Chapter 8

Multiple Choice

8-1. d
8-2. b
8-3. d
8-4. c
8-5. a
8-6. c
8-7. b
8-8. d
8-9. a
8-10. b
8-11. c
8-12. a
8-13. b
8-14. a
8-15. b
8-16. c
8-17. b
8-18. d
8-19. b
8-20. d

Discussion Questions

8-21 **[LO 6]** Assume that an auditor conducts an integrated audit in year one and issues a clean opinion on management's assessment of internal control, internal control effectiveness and fairness of the financial statements. There is no change in the accounting information system. During the first quarter of year two the auditor identifies a control deficiency that has not yet caused a material misstatement in the financial records or statements, but could cause a material misstatement.

What does this mean regarding the appropriateness of the auditor's reports on ICFR in the prior year?

Answer: It has no effect; since the accounting information system is unchanged, you can infer that the control deficiency does not relate to it and therefore has no bearing on the prior year's report.

8-22 **[LO 7]** If a company owns many business locations (for example, many store locations), and in the aggregate they could cause material misstatements to the financial statements, the auditor would need to obtain sufficient audit evidence for all the locations to conclude on ICFR effectiveness. Assume the stores do not share a standard accounting system, backroom operations and entity level controls are not uniform across locations.

Is it possible that this situation could make the audit procedures that would need to be performed cost prohibitive – so that the company could not get an audit? Discuss. How might the company need to modify its procedures?

Answer: AS #5 allows auditors to “dual test” both balances and internal controls. This is a significant method of reducing costs. As part of audit planning, the auditor would document the different accounting systems with the purpose being the integration of both substantive and internal control testing. Also, the auditor would assign weighting to the importance of one store versus another based on materiality, potentially limiting the testing needed at specific locations.

The client could assist the audit by standardizing procedures at a minimum and implementing entity level controls.

8-23 **[LO 1]** Jessica Chatman is a staff auditor assigned the task of performing tests of internal controls for the JC Automotive Parts engagement. Before she begins testing, Jessica must first determine the timing of her tests. Because JC Automotive is a very small engagement, all controls are manual. In planning the tests, she identifies that one control is a significantly recurring control over the revenue account that occurs once a week (52 times a year). For another control, she identifies that the control is over adjusting entries and occurs quarterly (4 times a year).

In planning the timing of the tests of the internal controls over financial reporting, which should Jessica plan to test more frequently? Would your answer change if the controls over the revenue account were automatic controls which did not change over the reporting period? Explain.

Answer: Jessica should answer the questions: What is the materiality of the potential misstatement? What are the controls over the adjusting entries? Normally, manual control should be tested more frequently than automated controls and controls that operate frequently should be tested more than those that operate less frequently. However, Jessica should test the internal control over adjusting entries more frequently because poor internal control over these entries could lead to a material misstatement. The control(s) over the adjustments occur less frequently and thus, may not be subject to the same review rigor as a control that operates once a week.

8-24 **[LO 1]** Assume that you are assigned the task of testing internal controls over financial reporting for the Van Jacobs Corporation year 2011 audit. Van Jacobs Corporation has a December 31 fiscal year end. Due to poor controls that existed previously, Van Jacobs implemented a new internal control system that became operational on February 14th 2011 and did not change throughout the rest of the year.

How much testing would you need to perform on the previous system to issue the 2011 opinion on ICFR? Justify your answer.

Answer: None; testing of the previous system is not necessary if they have been changed or were replaced later during the year under audit. For example, the auditor may not need to test the original controls if management decides to change the controls or remediate an ICFR deficiency before the auditor has performed any tests of the operation of that control. The auditor may decide to limit testing to the new controls that have been put in place.

8-25 **[LO 2]** While performing tests of controls for the cash-in-vault account ($50,000 total as of the Balance Sheet date) of P-Town Hotel, you realize that – contrary to the company's written controls description and your earlier walk through evidence – the Front-Desk manager has access via a vault key, can input transactions to the only set of records for cash-in-vault and even performs all the reconciliations between the cash in the vault and the records. Based on this newly discovered information, you decide to investigate further and discover that the Front-Desk manager has stolen cash and there is no money left in the vault. Because the P-Town Hotel has significant cash reserves, your materiality threshold for cash is $200,000.

Even though the fraud you've found is below your materiality threshold, do you need to take further steps? If so, what steps will you take? Does the fraud impact your audit opinion on ICFR effectiveness?

Answer: Yes. Fraud consideration is ongoing, and results of tests of operating effectiveness may affect subsequent audit procedures. Based on the facts, it is unclear whether or not the theft has been verified through confession, tip, or other means; thus, the cash may be misplaced, not missing. In any event, there is a serious lack of separation of duties here and the auditor's supervisor must be informed. Together, the auditors should discuss how to validate the loss of cash as theft and expand the testing of internal controls over cash receipts and related account transactions and balances (e.g. cash, sales, A/R) in order to assess the potential existence of fraud (AU 316.52). Even if there is no theft, a material misstatement could occur because of the lax controls over cash receipts and the auditor must complete follow-up work with proper authorization. If the theft is verified, then management and the audit committee of the board of directors must be notified. Results from the additional testing may indicate that the internal control system is not reliable and that the risk of fraud exceeds the tolerable limit set by the audit firm.

8-26 **[LO 3,6]** C. Ronaldo is an auditor working on the ICFR audit for the Manchester Corporation. Interest expense is an account that could produce a material misstatement on the financial statements, so it is tested in the ICFR audit. After performing a walkthrough the senior determines that the controls over interest expense are designed effectively. The audit plan for the ICFR audit includes testing an automated control for calculating interest expense transactions. In the audit planning stages, the senior sets the tolerable rate of error for this particular automated control at 2%. The audit plan directs C. Ronaldo to conducts his tests using a sample based on a nonstatistical approach. C. Ronaldo selects the sample and conducts the reperformance procedure the audit plan calls for to test the operating effectiveness of the control. He finds instances in 3% of his sample where the control did not operate as intended.

Does C. Ronaldo's testing indicate a deficiency in the control tested? If so, what is the next step? If C. Ronaldo's results are valid, do you think the deficiency is severe enough to be a significant deficiency or a material weakness? What impact does that have on the ICFR audit opinion? What impact do the findings have on the financial statement audit plan?

Answer: Not necessarily. The result could be cause by sampling risk (AU 350.10) that the sample does not represent the population from which it was drawn. If the auditor concludes the control is not operating effectively, then additional testing is warranted since the account the control monitors is material. This testing can take the form of either additional control testing to determine if the error rate continues above 2%. OR additional detailed tests of balances during the substantive portion of the audit. IF the control is not operating as designed, then this is a material weakness and warrants discussion with the audit committee, inclusion in the ICFR, and additional substantive work.

8-27 **[LO 5]** Gordon is a new staff auditor on the Fine Dining of London Co. engagement and is responsible for conducting some of the ICFR controls tests on the engagement. In the course of his audit work, Gordon finds instances where a control he is testing has numerous deviations from the prescribed procedures. Gordon discusses it with the senior and manager on the engagement. Based on evaluating the severity of the ICFR deficiency, they all conclude that there is only a very limited risk of the control deficiency causing a material misstatement in the financial statements. Therefore, it is not considered a material weakness.

What is Gordon required to document in the work papers since the deficiency does not result in a material weakness? Will Gordon's test result cause the audit team to change its plans concerning the financial statement audit? If so, how?

Answer: Yes, Gordon is required to document the work performed in the work papers. This would include referencing a work program and the memo describing his findings. While this incident is not material, it could impact later testing if additional non-material errors occur and cause the auditors to conclude the internal control environment as a whole is deficient. If this happens, then additional substantive testing is required.

8-28 **[LO 8]** Jaime, the senior auditor on the audit of the Boston Brewery Co., a public company, is responsible for initial planning of the integrated audit. She is responsible for the supervision and review of two staff accountants performing both controls tests and tests of details of balances. After the tests of controls are completed she reviews the work of the staff accountants and concludes that no significant deficiencies or material weaknesses exist in ICFR. Based on this she decides she can rely on the company's ICFR for the entire reporting period. This was not what she expected when she designed the initial audit plan.

How can Jaime's conclusion on internal controls affect the nature, timing, and extent of detail testing on the financial statement audit? Would your answer be different if the controls had changed halfway through the year and the audit team had determined that internal controls operated effectively only during the second half of the year?

