Chapter 6

Multiple Choice

6-1. C
6-2. B
6-3. D
6-4. B
6-5. D
6-6. B
6-7. C
6-8. B
6-9. A
6-10. D
6-11. A
6-12. B
6-13. C
6-14. D
6-15. C
6-16. C
6-17. A
6-18. C
6-19. D
6-20. C
6-21. C
6-22. C

Discussion Questions

6-23 **[LO 3]** Why do the audit standards address qualifications of the user of financial statements in the discussion of materiality?

Answer:
Because materiality involves qualitative as well as quantitative decisions.

6-24 **[LO 4]** Why is fraud that is committed by management always considered material, even if the amount is not quantitatively material?

Answer:

The main reason management fraud is considered material regardless of the amount is because of the concerns it raises regarding management integrity. Even if the one identified fraud is of a small dollar magnitude, it raises the question of whether management has been honest about all of the other items in the financial statements that are vulnerable to management influence and that could cause the overall financial statements to be misstated.

6-25 **[LO 1]** What is a top down approach to planning an audit? What are the steps? How does this approach link the financial statements to ultimate audit program steps? Why does AS 5 direct the auditor to use this approach in assessing materiality?

Answer:

A top down approach is intended to maximize audit efficiency by focusing the auditor's attention on those items that are actually important to the audit. The steps are as follows:

- Determine materiality at the financial statement level.
- Based on that, identify those accounts and disclosures that are important enough that, either alone or when aggregated, could cause the financial statements to be materially misstated.
- Decide which assertions are relevant to the important accounts and disclosures.

For the financial statement audit, the auditor then plans and executes audit procedures to evaluate the relevant assertions for the important accounts and disclosures.

For the ICFR audit:

- The auditor determines what could go wrong to impair the validity of management's assertions for the important accountants and disclosures.
- The auditor evaluates whether management has constructed controls that may be effective in preventing or detecting the identified problems.
- If controls are in place the auditor designs and executes procedures to test whether those controls that are targeted at the problems that could occur in the assertions for important accounts and disclosures actually operate effectively.

The top down approach begins with the important financial statement assertions and ends with the specific financial statement audit and ICFR audit procedures, thus creating a linkage.

The ICFR audit instructs this approach to be sure that the auditor addresses all of the important risks to the financial statement fairness, but does not waste audit effort on those that are not important.

6-26 **[LO 3]** When a benchmark approach is used to set materiality at the financial statement level, why are different benchmarks used for different types of entities, or companies in different entities?

Answer:

Because the concept of materiality is one of dollars (amount; quantitative) and quality (qualitative). Each industry offers a different set of inherent risks; therefore, each benchmark drawn from other companies in the industry will offer different materiality thresholds.

6-27 **[LO 5]** When a control is tested at an interim date the following are things the auditor considers in deciding how much audit evidence must be obtained about the control during the roll forward period. How would each one affect the evidence needed and why?

Answer:

(a) The importance of the control

The more important the control the more audit evidence the auditor would want close to the management report date. Even if the control was functioning earlier, if it is important, the auditor needs significant evidence at year end.

(b) How much evidence was obtained at the interim date

All things being equal, if more evidence is obtained at an interim date then less may be needed at year end. In other words, if the auditor did not collect much at interim, then more will be needed later. For example, assume for a company with a 12/31 fiscal year end, the auditor had tested the control and found that it functioned effectively through 9/30. The auditor would test the roll forward period but would be trying to establish that there is no disconfirming evidence and that things had not changed between 9/30 and 12/31. Absent the strong evidence about the earlier time period the auditor would have to collect much more evidence leading up to 12/31.

(c) The length of time between interim testing and fiscal year end

If the auditor found no problems at the interim date and a short time had elapsed between that date and the fiscal year end, just as in item b, the auditor is confirming no changes and looking for any disconfirming information. If the interim testing was done in, for example, May rather than September, the auditor does more control testing around and at fiscal year end.

(d) Any changes that have occurred to ICFR between the interim testing date and the end of the fiscal year

Generally, if the control has changed between the interim date and the fiscal year end the auditor has to establish that the control functions at fiscal year end much as would be required if the interim testing had not been done. If things have changed since the interim date, then those audit procedures don't really provide any information on the situation at fiscal year end.

6-28 **[LO 3]** Explain why controls have to be tested for the entire fiscal year if they are to be relied on in the financial statement audit. Why do they only have to be tested related to their effectiveness at the fiscal year end for an ICFR audit?

Answer:

If the auditor plans to rely on the control in the financial statement audit and – as a result – reduce the substantive procedures performed, then the auditor has to test that the control worked for the whole time that the control is to be relied on. If, for example, the auditor did not test controls over revenue for the first half of the year, then the auditor could not rely on the conclusion that the system produced appropriate revenue numbers for that period of time.

An ICFR audit differs because the auditor only issues an opinion on whether the ICFR functions at fiscal year end (the management report date) – so the auditor only has to test a sufficient period of time prior to that date to be able to issue the opinion. The basic difference is that the ICFR audit opinion only refers to a single point in time.

