CHAPTER 5

Audit Evidence and Documentation

Review Questions

5–1 Audit risk is the possibility that the auditors may unknowingly fail to appropriately modify their opinion on financial statements that are materially misstated. It is composed of the possibility that (1) a material misstatement in an assertion about an account has occurred (inherent risk and control risk), and (2) the auditors do not detect the misstatement (detection risk). Detection risk is this second component, the risk that the auditors’ procedures will lead them to conclude that a material misstatement does not exist in an assertion when in fact such misstatement does exist. All other factors held constant, audit risk increases with increases in detection risk.

5–2 The two components of the risk of material misstatement include inherent risk and control risk. Inherent risk is the risk of material misstatement of an assertion about an account, class of transaction, or disclosure without considering internal control, and control risk is the risk that internal control will fail to prevent or detect and correct the material misstatement.

5–3 Inherent risk refers to the possibility of a material misstatement occurring in an assertion assuming no related internal controls. Accordingly, since it exists independently of the auditors, the auditors cannot “reduce” inherent risk. Rather, they gather evidence that allows them to make an accurate assessment of the existing inherent risk.

5–4 Routine transactions involve recurring financial activities recorded in the accounting records in the normal course of business. Examples include sales transactions, purchase transactions, cash disbursements, cash receipts, and payroll transactions. Nonroutine transactions involve activities that occur only periodically. Examples include taking physical inventories, calculating depreciation, and consolidating financial results. Estimation transactions are financial reporting activities that involve creating an accounting estimate. Examples include estimating the allowance for uncollectible accounts, estimating warranty reserves, and assessing assets for impairment.

5–5 Because inherent risk and control risk are a result of characteristics of the client and its internal controls, auditors assess them. Because detection risk is a function of the effectiveness of the audit procedures used to gather evidence, it is restricted to the appropriate level based on the scope of procedures performed.

5–6 The sufficiency of audit evidence is a matter of judgment on every audit, because there are no firm guidelines on the quantity of evidence necessary in a specific audit. The strength of the client’s internal control, the inherent risk of the audit, the levels of materiality for the audit, and the existence of related party transactions are among the factors influencing the auditors’ judgment on the sufficiency of audit evidence. In addition, the quantity of evidence needed to support the auditors’ opinion varies inversely with the quality of the available evidence. Appropriateness is the...
measure of the quality of audit evidence—both its relevance and reliability. The reliability of audit evidence depends on its source, rather than wholly on the judgment of the auditors. For example, documentary evidence created outside the client organization and transmitted directly to the auditors is normally of higher quality than documentary evidence created and held within the client organization.

5–7 The quoted statement is misleading; the counting of office equipment and similar assets does not establish the propriety of the dollar amounts shown on the balance sheet. Neither does a physical count of assets to establish ownership. Establishing the physical existence of an asset is often only one step in the process of verification; the determination of valuation and of legal ownership are often of equal significance.

5–8 Because the purchase invoices are prepared by companies other than the client, they represent more reliable evidence. Falsification of such documents would require rather elaborate planning to obtain letterheads of an outside organization; whereas in many companies, sales invoice forms are readily available to many employees and may not even be controlled by serial numbers. This comparison is merely a specific example of the general rule that documentary evidence created outside an organization is generally considered more dependable than internally created documents.

5–9 The statement is incorrect. Although in general documents prepared within the client’s organization are considered less reliable than those prepared outside that organization, the fact that the check was processed externally by both the organization it was written to and the banking system makes it a reliable form of evidence. Note that some students may be confused as to the distinction between a cancelled check (as per here) and a voided check (a check that will not be used, often because of misprinting of the amount, payee, etc.).

5–10 Auditors may find it useful to apply analytical procedures at several different times during the audit. These procedures must be applied during the risk assessment stage to enhance the auditors’ understanding of the client’s business, to direct the auditors’ attention to higher risk areas, and to assist in the design of an effective audit program. Also, analytical procedures may be applied during fieldwork as substantive procedures to provide evidence as to the reasonableness of specific account balances. Finally, the auditors are required to apply analytical procedures to the audited financial statements as a part of the final overview of the engagement.

5–11 Among specialists whose findings might provide competent evidence for the independent auditors are (only four required): actuaries, appraisers, attorneys, engineers, environmental consultants, and geologists.

5–12 The major purposes of obtaining a client representation letter include: (a) to remind the client officers of their primary responsibility for the financial statements, (b) to document in the audit working papers the client’s responses to many questions asked by the auditors during the engagement, and (c) to provide evidence in areas where accounting presentation may be dependent upon management’s future intentions.

5–13 No. A client representation letter should be viewed as supplementary evidence; it should never be used as a substitute for performing other appropriate audit procedures.
Three approaches for auditing estimates are:

1. Review and test management’s process of developing the estimate. Using this approach an auditor will in essence follow the procedures performed by management and consider their accuracy, whether they follow GAAP, and their reasonableness.

2. Independently develop an estimate of the amount to compare to management’s estimate. Here, for example, if management has estimated the allowance for doubtful accounts using an estimated percentage of credit sales, the auditors might choose to estimate the allowance by aging receivables.

3. Review subsequent events or transactions bearing on the estimate. For example, collection of a receivable after year-end provides evidence relevant to the valuation of the account at year-end.

The statement is false. The auditors, as much as business executives, must consider the cost of the services they render. As an extreme example, the strongest evidence of the collectability of an account receivable held by a client might be to conduct an audit of the customer firm; the cost of such a step would make this method of securing evidence quite out of the question.