Answer: Jamie's conclusion is based on the results of testing, not pre-existing biases, as proscribed by Audit Standards. Based on the findings, Jamie can lower her estimation of control risk and reduce the amount of internal control and substantive testing performed. Additionally, since the internal control environment is operating as designed, Jamie can perform some of the work at interim (e.g. not at year-end), and test balances at year-end doing "roll forward" tests.

Problems

8-29 **[LO 1]** Sea Duds is retail clothing store specializing in resort clothing. The company purchases finished goods – apparel and accessories, and its other payments are typical operating costs such as rent, utilities, and payroll. When bills are received and input to be paid the software of the computer system requires certain information, such as the number from the chart of accounts and the company or person being paid. All of this information must match vendor names, employee information and accounts that have been previously approved by management and input to a master file. If the information input for a check to be created does not match the pre-approved information, the transaction is rejected and an exception report is printed. The clerk who entered the information investigates and resolves any exceptions identified. After the information is input, exceptions resolved and checks are printed the owner of the store reviews the supporting detail for each check and personally signs the check. The owner initials the supporting document package at the time of review. Any exception reports that were generated as a result of the input process also go to the owner with the checks, and are reviewed to be sure the proper corrections were made. Once every two weeks the owner reviews a cash disbursement report for the period, and at least once each month a general ledger report, the bank statement and a bank reconciliation prepared by a different clerk than the one who inputs the bills for processing.

Required:

(a) Identify the controls present in this cash disbursements process and the errors they are designed to prevent or detect.

(b) What documentary evidence is available to the auditor?
(c) What audit procedures can the auditor use to test the operations of these controls?

Answer: (a) One control is that a validation of vendor, employee, etc. is performed against a database. This is weakened, however, by the fact that the clerk who enters invoices into the system resolves errors, meaning that he/she presumably can add an employee and/or vendor to the appropriate master file. Other controls: the owner reviews each check and its supporting detail, including any exceptions, prior to signing the check. The owner also initials the supporting documentation- a form of identifying it as "used" and therefore rendering it unavailable to support a duplicate payment. The owner reviews the cash disbursement report and there is reconciliation by someone other than the clerk who processed the payment initially.

(b) Documentary evidence includes the check and its supporting detail, the bank statement, the bank reconciliation, as well as the information contained in the databases.

(c) The auditor should inspect the voucher package and reperform the authorization/posting process by tracing a sample of paid checks to the supporting documentation, such as the databases and bank statement, for verification of existence, authorization, completeness. The auditor should also inspect the bank statement and bank reconciliation, examining supporting detail for adjusting items. Since the clerk can presumably add someone to the database, the auditor would want to inspect the databases for entries made by the clerk in clearing the exceptions, especially for any entries that match employee names, unusual entries, or for a frequent practice of "correcting" exception reports by changing the database.

8-30 **[LO 8]** Assume that management of a company with a December 31 fiscal year end began its assessment of ICFR early in the fiscal year. Based on its procedures, management concluded deficiencies existed in ICFR and made major changes to the accounting information system that were completed by June 30. The auditor tested ICFR after the changes were made and concluded that ICFR was effective as of the fiscal year end.

Required:

(a) How does this situation affect the auditor's procedures for the financial statement audit?
(b) For the financial statement audit, can the auditor rely on internal controls for the second half of the fiscal year? The first half of the fiscal year? Why?
(c) How is the audit evidence for the financial statements for each half of the year affected?

Answer:
a). A change in controls during the year has additional implications for the financial statement audit. Even if ICFR is functioning effectively after the implementation of the

new controls, the auditor must consider the impact of the earlier controls on producing fair financial statements for the entire period. If the controls in place early in the year were not effective and the auditor did not test them, more substantive evidence about the affected account balances is needed.

b). During the financial statement audit, more evidence is collected for the part of the year when the auditor cannot rely on the controls. The auditor can rely on the controls for the second half of the year since they have been found to be effective.

c). The auditors cannot rely on the internal controls in planning the nature, extent, and timing of its financial audit for the first half of the year, but can for the second half.

8-31 **[LO 1]**You are a new auditor for B&O LLP, a large public accounting firm with many publicly traded audit clients. You have just been assigned to perform controls testing for the integrated audit on one of B&O's largest clients. One of the steps specified in your audit program is to test the review process over cash disbursements performed by the company's supervisor.

Required:
(a) Is inquiry the best way to test the control? If yes, why? If no, why not?
(b) Will inquiry provide sufficient audit evidence? Explain.
(c) Is inspection the best way to test the control? If yes, why? If no, why not?
(d) Is reperformance the best way to test the control? If yes, why? If no, why not?
(e) List the audit procedures you would perform to sufficiently test the control.

Answer:
(a) Inquiry is a good way to partially test the control. Asking the supervisor what he/she does during the review process will provide important audit evidence.
(b) While inquiry provides important audit evidence, alone it is not an efficient test of the control.
(c) Inspection is another good test to perform on the control. The auditor will be able to see if proper sign-offs are present. However, just because sign offs may not be present does not indicate that the control is ineffective. Inspection alone is not sufficient.
(d) Reperformance is a valuable audit tool. Of the three tests, Reperformance would probably be the most effective single test. Reperformance can show the auditor whether or not the control is working properly.
(e) Probably the best way to test the control would be to perform a combination of the afore mentioned tests to gain a high level of comfort around the effectiveness of the control.

8-32 **[LO 2]** Jose is a senior auditor in charge of testing controls over financial reporting. Step four of the audit procedures require that Jose "maintain professional skepticism in assessing controls for fraud risk." In the course of his testing, Jose finds a transaction that occurred on January 5^{th} at 11:30 PM that decreased the bad debts reserve account enough to increase earnings per share to $.20, which met analysts' predictions. Jose has a bad feeling about this transaction. For documentation purposes, he must articulate the red flags for fraud risk for this transaction.

Required:

(a) What are the red flags for fraud risk demonstrated by this transaction?
(b) For each red flag state (a) why it is important, in other words, what it suggests to the auditor and (b) the follow up procedure that Jose might use.

Answer:

(a) The fraud risk red flags demonstrated through this transaction are:

(1) Last minute adjustment that significantly affects financial results
(2) Adjustment in a subsequent period
(3) Journal entries that are entered at a time after regular working hours

(b)

(1) The last minute adjustments might indicate that management is dissatisfied with the financial statements that resulted from the standard adjusting and closing process and is trying to manipulate the results to one that is more expected or desired. Jose asks for a list of all the last minute adjustments, the support for each, including calculation and justification, and the approvals for the adjustments. Then he evaluates the propriety of each adjustment.
(2) It is not uncommon that adjusting entries are posted in the period after the financial period. That may be the time period when the analysis is performed. However, an unusual, large transaction requires further investigation – particularly if this was a second adjustment to bad debt allowance, after the initial one was posted.
(3) Again, this may or may not be a problem. If management is working late to get the financial statements into good form to meet a filing deadline, this may not indicate a problem. However, the auditor follows up to determine: who posted the entry, why it was done at that time, was the posting proper, was documentation supporting the journal entry proper?

8-33 **[LO 3]** Kim is a senior auditor at Wing CPA firm. She is in charge of formulating the audit plan for several key controls and accounts. Her manager has determined that if the account is misstated by $20,000 the misstatement is material. The account includes some unusual and significant transactions that have occurred over the year. When planning control tests for the account, Kim wants to utilize sampling for her testing.

Required:

(a) How can Kim stratify the transactions in the account to best utilize sampling?
(b) What is sampling risk? How might affect the audit conclusions Kim makes based upon the control tests?
(c) If Kim misses anything as a result of sampling, what audit procedures might uncover the error during the ICFR audit? During the financial statement audit?

(a) **Answer:** Probably the best way to disaggregate the balance is to test 100% of the transactions over the materiality threshold, test 100% of the unusual/significant transactions, and use sampling techniques to test the remainder of the population
(b) Sampling risk is the risk that controls are functioning effectively when they in fact are not. Sampling risk adds to the audit risk of each control/account that is tested using a sample.
(c) During the ICFR audit, procedures on other accounts or transaction cycles sometimes reveal problems that were missed by direct audit steps. Alternatively, problems might be noted during walkthroughs and inquiry with management. During the financial statement audit, any problems with account balances and disclosures that Kim had determined should have effective ICFR provide a red flag to go back and see if an ICFR problem was missed.