6-29 **[LO 6]** Review the Outline of a Planning Memo in. List all of the items included in the planning memo that are still new to you. Using the index of the book to find the topics. Identify the stage of the audit where these topics fit.
Answer:

Student answers will vary; the important point is that the items should occur before testing begins.

Problems

6-30 **[LO 2]** Samantha is a senior manager at a national CPA firm. She has recently taken over the planning responsibilities on her firm's largest client, a mid-size publicly traded company with multiple subsidiaries around North America. The client chose her firm primarily due to its cost efficiencies compared to larger firms. The client is publicly traded, so Samantha is planning an integrated audit as well as quarterly review work.

Required:

(a) How will each of the following concepts affect Samantha's audit planning?
    1. Nature
    2. Timing
    3. Extent

(b) Should Samantha consider the audit budget when planning the audit? Explain, particularly addressing pressures to limit any audit procedures to keep the budget within an expected range.

Answer:

(a) 1. The nature of the testing determines which tests will be performed to gain comfort around accounts and controls. Samantha should plan analytical and substantive work for the financial statement audit and control work for the audit of ICFR.

(a) 2. Timing affects the time frame for testing that is to be performed over the course of the audit. Samantha may choose to perform interim work throughout the year to minimize the amount of work performed at year-end. She has to plan sufficient work close to the end of the year to be able to issue an ICFR opinion as of the end of the year. Certain processes, for example, the year end closing and financial reporting process, must be tested when carried out.

(a) 3. Extent addresses how much work will be performed for each account and control. Samantha should plan more work around higher dollar accounts, higher risk accounts, more frequent controls, and higher risk controls.

(b) Samantha has a responsibility to her firm and the client to find a balance between performing sufficient audit work and maintaining an appropriate budget in terms of hours and dollars. The firm must perform enough work to gain sufficient, appropriate evidence that the financial statements are fairly presented and are not materially misstated and ICFR are effective. However, Samantha must also ensure that she appropriately considers the budget when formulating the audit plan.

6-31 **[LO 1,3]** Stephanie is a senior auditor at Hart & Brand CPA firm. This is Hart & Brand's first year on a new public client, Bellezza Casa. Bellezza Casa is a home and garden specialty retailer that consists of 120 retail locations nationwide and has no subsidiary businesses. This year, Bellezza Casa books show gross profits of $1.2 million, net income of $720 thousand, and total assets of $4.5 million. Stephanie is assigned the task of determining materiality for Bellezza Casa's financial statements.

Required

(a) In which stage of the audit should Stephanie determine overall financial statement materiality and planning materiality for the various accounts?

Answer:

Setting initial overall financial statement materiality occurs in the earliest planning stages of the audit, usually based on what the auditor knows about the client and the client's unaudited financial statements. Similarly, initial planning materiality for the various significant accounts and disclosures are set during initial planning. These amounts can be revisited during the audit and the auditor will change them if new information comes up that indicates materiality levels should be different than early expectations.

(b) If Stephanie is assigned the task of testing the accounts receivable account during the year-end audit, should she use the same level of materiality she formulated for financial statement materiality? If not, will materiality for accounts receivable be higher or lower? Explain.

Answer:
Materiality for any individual account is lower than materiality for the financial statements as a whole. This applies to accounts receivable as well as all of the other accounts. The materiality threshold on individual accounts is set so that if each account is misstated no more than its materiality threshold, and all the misstatements are aggregated, the financial statements as a whole will not be materially misstated.

6-32 **[LO 4]** You are the senior on an audit team for a large public company. This is your second year on the engagement and you have established a good working relationship with some of the client's staff. Your firm has only been the independent auditor of this company for four years, and the company has a history of fraud prior to your firm's involvement.

At lunch with some staff from the client, you overhear that Danilo, the long-time assistant controller for the company's South America operations, has had problems paying his mortgage. He may even face foreclosure if he doesn't find an opportunity for some supplemental income. Furthermore, through the fraud brainstorming meeting conducted at the beginning of the fiscal year's audit, you learned that the South America division was thought to be responsible for the fraud in the past. Danilo and his department were even investigated by the internal audit department, but all prior investigations were inconclusive due to lack of evidence.

Upon reviewing the current year's ICFR testing performed by a staff accountant working on the engagement, you see that the test results indicate that ICFR are effective. The audit plan for the financial statement audit relies on the operating effectiveness of controls for the entire fiscal year. The ICFR controls testing give no indication that the financial statement audit plan needs to be revised.

Required

(a) What are the 3 elements of the fraud triangle?
(b) Are all of the elements necessary for Danilo to commit fraud present?
(c) What should you do upon learning of this situation?
(d) How do you feel about the possibility of increasing the level of investigation if it might end up in Danilo being exposed – even though you know the nature of his

activities are not on a significant enough scale to have a material impact on the company's financial outcomes?

Answer:

(a) The three elements of the fraud triangle formulated in AU 316 are incentives/pressures, opportunities, and attitudes/rationalization.