The approach is basically an “exit value,” that is, a sales value approach. Fair value is defined to be the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Related party transactions, as the term would suggest, are those between related parties. Parties are considered to be “related” when one party has the ability to influence the other party to the extent that one of the transacting parties may not be pursuing its separate interest. Examples of parties related to the client entity include officers and directors (and their immediate family members) and affiliated companies. Routine transactions between related parties, such as normal compensation arrangements and expense accounts, are excluded from the definition of related party transactions.

Disclosure requirements for related party transactions include:

1. A description of the transactions, including dollar amounts.
2. The relationship between the parties.
3. Amounts receivable from or owed to related parties at the balance sheet date.
4. The terms and manner of settlement.

The statement is correct in that identifying related parties and obtaining a client representation letter are both required audit procedures. In addition, the client representation letter is dated as of the last day of fieldwork because it includes representations with respect to subsequent events. However, the identification of related parties should be done at the beginning of the engagement, not at the end. The audit staff needs to know the identities of related parties so that they may be alert for related party transactions throughout the engagement.

The primary functions of audit working papers are to provide (1) evidence of the auditor’s basis for concluding on the achievement of the audit’s overall objectives and (2) evidence that the audit was planned and performed in accordance with GAAS. Secondary functions include (1) assisting the audit team in planning and performing the work, (2) serving as a record of matters of continuing significance for future audits, (3) assisting audit team members responsible for supervising and reviewing the work, (4) demonstrating accountability of the various audit team members for the work performed, and (5) assisting firm reviewers, inspection and review individuals, and successor...
The prior year’s audit working papers are a useful guide to staff assistants because the audit procedures performed in the prior year usually are similar to those of the current year. By referring to last year’s working papers, the assistant can see how the procedures were documented and is given a possible format for organizing the current year’s working paper. In addition, exceptions noted in last year’s working papers may alert the assistant to possible problems in the current year. Finally, the prior year’s working papers contain information substantiating the beginning balances for the current year.

The more common types of audit working papers and their principal purposes may be summarized as follows:

1. Audit administrative—working papers that aid the auditors in planning and administration of the audit, and include such items as audit programs, questionnaires and flowcharts, decision aids, time budgets, and engagement letters.

2. Working trial balance—represents the backbone of the auditors’ working papers, for it contains the balances of the ledger accounts, the adjustments and reclassifications deemed necessary by the auditors, and the adjusted amounts that appear in the financial statements. It also contains references to all supporting schedules and analyses, thus serving to control the other types of working papers.

3. Lead schedules—working papers that serve to combine similar general ledger accounts, the total of which appears on the working trial balance.

4. Adjusting journal entries—material misstatements in the accounts disclosed by the auditors’ investigation are corrected by means of adjusting journal entries. These appear on the auditors’ working trial balance, and, in addition, a list of such entries is turned over to the client at the conclusion of the audit with the request that they be approved and entered in the accounting records.

5. Reclassification entries—entries necessary to properly reflect financial results but not representing misstatements in the financial records of the client.

6. Supporting schedules—although the term schedule is at times applied to various types of working papers, the preferred usage is to designate a listing of the details or elements comprising the balance in an account at a specified date. Preparation of such a listing is often an essential step in determining the nature of an account.

7. Analyses—consist of working papers showing the changes that occurred in an account during a given period. By analyzing an account, the auditors determine its nature and contents.

8. Reconciliations—working papers that prove the relationship between two amounts obtained from different sources.

9. Computational working papers—used to verify such data as interest expense, income taxes, and earnings per share.

10. Corroborating documents—working papers that provide support for specific representations made in the financial statements, such as letters of representations from clients, lawyers
letters, audit confirmations, and copies of contracts.

5–23 Audit working papers are the property of the auditors; however, they must not violate the confidential relationship between client and auditors by making the papers available to outsiders or even to the client’s employees without specific permission from the client. Working papers should be retained for a minimum of 5 years (7 years for public company audits). Also, under no circumstance should working papers be destroyed after they have been subpoenaed or after litigation involving an engagement has been announced.

5–24 The third parties who are likely to charge the auditors with negligence are bankers, creditors, stockholders, or other persons who invest money in a business in reliance upon audited financial statements and subsequently sustain losses. If events subsequent to the audit show that the audited statements did not provide a fair picture of financial position, operating results, or cash flows, the injured third parties are likely to attempt to recover their losses from the auditors on grounds that they were negligent in conducting the examination. During court cases, the auditors’ working papers are produced; the plaintiffs are given an opportunity to point out any conflicting statements or other evidence in the papers that tend to substantiate their charges.

5–25 Even though the balances of the client’s revenue and expense accounts have been closed to the Retained Earnings account prior to the auditors’ arrival, the balances of revenue and expense accounts prior to their closing should be included in the auditors’ working trial balance. Since the auditors ordinarily express an opinion on the income statement as well as the balance sheet, it is imperative that the audit working papers include full information on the revenue and expense accounts.

5–26 Inclusion of the final figures from the prior year’s audit in a working trial balance or lead schedules facilitates comparisons and focuses attention on any unusual changes; it also gives assurance that the correct starting figure is used if the auditors verify the year’s transactions in a balance sheet account in order to determine the validity of the ending balance.

5–27 The auditors should prepare adjusting journal entries for material items only. The auditors are concerned with the fairness, not the preciseness, of the client’s financial statements; thus the auditors may ignore immaterial errors having no significant effect on the fairness of the financial statements. However, the auditors should consider the cumulative materiality of “passed” adjustments that appear to be immaterial when considered individually. Also, management must concur and represent that it believes that adjustments made are not material individually or in the aggregate.

5–28 The permanent file consists of working papers that are of use in the audits of multiple succeeding years. Such papers are reviewed and brought up to date in each succeeding audit and, therefore, may be contrasted with the file of current year’s working papers that relate only to a single year’s audit. Typical of the papers to be placed in the permanent file are copies of the articles of incorporation or partnership agreement, long-term construction contracts, description of the history and policies of the company, and schedules or analyses of such accounts as capital stock, land, and buildings that often show little or no change over a period of years.
Rules to be observed in the preparation of working papers include the following:

(1) A separate working paper should be prepared for each topic.

