Chapter 9

Multiple choice

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

#17 is a bad question if it is changed as follows the answer is d

17. The audit of accounts receivables **[LO 6]**
    a. will generally be completed using procedures that focus only on the receivables account
    b. may include steps related to understanding the client's system and auditing debt
    c. can often be limited to confirmation as long as the confirmation process asks about the customers ability and willingness to pay in addition to confirming the existence and amount
    d. includes examining cash received in payment for receivables even though those payments would be received in the following fiscal year, which is not the period being audited
18. c
19. a
20. c

<u>Discussion Questions</u>

21.

1. The audit risk model is: AR=(CR*IR)*(DR*AP), where AP is the risk that analytical procedures will not detect a material misstatement and DR is where your test of details of balances will not detect a material misstatement. Essentially, the higher the detection or analytical risk, the higher the audit risk, and vice versa. Essentially, the risks interrelate; if you are willing to set DR high, then you would also set AP risk low.
2. The risk is that your testing will not reveal accounts listed as receivable that are non-existent or delinquent; in either case, the accounts receivable is overstated and you don't detect it.
3. Yes; if you set any of the risk components too high, then AR is also high, requiring additional testing. This additional testing may not be needed, leading to audit inefficiencies. The same result occurs when you incorrectly assess risk in an area as being high, when it is not (e.g. incorrect rejection); additional testing occurs which is inefficient and costly.

22.

The testing of assets involves the existence and valuation assertions: Does the asset exist and is it valued properly? Assets are more likely to be overstated than liabilities, therefore, auditors look for over-valued and non-existent assets. Auditors either observe the existence of assets directly (e.g. observation of the physical inventory; plant tour) or confirm them, with the intent of testing for overstatement. Conversely, the completeness, and disclosure assertions apply for liabilities. Liabilities are more likely to be understated or omitted than assets. Therefore, auditors search for unrecorded liabilities by examining payments made after the year-end cut-off and review the disclosure requirements for long-term liabilities, such as leases and pensions.

23.

Assets are more likely to be overstated because they are recorded at the cost of obtaining the asset, which may have decreased between the date of purchase and the financial statement date (e.g. value of receivables is a function of collectability). As a result, the auditor devotes attention to the valuation of assets, such as accounts receivable, property, plant, and equipment, inventory, etc. to determine if the value of the asset has declined, necessitating a write-down.

Yes, assets can be understated- this can be accomplished by writing assets down in one period - and then selling the asset (or collecting more than the assets is valued at) in a subsequent period. This is a method of managing earnings- by shifting profit from the sale of undervalued assets into a different period. This is done by managers for bonus purposes: If the current period is "bad," and no bonus will be paid, then managers may write down assets (it won't affect the bonus this period anyway) and allow a gain- profit to be recognized in the next period- when bonuses can be paid.

24.
The auditor would circularize, e.g. confirm, accounts receivable by using POSITIVE confirmations; a confirmation of the amount due provides direct, external evidence that the account is valid and properly valued. The auditor would also examine subsequent cash receipts since fictitious customers do not pay their bills. The confirmation and the subsequent cash receipt affirms the existence and valuation assertions.

25.

The purpose is to prevent shipments to unauthorized customers. It applies to the existence assertion.

26.
The auditor should suggest writing the accounts down to the correct value since the overstatement exceeds the maximum allowed for that individual account. Materiality is not only a function of an aggregate amount, but also a function of individual accounts, especially if the account is considered material to the financial statements. While the individual overstatements may not reach the materiality threshold, the individual overstatements also need to be considered, especially since the individual overstatements may equal or exceed the threshold.
In terms of the ICFR, the auditor will list these overstatements together as material weaknesses. Assuming the client makes the necessary adjustments, the auditor need not alter the opinion on the financial statements.

Problems

27.

1. He needs to confirm the existence of the account as well as the customer's intention and ability to pay it.

2. He needs to gather evidence that the customer has the ability to pay the account through examination of financial statements and a bank account review. He also needs to review prior payment history.