8-34 **[LO 5]** Gloria is a new hire at a local accounting firm. She is given the task of performing a control test on the ICFR portion of the integrated audit for one of her firm's larger clients. Gloria conducts her test and finds no control deviations. She concludes that the control she tested is effective. Gloria marked the step complete in the audit program. When the senior on the engagement started the review there were no work papers that documented Gloria's work.

Required:

(a) List the information Gloria should have included in her work paper documentation?
(b) Would any aspect of the procedure Gloria performed affect the permanent work paper file?

Answer:

(a) Gloria should include the nature, timing, and extent of the testing performed. She should include the purpose and procedures of her testing along with the specific items she looked at (or sufficient identification information for a reviewer to find the specific items) and conclusions based on the procedure performed. She should document that she performed the work and when.
(b) Gloria's work papers for current year testing would be considered.
Current work papers: The only aspect that might relate to the permanent file is if she used permanent file documents on the client's AIS to understand the source from which to select her sample.

8-35 **[LO 1, 6]** Koburn and Carrie CPAs has determined that cash and accounts receivable are significant accounts to the audit of XYZ Company. XYZ outsources its cash disbursements process to a bank. The bank deposits all cash receipts in XYZ's account and provides XYZ with detailed information about the source of the deposits. XYZ is able to download the detailed information directly into its IT system. Based on discussions with company personnel and review of company documentation, Koburn and Carrie learns that the company has the following procedures in place to account for cash received:

a. XYZ receives a download of detail on cash receipts from the bank.
b. The IT system uses the downloaded information to apply cash received to individual customer accounts.
c. Any cash received that does not match or is not applied to a customer's account is listed on an exception report called the "Unapplied Cash Exception Report."

The application of cash to a customer's account is a programmed application control. The review and follow-up of unapplied cash from the exception report is a manual control. To determine whether misstatements in cash and accounts receivable are prevented or detected on a timely basis, the auditor decides to test the controls in the daily reconciliation of receipts to customer accounts. The auditor also plans to test control over reviewing and resolving unapplied cash in the Unapplied Cash Exception Report.

To test the programmed application control for applying cash to a customer's account Koburn and Carrie apply the following steps:

(a) Conducts interviews with company personnel about the software used to receive the download from the bank and process the transactions. Verifies with company personnel that the bank supplies the download software. The company uses accounting software acquired from a third-party supplier. The software consists of a number of modules. XYZ modifies the software only for upgrades provided by the supplier.

(b) Determines through further discussion with company personnel that the IT cash module operates the download of cash receipts information and posting of cash to the general ledger. The accounts receivable module posts the cash to individual customer accounts and produces the Unapplied Cash Exception Report, a standard report supplied with the package. The auditor agrees this information to the supplier's documentation.

(c) Identifies through discussions with company personnel and review of the supplier's documentation the names, file sizes, and locations of the program files that operate the cash receipts and accounts receivable function. The auditor then identifies the compilation dates of these programs and agrees them to the original installation date of the application.

(d) Identifies the objectives of the programs to be tested. The auditor wants to determine whether only appropriate cash items are posted to customers' accounts and matched to customer number, invoice number, amount, and so on, and that there is a listing of inappropriate cash items (that is, any of the above items not matching) on the exception report.

In addition, Koburn and Carrie evaluates and tests IT general computer controls, including program changes (for example, confirmation that no unauthorized changes are undertaken) and logical access (for example, data file access to the file downloaded from the banks and user access to the cash and accounts receivable modules) and concludes that they are operating effectively. The initial audit step to determine whether such programmed controls were operating effectively was a walkthrough in the month of July. The computer controls operate in a systematic manner, therefore, Koburn and Carrie concluded that it was sufficient to perform a walkthrough for only the one item. During the walkthrough, they auditor performed and documented the following items:

- Selected one customer and agreed the amount billed to the customer to the cash received by the service provider bank.
- Agreed the total of the bank report to the posting of cash receipts in the general ledger.
- Agreed the total of the cash receipt download from the bank to the supporting documentation.
- Selected one customer's remittance advice and agreed it to the amount posted to the customer's account in the accounts receivable subsidiary ledger.

(Adapted from AS 2, Example B1)

Required:

A. Do the procedures performed by Koburn and Carrie provide sufficient evidence to conclude that the programmed control functions effectively? Explain.
B. What does each step (a-d) accomplish? For the programmed controls, what would be a material weakness?

Answer:

A. The auditor must have assurance that ITGC function effectively in order to rely on benchmarking or a "one-item" test approach to testing an application control. However, a walkthrough of the ITGC is not sufficient testing to determine that the ITGC are operating effectively. While observation is a valid audit technique, it is by no means sufficient in assessing the ITCG. More appropriate testing would include inspection and reperforming of key controls.

B. Step "a" provides evidence of agreement of customer with bank records during the matching process.
Step "b" provides a completeness test; it determines if the cash received per the books agrees with the bank processor.
Step "c" provides a test that the cash receipts agree to the documentation.

Step “d” provides evidence that the posting to A/R was correct.

(c) A material weakness is that the software is supplied by a third party, not the processor AND it appears that the software can be changed (e.g. the date of the last compilation). This implies that unauthorized changes to the programs could be made and these changes go undetected.

8-36 **[LO 1,7]** Review the facts for the Koburn and Carrie CPAs audit of XYZ Company presented in Problem 8-35. To test the detective control of review and follow up on the Daily Unapplied Cash Exception Report, Koburn and Carrie CPAs:

a. Makes inquiries of company personnel. To understand the procedures in place to ensure that all unapplied items are resolved, the time frame in which such resolution takes place, and whether unapplied items are handled properly within the system, the auditor discusses these matters with the employee responsible for reviewing and resolving the Daily Unapplied Cash Exception Reports. The auditor learns that, when items appear on the Daily-Unapplied Cash Exception Report, the employee must manually enter the correction into the system. The employee typically performs the resolution procedures the next business day. Items that typically appear on the Daily Unapplied Cash Exception Report relate to payments made by a customer without reference to an invoice number/purchase order number or to underpayments of an invoice due to quantity or pricing discrepancies.

b. Observes personnel performing the control. The auditor then observes the employee reviewing and resolving a Daily Unapplied Cash Exception Report. The day selected contains four exceptions – three related to payments made by a customer without an invoice number, and one related to an underpayment due to a pricing discrepancy. The auditor observes the employee resolving the exceptions as follows:

For the pricing discrepancy, the employee determines, through discussions with a sales person, that the customer had been billed an incorrect price; a price break that the sales person had granted to the customer was not reflected on the customer’s invoice. The employee resolves the pricing discrepancy, determines which invoices were being paid, and enters a correction into the system to properly apply cash to the customer’s account and reduce accounts receivable and sales accounts for the amount of the price break.

c. Reperforms the control. Finally, the auditor selects 25 Daily Unapplied Cash Exception Reports from the period January to September. For the reports selected, the auditor reperforms the follow-up procedures that the employee performed. The auditor inspects the documents and sources of information used in the follow-up and determines that the transaction was properly corrected in the system. The auditor scans other Daily Unapplied Cash Exception Reports to determine that the control was performed throughout the period of intended reliance.

Because the tests of controls were performed at an interim date, the auditor has to determine whether there were any significant changes in the controls from interim to year-end. Therefore, the auditor asks company personnel about the procedures in place at year-end. The procedures had not changed from the interim period, therefore, the auditor observes that the controls are still in place by scanning Daily Unapplied Cash Exception Reports to determine the control was performed on a timely basis during the period from September to year end.

Based on the auditor's procedures, the auditor concludes that the employee was clearing exceptions in a timely manner and that the control was operating effectively as of year-end. (Adapted from AS 2, Example B1)

Required:
List the detection controls related to the Daily Unapplied Cash Exception Reports.

Answer:

The employee who clears the exception has discretion/authorization to "correct" pricing errors by generating corrections to the account without proper authorization. The detective controls are: reperforming the control and walking through the exceptions with the appropriate employee.

8-37 **[LO 4]** Your audit firm uses the Audit Risk Model to plan detection risk and audit procedures for tests of details. The audit you are working on is a high profile client. Therefore, for risk assessment and planning your firm uses an audit risk of 3% for this engagement. In assessing the receivable accounts, you decide that an inherent risk of 50% is appropriate. Your history with the company indicates that its ICFR is good, and there have been no problems with ICFR for accounts receivable in the past. You set control risk at 20%. You plan to perform analytical procedures, but there have been changes both in the overall economy and the company's credit policies and price structure, so you don't think you can rely on trends to provide you with much assurance. You use an AP risk of 80%.