(2) Only one side of a sheet is used.

(3) Proper identification of a working paper includes a heading with the name of the client company, a clear description of the information presented, and the applicable date or period covered.

(4) Documents examined, employees interviewed, and sites visited should be completely identified.

(5) Working papers should be dated and signed or initialed by the preparer, and signed or initialed by the senior, manager, or partner who reviewed the working paper.

(6) All working papers should be indexed and should be cross-referenced to the working trial balance or lead schedules.

(7) Where reference is needed between papers, there must be adequate cross-referencing.

(8) The nature of verification work performed by the auditors should be indicated on each working paper.

(9) The extent and scope of tests of controls and substantive procedures should be stated clearly in the working papers for every phase of the audit.

(10) The working papers should include comments by the auditors indicating their conclusions on each aspect of the work.

(11) The rewriting of working papers should be considered evidence of inefficiency and inadequate planning.

(12) The purpose of each working paper and its relation to the audit objectives should be clear.

(13) Working papers should be placed in the completed file as soon as they are finished.

In summarizing for the working papers the extent and results of the work in verifying footings of the cash journals, the auditor’s statement of the periods for which footings were verified would be of greater significance than the dollar amounts verified. A statement of the periods covered provides the reviewer with the basis for an opinion as to the adequacy of the procedure.

The purpose of a “second partner review” is to provide assurance that all of the CPA firm’s quality control policies have been met during the engagement, as well as that the audit was performed in accordance with generally accepted auditing standards.

In their review of audit working papers, managers and partners look for indications that the audit was performed in accordance with generally accepted auditing standards and firm quality control policies and procedures; and they judge whether the evidence accumulated during the audit supports the CPA firm’s opinion on the client’s financial statements.
Questions Requiring Analysis

5–33 a. Management makes the assertions that are embodied in the financial statements.

b. The financial statement assertions are:

Assertions about account balances:

- **Existence**—assets, liabilities, and equity interests exist.
- **Completeness**—all assets, liabilities, and equity interests have been recorded.
- **Rights and obligations**—the entity holds or controls the rights to assets and liabilities are the obligations of the entity.
- **Valuation and allocation**—assets, liabilities, equity interests are included at appropriate amounts.

Assertions about transactions and events:

- **Occurrence**—transactions and events that have been recorded have occurred and pertain to the entity.
- **Completeness**—all transactions and events have been recorded.
- **Accuracy**—amounts and other data relating to recorded transactions have been recorded appropriately.
- **Cutoff**—transactions and events have been recorded in the correct accounting period.
- **Classification**—transactions and events have been recorded in the proper accounts.

Assertions about presentation and disclosure:

- **Occurrence**—disclosed events and transactions have occurred.
- **Rights and obligations**—disclosed events pertain to the entity.
- **Completeness**—all disclosures that should have been included have been included.
- **Accuracy and valuation**—information is disclosed fairly and at appropriate amounts.
- **Classification and understandability**—information is presented and described clearly.

5–34 a. Audit Risk = Inherent Risk \times Control Risk \times Detection Risk

Detection Risk = Audit Risk / (Inherent Risk \times Control Risk)

Detection Risk = 3% / (100% \times 50%)

Detection Risk = 6%

b. Detection Risk = Audit Risk / (Inherent Risk \times Control Risk)

Detection Risk = 5% / (100% \times 50%)

Detection Risk = 10 %

5–35 Types of audit evidence (with examples) include:

- Accounting information system (examples—examine journals and ledgers)
- Documentary evidence (examples—examine invoices and purchase orders)
- Third-party representations (examples—confirmation of debt, cash, and receivables)
- Physical evidence (examples—examination of plant equipment and inventory items)
- Computations (examples—compute depreciation and foot sales journal)
- Data interrelationships (example—analytical procedures)
5-36  a. Copies of client’s sales invoices are less competent evidence. These documents are created inside the client organization and are not scrutinized by outsiders. Their competence as evidence depends upon the strength of the client’s internal control.

b. The auditors’ independent computation of earnings per share is highly competent evidence. Computations of key financial statement quantities made independently by the auditors furnish excellent evidence as to the validity of the client’s computations of the same items.

c. Paid checks returned with bank statements are highly competent evidence. Although these documents originated inside the client organization, they bear the endorsement of the payee (a party with opposing interests) and have been subject to scrutiny (and perforation or stamping) by one or more banks.

d. A response from a customer of the client addressed to the auditors’ office confirming amount owed at the balance sheet date is highly competent evidence. This type of document is of excellent quality as evidence because it comes directly to the auditors from outside the client organization. Moreover, the customer has an opposing interest to the client in that he or she does not want the account to show any larger amount than he or she is obligated to pay.

e. A representation letter by the controller of the client company stating that all liabilities of which she has knowledge are reflected in the company’s accounts is less competent evidence. Since the officers of the client company are responsible for fair and accurate reporting in the financial statements, representation letter by the controller is little more than an acknowledgment of this responsibility and repetition of the representations inherent in the financial statements. The letter does not relieve the auditors of their obligation to verify management’s representations.

5-37  a. In the risk assessment stage of an audit, analytical procedures help the auditors in obtaining an understanding of the client’s business and may direct the auditors’ attention to potential problems and to areas requiring special investigation.

Analytical procedures performed as substantive procedures are useful because they provide the auditors with evidence that substantiates the reasonableness of specific account balances or financial statement amounts.

