph of the report to identify the method of accounting being applied and specify that it is not GAAP.
  - (2) The opinion paragraph then states whether there is fair presentation based on the specified method in use.
- (B) Another type of special report is based on the examination of a single account or schedule – such as sales revenue at a certain location. The CPA can audit the information and give an opinion based on GAAP (or whatever basis of accounting has been used).
  - (1) If the basis of accounting is anything other than GAAP, a fourth paragraph is added after opinion paragraph to restrict the distribution of report to those parties who understand what basis was utilized.

(2) The attestation function covers any examination and report made by a CPA and can go far beyond the traditional audit of financial statements.
- (A) **Statements on Standards for Attestation Engagements** of the AICPA provide rules for any attestation other than an audit.
- (B) One type of attestation is the application of agreed-upon procedures where the CPA is engaged to issue a report of findings based on specific procedures that were performed. In this way, the CPA can report on almost anything – such as the number of votes at the Academy Awards.
  - (1) CPA may evaluate either a particular subject matter or an assertion.
  - (2) CPA and the hiring party must agree on work to be carried out and this party must take responsibility for sufficiency of those procedures.
  - (3) The matter to be examined must be subject to consistent measurement and the criteria must be agreed on by all parties.
  - (4) The report must be restricted to specified parties who understand what was done.
  - (5) The report should indicate the subject matter (or assertion), the specified parties to receive the report, the party who was responsible for the subject matter, the procedures performed, and the findings.

(3) CPA can be associated with **financial forecasts** and **projections** (sometimes known as **prospective financial statements**).
- (A) Financial forecast is a general anticipation of a company's future statements. Distribution may be limited or may be given to the general public.
- (B) Financial projection indicates effect that a hypothetical event would have on future financial statements. Distribution is restricted to party responsible for projection and to anyone with whom this party is negotiating directly.

(C) CPA may compile statements (no assurance), apply agreed upon procedures (indicate findings), or exam statements (give positive assurance that assumptions are reasonable). CPA never gives any assurance as to the achievability of the figures.

(D) In an examination, CPA also makes certain that all assumptions are disclosed and followed. In report, CPA warns that results will usually be different than projected.

(4) **Pro forma financial statements** are created to indicate effect that a hypothetical event (a merger, for example) would have had on past statements. CPA may either review or exam. Examination and report are similar to that done for a financial projection.

(5) **Registration statements** must be filed by a company with the SEC before new securities can be issued. Normally, these securities are transferred to underwriting companies (stock brokerage houses) which then sell them to the public. Legally, the underwriters must make a reasonable investigation to be certain that information they are using is not false or misleading.

(A) To help an underwriter meet these legal requirements, it will seek assurance from auditor who furnishes what is called a **comfort letter** (or a **letter for underwriters**). This letter provides assurance beyond that which was given on the financial statements included in the registration statement.

(B) Auditor provides positive assurance about independence and that audit followed SEC standards.

(C) Auditor provides limited (or negative) assurance for specified information (such as interim data) that is included within the registration statement.

(6) An auditor may be engaged to provide an examination and **report on internal control**.

(A) In an audit, internal control is studied solely to determine amount of control risk. Any **reportable conditions** or material weaknesses noted in internal control must be indicated to the board of directors and appropriate members of management.

(B) In a separate engagement, examination of internal control is more comprehensive. First, management makes an assertion that internal control is effective. Auditor then makes examination and reports on internal control. As an alternative, auditor can report on management's assertion.

(C) Auditor's standard report on internal control has four paragraphs.

(1) First paragraph indicates nature of examination and outlines responsibilities.

(2) Second paragraph indicates that standards established by the AICPA were followed. Also specifies that auditor (1) obtained understanding, (2) tested, and (3) evaluated both design and effectiveness of internal control.

(3) Third paragraph spells out inherent limitations of internal control.