Required:

(a) Using the Audit Risk Model, what is your planned detection risk for tests of details for Accounts Receivable?
(b) What do the various risk estimates mean?
(c) What does this planned detection risk for Accounts Receivable test of details mean for your audit tests?

Answer: Addressing audit risk while planning the ICFR and financial statement audits helps the auditor decide on the nature and timing of audit procedures, and extent of testing. The algebraic relationship is:

$$AR = RMM \times DR$$

and

$$AR = (IR \times CR) \times (TD \times AP)$$

DR stands for detection risk. Detection risk is the risk that the auditor will not detect a material misstatement related to an assertion. The higher the RMM, the less detection risk an auditor can accept. As shown in the equations, DR is a function of TD and AP (AICPA AU 312.26, PCAOB AU 312.27).

By filling in the numbers of the audit risk model:

3%=(50% * 20%) * (TD * 80%)
=3%=.10*(TD*.80)=.03=.10*.8TD=.03=.08TD=TD=.375 or 37.5%.

Inherent risk is the risk that exists aside from control or detection risk; the risk that applies to the company/industry regardless of internal controls, etc.

AP risk is the risk that a material misstatement is missed by the analytical procedures.

CR (control risk) is the risk that the client's internal control will not prevent or detect a material misstatement from occurring.

TD(detection risk) risk is the risk that the auditor's testing will not detect a material misstatement.

AR (audit risk) is the risk that the auditors will issue a "clean" opinion when a material misstatement exists in the financial statements.

8-38 **[LO 7]** Sonia started working for Martin & Thomas, CPAs in June, after her graduation from State University. She attends staff training school and was then assigned to the Young Industries audit. Her first assignment was to recalculate the inventory compilation, using audit test counts and audit unit prices for several hundred inventory items. The time budgeted for this task was 6 hours. She began the work at 12noon and was not finished when the audit team left at 6pm. Since this was her first job and she didn't want to admit her shortcomings, Sonia took all necessary workpapers and documentation home. She started again recalculating at 8pm and also put her husband to work on the recalculation. They finished by 12 midnight. The next morning, she returned to work, put the completed documentation in the file and recorded six hours as actual time spent. Her supervisor was pleased with her diligence to get the job done.

Required:
List at least three questions of ethics raised in this situation, one of which deals with future planning for next year's or similar audits.

Answer:
- Did Sonia violate audit policy by taking the workpapers and documentation home?
- Does Sonia's action just add to next year's audit woes (under budgeting) by indicating that the job can be done in six hours?
- Did Sonia violate client confidentiality by having her husband work on the project?
- Did Sonia put the audit at risk by having an unqualified person (her husband) do some of the work?

- What did Sonia’s supervisor know about the situation? Did he/she turn a blind eye in order to get the audit work done and what impact will this have on future audits?

8-39 **[LO 4]** Use the audit risk model as a framework to explain the following independent situations and to decide if the auditor’s conclusion is appropriate.

(a) Jan Morris, CPA, is finishing an audit of Night Time Manufacturing and completed an extensive evaluation of internal controls. She thinks that control risk must be zero, since she has performed so many dual-purpose tests. Is she justified in her belief?

(b) Upton Jordan, CPA, has participated in the audit of Bassetts, Inc. for six years – three years as a staff accountant and two years as a senior accountant. If this year’s audit is the same as the rest, no accounting adjustments will be recommended. Is he justified in his belief that inherent risk is zero?

Answer:

(a) No. Unfortunately, Even if you test the entire population of transactions and controls, control risk is never 0%, since a control may not work in the future.
(b) No. Audit standards require auditors maintain a degree of “professional skepticism”. Also, audit standards require auditors to reassess the internal control framework each year, without bias as to the previous audit.

8-40 **[LO 1, 2]** You are auditing the Stanfish Hotel Corporation. At one of their facilities in San Francisco, you have been made aware of two senior purchasing employees that were recently fired for receiving several hundred thousand dollars in kickbacks from their meat and produce suppliers over a period of several years. Their "commission" amounted to 3 percent of the items purchased.

Required: List preventive and detective internal controls that you recommend to prevent this situation from happening again.

Answer: Answers should include:

- Training of employees about fraud
- Rotation of responsibilities in the purchasing department
- Set up a system that requires vendor bids

Also, perform credit checks on purchasing personnel and let them know you are doing it. This should disclose financial problems on the part of the buyers (motivation) as well as serve as a deterrent.

8-41 **[LO 1,2, 6, 8]** You are considering an audit engagement with a new, privately-held entrepreneurial company (Moxy, Inc.) headed by Ryan Morris, a charming CEO. The company specializes in chemical lawn treatments. Ryan indicates that his business has really taken off and he shows you last year's financial statements which show sales growth increase from $1,200,000 to $4,500,000 and gross profit growth from $575,000 to $2,800,000 in just one year. He has had to finance this growth with an $850,000 short-term promissory note, but would like to go public and attract investors. He also gives you the following limited information from his balance sheet:

	Year 1	**Year 2**
Assets		
Current Assets:		
Cash	$ 30,100	$ 88,120
Accounts Receivable	---	697,500
Other	77,320	942,000
Total current assets	$107,420	$1,727,620
Liabilities		
Current liabilities:		
Notes payable	$ ---	$ 780,500
Taxes payable	---	29,000
Other	3,240	967,000
Total current liabilities	$3,240	$1,776,500

Required:

(a) Discuss why engagement risk, professional skepticism, and assessment of fraud risk is important in this scenario.

(b) Calculate the current ratios for Year 1 and Year 2. What concerns do these calculations raise?

(c) Present at least three questions you would like to ask Ryan about the information provided, before making your decision about accepting the client.

Answer:

(a) Engagement risk is the term used for the overall risk to the auditor of being associated with a client. Engagement risk includes the possibility of financial loss or damage to the audit firm's reputation from a particular client. Addressing engagement risk is one of the important outcomes of client acceptance and continuance procedures. Also, in making judgments and drawing conclusions about the impact of control exceptions, the auditor must use professional skepticism. Using professional skepticism in the assessment means the auditor will have a questioning mind and make a critical assessment of the audit evidence. This skepticism and assessment of fraud risk begins with the client acceptance and continues as the auditor gains an understanding of the system and assesses design of ICFR. Given the dramatic changes at this company, it appears that there are many inconsistencies that flag irregularities or fraud.

(b) Current Ratio = Current Assets ÷ Current Liabilities

Year 1: $107,420 ÷ $3,240 = 33.15

Year 2: $1,727,620 ÷ $1,776,500 = 0.97

The current ratio implies that current assets can only cover 97% of current liabilities. That would not necessarily be problematic for some companies, but here the change from Year 1 to Year 2 is dramatic. Some cash shortages are to be expected when a company is rapidly expanding, but in this case, the difference in current assets is not consistent with the CEO's claims that sales have increased 3.75 times and gross profit has increased 4.87 times.

(c) Given the information that Ryan has provided, the auditor should ask many questions, including:

- Why has accounts receivable increased so much?
- Is the company having problems with the collection of accounts receivable?
- What are the items included in Other Current Assets and Other Current Liabilities?
- Why would a lawn treatment company require significant other current assets and other current liabilities?

8-42 **[LO 1]** Dottie Martin is the CEO of Martin Industries. She seeks your advice as to how to assign the functions among her three clerical employees in order to achieve the highest degree of internal control.

Below are the 8 functions performed by these clerks:

- (a) Maintains disbursement (payments) journal.
- (b) Reconciles bank account.
- (c) Prepares checks for signature.
- (d) Opens mail and lists receipts.
- (e) Deposits cash receipts.
- (f) Maintains accounts receivable records.
- (g) Determines when accounts receivable are uncollectible.
- (h) Is responsible for the petty cash fund.

Required:

(A) Advise Dottie on how to distribute the various functions amount Clerk # 1, Clerk #2, and Clerk #3, assuming all functions require about the same amount of time.

(B) Explain at least three combinations of functions that would be unsatisfactory.

Answer:

(A)

Student combinations may vary, but the key issue is the assign (1) custodial duties to one clerk, (2) recordkeeping duties to another clerk and (3) authorization duties to the third clerk.

For example:

Clerk #1: Could do: (b) Reconciles bank account.
(c) Prepares checks for signature.
(d) Opens mail and lists receipts.

Clerk # 2: Could do: (a) Maintains disbursement (payments) journal.
(e) Deposits cash receipts.
(g) Determines when accounts receivable are uncollectible.