Analytical procedures applied at the overall review stage of an audit provide an overview of the final audit figures. This final application is to provide assurance that the end results of the audit “make sense,” and that the auditors have not “failed to see the forest for the trees.”

b. The types of information that are available to auditors in developing expectations for analytical procedures include:

(1) Comparable financial data from prior periods.
(2) Industry averages.
(3) Relationships among elements of financial information within a period.
(4) Budgets or forecasts.
(5) Relevant nonfinancial information. For example, many operating costs of a trucking business should be related closely to the number of miles driven.
c. Auditors develop expectations for analytical procedures by:

1. **Trend analysis**—Involves the review of changes in an account balance over time.
2. **Ratio analysis**—Involves comparisons of relationships between two or more financial statement account, or comparisons of account balances to nonfinancial data. The two basic approaches are horizontal analysis and cross-sectional analysis.
3. **Regression analysis**—Involves the use of statistical models to quantify the auditors’ expectation about a financial statement amount or ratio.
4. **Reasonableness tests**—Are similar to regression in that an expectation is developed, but use other approaches to develop the estimate.

5–38

a. The possible reasons for a decrease in the rate of inventory turnover include the following:

1. Decline in sales.
2. Increase in inventory quantities, either intentional or unintentional.
3. Incorrect computation of inventory because of errors in pricing, extensions, or taking of physical inventory.
4. Inclusion in inventory of slow-moving or obsolete items.
5. Erroneous cutoff of purchases.
6. Erroneous cutoff of sales under the perpetual inventory accounting system.
7. Unrecorded purchases.
8. Change in inventory valuation method.

b. The possible reasons for an increase in the number of days’ sales in receivables include the following:

1. Change in credit terms.
2. Decreasing sales.
3. Change in the sales mix of products with different sales terms.
4. Change in mix of customers.
5. Improper sales cutoff.
6. Unrecorded sales.
7. An employee’s fraudulent abstraction of collections from customers.
8. Slower collections caused by tighter economic conditions or lowering of the quality of the receivables.

5–39

a. The objectives of the client’s representation letter are to:

1. Remind the client’s officers of their primary responsibility for the financial statements.
2. Provide evidence that management believes that adjusting entries brought to its attention by the auditors and not made are not material.
3. Provide written documentation of the client’s replies to various inquiries made by the auditors during the examination.
4. Provide evidence in those areas in which accounting presentations are dependent upon management’s future intentions.

b. Representation letters should be prepared on the client’s letterhead and signed by the appropriate officers and employees. In most cases the CPAs will draft the representation letter but the officers or employees must accept the statements in the letter as their own representations.

It is important that the representation letter be signed by one or more officers or
responsible employees who are knowledgeable about the particular area or activity reported upon. For example (and depending on the circumstances), the company secretary might prepare the representation concerning minutes of meetings of the board of directors, the controller and the president might affirm the fair presentation of the financial statements and recording of liabilities, and the purchasing agent might report on purchase commitments. Usually the letters are signed, at a minimum, by the client’s chief executive officer and chief financial officer.

c. Since the representation letter refers to events occurring in the subsequent period, it is appropriate that the letter be signed, dated, and delivered to the auditors on the last day of fieldwork.

5–40 The evidence commonly accepted in support of entries in each of the following records is listed below.

a. Sales Journal
   Copies of consecutive numbered sales invoices, signed contracts, shipping records, customers’ purchase orders.

b. Sales Returns Register
   Copies of consecutively numbered credit memoranda, properly approved; correspondence; receiving records.

c. Voucher or Invoice Register
   Vendors’ invoices (originals) or signed contracts, properly approved by the accounting department, with attached receiving reports; consecutively numbered copies of purchase orders; freight bills.

d. Payroll Register
   Approved time cards or piecework tickets; approved wage and salary increase or decrease notices; personnel department records; union contracts; contracts with individual employees (including officers); paid checks; payroll receipts, if any; social security and income tax withholding records.

e. Check Register
   Approved vendors’ invoices; paid checks; signed vouchers; bank statements.

5–41 Working papers may properly include both factual data and expressions of opinion; however, the two should always be carefully distinguished. Thus, the statement, “We examined the petty cash vouchers for the month of July and found these documents to be poorly prepared and inadequately controlled,” is an unsatisfactory mixture of fact and opinion. Deficiencies in the preparation of petty cash vouchers, such as omission of dates and signatures, should be presented as factual matters. The auditors’ opinion as to the adequacy of the internal control over petty cash is properly included in the working paper but should clearly be labeled as an expression of opinion.

5–42 The criticism by the auditor-in-charge was properly based on the fact that the assistant auditor left the working papers (which are of a confidential nature) exposed to the examination of anyone who came along during the lunch hour. The working papers should have been placed in a locked briefcase or similar protected place during the auditor’s absence.
Objective Questions

Multiple Choice Questions

5–43

a. (4) The effectiveness of internal control is not a financial statement assertion made by management.

b. (4) A large amount of assets by itself is not indicative of high inherent risk. Operating results highly sensitive to economic factors, large past misstatements, and turnover of management all represent characteristics that may indicate high inherent risk.

c. (1) A client letter of representations may never be used as a substitute for other appropriate auditing procedures.

d. (2) According to the definition of “related parties,” one party may be able to influence the other to the extent that the two parties do not pursue their own separate interests in conducting transactions. Thus, a risk exists that the substance of related party transactions may differ from their form.

e. (3) Copies of sales invoices represent internally generated evidence, which is considered least reliable. Confirmations mailed by outsiders and correspondence between the auditor and suppliers represent more reliable externally generated evidence. Canceled checks, although internally generated, are considered reliable because they bear the endorsement of the payee and a perforation or stamp indicating payment by the bank.

f. (2) Analytical procedures are effective in isolating unusual transactions because such transactions may represent a change in a relationship being investigated. Analytical procedures are not typically considered to be tests of internal control, although in certain circumstances they might reveal errors caused by weaknesses in the internal control.