(4) Fourth paragraph indicates whether the company has maintained effective internal control over financial reporting based on criteria established in "Internal Control-Integrated Framework" issued by the organizations sponsoring the Treadway Commission.

(7) If auditor is asked to issue a report on statements that have been condensed, report indicates that the audit was performed on the basic financial statements, gives the date and type of opinion, and indicates whether the condensed statements are fairly stated in all material respects in relation to the basic financial statements.

(8) CPA can accept a **WebTrust** engagement to help give customers assurance about the security of transactions placed through a web site.

- (A) CPA examines and reports on three principles
  - (1) Business Practices Disclosure – all business operating practices used in the web site are disclosed and followed appropriately.
  - (2) Transaction Integrity – company controls are effective in making certain that customer orders are complete and properly filled.
  - (3) Information Protection – all information provided by customers is protected.
- (B) CPA grants company the user of the WebTrust seal. Consumer can then click on this seal to read the CPA's report.
- (C) The CPA's report will include the following information.
  - (1) Indication that the web site does conform to the three principles listed above.
  - (2) Company is responsible for the assertions made about the web site.
  - (3) CPA has obtained reasonable assurance that management's assertion about the web site is not materially misstated.
  - (4) Projections of assurance into future periods are subject to risk.

(9) Auditor can perform engagements for governments and agencies receiving government funding. Guidelines may require auditor to follow GAAS, GAS (**government audit standards**), and/or the Single Audit Act.

- (A) In a financial audit carried out according to GAS, audit may cover an entire set of financial statements or just a segment or schedule.
  - (1) Reporting is extended. Three different areas must be covered in a combined report or in separate reports.
    - (a) An audit report is provided to indicate whether information is fairly presented according to GAAP.
    - (b) An indication is provided as to whether entity has complied with laws and regulations for all material transactions and events. Any material noncompliance must be reported. Positive assurance is given for tested items; negative assurance is given for items not tested.
    - (c) A listing is provided of any material weaknesses or reportable conditions found in internal control.
- (B) Auditor can also carry out **performance audits**.
  - (1) In an **economy and efficiency audit**, auditor indicates whether entity protected and used financial resources efficiently and effectively.
  - (2) In a **program audit**, auditor indicates whether desired benefits or results are being achieved.

## PROBLEMS AND SOLUTIONS
## SPECIAL REPORTS AND OTHER REPORTS

ONE – A company prepares its financial statement on the cash basis of accounting. In the report of the independent auditor, an additional paragraph must be included before the opinion paragraph to draw attention to the method being applied. The auditor must then render a qualified audit opinion because generally accepted accounting principles were not followed. (True or False?)

*Answer – When a comprehensive basis of accounting other than generally accepted accounting principles has been applied, a special report is given. The auditor does include an extra paragraph in this report to indicate the method in use. Then, in the final paragraph, the auditor renders an opinion on whether the financial statements are presented fairly according to that particular method. If so, the opinion is unqualified. (Number One is False.)*

TWO – An audit firm has been asked to perform an audit on the Royalty Expense account of a particular publishing company because of a dispute. The auditor is to determine whether the balance is in conformity with generally accepted accounting principles. Because of the narrow scope of this engagement, the auditor must restrict the release of the report to the parties who are involved in the dispute. (True or False?)

*Answer – There are times when an accountant or auditor must restrict the distribution of a report. However, if an audit is performed and the account is being evaluated according to generally accepted accounting principles, no reason exists for restriction even if the report only concerns a single account or schedule. Conversely, if a different criteria is used or if the accountant or auditor is carrying out agreed-upon procedures, the report should be restricted to parties with an adequate knowledge of the situation. (Number Two is False.)*

THREE – In a comfort letter (a letter for an underwriter), the auditor will provide limited assurance. (True or False?)