Clerk # 3: Could do: (f) Maintains accounts receivable records &
(h) Is responsible for the petty cash fund.

(B)

Student answers may vary and include any combinations that give two or three duties (custodial, recordkeeping, or authorization) to the same clerk. For example, it would be **unsatisfactory** to have:

Clerk # 1 do: (a) Maintains disbursement (payments) journal.(b) Reconciles bank account. (c) Prepares checks for signature.

Clerk # 2 do: (d) Opens mail and lists receipts, (e) Deposits cash receipts, and (f) Maintains accounts receivable records.

Clerk # 3 do: (g) Determines when accounts receivable are uncollectible and (h) Is responsible for the petty cash fund.

8-43 **[LO 1, 2]** At Genuine Products, Inc., time cards of 550 employees are collected weekly by the plant foreman and delivered to the IS department. There, the cards are sorted and the hours worked are entered into the computer. These records are used to prepare individual payroll records, paychecks, and labor cost distribution records. The paychecks are compared with individual payroll records and signed by the treasurer, who returns them to the IS Department supervisor for distribution.

Required:

(a) Describe any weaknesses that exist.
(b) Indicate any frauds or material irregularities that might occur, as a result of the weaknesses.
(c) List any recommendations for improvement of the process.

Answer:

Students answers may vary but can include the following:

(a)
The payroll checks should not be returned to the IS department supervisor, but should be distributed by persons independent of those having a part in payroll data processing. Also, in this scenario, it appears there is a lack of internal certification of the hours, rates, extensions or employees.

(b)
Padding of payroll could occur, with fictitious names and extracting the checks made out to these ghost employees when they are returned after they have been signed. There may also be errors in hours, rates, extensions, along with the existence of ghost employees.

(c)
Have checks handed out by an independent person and not returned to the IS department supervisor. Require direct deposit to be set up at time of hiring.
Develop an internal certification process.
Rotate the individuals that collect and deliver the time cards to the IS Department.

8-44. Go to the AICPA or PCAOB Web site and find AU 350 entitled “Audit Sampling.” Find paragraph .07 where the discussion of Uncertainty and Audit Sampling begins. What are the sources of uncertainty described in this section of the auditing standard? Read, beginning with paragraph .12 on Sampling Risk. With which types of sampling risks is the auditor concerned when performing substantive tests? Tests of controls?

Answer:

Paragraph 7 states:

> Some degree of uncertainty is implicit in the concept of "a reasonable basis for an opinion" referred to in the third standard of field work. The justification for accepting some uncertainty arises from the relationship between such factors as the cost and time required to examine all of the data and the adverse consequences of possible erroneous decisions based on the conclusions resulting from examining only a sample of the data. If these factors do not justify the acceptance of some uncertainty, the only alternative is to examine all of the data. Since this is seldom the case, the basic concept of sampling is well established in auditing practice.

Paragraph 12 states:

> The auditor should apply professional judgment in assessing sampling risk. In performing substantive tests of details the auditor is concerned with two aspects of sampling risk:

- *The risk of incorrect acceptance* is the risk that the sample supports the conclusion that the recorded account balance is not materially misstated when it is materially misstated.
- *The risk of incorrect rejection* is the risk that the sample supports the conclusion that the recorded account balance is materially misstated when it is not materially misstated.

The auditor is also concerned with two aspects of sampling risk in performing tests of controls when sampling is used:

- *The risk of assessing control risk too low* is the risk that the assessed level of control risk based on the sample is less than the true operating effectiveness of the control.
- *The risk of assessing control risk too high* is the risk that the assessed level of control risk based on the sample is greater than the true operating effectiveness of the control.

8-45. Go to the AICPA or PCAOB Web site and find AU 316 entitled "Consideration of Fraud in a Financial Statement Audit." Beginning with AU 316.05, how does the standard define *fraud*? What are the two types of financial statement fraud? Beginning with AU 316.12, how does the standard present the auditor's responsibility related to detecting fraud? Paragraph 14 discusses a brainstorming session regarding fraud in which all members of the audit team should participate. How does the guidance in paragraph 18 relate to the brainstorming session? Based on what you have read, how might results of control tests impact the financial statement audit plan and procedures regarding fraud?

Answer:

Fraud is defined in paragraph 5 as:

… a broad legal concept and auditors do not make legal determinations of whether fraud has occurred. Rather, the auditor's interest specifically relates to acts that result in a material misstatement of the financial statements. The primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional. For purposes of the section, *fraud* is an intentional act that results in a material misstatement in financial statements that are the subject of an audit.

The two types of financial statement fraud are: (1) misstatements arising from fraudulent financial reporting and (2) misstatements arising from misappropriation of assets.

Paragraph 12 states:

> As indicated in paragraph .01, the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by fraud or error. However, absolute assurance is not attainable and thus even a properly planned and performed audit may not detect a material misstatement resulting from fraud. A material

> misstatement may not be detected because of the nature of audit evidence or because the characteristics of fraud as discussed above may cause the auditor to rely unknowingly on audit evidence that appears to be valid, but is, in fact, false and fraudulent. Furthermore, audit procedures that are effective for detecting an error may be ineffective for detecting fraud.

Paragraph 14 states:

> Prior to or in conjunction with the information-gathering procedures described in paragraphs .19 through .34 of this section, members of the audit team should discuss the potential for material misstatement due to fraud. The discussion should include:
>
> - An exchange of ideas or "brainstorming" among the audit team members, including the auditor with final responsibility for the audit, about how and where they believe the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated. (See paragraph .15.)
> - An emphasis on the importance of maintaining the proper state of mind throughout the audit regarding the potential for material misstatement due to fraud. (See paragraph .16.)

Paragraph 18 states:

> Communication among the audit team members about the risks of material misstatement due to fraud also should continue throughout the audit—for example, in evaluating the risks of material misstatement due to fraud at or near the completion of the field work.

8-46. Go to the AICPA Web site. From the dropdown menu choose Professional Resources; Accounting and Auditing; Audit Committee Effectiveness Center. Find the article, "Fraud …Can Audit Committees Really Make a Difference?"Using any of the resources you find at this site, answer the following questions: What should the audit committee know concerning how management can perpetrate fraud via internal control override? What actions should the audit committee take to address the risk of management override? What should the audit committee do once it discovers management override?

Answer:

The access to this article has changed at the publication of this text. Current access is http://www.nysscpa.org/cpajournal/2007/107/essentials/p24.htm

Student answers will vary but should focus on the fact that an independent audit committee is central in ensuring the credibility of financial reporting and reducing the possibility of management fraud. The passage of SOX in 2002 has strengthened the responsibilities and requirements placed on audit committees However, there are still a number of barriers to the effective functioning of audit committees, including an overreliance on a financial expert, poor-quality information for the committee, and a significant compliance burden. As a result, audit committees have greater power to participate in the financial reporting process.

8-47. Perform an Internet search for "internal control failure" and find a story about one company that experienced an internal control failure. What was the impact of the failure on reported net income for the period? Did the company have to restate prior period earnings as a result of the failure? What was the announcement's effect on the company's stock price? Who, if anyone, was blamed for the failure?

Answer:

Student answers will vary. However, a good example is the story of Merrill Lynch, which was forced to declare in its annual report that it understated 2008 losses by more than $500 million, because according to auditor Deloitte & Touche, Merrill had "not maintained effective internal control over financial reporting" as of the end of 2008.

Chapter 8 Appendix A

Multiple Choice

8-48. a
8-49. d
8-50. d
8-51. a

Activity Assignments

8-52. Access AS 2, Example B1 from the PCAOB Web site.

(a) List programmed application controls included in this PCAOB example of cash and accounts receivable processes.
(b)What are the assertions related to cash and accounts receivable being tested in this example?
(c) What aspects of the programmed application control did the auditor test through inquiry (discussion)? How was the audit evidence that was obtained through audit inquiry supplemented?

Answer:

Example B-1 states: ***Daily Programmed Application Control and Daily Information Technology-Dependent Manual Control***

The auditor has determined that cash and accounts receivable are significant accounts to the audit of XYZ Company's internal control over financial reporting. Based on discussions with company personnel and review of company documentation, the auditor learned that the company had the following procedures in place to account for cash received in the lockbox:

a. The company receives a download of cash receipts from the banks.

b. The information technology system applies cash received in the lockbox to individual customer accounts.

c. Any cash received in the lockbox and not applied to a customer's account is listed on an exception report (Unapplied Cash Exception Report).