g. (3) Auditors use three basic approaches for auditing accounting estimates—reviewing management’s process, reviewing subsequent transactions, and developing an independent estimate. Confirmation is not a basic approach for auditing most accounting estimates.

h. (4) A primary purpose of audit working papers is to provide documented evidence that the auditors had a firm basis for their report.

i. (2) Relatively unchanging data, such as a long-term lease agreement, is placed in the permanent working paper file.

j. (1) The audit working papers are not prepared to assist management in illustrating that the financial statements are in accordance with generally accepted accounting principles. The other three replies are functions of audit working papers.

k. (2) The work of a specialist is only referred to in circumstances in which those findings do not support the representations made by management in the financial statements, thus causing the auditors to modify their report.
l. (4) When a difference of opinion cannot be resolved, the working papers should be expanded to document the various positions and to describe how the difference of opinion was resolved.

5–44 Adapted AICPA Task-Based Simulation

- a. 3 All assets have been recorded.
- b. 4 Transactions are recorded in the correct accounting period.
- c. 1 There is such an asset.
- d. 6 Assets are properly classified.
- e. 2 The company legally owns the assets.
- f. 5 Assets are recorded at proper amounts.
- g. 9 Risk assessment procedures.
- h. 7 Analytical procedures.
- i. 8 Tests of controls.
- j. 10 Tests of details of account balances, transactions, or disclosures.
- k. 7 Analytical procedures.

5–45

- a. Incorrect. The risk of material misstatements composed of inherent risk and detection risk.
- b. Correct.
- c. Incorrect. A decrease in control risk, absent other changes, results in a decrease in the risk of material misstatement.
- d. Correct. Detection risk is a function of the audit and its procedures. If there is no audit there is no measure of detection risk.
- e. Incorrect. This is backwards. Auditors restrict detection risk through the performance of more substantive procedures. Auditors assess inherent risk and control risk.
- f. Correct.
- g. Incorrect. The error is the “or immaterially.” Audit risk deals with material misstatements.
- h. Correct.

5–46 Multiple Choice Questions

- a. 1 Achieve audit objectives related to a particular assertion.
- b. 3 Considering unusual or unexpected account balances that were not previously identified.
- c. 3 Ratio analysis.
- d. 1 Low.
- e. 3 Anticipated costs of audit completion.

Problems

5–47 SOLUTION: Audit Risk (Estimated time: 20 minutes)

- a. Audit risk is the possibility that the auditors may unknowingly fail to appropriately modify their opinion on financial statements that are materially misstated. It consists of the possibility that (1) a material misstatement in an assertion about an account has occurred (inherent risk and control risk), and (2) the auditors do not detect the misstatement (detection risk).

- b. Inherent risk refers to the possibility of a material misstatement occurring before considering internal control. Control risk is the risk that a material misstatement will not be prevented or detected on a timely basis by the company’s internal control. Detection risk is the risk that the auditors will fail to detect the misstatement with their audit procedures.
c. The risks vary inversely from one another. The less inherent or control risk the auditor believes exists, the greater the acceptable detection risk. Conversely, the greater the inherent or control risk the auditor believes to exist, the less the acceptable detection risk.

d. Detection risk—the risk that the auditors fail to detect a misstatement—is the only risk that is completely a function of the sufficiency of the evidence gathered by the auditors’ procedures. It only exists when an audit (or other attest service) is being performed. Inherent risk and control risk are a function of the client and its operating environment. Regardless of how much evidence the auditors gather, they cannot change the actual levels of these risks. Evidence gathered by the auditors is used to assess the levels of inherent and control risk. On the other hand, evidence gathered for detection risk is used to restrict audit risk to the appropriate level.

e. The statement is incorrect in that it overlooks the liquid nature of cash as well as its high rate of turnover. Throughout a year a large amount of cash is typically generated and spent, allowing for material misstatements, potential embezzlement, and other improper use. Thus, inherent risk for the account is normally high. Control risk is based on the operating effectiveness of a company’s internal control. Because inherent risk is high and control risk varies from client to client, little can be said concerning the appropriate level of detection risk.

5–48 SOLUTION: Oak Canyon, Inc. (Estimated time: 25 minutes)

Because of the weaknesses in internal control, the auditors would place less than the usual reliance upon items (a) and (e). More reliance would be placed on items (b), (c), and (d). The reasoning for this conclusion can be explained by considering the nature of each of the five types of evidence.

a. Limited reliance can be placed on documentary evidence created within the organization and not reviewed by outsiders. Weak internal control often results in documents being prepared by individuals whose duties give them an incentive to create false documentation. For example, an employee with access to cash receipts may also issue credit memoranda that are not subject to supervisory review. If a cash shortage arises for any reason, the employee may be tempted to “solve the problem” by issuing fraudulent credit memoranda. Failure to account for all documents by serial number is also a threat because this practice leaves the auditors with no assurance that a population of documents is complete. Finally, weak internal control provides a setting in which management could, if it chose to do so, use false supporting documents for the dual purpose of supporting misleading financial statements and deceiving the auditors.

b. Reliance upon physical evidence may increase when internal control is weak. For example, if internal control over inventory is weak, the auditors may place more weight upon a complete physical inventory taken at the balance sheet date.

c. Reliance upon evidence provided by specialists may be increased if internal controls over inventory are weak. In addition to emphasizing a complete physical count at the balance sheet date, the auditors may want the assurance of independent experts (specialists) as to the quality and condition of the wine inventory.

d. Reliance upon analytical procedures may be increased. The weakness in internal control could cause large errors in account balances. Consequently, the analytical procedures that call attention to any unusual relationship between amounts in the financial statements take on
added importance.

e. Reliance upon accounting records as evidence tends to be reduced when internal controls are weak. The reliability of journals and ledgers is determined by the strength of internal controls in their preparation. For example, if the same person who maintains the general ledger maintains subsidiary ledgers, little assurance of accuracy is provided by agreement between these records. Similarly if there are no control measures to insure that all retirements of plant and equipment are recorded, the equipment shown in the records may in fact no longer be used in operations.