*Answer – In connection with the issuance of new securities to the public, a registration statement must be produced by the reporting company. The underwriter that will actually sell these securities to the public is required by law to carry out a reasonable investigation to ensure that the information in the registration statement is not false or misleading. As part of this responsibility, the underwriter requests a letter from the auditor (a comfort letter) that provides positive assurance as to independence and limited (or negative) assurance on any data in the registration statement that was reviewed by the auditor. (Number Three is True.)*

FOUR – A financial forecast can be issued to the public. (True or False?)

*Answer – A financial forecast is a general anticipation of future financial statements for a company. Distribution may be restricted but the forecast can also be given to the public. In contrast, a financial projection is a measure of the impact that a hypothetical event will have on future statements and must be restricted to parties having adequate knowledge. (Number Four is True.)*

FIVE – An audit firm has been auditing the financial statements of ABX Company for a number of years. This year the company wants the firm to perform a separate examination of its internal control. The techniques used by the audit firm will be different for this engagement than those used in assessing control risk as part of the annual audit. (True or False?)

*Answer – The work carried out in an examination of internal control is very similar to that done in the assessment of control risk. The auditor comes to an understanding of the five components of internal control and then documents the understanding of each system to determine the design of control activities so that they can be tested for effectiveness. However, the auditor's work will be much more extensive in this engagement. When hired to evaluate internal control, the auditor looks more carefully at each significant control activity. (Number Five is False.)*

SIX – In a report on internal control, the auditor will describe reasons that errors or fraud may occur regardless of the internal control. (True or False?)

*Answer – The third paragraph of a report on internal control indicates that inherent limitations (such as human error or management overriding of the system) may always allow misstatements to occur and not be detected. In addition, changes in conditions over time may cause the internal control to become inadequate. Thus, the reader is warned that errors or fraud may still occur despite the presence at the current time of internal control activities and procedures. (Number Six is True.)*

SEVEN – An audit is conducted in accordance with government audit standards (GAS) because the reporting entity receives certain federal financial assistance. The report is more extensive than is prepared traditionally because it includes references to both internal control and the efficiency of the federal program in meeting its stated objectives. (True or False?)

*Answer – When an audit is conducted in accordance with GAS, an audit report on the financial statements must be made. In addition, either in a separate or combined report, the auditor must report on both internal control and compliance with laws and regulations. (Number Seven is False.)*

EIGHT – An audit is conducted in accordance with government audit standards (GAS). The auditor must include a report on internal control that is primarily designed to disclose any material weaknesses that are discovered. (True or False?)

*Answer – Within an audit conducted according to GAS, an internal control report is included to report any reportable conditions that were discovered. A separate discussion is only required if any of the reportable conditions is so serious as to be considered material weaknesses. (Number Eight is False.)*

NINE – An audit is conducted in accordance with government audit standards (GAS). As part of this examination, the auditor must test the reporting entity's compliance with laws that have both a direct and a material effect on the financial statements. (True or False?)

*Answer – In following GAS, evidence must be gathered concerning compliance with laws. These tests concern laws and regulations that have a direct and material effect on the financial reporting of the entity. (Number Nine is True.)*

TEN – An audit is conducted in accordance with the Single Audit Act. As part of this audit, the auditor is required to test internal control activities and procedures over federal programs in order to determine if they are effective. (True or False?)

*Answer – When a company or other organization is governed by the regulations of the Single Audit Act, the auditor is required to test the controls that are in place in connection with the federal programs of the reporting entity. (Number Ten is True.)*

## LONG-TERM LIABILITIES AND CONTINGENCIES

(1) In looking at **long-term liabilities** and **contingencies**, auditor should be aware of certain potential problems.
- (A) Auditor is always concerned about the understatement of debt because that would improve the company's reported debt to equity position. Consequently, completeness is a particular worry.
- (B) Because of lack of documentation, the mere discovery of contingencies can be difficult. Once discovered, evaluating the likelihood of occurrence and possible amounts poses special problems.
- (C) For debts that have been issued, amortization of any discounts and premiums must be verified.
- (D) **Loan covenants** must be properly disclosed. Auditor should also make certain that no covenants have been broken; failure to meet covenants can necessitate debts being reported as current liabilities.