3. Salvadore can take management's opinion into consideration, but he must maintain his independence and exercise professional skepticism in determining the amount of any needed adjustments.

28.

1. The objectives in the audit are to verify the existence, cut-off, rights, presentation, completeness, and valuation of inventory.

2. The senior should perform comparisons of key ratios, such as the gross margin ratio for the current and previous years. The auditor should look for any changes that may suggest a change in inventory policies. The auditor should also calculate key inventory turnover ratios (number of days sales and turnover ratios.) and a review of inventory on-hand for trends such as obsolescence, et.

3. Verifying proper cut-off is key audit step. The auditor must conduct a thorough tour of the plant/warehouse where the inventory is held. Care should be taken to assure that proper control over inventory tickets is maintained and that test counts are sufficient to obtain an understanding of the count accuracy. Test counts should be traced to the physical inventory listing for inclusion and accuracy purposes.

4. Testing for obsolete/excess inventory is performed by examining sales invoices for recent shipments and comparing the physical inventory for items not recently shipped. Then annually, the auditor can examine invoices for items deemed to be slow-moving in order to assess net realizable value issues (e.g. selling inventory below cost) as well as the time between the last shipment of an item and the number of items on hand.

5. The audit team needs to document the work performed, documents examined, results of reperformance (e.g. calculation of net realizable value, number of items considered obsolete), personnel interviewed, direct observations (e.g. dust accumulated on boxes), and all analytical procedures performed along with their conclusions.

29.

(1) Ivan should look at AU 339 and AS 3 to learn more about documentation requirements.

(2) Audit documentation should contain information concerning:
- Nature, timing and extent of procedures performed
- The identity of the preparer and reviewer
- Specific items tested
- Results of procedures performed
- Audit evidence obtained from procedures
- Conclusions reached on significant matters
- Reconciliation of accounting records to financial statements
- And Departures from statements of auditing standards

(3) The audit documentation should allow an outside party to understand the purpose of the testing, be able to reperform all of the testing, and understand the reasoning and appropriateness of the conclusion of the testing.

30.

a. Examine the employment contract, board of directors' minutes approving such a bonus, and/or subsequent payment to the CEO.

a. Examine cut-off documents (receiving tickets, invoices unpaid) and subsequent payments to the vendors.

b. Examine receiving tickets for the items; physical inventory listing; interview company personnel as to rights and existence of inventory.

c. Examine the support for large account payable amounts and trace to the transaction(s) generating the payable for disclosure requirements.

d. Examine subsequent payments; recalculate the accrual

e. Have an expert examine the inventory for proper valuation and obtain a written, third party statement as to its value.

f. Examine the cash disbursements journal for duplicates (e.g. payments to the same vendor for the same amounts); examine the documents supporting the accounts payable.

g. Testing the contents by drawing a sample and having it analyzed by an independent, third party familiar with fuel types

h. Review subsequent warranty payments for proper inclusion in the correct expense account. Trace entries in the warranty liability account to the associated sales revenue account. Verify that warranties for all sales have been properly accrued.

i. Perform a tour of the plant and obtain an understanding of which material is stored where. Compare the physical inventory listing to the results of your tour, noting any exceptions. Trace items on the tour to the physical inventory listing.

31.

1. Are there plans to re-finance long-term debt in the near future?
2. Is any long-term debt currently due, or will be due within a year?
3. What are the covenants for each long-term debt agreement?
4. Is the company in violation/close to violation of the long-term debt covenants?
5. Does the long-term debt include leases or amounts due to related parties?

32.

1. The known misstatement from the balance is $2 million – what you found in your testing.
2. Yes, there is a likely error that is probably more than the known misstatement. The auditor would probably calculate the likely error by an extrapolation from the sample.
3. You would probably discuss an adjusting journal entry with management to correct for likely error.

33.

(1) (A) Existence, Rights, Cutoff, Disclosure. (B) Confirmations and bank reconciliation.

(2) (A) Existence, Rights, Valuation. (B) Confirmations, examine payments received in subsequent periods, examine whether the entity has the rights to retain the receivables.