5–49 SOLUTION: Hope Ranch (Estimated time: 25 minutes)

a. Examination of the computer printout for this large account would be merely a preliminary step in the gathering of evidence by the auditors. The reliability of this printout would depend a great deal upon the adequacy of internal controls; specifically upon such points as whether the person maintaining this subsidiary ledger for accounts receivable had access to cash receipts, whether he or she was also responsible for maintaining the general ledger, and whether he or she played a part in the preparation of monthly statements sent to customers.

b. Copies of the sales invoices in the amount of the receivable would be dependable only if the internal control was strong, so that the person maintaining the accounts receivable records had no opportunity to obtain or falsify invoices, and the invoices were carefully controlled by serial numbers. Even under these favorable circumstances, not much weight could be attached to copies of sales invoices considered by themselves.

c. A purchase order received from a customer constitutes somewhat stronger documentary evidence than invoices created within the client organization, but could nevertheless be fraudulently created without too much difficulty. The purchase order would be of more significance if the auditors knew the customer company and the nature of its operations.

d. A shipping document describing the articles sold would be of considerable significance if prepared in the shipping department by persons having nothing to do with accounting records and if the document were serially numbered and properly controlled. This document is still, however, subject to the limitations of all documentary evidence prepared within the client company and circulating only within that company.

e. A letter received by the client from the customer acknowledging the receivable is not of much value when it has passed through the client’s hands prior to its inspection by the auditors. It is of the same general order of reliability as the purchase order from the customer.

f. A letter received by the auditors directly from the customer acknowledging the correctness of the amount shown as a receivable on the client’s accounting records is excellent evidence. As a further precaution, when the receivable in question is large in relation to the other assets of the client, the auditors may wish to verify the existence and the credit rating of the customer by reference to trade journals and directories and by inquiry of a credit rating agency.
SOLUTION: Brody Corporation (Estimated time: 25 minutes)

a. Accounts that might be out of line
(1) Sales returns and allowances (accounts receivable may be overstated). A misstatement in sales returns and allowances will result in overstatement of all subsequent operating results.

(2) Cost of goods sold. One would not expect a 7 percent increase in sales to result in a 10 percent increase in cost of goods sold. Misstatements of purchases and ending inventory are possible here (the beginning inventory is assumed correct in the problem). Overstated purchases might result in overstated accounts payable. An understatement of the ending inventory will result in overstated cost of goods sold.

(3) Selling, Advertising, and Research and Development expense. This might be the result of failure to record accrued expenses as of year-end and thus be consistent with understated accounts payable. Alternatively, management may simply have decreased these largely discretionary expenses.

b. Ratios that might be out of line
(1) Receivable turnover. The decrease in receivable turnover seems significant. One would want to analyze receivables and consider them in conjunction with the allowance for doubtful accounts. Also, one might consider whether sales returns and allowance have not been recorded and thereby overstated ending receivables and possibly inventory if the ending inventory includes such as returned items.

(2) Days sales in ending receivables. The change in this ratio is consistent with collection problems as is the receivable turnover ratio.

(3) Inventory turnover. This decrease in the turnover ratio, although of a similar management to that of the preceding year may indicate overstatements of inventory or possibly obsolete inventory items.

(4) Days sales in ending inventory. This represents an increase in inventory and the possible misstatements parallel those discussed for the inventory turnover.

Note to Instructor: The above are simply examples. Students may bring up others. In an actual situation an auditor would have more balance sheet information to work with as well as account information. The problem should generate a discussion of difficulties in developing an expectation.

SOLUTION: Accounting estimates and management assertions (Estimated time: 25 minutes)

a. Three approaches for auditing estimates are:

(1) Review and test management’s process of developing the estimate. Using this approach an auditor will recalculate the amount included in the allowance and consider the reasonableness of the method and result.

(2) Independently develop an estimate of the amount to compare to management’s estimate. Here, for example, an auditor might age the year-end receivables, estimate percentages uncollectible in each age group, and calculate a year-end expected account balance. This amount will be compared to the amount calculated by the client.

(3) Review subsequent events or transactions bearing on the estimate. Collection of receivables after year-end will provide evidence relevant to the valuation of the account at year-end. Overdue accounts will then be analyzed to determine collectibility.
b. The valuation assertion for the allowance for uncollectible accounts addresses whether the amount in the account is determined in accordance with generally accepted accounting principles. Since accounts receivable should be valued at their net realizable value, the receivable balance less the allowance for uncollectible accounts should equal this amount.

c. The following factors are indicative of an account with high inherent risk: (1) difficult to audit transactions or balances, (2) complex calculations, (3) difficult accounting issues, (4) significant judgment, and (5) valuation that varies significantly based on economic factors.

Although the calculation of the transactions involved in the allowance for doubtful accounts may be relatively simple, significant judgment is involved in determining the ultimate net realizable value of receivables. The ability of a customer to pay its debts depends on a number of factors, including future economic and industry conditions, and whether its management makes good business decisions. This means that estimating the proper valuation of the allowance for doubtful accounts is often very difficult.

5–52 SOLUTION: Pratt Company (Estimated time: 20 minutes)

Deficiencies in the Pratt Company audit working paper include the following:

(1) The working paper is not properly identified. It appears to be a bank reconciliation; if so, the heading of the paper should include this information as well as the exact title of the ledger account and the name of the bank. In addition, the audit date should be indicated.