(2) Auditor would expect to find certain actions taken by company in connection with long-term liability balances.
- (A) Normally, approval for incurring additional debt must be made by board of directors and/or stockholders.
- (B) A formal contract (indenture) should be drawn up by lawyers and signed by company officials so that all terms are clearly understood.
- (C) The issuance of bonds or other long-term debt may be made through the use of an independent trustee.
- (D) Cash received should be recorded in cash summary or **cash receipts journal** and bank deposit slip to provide documentation.
- (E) Unpaid interest should be accrued at end of year along with the recording of any discount or premium amortization.

(3) A number of substantive testing procedures should be performed to verify the five **assertions** made by management about long-term liabilities.
- (A) **Analytical procedures** are carried out. For example, cash receipts and interest expense are compared with previous years or with anticipated figures.
- (B) Debt transactions are traced from initiation through the accounting system to the formal recording in order to substantiate completeness. Because debt must usually be approved by board of directors, minutes should be read to check for approval and for mention of debts that may have gone unrecorded.
- (C) Entries in ledger are vouched back to source documents to substantiate existence and, possibly, valuation.
- (D) Amortization of any discount or premium should be recomputed.
- (E) Interest expense is reconciled to debt balance. If interest is higher than expected, unrecorded liabilities may be present.
- (F) Verify that any unpaid interest at end of year is accrued.
- (G) Examine events in subsequent period for evidence of the incurrence of any new debts, a transaction that might require disclosure. Also in subsequent period, look for any payments on debts. May indicate unrecorded liabilities or substantiate balances being reported.
- (H) On representation letter, ask about any unrecorded debts.

- (I) Read loan indentures to determine nature of covenants so that a verification can be made that they have not been broken.
- (J) If risk is high, auditor can confirm balances with creditors. Transactions during the year can be confirmed with trustee.
- (K) **Bank confirmations** should be reviewed for existence and terms of long-term liabilities.

(4) Additional testing should be performed in connection with contingencies.

- (A) Ask client for (1) a list of contingencies, (2) an evaluation of the possibility of loss for each, and (3) the amounts, if any, expected to be lost.
- (B) Check files for correspondence with lawyers or insurance companies that might relate to contingencies. Look at invoices from lawyers that might indicate existence of contingencies.
- (C) Read contracts to see if failure to meet requirements creates a contingency.
- (D) **Lawyers letter** should be sent by auditor to company's outside attorneys to substantiate information. Should list all contingencies as well as company's evaluation of each.
  - (1) Lawyer responds directly to auditor indicating any disagreements. Lawyer should also mention any asserted claims that were not included.
  - (2) Lawyers do not have to respond about contingencies where they lack adequate knowledge. However, the lawyer must indicate any limitation in the response.
  - (3) If **unasserted claim** has been omitted and lawyer believes auditor should be told, lawyer suggests client make disclosure. If not disclosed, lawyer considers resigning.

## PROBLEMS AND SOLUTIONS
## LONG-TERM LIABILITIES AND CONTINGENCIES

ONE – In auditing long-term liabilities, the auditor should read all debt indentures to determine the existence of any loan covenants. The auditor is attempting to corroborate the valuation assertion. (True or False?)

*Answer – If loan covenants are in existence, the financial statements will probably need to disclose their nature and presence. Thus, the auditor is obtaining support for the presentation and disclosure assertion. (Number One is False.)*

TWO – In searching for unrecorded liabilities, the auditor will probably read the minutes of the meetings of the board of directors. (True or False?)

*Answer – In most companies, incurring long-term debt requires approval by the board of directors. Thus, the auditor will read the minutes of those meetings looking (at least in part) for the mention of additional debt that might not have been reported properly. (Number Two is True.)*

THREE – A company is reporting a total of $1 million in long-term debt that bears an annual 8 percent interest rate. The company also reports an Interest Expense account of $240,000. The auditor's primary concern is that net income may be misstated. (True or False?)