(3) (A) Existence, Completeness, Rights, Valuation, Presentation. (B) Inspection, examining and performing inventory counts, reconciliation of counts to items in the accounting record and the financial statements.

(4) (A) Existence, Rights, Valuation. Presentation/Disclosure. (B) Confirmation with custodians, examining the documentation and intent of the investment, perform substantive tests of management's underlying valuations, and agree to the financial statements.

(5) (A) Existence, Rights, Valuation/Allocation. (B) Recalculate the company's allocation and agree the amounts to company's records.

(6) (A) Existence, Rights, Valuation/Allocation, Disclosure. (B) Physically examine the assets for existence and impairment, recalculate depreciation or amortization, read and evaluate disclosures for agreement with audit evidence and compliance with accounting standards.

34.

(A) Completeness. (B) Confirmations, search for unrecorded liabilities, review of subsequent cash disbursements.

(1) (A) Completeness, Valuation/Allocation, Disclosure. (B) Review processes behind any new long-term debt issuance, review contracts for long-term debt, recalculate interest payments, and critical evaluation of the presentation and disclosure.
(2) (A) Existence/Occurrence. (B) Some substantive testing but more significantly analytical procedures.

35.

(1) The risk associated with related parties is that they are not conducted at “arms length.” The auditor must be comfortable with the accounting for related party transactions.
(2) To gain comfort around related party transactions, Gloria should (A) perform procedures to identify any related parties, (B) identify transactions with related parties, (C) understand the transactions with related parties, and (D) obtain and evaluate sufficient and appropriate evidence to be persuaded that the financial statement disclosure is adequate.
(3) The existence of related party transactions significantly increases the total audit risk.

36.

1. Since a major concern for auditors and management is whether the accounts receivable shown are actually assets of the company that will ultimately be collected, the important management assertions are existence, rights and valuation. Existence should extend to considering cutoff.

2. Test the accuracy of the amount of receivables posted by using CAATS to recomputed the accounts receivable subsidiary ledger. Trace the total to the general ledger.

Stratify the accounts receivable balance between those accounts that need to be examined 100% and those that can be sampled.

Select a sample.

For those to be examined 100% and those selected as a part of the sample:

> Perform confirmation procedures: decide on positive or negative format, have client prepare under your supervision, send, reconcile any differences, follow up on non-response of positive form confirmations.
>
> Examine cash received in the following period that is posted as accounts receivable payments and tie to the accounts receivable subsidiary ledger and responses of any confirmations.

For the allowance for doubtful accounts:

Understand management's method for estimating bad debt expense and the allowance for doubtful accounts.

Assess the appropriateness of management's underlying assumptions.

If satisfied with the reasonableness of the method and assumption, reperform the calculation of the allowance for doubtful accounts and bad debt expense. Trace the amount of the company's adjusting journal entry to the general ledger.

3. Understand management's method for making estimates and evaluate the reasonableness of the resulting estimates.

Consider the reasonableness of management's process and assumptions on which the estimates are based.

Consider the reasonableness of final outcomes.

4. Other estimates include useful life and salvage value of assets, accrued expenses, accrued revenue, percentage of completion in long-term contracts, interest rates for present value calculations, pension benefits and expenses, future cash flow fair value models, liability accruals, certain asset reserves, and many more.

37.
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Accounts, Classes of Transactions	Audit Procedure	Directed at:	Assertion:
All	Inquire who controls passwords for IT access	Control	All
Sales, Receivables, Inventory	Examine document packages for items that have been shipped for inclusion of a customer order, credit approval, shipping document. Make sure the documents are properly matched and complete with all required signatures and trace amounts to the sales journal, accounts receivable subsidiary ledger and inventory files.	Control and Amount	Existence, cut-off, valuation
Payroll	For the Hourly Payroll Expense account multiply the average number of workers times average number of hours worked per year times the average hourly rate.	Amount	Completeness, Valuation
Cash	Inspect the client prepared bank reconciliation for each month of the year, recalculate the amounts, examine the supporting bank statements and trace the cash amount to the general ledger.	Control and amounts	Existence, Valuation, Presentation & Disclosure, Cut-off, Rights & Obligations
Fixed assets	Obtain a list of fixed assets and physically look at the assets	Control	Existence
Long term debt	Read the contract related to each of the company's long term borrowings and agree the terms of the contracts to the notes to the financial statements	Disclosure	Rights & Obligations, Presentation & Disclosure
Cash, Long term debt	For each item of long term debt that existed both at the beginning and end of the year inspect the debt contracts and the company's analysis of the discounted debt amount and its analysis of violation of debt covenants and look for whether	Control, amount, and disclosure	Valuation, Presentation & Disclosure, Rights & Obligations, Completeness