(2) “Per bank” is not a specific identification of the beginning amount in the working paper. A better caption would be “Balance per bank statement, December 31, 200X.”

(3) “Per ledger” is not a specific identification of the ending amount in the working paper. A better caption would be “Balance per general ledger, December 31, 200X.”

(4) The outstanding checks are not properly identified. The appropriate check numbers should be indicated.

(5) Assuming no adjusting journal entries are required, the $42,034.58 balance per general ledger should be cross-referenced to the working trial balance or cash lead schedule.

(6) The nature of the verification work performed by the auditor is not clear. The one tick mark and the word “Verified,” are inadequate. Separate tick marks should be used for the following legend:

“Confirmed” (for balance per bank statement, December 31, 200X).

“Examined paid check returned with January, 200Y, cutoff bank statement” (for the six outstanding checks indicated as “verified”).

“Traced to general ledger” (for balance per general ledger, December 31, 200X).
The conclusions of the staff assistant should be stated.

Description ① seems questionable. If these represent cash sales for December 31, 200X, one must question why the bank did not receive the receipts until 1/9/0Y. Further procedures are necessary to determine whether the cash may have been received after year-end.

Description ② is inconsistent with subtracting the bank charges from the balance per bank. The bank has already recorded this as a disbursement. The entry in effect deletes the charge again from the bank’s balance. Since the cash disbursement is not recorded on the books until January, it should be necessary to add back the service charge to obtain the book balance at 12/31/0X. Although the amount is obviously immaterial in and of itself, it may be indicative of a much larger problem since one should not be able to reconcile to the penny when there is an incorrect entry such as this.

Because the checks described by → were on hand at year-end, they do not represent disbursements until January. Accordingly, the entry in which these were recorded as disbursements should be reversed at year-end, and then recorded in January.

5–53 SOLUTION: Uden Supply Company (Estimated time: 45 minutes)

a. Analytical procedures performed at the risk assessment stage are designed to help the auditors identify unusual transactions, events, or amounts that might affect the fairness of the financial statements. They are also used to help the auditors increase their understanding of the client’s business.

b. The solutions to parts (b) and (c) will vary depending upon the expectations developed by the student. The suggested solutions are based on the pattern of the trends, giving consideration to the nature of the account.

Sales ($10,100 + $700) ................................................................. $ 10,800
Cost of goods sold ($10,800 × .6915) ................................................ 7,468
Gross profit ................................................................................. $3,332

Sales commissions ($10,800 × .07) ............................................. $      756
Advertising ($10,800 × .02) ............................................................. 216
Salaries ($1,103 + $21) ................................................................. 1,124
Payroll taxes ($199 + $8) ............................................................... 207
Employee benefits ($181 + $7) .................................................... 188
Rent ($62 + $1) ................................................................. 63
Depreciation ($66 + $3) ............................................................... 69
Supplies ($30 + $2) ................................................................. 32
Utilities ($23 + $1) ................................................................. 24
Legal and accounting (($40 + $3) .................................................. 43
Miscellaneous ($14 + $1) ........................................................... 15
Interest expense ($240 + $12) ................................................... 252
Total expenses ............................................................................. $2,989

Net income before taxes .......................................................... $  343
Income taxes ($343 × .22) ............................................................ $ (75)
Net income ................................................................. $ 268

c. $10,800 \times .31 = $3,348 \text{ gross profit}
$3,348 – $3,332 (expected gross profit) = $16 \text{ expected misstatement}

d. Many would consider the amount as immaterial as a $16,000 misstatement of a net income
before taxes of $343,000 is less than 5 percent of income. Chapter 6 discusses materiality in
greater detail. A difference such as this makes clear the difficult task of determining what is
actually a material misstatement.

In-Class Team Case

5–54 SOLUTION: Houseco (Estimated time: 25 minutes)

The financial statements for this case were loosely constructed using those of the Regina Vacuum
Cleaner Company shortly before its failure. Regina, a manufacturer of electric broom type vacuum
cleaners (not toasters as in this case) overstated sales and receivables and understated sales returns
and allowances relating to cheap models of electric brooms that did not operate as advertised.

(1) Cash—The horizontal analysis shows large increases. However, these increases are largely
due to the small amount of cash on hand at 12/31/X6.

(2) Accounts receivable—The vertical analysis reveals that receivables increased in 20X7 as a
proportion of total assets, and stayed at that relative level for 20X8. The horizontal analysis
reveals that the percentage increase in receivables was 93 percent and 84 percent,
respectively, for the two years. These are particularly large increases as compared to the
increases in gross sales (70 percent and 38 percent) for the two years. This causes one to
question whether receivables are possibly overstated at year-end or whether collectibility of
receivables may be in question. The decrease in the receivable turnover, and increase in
days’ sales in ending receivables also raise questions concerning collectibility of receivables.
The increase in receivables (as well as inventory) explains most of the changes in the current
and quick ratios.

(3) Inventories—Inventories have increased from 23 percent of total assets in 20X6, to 33
percent in 20X8. Raw materials, work in process, and finished goods have all increased
significantly. The horizontal analysis reveals that increases in inventories greatly exceed the
increases in gross sales. Days’ sales in ending inventory have increased from 75 to more than
112. As indicated above, the increase in inventory and receivables explains most of the
changes in the current and quick ratios. The case does not indicate the date of the meeting
between the CPA and the client, but these increases raise questions as to existence, which
might be addressed through the inventory observation. Valuation questions might be
addressed through analysis of components of the inventory.

(4) Overall current liabilities—Accounts payable and accrued liabilities in particular seem low,
given the great increases in the size the overall company. These small changes also help
explain the increased current and quick ratios.

(5) Bank debt—The company apparently secured a large new bank loan during the year. Details
of this loan will be confirmed, and the debt agreement examined.