*Answer – The $1 million in debt would indicate interest expense of $80,000 based on the 8 percent annual rate. Thus, the $240,000 amount reported for interest could well be in error by $160,000. However, the large Interest Expense balance could also indicate that debts of several million dollars have been left off of the financial records by the company. Because of the size of the potential problem, the omission of the debt would probably be a bigger concern for the auditor. (Number Three is False.)*

FOUR – In auditing contingencies, the auditor is most concerned with the completeness and the valuation assertions. (True or False?)

*Answer – Because records may not be readily available for contingent losses, balances may be omitted from the financial statements. Thus, the auditor must always attempt to corroborate the completeness assertion for contingencies. In addition, since the actual loss (if any) will not be determined until the future, the valuation assertion is another primary worry for the auditor. (Number Four is True.)*

FIVE – A company lists all of its contingencies and then evaluates the likelihood of loss and the anticipated amount. The auditor forwards this information to the company's outside law firm. The firm refuses to corroborate the information. The auditor will normally have to render either a qualified or an adverse opinion. (True or False?)

*Answer – Failure of the outside attorney to substantiate the information provided by the client in connection with contingencies will normally lead to either a qualified opinion or a disclaimer of opinion. Whenever a problem is based on a lack of evidence, one of these reports is appropriate. (Number Five is False.)*

SIX – A company lists all of its contingencies and evaluates the likelihood of occurrence and the anticipated amount of loss. This information is forwarded to the company's law firm. If the firm disagrees with the amounts listed, the law firm must contact the client and ask that the information be modified. (True or False?)

*Answer – Unless an unasserted claim has been omitted, the law firm should contact the independent auditor directly in order to express reservations about the information that was provided concerning contingencies. (Number Six is False.)*

## PAYROLL

(1) When auditing payroll balances, auditor should be aware of several potential problems.
- (A) Because money is being removed from company, theft is biggest concern. Overpayment can occur for several reasons.
  - (1) Payment may be for more hours than employee actually worked or for a higher rate than employee earned.
  - (2) Extra deductions may be taken from one employee in order to increase another employee's paycheck.
  - (3) Paychecks may be issued in the name of false employees or employees who have quit or been fired. These checks are stolen and cashed.

(2) Company should have a well designed payroll system to ensure that records are correct and payments appropriate.
- (A) **Personnel department** hires employees and sets up a personnel file to accumulate information for computing payroll.
  - (1) W-4 form lists marital status and number of dependents.
  - (2) Employee or union contract gives pay rate and terms of fringe benefits.
  - (3) Deduction authorizations are signed by employee as approval for deducting money for medical insurance, savings bonds, union fees, donations, etc.
  - (4) Personnel department prepares a payroll input record for each pay period giving list of employees, marital status, pay rate, deductions, etc. Copy is sent to payroll department so that wages can be computed.
- (B) For employees paid an hourly rate, number of hours worked is maintained by **timekeeping department**. Clock cards or other system is used to determine exact time spent at work.
- (C) Where applicable, employees keep record of their work on **time tickets** (or job order cards). This information can be used in determining labor costs charged to each job.
- (D) Employee's supervisor reviews number of hours being reported and provides authorization. Since overtime hours are usually paid at a higher rate, a special authorization may be necessary.
- (E) **Payroll department** computes each employee's gross wages, deductions and net pay based on hours worked and information from payroll input record.
  - (1) Salary information is recorded for each employee in payroll register. Totals are forwarded to general accounting for reporting purposes.
  - (2) Second employee verifies all figures and computations and provides authorization.
- (F) **Payroll register** is sent to cash disbursements department in treasurer's office. It is reviewed and approved unless discrepancies are apparent.
- (G) Paychecks are written on a separate payroll bank account which has no money in it except when payroll is issued. Use of second account reduces the chance and potential amount of theft.
  - (1) Second employee compares checks to register and signs.
- (H) **Paymaster** distributes checks to employees but only after they provide proper identification.