(b) Only 2 of the 3 components of the fraud triangle are present in this situation. Danilo certainly has the incentives/pressure to commit fraud because he does not want to lose his house. Additionally, past evidence suggests that Danilo may have the attitude/rationalization component due to possible fraud committed from his department in the past. However, as your own audit firm has found that appropriate internal controls are in place, the opportunity element of the fraud triangle is not present in this situation.

(c) Even though fraud is not probable due to effective internal controls, this situation should not be ignored. You should certainly communicate your concerns to your audit team. The audit team may consider Danilo's department a high-risk area and revise the level of certainty placed on internal controls and the amount of detail testing for the accounts related to the department.

(d) This question does not address audit propriety – it asks how you feel. It explores your moral dilemma of your feelings for a person vs. a professional judgment related to the commitment to your job. However, as a member of an audit team you should feel the commitment to report this information to the team. Remember that what you can see from your vantage point is not the clear picture. The truth could range anywhere from the stories about Danilo being rumors – to Danilo being heavily involved in helping management carry out a major money laundering operation in South America. The point is the staff member in this scenario does not have enough information so needs to speak up.

6-33 **[LO 1, 3]** Philly Communications is the largest provider of telephone and cable service in Pennsylvania. During its year end audit, the manager at Dell & Wayne, Philly's independent audit firm determined that the appropriate amount for materiality at the financial statement level to be used during planning for the current year's audit is $1,000,000. Derek, a staff auditor at Dell & Wayne, is assigned the task of performing substantive tests on Philly's asset accounts. The following table summarizes Derek's findings. All the misstatements are overstatements.

Account	Tolerable Misstatement	Actual Misstatement
Cash	115,000	95,000
Accounts Receivable	310,000	245,000
Investments	145,000	120,000
Inventory	120,000	80,000
Buildings	510,000	450,000
Prepaid Expenses	100,000	20,000

Required:

(a) When viewed independently of one another, do any of the actual misstatements in the individual asset accounts indicate a material misstatement that calls for an adjusting journal entry in Philly Communications' books?

Answer:
No. The actual misstatement for each individual account is below its tolerable misstatement.

(b) Should Derek recommend adjusting journal entries to Philly's management? If so, what journal entry might Derek propose?

Answer:

Derek will likely have management investigate all of the misstatements and management may choose to book the adjusting entries to correct its books. For any actual errors (or fraud) that Derek found it is likely that management will make the corrections. For example, Derek probably found the specific misstatements in Cash, Buildings and Prepaid entries as a result of account or transaction examination, so the client will know exactly where the problems are that need to be fixed. In contrast, the misstatement in accounts receivable, investments and inventory might be composed of specific errors that Derek identified from looking at a sample and expected misstatement in the account that Derek estimated from looking at the sample and projecting it to the population. In that situation management may choose to correct only actual errors that Derek identified and not those that he estimated may exist. For example, it is more difficult to correct misstatements to the accounts receivable account if the client does not know exactly which items in the client's underlying accounts receivable subsidiary ledger contain a misstatement.

(c) How does the concept of aggregate misstatement affect your answer?

Answer:

In this case, all of the actual misstatements are well below the tolerable misstatement. In theory, all of the accounts should be able to be misstated up to, but not beyond the tolerable misstatement threshold and the financial statements should still be ok. However, from a practical perspective, if a lot of accounts have large misstatements in them, even if they are below the tolerable misstatement threshold, the auditor may be concerned that if anything was missed in the audit, the overall financial statements could be misstated. In this situation the auditor may conclude that adjustments are needed before a clean opinion can be issued. This is an example of how the materiality set during planning may not be the one ultimately used for evaluating results of the audit.

6-34 **[LO 2,3]** Fred is a partner at D&Y, an international professional services firm. Fred's primary client, Green Investments, is a publicly traded holding company with subsidiaries around the world. Most of Green Investment's subsidiaries are audited by D&Y's worldwide affiliates. However, two of their subsidiaries are audited by local firms not affiliated with D&Y. One of these subsidiaries accounts for approximately 10% of Green's annual income, and the other accounts for only 0.3% of Green's annual income. This year, all of Green Investments subsidiaries received a clean audit opinion.

Required

(a) List elements of audit planning impacted by Green Investments structure of multiple subsidiaries.
(b) Identify how the ICFR audit changes because of multiple locations. Particularly consider the impact of the overseas operations.
(c) How is the audit plan affected by the two subsidiaries audited by other CPA firms? Address each subsidiary in your answer.

Answer:
(a)The concept of audit materiality suggests that only material items, including subsidiaries and departments, be considered during a year-end audit. With respect to materiality and efficiency, Fred will probably not need to perform the same amount of work on all of Green's subsidiaries. The first two are probably deemed to be material as they represent an aggregate 10% of operations. However, the last one may be passed on completely because its 0.3% contribution to total income is most likely deemed immaterial. Therefore, not all of Green's subsidiaries are considered within the scope of the audit.