(6) Gross Sales—As indicated above, sales have increased at a high rate.
(7) Sales returns and allowance—This number seems particularly low for 20X8. While sales increased 38 percent in 20X8, the returns and allowances decreased by 50 percent.

(8) Cost of goods sold—Cost of goods sold, as a percentage of net sales, has decreased from 61 percent in 20X6, to 52 percent in 20X8. While this may be due to increased levels of sales, one must question it, particularly given the increased reported total inventories.

(9) Interest expense—The increase in interest does not relate well to the increase in bank debt. One explanation might be that the debt was obtained near year-end. However, given the limited cash remaining this might not be accurate.

(10) Income taxes—The increase here is less than one would expect, given the increase in income before taxes.

Research and Discussion Cases

SOLUTION: Datasave, Inc. (Estimated time: 25 minutes)

The purposes of obtaining the representation letter are to have management acknowledge their primary responsibility for the financial statements, and to get in writing the important oral representations that have been obtained from management during the course of the audit. 

AICPA AU 580 (PCAOB 333) requires that the auditors obtain written representations from management on every audit engagement. Failure to do so is a “scope limitation,” which precludes the auditors from issuing an unqualified opinion. AICPA AU 580 also indicates that the representation letter should be signed by members of management that are responsible for and knowledgeable about the matters covered by the representations and that, normally, they should be signed by the chief executive officer and the chief financial officer. AICPA AU 580 further states that the auditors should consider the effects of management’s refusal to furnish written representations on their ability to rely on other of their representations.

AICPA AU 700 (PCAOB 508) provides that when the client imposes restrictions that significantly limit the scope of the audit, the auditors generally should issue a disclaimer of opinion.

a. The following are alternative courses of action that are available to you, and supporting arguments.

(1) You could accept Cox’s suggestion and issue an unqualified opinion. Wagner is no longer part of management of the company. Therefore, there is no reason to require his signature on the representation letter. Your firm can still adhere to the letter of the standard by having Ross sign the letter.

(2) You could issue a qualified opinion because of the scope limitation. Wagner was an important part of management during the period under audit. He is knowledgeable of and responsible for many of the matters covered by the representations. Failure to obtain his signature would be a significant scope limitation. Since Wagner is no longer part of management, this is not a scope limitation imposed by the client that would generally result in a disclaimer of opinion.
(3) You could issue a disclaimer of opinion, using the arguments from (2), but concluding that the refusal to sign is a scope limitation imposed by management. The mysterious circumstances surrounding the resignation of Wagner might also support this conclusion.

(4) You could withdraw from the engagement. This course of action may be justified if Wagner’s refusal to sign the letter causes you to question the integrity of management. The unanswered questions regarding the reasons for Wagner’s resignation also provide some support for this course of action.

b. Our opinion:

The mysterious circumstances surrounding the resignation of Wagner should be of as much concern as Wagner’s failure to sign the representation letter. Perhaps Wagner was being forced by other members of management to misstate the financial statements. Assuming that the auditors could resolve their concerns about that matter, it probably would not be necessary to obtain Wagner’s signature on the letter, and an unqualified opinion could be issued. Obtaining the signature of Ross on the letter also is probably not important, because he is neither knowledgeable of nor responsible for the matters contained in the representation letter.

5–56 SOLUTION: Interstate Land Development Corporation (Estimated time: 45 minutes)

a. In connection with registration audits, auditors may be liable for any losses to persons acquiring the security that are proximately caused by the auditors’ ordinary negligence. This is a higher standard of liability than the gross negligence standard existing under common law (Ultramares approach) and under the Securities Exchange Act of 1934. In addition to being liable for losses attributable to ordinary negligence, a considerable portion of the burden of proof is transferred by the 1933 Act to the defendants. Thus, the auditors must prove “due diligence,” rather than the plaintiffs having to prove negligence.

b. The IRS investigation constitutes a subsequent event—that is, information coming to the auditors’ attention subsequent to the balance sheet date. As indicated in the text, the Securities Act of 1933 extends the auditors’ attention to subsequent events to the effective date of the registration statement. Since this IRS investigation has come to light prior to that date, the auditors are responsible for proper financial statement presentation of these facts. The $800,000 tax liability is a loss contingency, in that there exists some uncertainty as to whether or not the loss has actually occurred.

FASB ASC 450-20-2, dealing with loss contingencies, establishes criteria for accruing, disclosing, or ignoring loss contingencies. If the loss is “probable” and can be “reasonably estimated,” it should be accrued in the 20X6 financial statements. If either one of these criteria has not been met, but it is still at least “reasonably possible” that a loss has been incurred, disclosure is required. Only if the prospects of a loss having been incurred are “remote” can this contingency be ignored in the financial statements. Thus, the auditors must make a judgmental decision as to whether it is appropriate to ignore, disclose, or accrue a loss relating to this matter in the 20X6 financial statements.

Prior to making this decision, the CPA firm should investigate the potential tax liability of Interstate, rather than merely relying upon Dunkirk’s evaluation. The auditors should review Interstate’s tax returns for the years in question. They should also review all correspondence between Interstate and the IRS in order to determine the areas under challenge and to judge the validity of the IRS’s assessment. Furthermore, the CPAs should obtain Interstate’s legal counsel’s evaluation of the situation. In all probability, Marshal and
Wyatt should at least insist upon complete disclosure of this situation in the financial statements; they may even need to insist upon accrual of a liability for some or all of the $800,000, depending upon the outcome of their investigation.

c. No. Although a minority of state courts apply the privileged communication rule to the CPA-client relationship, the federal courts do not follow this rule of evidence. Hence, the CPA firm had no choice but to honor the subpoena even though it did not prepare the client’s tax returns.