(I) Unclaimed paychecks are recorded by paymaster and given to independent party for follow up.

(3) A number of substantive testing procedures should be performed to verify the five assertions made by client about payroll.

(A) **Analytical procedures** should be carried out such as comparing expense to previous years, budgeted figures, and number of employees. May want to compare expense from month to month to note any unusual amounts.

(B) Select a sample of employees and trace payroll information from personnel file to payroll input form to clock cards to payroll register to general ledger account to canceled check.

(C) Vouch a sample of payroll checks to find supporting documentation.

(D) Verify mathematical computation of individual paychecks including all deductions.

(E) Verify extensions and footings in payroll register.

(F) Recompute year-end accrual of any unpaid salaries.

(G) Observe paymaster's distribution of checks to verify that each employee has proper identification. Investigate the handled of any unclaimed checks.

## PROBLEMS AND SOLUTIONS
## PAYROLL

ONE – The personnel department calculates the amount of gross wages earned by each employee in a company. (True or False?)

*Answer – The personnel department makes decisions about hiring and firing employees. It also maintains employee records and provides information such as pay rates and marital status. However, the actual computation of gross wages for each employee is handled by the payroll department. (Number One is False.)*

TWO – In auditing the Salary Expense account, the auditor is especially concerned with supporting the existence assertion. (True or False?)

*Answer – Theft of company cash is often accomplished by issuing paychecks to false employees or to employees who have quit or retired. The checks are simply stolen and cashed by other individuals who are usually employees of the company. Thus, the auditor is especially interested in ascertaining that each employee who is to receive a paycheck actually does exist. (Number Two is True.)*

THREE – A company has a paymaster who distributes paychecks after verifying the appropriate identification of each recipient. Any paychecks that are not distributed should be turned over to an independent party within the company for verification purposes. (True or False?)

*Answer – When a paycheck is not claimed, the problem may be that no employee exists with that identification. The check was requested or issued in hopes of misappropriating the funds. Thus, some party who is independent of both the* *payroll and the personnel departments should investigate any unclaimed checks. (Number Three is True.)*

FOUR – The payroll register is used to capture all information about each employee's paycheck so that an appropriate recording can be made. (True or False?)

*Answer – The payroll register indicates the amounts earned by each employee as well as deductions and withholding and the actual payment made. These balances are used in the general accounting department to record the entire impact of the payroll payment. (Number Four is True.)*

## LAND, BUILDINGS, AND EQUIPMENT

(1) In looking at **land, buildings, and equipment**, auditor is aware that several problems could prevent fair presentation.
- (A) The cost of new items are not properly capitalized. The cost of additions and other changes in items already in use has not been recorded correctly.
- (B) Depreciation is computed incorrectly or is based on estimations that are not reasonable.
- (C) Assets are retired or disposed of in some manner without being removed from the accounting records.

(2) Auditor performs a number of substantive tests in connection with land, buildings, and equipment.
- (A) On a test basis, recompute depreciation amounts.
- (B) Physically inspect a sample of assets and compare to records maintained by company.
- (C) For assets retired, compare life and residual value to amounts that were anticipated.
- (D) Review Repair Expense account and Maintenance Expense accounts to determine if any capitalized amounts have been expensed.
- (E) For **constructed assets**, review all cost records for appropriate classification. Make certain that capitalized interest has been appropriately recorded.
- (F) For new acquisitions, review vendor invoice and search for any other normal and necessary costs that should be capitalized.
- (G) For all additions to land, buildings, and equipment, vouch entries back to source documentation to substantiate balances.
- (H) During tours of facilities, look for **idle assets** that should be reclassified.
- (I) For capitalized leased assets, review contract and computations.
- (J) Review cash receipts for an amount that might indicate the sale of a fixed asset. Company may have recorded transaction as miscellaneous income without removing asset.
- (K) Look over loan agreements to see if any assets have been pledged as security. If so, that information must be disclosed.