Other planning considerations are how much work needs to be done at the various locations—given consideration of what is known about the locations from prior engagements. An important planning concept is how much work D&Y is intending to have the local firms take responsibility for. In this situation it makes sense for D&Y to plan the work at the engagements audited by others, review the work and make its own conclusions regarding the findings. Thus, the other CPA firm is helping D&Y, but since it is auditing a small part of the client, D&Y takes full audit responsibility.

(b) ICFR at every unit or location that is material or can have a material impact, either on its own or when considered with other locations or units, must be addressed in the ICFR audit every year. However, based on information known about the client, the extent to which procedures must be carried out at each location can vary year to year. For example, if extensive controls tests were performed at one location the prior year and no problems found, and the client has not made any significant changes in personnel or systems, and ITGC are strong, the auditor might choose to change the nature, timing and extent of procedures at that location in the following year, and limit it to, for example, inquiry and document review.

(c) Fred does not have to demand that D&Y perform audits on all of Green Investments' affiliates. In fact, this may actually hurt customer relations. D&C can rely on work performed by other auditors. However, if D&Y finds that such audits are ineffectively performed, D&C may suggest that Green Investments' subsidiaries hire adequate auditors to realize greater efficiencies. Fred's audit team needs to review the work performed by other auditors to gain comfort. If the team concludes that work was performed effectively, they may rely on that work. The big impact on the audit plan is developing the procedures the other audit should carry out, reviewing the work and conclusions, and making sure the timing is right to enable D&Y to meet Green's reporting deadlines.

6-35 **[LO 5,7]** Assume the role of the audit manager on a publicly traded internet auction company. The company is known as an industry innovator and has recently implemented a new IT system. Upon a review of the company's operations, you also discover that the client has a heavy reliance on complex IT controls and has undergone a new "green" movement to enhance paperless operations.

Required

(a) When preparing the plan for this year's audit, what are some special considerations you should include?
(b) What are indications of high risk areas?
(c) What are some indicators that specialists may be necessary for the audit?
(d) According to AU 311, what are some planning activities a specialist may be involved in?
(e) Summarize the company's characteristics that require special attention in the audit plan.

Answer:

(a)Due to the pervasive nature of Information Technology in the client's activities, you should consider budgeting for an IT Specialist to assist with planning and testing activities.

(b) Due to the pervasive nature of IT in the company, accounts associated with and controls around IT should be considered high risk areas.

(c) Specific indicators that an IT specialist is necessary include:

a. complex IT controls
b. new systems implementation
c. use of e-commerce
d. use of emerging technologies
e. audit evidence that is available only in electronic form

(d) According to AU 311, during the planning stages an IT specialist may be involved in the following:

a. inquiry of the company's IT personnel concerning how data are initiated, authorized, recorded, processed, and reported
b. asking the company's IT personnel how IT controls are designed
c. inspecting system documentation
d. observing operations of IT controls
e. planning tests of IT controls

(e) The auditor considers the following in planning the audit:

a. the company is public traded
b. the company has a specialized industry –internet auctions
c. the company has a sophisticated IT system which is NEW
d. evidence may be difficult to obtain in hard copy form and you don't yet know anything about how long it retains records in electronic form

6-36 **[LO 8]** As a manager at RHC, LLP, part of Charlie's tasks include drafting the audit plan for his audit clients, including determining the appropriate audit procedures to be performed over the course of the audit.

Required:

(a) List the procedures Charlie can utilize to complete the audit in accordance with AS 5.
(b) List the procedures Charlie can utilize to complete the audit in accordance with AU 326 and identify which are appropriate for the audit of financial statements and which are appropriate for the ICFR audit.

Answer:

(a) The procedures specified by AS 5 include inquiry, inspection, observation, and reperformance. Such procedures should be used to test controls.
(b) According to AU 326, Charlie can use the following procedures in the course of an audit:
    1. Inspection of records or documents
    2. Inspection of tangible assets
    3. Observation
    4. Inquiry
    5. Confirmation
    6. Recalculation
    7. Reperformance
    8. Analytical Procedures

6-37 **[LO 1,3]** Classify each of the following based on whether they can be performed at an interim date (assuming appropriate procedures are performed during the roll forward period) or whether they must be performed at or after the fiscal year end. Briefly justify your answer. State why for each.

Answer:

a. **Control tests of the client's year end closing and financial reporting process**

Can only be done when the process is taking place, which is actually after the fiscal year end; in theory the auditor might be able to do some testing at quarter end closing and reporting – but additional year end work would still be required.

b. **Observations and tests of the client's count of physical inventory**

Can take place at an interim date; actually has to happen whenever the client does the physical count; rollforward tests are needed, and may be significant work if for some reason the client's count date is not relatively close to fiscal year end; usually observing the count when it is performed and performing rollforward tests is not a big obstacle for an audit

c. **Substantive tests of accounts receivable amounts**

Interim is ok, but if performed close to year end can also be part of dual purpose tests

d. **Audit of cash**

Interim is ok, but if performed close to year end can also be part of dual purpose tests

e. **Design effectiveness evaluation of ICFR**

Interim is ok, and has to be updated for any changes that occur between the interim date and fiscal year end; if performed early in the year can give the client to make changes for any problems to avoid material weaknesses still existing at year end

f. **Operating effectiveness evaluation of ICFR**

Interim is ok, and has to be updated at fiscal year end; if performed early in the year can give the client to make changes for any problems to avoid material weaknesses still existing at year end; for any income statement accounts tests throughout the year can be dual purpose tests that will also provide evidence for the financial statement substantive work; for balance sheet accounts, interim tests of operating effectiveness are less likely to provide a lot of useful information regarding the fairness of the account balances at fiscal year end

6-38 **[LO 1]** The following two paragraphs are used to present the auditor's opinions of XYZ company:

In our opinion, the financial statements referred to above present fairly, in all material aspects, the financial position of XYZ company as of October 31, 2009 and 2010, and the changes in net assets and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America….