	the details agree. Recalculate the amounts, examine recorded entries and bank statements for cash disbursements for debt repayments. Using that information determine whether the company has been in violation of any debt covenants during the year.		
Prepaid rent	Using the beginning financial statement amount, cash receipts and cash disbursements evidence, and the lease agreement, calculate year end prepaid rent and agree that amount to what is shown in the general ledger.	Amount	Existence, Valuation, Rights & Obligations, Completeness
Inventory	At the end of the last day in the fiscal year go to the client's shipping area and record the last shipment; trace the shipment into the client's records.	Control, Amount	Existence, cut-off, Completeness

38.

(1) (a) The securities may not exist or they may not be owned by the client.
(b) Arrange for a correspondent auditor from a local St. Louis firm to examine the securities for existence and ownership and submit a report.

(2) (a) The income may not exist. As a result, net income may be overstated.
(b) Arrange for correspondent auditors from a local Jacksonville and Memphis firms to examine the inventory for existence and ownership and submit a report.

(3) (a) The equipment may not exist and may be a way to fraudulently capitalize operating expenses.
(b) Obtain work orders and audit them. This may require arranging for correspondent auditors to obtain them, inspect the premises in Florida and Tennessee, and submit a report.

39.

(a) New, inexperienced employees are hired.
Claims that all firms do this before peer review.
Evidence of unfinished analytical reviews.
Suspiciously drafted statements about the audit work done and trends considered.
Sudden change in market capitalization after the audit.
No mention of outlier payments in the audit report.
Robertson's engagement accounts for a material amount of the CPA firm's income.

(b) You are being asked to create the false impression that the audit had been adequately performed.

This is a difficult position for a new staff auditor, but at this point, you have done nothing but take a job with the accounting firm. Sure, your first job is important, but not so important to violate a code of ethics and commit fraud. Resign and consult an attorney and/or and ethics hotline with a professional accounting association.

Do not act on blind faith. In any accounting engagement, it is important that you continually do the "smell" test on what you are asked to do and also do your homework on background of companies, situations you encounter, and learn about unfamiliar audit processes. Regarding an understanding of peer review, firms are reviewed by teams familiar with your area of practice and these reviews are charged with improving transparency by getting another set of experienced eyes to look at it what the firm does. It is not legal or ethical to "redo" an audit, without subsequent disclosure. The outcome of staying with John Smith is that the SEC would strip you and the other CPAs involved of their licenses, the stockholders would be defrauded, there would be criminal and civil litigation against the accountants, the vendors and creditors lose money, and the clients of the company would likely lose services of the company.

40.

Misstatement	Result indicating a problem
a.	Detect larger than usual returns; sales and accounts receivable overstatement. Larger than normal percentages indicate a change, either in accounts receivable terms, quality, pricing errors, or all of the above.
b.	Large changes (either way - increase or decrease) indicate that management is avoiding the recognition of bad debt expense or is incurring more of it. Either of these indicates pricing, terms, credit issues and/or pressure to manage earnings. This could lead to overstatement of accounts receivable and Sales and/or understatement of expenses.
c.	Detects changes in credit terms, ability of customers to pay. Accounts that are past due may indicate that the customer was billed, but that shipment was delayed, resulting in older, past due accounts.

41. activity exercise
42. activity exercise
43. activity exercise

Chapter 9 Appendix A

Multiple Choice

44. a
45. c
46. c
47. b
48. c