### PROBLEMS AND SOLUTIONS
### LAND, BUILDINGS, AND EQUIPMENT

ONE – A company is in the process of constructing a new building. In examining this account, the auditor is concerned with the presentation and disclosure assertion. (True or False?)

*Answer – A long-lived asset is classified as an "other asset" until the time that it begins to generate revenues. At that point, the reported balance should be reclassified as "land, buildings, and equipment." Thus, the auditor needs to verify the appropriate placement of the account within the company's balance sheet. (Number One is True.)*

TWO – An auditor discovers a cash receipt of $18,000 with the notation "amount received from sale of equipment." The auditor also finds an equal amount recorded within miscellaneous income. Net income is likely to be overstated while the total reported for assets is understated. (True or False?)

*Answer – Unless the equipment was fully depreciated, the amount of cash received should not be recorded as an increase in net income but only the amount (if any) that is in excess of book value. Since the entire amount was recorded as miscellaneous income, the book value of the asset was apparently not removed from the books. Thus, income is probably overstated and, because the book value of the equipment was not removed, assets are also overstated. (Number Two is False.)*

THREE – In performing analytical procedures, the amount reported by the company in its Repair Expense account is lower than the auditor's anticipated figure. The auditor should be concerned that the client may be attempting to inflate net income. (True or False?)

*Answer – Whenever a Repair Expense or a Maintenance Expense account is lower than expected, the auditor must be aware that company officials may be incorrectly capitalizing expense expenditures in order to increase net income artificially. (Number Three is True.)*

## INVESTMENTS

(1) Investments include securities and derivative instruments. In looking at investments, auditor is aware that several problems could prevent the fair presentation of reported balances.
- (A) If control or significant influence exists, the investments must be recorded through consolidation or the equity method. Company may not be aware of this need or may not know how to apply these accounting methods.
- (B) Interest or dividends can be received by the company and then be stolen.
- (C) Most securities must be valued at fair value. The company may not appropriately apply GAAP with respect to valuing the securities.
- (D) A change in market value creates an income effect for a trading security but only a stockholders' equity effect for a security available for sale. Company may manipulate these classifications in order to impact reported net income.
- (E) Securities may be sold with the money misappropriated by an employee. At the end of the year, the stock is repurchased and replaced.
- (F) For **bonds being held to maturity**, any discount or premium must be properly amortized.
- (G) Accounting for and valuing derivative instruments is complex.
- (H) GAAP may require developing assumptions about future conditions.
- (I) Strict GAAP requirements apply to the use of derivatives for hedging. The company may not appropriately apply these rules.

(2) The auditor may need specialized knowledge to plan and perform auditing procedures for certain assertions about derivatives and securities.

(3) Auditor should perform a number of substantive tests in connection with investments.
- (A) Should investigate whether control or significant influence is present. If so, auditor verifies that the proper method of reporting is being utilized and that amounts are being reported properly. Audited financial statements furnished by the investee should be used to verify appropriate financial reporting.
- (B) For each new purchase, the auditor should review documentation to ensure that capitalized cost figure is correct.
- (C) For each sale, auditor recomputes gain or loss that is reported.
- (D) Auditor uses reported amounts of dividend and interest payments to verify amount being reported by company. Dates that individual amounts are recorded should be checked with distribution dates for any unusual delays.
- (E) If certificates are being held by an independent trustee, auditor should confirm these securities.
- (F) If certificates are being held within the company, auditor should consider making a surprise inspection to be sure that all documentation is present. Auditor should verify name of company, number of shares or face value, and serial numbers on all stocks and bonds to make sure they have not been switched or replaced.
- (G) Review company's justification for classifying marketable securities as trading securities, securities available for sale, or bonds to be held until maturity. Look at past history to determine how long investments are usually held.
  - (1) Auditor may also want to determine company's intentions by examining recorded investment strategy as well as the **minutes of meetings of the board of directors** and any investment committees.