Our audits were performed for the purpose of forming an opinion on the basic financial statements of XYZ company taken as a whole. The accompanying Schedule of Expenditures of Federal Awards and State Projects is presented for purposes of additional analysis as required by the U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and chapter 10.650, Rules of the Auditor General, and is not a required part of the basic financial statements. The Schedule of Explicit and Discrete Disclosure for Able County and the Schedule of Revenue and Expenses are presented for purposes of additional analysis and are not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects in relation to the basic financial statements taken as a whole.

a. What do you know about XYZ Company based on the audit report?
b. How are the deliverables in this audit engagement different from those of a "standard" integrated audit of a company that has to file with the SEC?
c. Based on the information you can glean from the audit report paragraphs above, what would the auditor consider in planning the scope, timing and resources for the audit engagement?

Answer:

a. Known facts: the organization receives grants from the state or local government (here, Able County); the organization is non-profit; the period under audit was F/Y: 2010; the auditors also audited F/Y 2009.
b. There is no mention of auditing under GAAS or other standards; there is no mention of auditing on a sample basis; there is no mention of management's responsibility for the financial statements.
c. We can gleam that the financial statements were audited and that a material part of the revenue for the company under audit was derived from grants paid by Able County. The resources needed are: knowledge of non-profit accounting and accepted practices; knowledge of federal and state and local requirements for grant recipients; knowledge of restricted grants- or those given for an express purpose. All of the above should be available prior to planning and testing.

Problems

6-39 **[LO 6]** The first standard of fieldwork of the generally accepted auditing standards states that audit work is to be adequately planned. Two tools that auditors use to document their planning activities include an audit planning memorandum and an audit plan or program.

Required:

(a) Describe an audit planning memorandum. What purpose does it serves on an audit engagement? List types of information that it includes.

Answer:

An audit planning memorandum adds to the audit documentation started during the client acceptance and continuance process by summarizing the various issues discussed as a part of the audit strategy. This memorandum serves as the basis for developing the current audit program. Following is a list of the key items included in the audit planning memorandum:

a. Engagement objectives, deliverables, key dates
b. Key information from the risk assessment procedures, including the preliminary assessment of materiality
c. Descriptions of the company's internal controls and IT environment
d. Follow-up on prior year control deficiencies
e. Planned use of the work of others during the audit
f. Summary results of the planning process and expected impact on the audit plan
g. Communication and coordination

(b) Describe an audit program. What purpose does it serves on an audit engagement and what kind of information does it include?

Answer:

Audit programs lay out the steps that are followed in conducting an audit so that when the audit is finished the audit risk is acceptably low and the auditor can issue an audit report expressing reasonable assurance. The audit program serves as a record of the testing performed by the audit; thus it must set forth the details comprising the nature, timing, and extent of audit procedures to be performed. An audit program is often divided into parts that address the various cycles of the audit.

6-40 **[LO 8]** Refer to Auditing in Action on Roll Forward Procedures featuring Shadow Company. Assume that Shadow has a significant amount of cash held in an interest-bearing bank account, and that the auditors performed substantive procedures to determine the fairness of the recorded amount of interest revenue through September 30th. These procedures included recalculation of monthly interest earned based on balances and interest rates documented on the bank statements, and tracing the amounts to the accounting records.

List roll forward procedures that Shadow's auditors can perform at year-end regarding the interest revenue.

Answer:

- Determine whether any changes have occurred with regard to interest computations, such as significant changes in invested funds or interest rates. This information may be obtained from a year-end bank confirmation.
- If no significant changes have occurred, project the September 30th balance of interest revenue through the end of the year by multiplying the September 30th amount by 12/9. Trace the projected amounts to the general ledger total.
- If significant changes occurred, determine the amounts reported on the October through December bank statements and trace them to the general ledger.

6-41 **[LO 8]** Several specific audit procedures are listed below. For each item, identify the type of procedure listed and which of the assertions is being addressed by the procedure.