- Therefore, the application of cash to a customer's account is a programmed application control, while the review and follow-up of unapplied cash from the exception report is a manual control.

To determine whether misstatements in cash (existence assertion) and accounts receivable (existence, valuation, and completeness) would be prevented or detected on a timely basis, the auditor decided to test the controls provided by the system in the daily reconciliation of lock box receipts to customer accounts, as well as the control over reviewing and resolving unapplied cash in the Unapplied Cash Exception Report.

Nature, Timing, and Extent of Procedures. To test the programmed application control, the auditor:

- Identified, through discussion with company personnel, the software used to receive the download from the banks and to process the transactions and determined that the banks supply the download software.

  -- The company uses accounting software acquired from a third-party supplier. The software consists of a number of modules. The client modifies the software only for upgrades supplied by the supplier.

- Determined, through further discussion with company personnel, that the cash module operates the lockbox functionality and the posting of cash to the general ledger. The accounts receivable module posts the cash to individual customer accounts and produces the Unapplied Cash Exception Report, a standard report supplied with the package. The auditor agreed this information to the supplier's documentation.

- Identified, through discussions with company personnel and review of the supplier's documentation, the names, file sizes (in bytes), and locations of the executable files (programs) that operate the functionality under review. The auditor then identified the compilation dates of these programs and agreed them to the original installation date of the application.
- Identified the objectives of the programs to be tested. The auditor wanted to determine whether only appropriate cash items are posted to customers' accounts and matched to customer number, invoice number, amount, etc., and that there is a listing of inappropriate cash items (that is, any of the above items not matching) on the exception report.

In addition, the auditor had evaluated and tested general computer controls, including program changes (for example, confirmation that no unauthorized changes are undertaken) and logical access (for example, data file access to the file downloaded from the banks and user access to the cash and accounts receivable modules) and concluded that they were operating effectively.

To determine whether such programmed controls were operating effectively, the auditor performed a walkthrough in the month of July. The computer controls operate in a systematic manner, therefore, the auditor concluded that it was sufficient to perform a walkthrough for only the one item. During the walkthrough, the auditor performed and documented the following items:

a. Selected one customer and agreed the amount billed to the customer to the cash received in the lockbox.

b. Agreed the total of the lockbox report to the posting of cash receipts in the general ledger.

c. Agreed the total of the cash receipt download from the bank to the lockbox report and supporting documentation.

d. Selected one customer's remittance and agreed amount posted to the customer's account in the accounts receivable subsidiary ledger.

To test the detective control of review and follow up on the Daily Unapplied Cash Exception Report, the auditor:

a. Made inquiries of company personnel. To understand the procedures in place to ensure that all unapplied items are resolved, the time frame in which such resolution takes place, and whether unapplied items are handled properly within the system, the auditor discussed these matters with the employee responsible for reviewing and resolving the Daily Unapplied Cash Exception Reports. The auditor learned that, when items appear on the Daily-Unapplied Cash Exception Report, the employee must manually enter the correction into the system. The employee typically performs the resolution procedures the next business day. Items that typically appear on the Daily Unapplied Cash Exception Report relate to payments made by a customer without reference to an invoice number/purchase order number or to underpayments of an invoice due to quantity or pricing discrepancies.

b. Observed personnel performing the control**.** The auditor then observed the employee reviewing and resolving a Daily Unapplied Cash Exception Report. The day selected contained four exceptions - three related to payments made by a customer without an invoice number, and one related to an underpayment due to a pricing discrepancy.

- For the pricing discrepancy, the employee determined, through discussions with a sales person, that the customer had been billed an incorrect price; a price break that the sales person had granted to the customer was not reflected on the customer's invoice. The employee resolved the pricing discrepancy, determined which invoices were being paid, and entered a correction into the system to properly apply cash to the customer's account and reduce accounts receivable and sales accounts for the amount of the price break.

c. Reperformed the control. Finally, the auditor selected 25 Daily Unapplied Cash Exception Reports from the period January to September. For the reports selected, the auditor reperformed the follow-up procedures that the employee performed. For instance, the auditor inspected the documents and sources of information used in the follow-up and determined that the transaction was properly corrected in the system. The auditor also scanned other Daily Unapplied Cash Exception Reports to determine that the control was performed throughout the period of intended reliance.

Because the tests of controls were performed at an interim date, the auditor had to determine whether there were any significant changes in the controls from interim to year-end. Therefore, the auditor asked company personnel about the procedures in place at year-end. Such procedures had not changed from the interim period, therefore, the auditor observed that the controls were still in place by scanning Daily Unapplied Cash Exception Reports to determine the control was performed on a timely basis during the period from September to year-end.

Based on the auditor's procedures, the auditor concluded that the employee was clearing exceptions in a timely manner and that the control was operating effectively as of year-end.

8-53. Access the most recent 10K for Best Buy. Find Item 1A,“Risk Factors.”Read through the risk factors explained and find those related to the management information system.

(a) Does Best Buy comment regarding risks related to order entry, order fulfillment, pricing, point-of-sale processes, and inventory replenishment processes?
(b) How do the application controls discussed in this chapter relate to these functions?
(c) Based on the company’s disclosures, how might problems that could occur in Best Buy’s applications controls affect the company’s financial outcomes, and the auditor’s

concerns for the financial statement portion of the audit?
(d) Address questions (a), (b), and (c) for Best Buy's disclosures related to the integrity and security of the customer's information.

Answer:

Student answers will vary, depending on the year of the report selected. However, the Best Buy 10K for the fiscal year ending February 27, 2010 indicates the following risk factors:

Item 1A. Risk Factors.

Described below are certain risks that our management believes are applicable to our business and the industry in which we operate. There may be additional risks that are not presently material or known. You should carefully consider each of the following risks and all other information set forth in this Annual Report on Form 10-K.

If any of the events described below occurs, our business, financial condition, results of operations, liquidity or access to the capital markets could be materially adversely affected. The following risks could cause our actual results to differ materially from our historical experience and from results predicted by forward-looking statements made by us or on our behalf related to conditions or events that we anticipate may occur in the future. The following risks should not be construed as an exhaustive list of all factors that could cause actual results to differ materially from those expressed in forward-looking statements made by us or on our behalf. All forward-looking statements made by us or on our behalf are qualified by the risks described below.

Economic conditions in the U.S. and key international markets, a decline in consumer discretionary spending or other conditions may materially adversely impact our operating results.

We sell certain products and services that consumers may view as discretionary items rather than necessities. As a result, our results of operations tend to be more sensitive to changes in macroeconomic conditions that impact consumer spending, including discretionary spending. Challenging macroeconomic conditions also impact our customers' ability to obtain consumer credit in a timely manner, if at all. Other factors, including consumer confidence, employment levels, interest rates, tax rates, consumer debt levels, and fuel and energy costs could reduce consumer spending or change consumer purchasing habits. In the past two fiscal years, many of these factors adversely affected consumer spending and, consequently, our business and results of operations. A slowdown in the U.S. or global economy, or an uncertain economic outlook, could materially adversely affect consumer spending habits and our operating results in the future.

The domestic and international political situation also affects consumer confidence. The threat or outbreak of domestic or international terrorism or other hostilities could lead to a decrease in consumer spending. Any of these events and factors could cause a decrease in revenue or an increase in inventory markdowns or certain operating expenses, which could materially adversely affect our results of operations.

If we do not anticipate and respond to changing consumer preferences in a timely manner, our operating results could materially suffer.

Our business depends, in large part, on our ability to successfully introduce new products, services and technologies to consumers, the frequency of such introductions, the level of consumer acceptance, and the related impact on the demand for existing products, services and technologies. Failure to accurately predict constantly changing consumer tastes, preferences, spending patterns and other lifestyle decisions, or to effectively address consumer concerns, could have a material adverse effect on our revenue, results of operations and reputation with our customers.

Our results of operations could materially deteriorate if we fail to attract, develop and retain qualified employees.

Our performance is dependent on attracting and retaining qualified employees who are able to meet the wants and needs of our customers. We believe our competitive advantage is providing unique end-to-end solutions for each individual customer, which requires us to have highly trained and engaged employees. Our success depends in part upon our ability to attract, develop and retain a sufficient number of qualified employees, including store, service and administrative personnel. The turnover rate in the retail industry is high, and qualified individuals of the requisite caliber and number needed to fill these positions may be in short supply in some areas. Our inability to recruit a sufficient number of qualified individuals in the future may delay planned openings of new stores or affect the speed with which we expand initiatives related to the connected world, our exclusive brands and our international operations. Delayed store openings, significant increases in employee turnover rates or significant increases in labor costs could have a material adverse effect on our business, financial condition and results of operations.