(2) Auditor should also consider company's ability to hold securities for an extended period by looking at current financial position, working capital needs, debt agreements and the like.

(H) Inspect derivative contracts.

(I) Request counterparties or holders to confirm terms of agreements and whether there are any side agreements or agreements to repurchase securities sold.

(J) Inspect financial instruments and other agreements to identify embedded derivatives.

(K) For derivatives accounted for as hedges, the auditor should gather evidence that management (1) complied with GAAP, (2) originally expected and documented that the hedging relationship would be highly effective, and (3) periodically assessed the hedge's ongoing effectiveness.

(L) Review company's application of fair market value to securities and derivatives. Market value can be determined in one of several ways.

- (1) Get a quoted market price.
- (2) Talk with broker who makes a market in the investment.
- (3) If no market price is available, a valuation pricing model may be used to estimate fair value. In such cases the auditor can use one or a combination of the following approaches.
  - (a) Review and test management's process.
  - (b) Independently develop and estimate.
  - (c) Review subsequent events.

(M) Recompute the amortization of any premium or discount on bonds being held to maturity.

(N) For investments being held until maturity, a write-down in book value is necessary if a permanent drop in market value has occurred.

- (1) A permanent drop in market value should be suspected if one of several events occurs: fair market value is significantly below cost, the entire industry or geographic region is in decline, decline in market value has persisted for an extended period of time, financial condition of issuer has deteriorated, there has been a reduction in dividend distributions, etc.

## PROBLEMS AND SOLUTIONS
## INVESTMENTS

ONE - A company buys ownership shares of a large company during the current year. By year end, the value of this investment has risen rather substantially on a national stock exchange. Company officials indicate that they plan to report these shares as trading securities. Unless evidence to the contrary is indicated, the auditor must allow this classification. (True or False?)

*Answer – As trading securities, the rise in value of the investment will increase net income rather than being reported within stockholders' equity. Thus, the company may have reason to report the investment in this manner regardless of its actual intentions. The auditor should look for evidence to support this placement. For example, the auditor may search for any investment strategies put forth by the company as well as indications by the board of directors of its* *objectives for the investments. If evidence exists that the company plans to hold the investments indefinitely, a reclassification will be necessary to "securities available for sale." (Number One is False.)*

TWO – A company holds ownership shares of a stock that is not publicly traded. Thus, without a market value, the company will have to leave this investment on its books at historical cost. (True or False?)

*Answer – If a market price is not readily available for an investment in securities, the auditor should attempt to determine an approximate market value by the use of a valuation pricing model or by discussions with investment brokers. (Number Two is False.)*

THREE – A company acquires $500,000 in bonds for $470,000. The company plans to hold this investment until the maturity date of the bonds. Thereafter, the value of these bonds drops rather significantly. Because the investment is being held until maturity, it will be reported at amortized cost rather than at fair market value. (True or False?)

*Answer – Normally, a change in the market value of bonds being held until maturity has no impact on amounts to be reported. Any associated discount or premium will be amortized using either the effective rate method or the straight-line method. However, if a drop in market value is permanent, the reported value of the investment must be reduced. For example, if a decline in market value is significant and has persisted for an extended period of time, a reduction may be necessary. (Number Three is False.)*

FOUR – Derivatives are often hard to discover because they may be embedded in other financial agreements. (True or False?)

*Answer – Derivatives can be embedded in a manner of different types of financial agreements (e.g., loan agreements). (Number Four is True.)*

FIVE – If management has elected to account for a financial instrument as a hedge, the auditor must inspect documentation of management's basis for concluding that the hedge would be effective. (True or False?)

*Answer – To account for a financial instrument as a hedge management must document this fact and the basis for concluding that the hedge will be highly effective. (Number Five is True.)*

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