(a) Examine a list of investment securities held by the client's trustee.
(b) For a sample of transactions posted to the client's accounts payable subsidiary ledger, examine supporting purchase orders and receiving reports agreeing amounts and information.
(c) Send a written request to the client's customer for verification of the amount owed to the client company.
(d) Examine the dealer's invoice for a new vehicle reported on the client's fixed assets subsidiary ledger.
(e) Ask the client's credit manager about the collectability of certain customer account balances.
(f) Watch the client's process of conducting the physical inventory counts.
(g) Compute interest expense on notes payable.
(h) Verify the client's bank reconciliation by testing the proper inclusion of all reconciling items.
(i) Send written request to the client's attorney for verification of legal matters.
(j) Compare key ratios for the current year with the same ratio results for the prior year.
(k) Trace the total of the client's accounts payable subsidiary ledger to the general ledger.

Answer:

Item	**Procedure**	**Assertion**
a	**Inspection**	**Valuation**
b	**Inspection**	**Existence**
c	**Confirmation**	**Existence and Valuation**
d	**Inspection**	**Valuation and Rights**
e	**Inquiry**	**Valuation**
f	**Observation**	**Existence**
g	**Recalculation**	**Valuation and Completeness**
h	**Reperformance**	**Valuation and Completeness**
i	**Confirmation**	**Valuation and Presentation**
j	**Analytical procedures**	**Existence and Completeness**
k	**Inspection**	**Completeness**

6-42 **[LO 8]** Several audit objectives are listed below. For each item, identify the related assertion and a specific audit procedure that can be applied to accomplish the objective.

(a) Establish whether recorded amounts due from customers are valid.
(b) Determine whether leases are properly recorded as capital or operating leases.
(c) Assess the adequate inclusion of related party transactions.
(d) Determine that year-end inventory quantities are actually on hand.
(e) Determine whether prices used in the client's billing program are authorized.
(f) Determine whether payroll is properly accrued at year-end.
(g) Verify whether all cash collections are included in bank deposits.
(h) Determine whether the general ledger includes any unusual adjusting entries.

Answer:

Item	**Assertion**	**Procedure**
a	**Existence and Valuation**	**Confirm balances with customers**
b	**Presentation and Disclosure**	**Inspect lease agreements and compare with client's accounting records and footnote descriptions**
c	**Presentation and Disclosure**	**Inspect supporting documentation and compare with footnote descriptions**
d	**Existence**	**Observe the client's physical inventory procedures**
e	**Existence and Valuation**	**Inspect a sample of invoices and compare pricing to the authorized price list**
f	**Valuation**	**Recalculate accrued payroll**
g	**Completeness**	**Reperform the bank reconciliation**
h	**Existence**	**Inspect the general ledger and scan for unusual amounts**

6-43 **[LO 8]** Auditors can use documentary evidence for vouching or tracing. Several audit objectives are listed below, each of which may apply inspection of documentary evidence to accomplish the objective. For each item, indicate whether the specific audit procedure that could be applied would involve (1) vouching or (2) tracing.

(a) Determine whether credits in the accounts payable subsidiary ledger represent actual purchase transactions.
(b) Determine whether debits in the accounts receivable subsidiary ledger represent actual sales of goods or services.
(c) Determine whether all transactions in the sales journal represent shipments of goods.
(d) Determine that all purchase invoices have been recorded in the proper vendor account in the accounts payable subsidiary ledger.
(e) Determine that all shipments of goods have been recorded as credits in the perpetual inventory records.
(f) Determine the propriety of the recorded amount of newly-acquired machinery.
(g) Determine whether all cash collections are recorded in the cash receipts journal.
(h) Determine whether all recorded cash disbursement transactions are supported by an authorized purchase order.

Answer:

(a) Determine whether credits in the accounts payable subsidiary ledger represent actual purchase transactions**. –VOUCHING CREDITS IN THE ACCOUNTS PAYABLE SUBSIDIARY LEDGER TO A RECEIVING REPORT AND AUTHORIZED PURCHASE ORDER**
(b) Determine whether debits in the accounts receivable subsidiary ledger represent actual sales of goods or services. **– VOUCHING DEBITS IN THE ACCOUNTS RECEIVABLE SUBSIDIARY LEDGER TO A SALES INVOICE, SHIPPING DOCUMENT, AND SALES ORDER**
(c) Determine whether all transactions in the sales journal represent shipments of goods. **– VOUCHING SALES JOURNAL ENTRIES TO SHIPPING DOCUMENTS**
(d) Determine that all purchase invoices have been recorded in the proper vendor account in the accounts payable subsidiary ledger. **– TRACING PURCHASE INVOICES FROM VENDORS TO THE ACCOUNTS PAYABLE SUBSIDIARY LEDGER**
(e) Determine that all shipments of goods have been recorded as credits in the perpetual inventory records. **– TRACING SHIPPING DOCUMENTS TO THE PERPETUAL INVENTORY RECORDS**
(f) Determine the propriety of the recorded amount of newly-acquired machinery. **– VOUCHING AMOUNTS IN THE PROPERTY SUBLEDGER TO A PURCHASE INVOICE**
(g) Determine whether all cash collections are recorded in the cash receipts journal. **– TRACING CASH RECEIPTS TRANSACTIONS TO THE CASH RECEIPTS JOURNAL**

(h) Determine whether all recorded cash disbursements are supported by an authorized purchase order. **– VOUCHING ENTRIES IN THE CASH DISBURSEMENTS JOURNAL AN AUTHORIZED PURCHASE ORDER**

<u>Activity Assignments</u>

6-44. Go to the AICPA Web site and access AU 311 on planning and supervision. The standard covers some aspects of client acceptance discussed in Chapter 5 as well as topics covered in this chapter. (Note that this SAS has been revised by the AICPA since the adoption of the interim standards by the PCAOB, and therefore applies to the audit of nonpublic companies.) Other SASs are listed in the following locations in the standard. What are the names of the other standards to which reference is made?