We face strong competition from traditional store-based retailers, Internet businesses, our vendors and other forms of retail commerce, which could materially adversely affect our revenue and profitability.

The retail business is highly competitive. We compete for customers, employees, locations, products and other important aspects of our business with many other local, regional, national and international retailers, as well as our vendors who offer their products and services direct to the consumer. Pressure from our competitors, some of which have a greater market presence and financial resources than we do, could require us to reduce our prices or increase our costs of doing business. As a result of this competition, we may experience lower revenue and/or higher operating costs, which could materially adversely affect our results of operations.

The failure to control our costs could have a material adverse impact on our profitability.

Consumer spending remains uncertain, which makes it more challenging for us to maintain or grow our operating income rate. As a result, we must continue to control our expense structure. Failure to manage our labor and benefit rates, advertising and marketing expenses, other store expenses or indirect spending could delay or prevent us from achieving increased profitability or otherwise have a material adverse impact on our results of operations.

Our liquidity may be materially adversely affected by continuing constraints in the capital markets.

We must have sufficient sources of liquidity to fund our working capital requirements, service our outstanding indebtedness and finance investment opportunities. Without sufficient liquidity, we could be forced to curtail our operations or we may not be able to pursue promising business opportunities. The principal sources of our liquidity are funds generated from operating activities, available cash and cash equivalents, and borrowings under credit facilities and other debt financings.

For the past several quarters, global financial markets have experienced diminished liquidity, constrained credit availability and volatility in securities prices. If our sources of liquidity do not satisfy our requirements, we may have to seek additional financing. The future availability of financing will depend on a variety of factors, such as economic and market conditions, the availability of credit and our credit ratings, as well as the possibility that lenders could develop a negative perception of us or the retail industry generally. If required, we may not be able to obtain additional financing, on favorable terms, or at all.

Changes in our credit ratings may limit our access to capital markets and materially increase our borrowing costs.

In fiscal 2010, Moody's Investors Service, Inc., Fitch Ratings Ltd. and Standard & Poor's Ratings Services all maintained their ratings and outlook of our debt securities at above investment grade level.

However, future downgrades to our long-term credit ratings and outlook could negatively impact our access to the capital markets and the perception of us by lenders and other third parties. Our credit ratings are based upon information furnished by us or obtained by a rating agency from its own sources and are subject to revision, suspension or withdrawal by one or more rating agencies at any time. Rating agencies may review the ratings assigned to us due to developments that are beyond our control, including as a result of new standards requiring the agencies to re-assess rating practices and methodologies.

Any downgrade to our debt securities will result in higher interest costs for certain of our credit facilities and other debt financings, and could result in higher interest costs on future financings. Further, in the event of such a downgrade, we may not be able to obtain additional financing, if necessary, on favorable terms, or at all.

Our growth is dependent on the success of our strategies.

Our growth is dependent on our ability to identify, develop and execute our strategies. Because we have outlined an ambitious growth and strategic development platform on which to expand our business, our failure to properly deploy and utilize capital and other resources may adversely affect our initiatives designed to assist our customers connect to a digital lifestyle, while expanding our footprint globally. While we believe our customer centricity and connected world initiatives, as well as the pursuit of international growth opportunities, will enable us to grow our business, misjudgments or flaws in our execution could have a material adverse effect on our business, financial condition and results of operations.

Our growth strategy includes expanding our business by opening stores in both existing markets and new markets.

Our future growth is dependent, in part, on our ability to build, buy or lease new stores. We compete with other retailers and businesses for suitable locations for our stores. Local land use, local zoning issues, environmental regulations and other regulations applicable to the types of stores we desire to construct may impact our ability to find suitable locations, and also influence the cost of building, buying and leasing our stores. We also may have difficulty negotiating real estate purchase agreements and leases on acceptable terms. Failure to manage effectively these and other similar factors will affect our ability to build, buy and lease new stores, which may have a material adverse effect on our future profitability.

We seek to expand our business in existing markets in order to attain a greater overall market share. Because our stores typically draw customers from their local areas, a new store may draw customers away from our nearby existing stores and may cause customer traffic and comparable store sales performance to decline at those existing stores.

We also intend to open stores in new markets. The risks associated with entering a new market include difficulties in attracting customers where there is a lack of customer familiarity with our brands, our lack of familiarity with local customer preferences, seasonal differences in the market and our ability to obtain the necessary governmental approvals. In addition, entry into new markets may bring us into competition with new competitors or with existing competitors with a large, established market presence. We cannot ensure that our new stores will be profitably deployed. As a result, our future profitability may be materially adversely affected.

Failure in our pursuit or execution of new business ventures, strategic alliances and acquisitions could have a material adverse impact on our business.

Our growth strategy also includes expansion via new business ventures, strategic alliances and acquisitions. Assessing a potential growth opportunity involves extensive due diligence. However, the amount of information we can obtain about a potential growth opportunity may be limited, and we can give no assurance that new business ventures, strategic alliances and acquisitions will positively affect our financial performance or will perform as planned. Integrating new businesses, stores and concepts can be a difficult task. Cultural differences in some markets into which we expand or into which we introduce new retail concepts may result in customers in those markets being less receptive than originally anticipated. These types of transactions may divert our capital and our management's attention from other business issues and opportunities. Further, implementing new strategic alliances or business ventures may also impair our relationships with our vendors or strategic partners. We may not be able to successfully assimilate or integrate companies that we acquire, including their personnel, financial systems, distribution, operations and general operating procedures. We may also encounter challenges in achieving appropriate internal control over financial reporting in connection with the integration of an acquired company. If we fail to assimilate or integrate acquired companies successfully, our business, reputation and operating results could suffer materially. Likewise, our failure to integrate and manage acquired companies successfully may lead to impairment of the associated goodwill and intangible asset balances.

Failure to protect the integrity, security and use of our customers' information and media could expose us to litigation and materially damage our standing with our customers.

The use of individually identifiable data by our business and our business associates is regulated at the state, federal and international levels. Increasing costs associated with information security — such as increased investment in technology, the costs of compliance with consumer protection laws and costs resulting from consumer fraud — could cause our business and results of operations to suffer materially. Additionally, the success of our online operations depends upon the secure transmission of confidential information over public networks, including the use of cashless payments. While we have taken significant steps to protect customer and confidential information, there can be no assurance that advances in computer capabilities, new discoveries in the field of cryptography or other developments will prevent the compromise of our customer transaction processing capabilities and personal data. If any such compromise of our security were to occur, it could have a material adverse effect on our reputation, operating results and financial condition. Any such compromise may materially increase the costs we incur to protect against such information security breaches and could subject us to additional legal risk.

Risks associated with the vendors from whom our products are sourced could materially adversely affect our revenue and gross profit.

The products we sell are sourced from a wide variety of domestic and international vendors. Our 20 largest suppliers account for just under 60% of the merchandise we purchase. If any of our key vendors fails to supply us with products or continue to develop new technologies, we may not be able to meet the demands of our customers and our revenue could materially decline. We require all of our vendors to comply with applicable laws, including labor and environmental laws, and otherwise be certified as meeting our required vendor standards of conduct. Our ability to find qualified vendors who meet our standards and supply products in a timely and efficient manner is a significant challenge, especially with respect to goods sourced from outside the U.S. Political or financial instability, merchandise quality issues, product safety concerns, trade restrictions, work stoppages, tariffs, foreign currency exchange rates, transportation capacity and costs,

inflation, civil unrest, outbreaks of pandemics and other factors relating to foreign trade are beyond our control. These and other issues affecting our vendors could materially adversely affect our revenue and gross profit.

Our exclusive brands products are subject to several additional product, supply chain and legal risks, which could have a material adverse impact on our business.