Why do you think these other standards are related to the Planning and Supervision auditing standard?

(a) footnote 1
(b) 311.07
(c) footnote 7
(d) footnote 8
(e) 311.21
(f) 311.25
(g) 311.26
(h) footnote 9
(i) 311.31

Answer:

(a) Footnote 1: Section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, establishes standards and provides guidance on obtaining an understanding of the entity and its environment, including its internal control, sufficient to assess the risks of material misstatement, whether due to error or fraud, at the financial statement and relevant assertion levels. Section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, establishes standards and provides guidance on the auditor's overall responses and the nature, timing, and extent of further audit procedures that are responsive to the assessed risks.

(b) .07 Section 315, *Communications Between Predecessor and Successor Auditors*, provides guidance concerning a change of auditors. Among other matters, it describes communications that a successor auditor should evaluate before accepting an engagement.

(c) Footnote 7: Paragraph .07 of section 312, *Audit Risk and Materiality in Conducting an Audit*, states that a misstatement can result from errors or fraud.

(d) Footnote 8: See paragraphs .04 through .06 of section 318 for further guidance on the auditor's overall responses in performing an audit.

(e) .21 The audit plan should include:

> • A description of the nature, timing, and extent of planned risk assessment procedures sufficient to assess the risks of material misstatement, as determined under section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.
>
> • A description of the nature, timing, and extent of planned further audit procedures at the relevant assertion level for each material class of transactions, account balance, and disclosure, as determined under section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*. The plan for further audit procedures reflects the auditor's decision whether to test the operating effectiveness of controls, and the nature, timing, and extent of planned substantive procedures.

(f) **Communication With Those Charged With Governance**

.25 Section 380, *The Auditor's Communication With Those Charged With Governance*, requires the auditor to communicate with those charged with governance an overview of the planned scope and timing of the audit. [As amended, effective for audits of financial statements for periods beginning on or after December 15, 2006, by Statement on Auditing Standards No. 114.]

(g) **Additional Considerations in Initial Audit Engagements**

.26 The auditor should perform the following activities before starting an initial audit:
a. Perform procedures regarding the acceptance of the client relationship and the specific audit engagement (see QC section 10).
b. Communicate with the previous auditor, where there has been a change of auditors (see section 315) [Paragraph amended due to the issuance of SQCS No. 7, December 2008.]

(h) Footnote 9: For further guidance on the discussion among the audit team, see paragraphs .14 through .18 of section 316, *Consideration of Fraud in a Financial Statement Audit*, and paragraphs .14 through .20 of section 314.

(i) .31 The work performed by each assistant, including the audit documentation, should be reviewed to determine whether it was adequately performed and documented and to evaluate the results, relative to the conclusions to be presented in the auditor's report. The person with final responsibility for the audit may delegate parts of the review responsibility to other assistants, in accordance with the firm's quality control system. See section 339, *Audit Documentation*, for guidance on documenting the review of audit documentation.

6-45. Go to the PCAOB Web site and access AS 5. Read paragraphs 9 through 20 on planning. What guidance do you find in these paragraphs related to planning the audit for smaller or less complex companies?

Answer:

The guidance in paragraphs 9-20 are as follows:

9. The auditor should properly plan the audit of internal control over financial reporting and properly supervise any assistants. When planning an integrated audit, the auditor should evaluate whether the following matters are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures -

- Knowledge of the company's internal control over financial reporting obtained during other engagements performed by the auditor;
- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;
- Matters relating to the company's business, including its organization, operating characteristics, and capital structure;
- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting;
- The auditor's preliminary judgments about materiality, risk, and other factors relating to the determination of material weaknesses;
- Control deficiencies previously communicated to the audit committee [8/] or management;
- Legal or regulatory matters of which the company is aware;
- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting;
- Preliminary judgments about the effectiveness of internal control over financial reporting;
- Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting;
- Knowledge about risks related to the company evaluated as part of the auditor's client acceptance and retention evaluation; and
- The relative complexity of the company's operations.

Note: Many smaller companies have less complex operations. Additionally, some larger, complex companies may have less complex units or processes. Factors that might indicate less complex operations include: fewer business lines; less complex business processes and financial reporting systems; more centralized accounting functions; extensive involvement by senior management in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control.

Role of Risk Assessment

10. Risk assessment underlies the entire audit process described by this standard, including the determination of **significant accounts and disclosures** and **relevant assertion**s, the selection of controls to test, and the determination of the evidence necessary for a given control.

11. A direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company's internal control over financial reporting and the amount of audit attention that should be devoted to that area. In addition, the risk that a company's internal control over financial reporting will fail to prevent or detect misstatement caused by fraud usually is higher than the risk of failure to prevent or detect error. The auditor should focus more of his or her attention on the areas of highest risk. On the other hand, it is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements.

12. The complexity of the organization, business unit, or process, will play an important role in the auditor's risk assessment and the determination of the necessary procedures.

Scaling the Audit

13. The size and complexity of the company, its business processes, and business units, may affect the way in which the company achieves many of its **control objective**s. The size and complexity of the company also might affect the risks of misstatement and the controls necessary to address those risks. Scaling is most effective as a natural extension of the risk-based approach and applicable to the audits of all companies. Accordingly, a smaller, less complex company, or even a larger, less complex company might achieve its control objectives differently than a more complex company.

Addressing the Risk of Fraud

14. When planning and performing the audit of internal control over financial reporting, the auditor should take into account the results of his or her fraud risk assessment. [10/] As part of identifying and testing entity-level controls, as discussed beginning at paragraph 22, and selecting other controls to test, as discussed beginning at paragraph 39, the auditor should evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud and controls intended to

address the risk of management override of other controls. Controls that might address these risks include -

- Controls over significant, unusual transactions, particularly those that result in late or unusual journal entries;
- Controls over journal entries and adjustments made in the period-end financial reporting process;
- Controls over related party transactions;
- Controls related to significant management estimates; and
- Controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.

15. If the auditor identifies deficiencies in controls designed to prevent or detect fraud during the audit of internal control over financial reporting, the auditor should take into account those deficiencies when developing his or her response to risks of material misstatement during the financial statement audit, as provided in AU sec. 316.44 and .45.

Using the Work of Others

16. The auditor should evaluate the extent to which he or she will use the work of others to reduce the work the auditor might otherwise perform himself or herself. AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* applies in an integrated audit of the financial statements and internal control over financial reporting.

17. For purposes of the audit of internal control, however, the auditor may use the work performed by, or receive direct assistance from, internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee that provides evidence about the effectiveness of internal control over financial reporting. In an integrated audit of internal control over financial reporting and the financial statements, the auditor also may use this work to obtain evidence supporting the auditor's assessment of control risk for purposes of the audit of the financial statements.

18. The auditor should assess the competence and objectivity of the persons whose work the auditor plans to use to determine the extent to which the auditor may use their work. The higher the degree of competence and objectivity, the greater use the auditor may make of the work. The auditor should apply paragraphs .09 through .11 of AU sec. 322 to assess the competence and objectivity of internal auditors. The auditor should apply the principles underlying those paragraphs to assess the competence and objectivity of persons other than internal auditors whose work the auditor plans to use.

Note: For purposes of using the work of others, competence means the attainment and maintenance of a level of understanding and knowledge that enables that person to perform ably the tasks assigned to them, and objectivity means the ability to perform those tasks impartially and with intellectual honesty. To assess competence, the auditor should evaluate factors about the person's qualifications and ability to perform the work the auditor plans to use. To assess objectivity, the auditor should evaluate whether factors are present that either inhibit or promote a person's ability to perform with the necessary degree of objectivity the work the auditor plans to use.

Note: The auditor should not use the work of persons who have a low degree of objectivity, regardless of their level of competence. Likewise, the auditor should not use the work of persons who have a low level of competence regardless of their degree of objectivity. Personnel whose core function is to serve as a testing or compliance authority at the company, such as internal auditors, normally are expected to have greater competence and objectivity in performing the type of work that will be useful to the auditor.

19. The extent to which the auditor may use the work of others in an audit of internal control also depends on the risk associated with the control being tested. As the risk associated with a control increases, the need for the auditor to perform his or her own work on the control increases.

Materiality

20. In planning the audit of internal control over financial reporting, the auditor should use the same materiality considerations he or she would use in planning the audit of the company's annual financial statements.

6-46. Refer to Problem 6-38. Look up US OMB Circular A-133.What is it? What does this tell you about XYZ Company?

Answer:

US OMB Circular A-133 is a United States federal government guide created by the Office of Management and Budget (OMB) and used in auditing federal assistance and federal grant programs and their recipients. It is considered to be the most important tool of an auditor for a Single Audit under the Single Audit Act**.** This tells you that XYZ Company is most likely a recipient of federal assistance or a federal grant program.

Chapter 6 Appendix A

Multiple Choice
6-47. d
6-48. c
6-49. b
6-50. a

Discussion Question

6-51 Access and read AICPA AU 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements."

Do you believe that the auditor will be able to determine whether and how to utilize the work of the internal audit function in the financial statement audit as a result of considering the work of others for the ICFR audit? What does this mean in terms of efficiency for the ICFR and financial statement components of an integrated audit?

Answer: Student answers will vary. The point is that the relevance, competence, and work performed by the internal audit staff needs to be assessed and where practical, can be used in by the auditors (CPAs) in their planning and testing. Internal Audit also performs work under the direction and supervision of the external auditors.