Sales of our exclusive brands, which include Insignia, Dynex, Init, Geek Squad and Rocketfish branded products, represent a growing component of our revenue. Most of these products are manufactured under contract by vendors based in southeastern Asia. This arrangement exposes us to the following additional potential risks, which could materially adversely affect our reputation, financial condition and operating results:

- We have greater exposure and responsibility to the consumer for warranty replacements and repairs as a result of product defects, as we generally have no recourse to contracted manufacturers for such warranty liabilities;
- We may be subject to regulatory compliance and/or product liability claims relating to personal injury, death or property damage caused by such products, some of which may require us to take significant actions such as product recalls;
- We may experience disruptions in the manufacturing or the logistics within the manufacturing environment in southeastern Asia caused by inconsistent and unanticipated order patterns or if we are unable to develop long-term relationships with key factories;
- We are subject to developing and often-changing labor and environmental laws for the manufacture of products in foreign countries and we may be unable to conform to new rules or interpretations in a timely manner;

- We may be subject to claims by technology owners if we inadvertently infringe upon their patents or other intellectual property rights, or if we fail to pay royalties owed on our products; and

- We may be unable to obtain or adequately protect our patents and other intellectual property rights on our products, the new features of our products and/or our processes.

We are subject to certain statutory, regulatory and legal developments which could have a material adverse impact on our business.

Our statutory, regulatory and legal environment exposes us to complex compliance and litigation risks that could materially adversely affect our operations and financial results. The most significant compliance and litigation risks we face are:

- The difficulty of complying with sometimes conflicting statutes and regulations in local, national or international jurisdictions;

- The impact of proposed, new or changing statutes and regulations including, but not limited to, financial reform, environmental, labor reform, health care reform and/or other as yet unknown legislation, that could affect how we operate and execute our strategies as well as alter our expense structure;

- The impact of changes in tax laws (or interpretations thereof by courts and taxing authorities) and accounting standards; and

- The impact of litigation trends, including class action lawsuits involving consumers and shareholders, and labor and employment matters.

Defending against lawsuits and other proceedings may involve significant expense and divert management's attention and resources from other matters.

Changes to the National Labor Relations Act or other labor-related statutes or regulations could have a material adverse impact on our business.

The Employee Free Choice Act ("EFCA") is pending before the U.S. Congress. The EFCA, also referred to as the "card check" bill, if passed in its current or a similar form, or changes to other labor-related statutes or regulations, could significantly change the nature of labor relations in the U.S. Specifically, EFCA would impact how union elections and contract negotiations are conducted. At February 27, 2010, none of our U.S. stores had employees represented by labor unions or working under collective bargaining agreements. Passage of the pending or similar legislation, or changes in other labor-related statutes or regulations, could make it easier for unions to be formed, and employers of newly unionized employees may face mandatory, binding arbitration of labor scheduling, costs and standards, which could increase our costs of doing business and materially adversely affect our results of operations.

Additional legislation or rulemaking relating to environmental matters, including but not limited to, energy emissions, could have a material adverse impact on our business.

Environmental legislation or rulemaking efforts could impose unexpected costs or impact us more directly than other companies due to our operations as a global consumer electronics retailer with over 4,000 stores and 87 distribution centers worldwide.

Specifically, legislation that aims to control and reduce energy emissions has been considered by the U.S. Congress as well as governing bodies internationally, particularly in Europe. Should such legislation pass, we anticipate that energy costs within our operations would increase such as the expense to power our stores. In addition, rulemaking is being considered that could impose higher safety and compliance standards on transporting certain goods. Any significant rulemaking could increase the cost to transport our goods. Passage of any of these forms of legislation or rulemaking could materially adversely affect our results of operations.

Regulatory developments in the U.S. could impact the promotional financing offers available to our credit card customers and have a material adverse impact on our revenue and profitability.

We offer promotional financing in the U.S. through credit cards issued by third party banks that manage and directly extend credit to our customers. The cardholders can receive low- or no-interest promotional financing on qualifying purchases. Promotional financing credit card sales accounted for 17%, 18% and 16% of our Domestic segment's revenue in fiscal 2010, 2009 and 2008, respectively.

Recently enacted legislative and regulatory changes that focus on a variety of credit related matters have had no material adverse impact on our operations to date. However, if future legislative or regulatory restrictions or prohibitions arise that affect our ability to offer promotional financing and we are unable to adjust our operations in a timely manner, our revenue and profitability may be materially adversely affected.

Changes to our credit card agreements could adversely impact our ability to facilitate the provision of consumer credit to our customers and could materially adversely impact our results of operations.

We have agreements with third party banks for the issuance of promotional financing and customer loyalty credit cards bearing the Best Buy brand. Under the agreements, the banks manage and directly extend credit to our customers. The banks are the sole owner of the accounts receivable generated under the credit card programs and absorb losses associated with non-payment by the cardholders and fraudulent usage of the accounts. We earn revenue from fees the banks pay to us based on the number of credit card accounts activated and card usage. The banks also reimburse us for certain costs associated with our credit card programs. Financing fees are paid by us to the banks and are variable based on certain factors such as the London Interbank Offered Rate ("LIBOR"), charge volume and/or the types of promotional financing offers.

Given the continuing changes in the economic and regulatory environment for banks, as well as a continuing period of consumer credit delinquencies, banks continue to re-evaluate their lending practices and terms, including but not limited to the levels at which consumer credit is granted. If any of our credit card programs ended prematurely or the terms and provisions, or interpretations thereof, were substantially modified, our results of operations and financial condition may be materially adversely impacted.

Our International activities subject us to risks associated with the legislative, judicial, accounting, regulatory, political and economic conditions specific to the countries or regions in which we operate, which could materially adversely affect our financial performance.

We have a presence in various foreign countries including Belgium, Bermuda, Canada, China, France, Germany, Honk Kong, India, Ireland, Japan, Luxembourg, Mexico, the Republic of Mauritius, the Netherlands, Portugal, Spain, Sweden, Switzerland, Taiwan, Turkey, Turks and Caicos, and the U.K. During fiscal 2010, our International segment's operations generated 25% of our revenue. Our growth strategy includes expansion into new or existing international markets, and we expect that our International segment's operations will account for a larger portion of

our revenue in the future. Our future operating results in these countries and in other countries or regions throughout the world where we may operate in the future could be materially adversely affected by a variety of factors, many of which are beyond our control including political conditions, economic conditions, legal and regulatory constraints and foreign currency regulations.

In addition, foreign currency exchange rates and fluctuations may have an impact on our future costs or on future cash flows from our International segment's operations, and could materially adversely affect our financial performance. Moreover, the economies of some of the countries in which we have operations have in the past suffered from high rates of inflation and currency devaluations, which, if they were to occur again, could materially adversely affect our financial performance. Other factors which may materially adversely impact our International segment's operations include foreign trade, monetary, tax and fiscal policies both of the U.S. and of other countries; laws, regulations and other activities of foreign governments, agencies and similar organizations; and maintaining facilities in countries which have historically been less stable than the U.S.

Additional risks inherent in our International segment's operations generally include, among others, the costs and difficulties of managing international operations, adverse tax consequences and greater difficulty in enforcing intellectual property rights in countries other than the U.S. The various risks inherent in doing business in the U.S. generally also exist when doing business outside of the U.S., and may be exaggerated by the difficulty of doing business in numerous sovereign jurisdictions due to differences in culture, laws and regulations.

We rely heavily on our management information systems for inventory management, distribution and other functions. If our systems fail to perform these functions adequately or if we experience an interruption in their operation, our business and results of operations could be materially adversely affected.

The efficient operation of our business is dependent on our management information systems. We rely heavily on our management information systems to manage our order entry, order fulfillment, pricing, point-of-sale and inventory replenishment processes. The failure of our management information systems to perform as we anticipate could disrupt our business and could result in decreased revenue, increased overhead costs and excess or out-of-stock inventory levels, causing our business and results of operations to suffer materially.

A disruption in our relationship with Accenture, who helps us manage key elements of our information technology and human resources operations and conducts certain procurement activities, could materially adversely affect our business and results of operations.

We have engaged Accenture LLP ("Accenture"), a global management consulting, technology services and outsourcing company, to manage significant portions of our information technology and human resources operations as well as to conduct certain procurement activities. We rely heavily on our management information systems for inventory management, distribution and other functions. We also rely heavily on human resources support to attract, develop and retain a sufficient number of qualified employees. We also use Accenture to provide procurement support to research and purchase certain non-merchandise products and services. Any material disruption in our relationship with Accenture could result in decreased revenue and increased overhead costs, causing our business and results of operations to suffer materially.

We are highly dependent on the cash flows and net earnings we generate during our fourth fiscal quarter, which includes the majority of the holiday selling season.

Approximately one-third of our revenue and more than one-half of our net earnings are generated in our fourth fiscal quarter, which includes the majority of the holiday shopping season in the U.S., Europe and Canada. Unexpected events or developments such as natural or man-made disasters, product sourcing issues or adverse economic conditions in our fourth quarter could have a material adverse effect on our results of operations.