



ACCO 450 Review- Winter 2017

Final Exam: Friday April 21 - 7pm-10pm

- Worth 50% of overall grade
- Exam is cumulative to the extent some material from pre-midterm carries over (ie. Assertions, audit risk model, etc).
- Formulas in the Lakeside case book- standard deviation, sample size, & precision interval = do not need to memorize them

Lecture 1- Course introduction, Introduction to Auditing, Auditor Roles & Responsibilities, & the Audit Process

1. Describe the Audit Regulatory Environment

- Auditing is important to the economy so it is regulated to ensure it is effective.
- CPAB- Canadian Public Accountability Board- Monitors auditors of public companies
 - Annual inspections of accounting firms
- Canadian Accounting Profession
- Provincial regulation
- US Influence- Canadian firms listed in the US must comply with SEC regulations and with SOX
 - SOX- PCAOB Does audit quality control inspections and management internal control statements are mandatory and contain disclosures about the reliability of internal controls

2. Briefly Explain Professional Practice Standards

- In Canada follow GAAS- Generally Accepted Auditing Standards
 - Auditing recommendations that have been established in a particular jurisdiction by formal recognition by a standard setting body, or by authoritative support or precedent such as the auditing & assurance recommendations of the CPA Canada Handbook.
- CAS- Canadian Auditing Standards

-Ethical requirements of GAAS relates to the personal integrity & professional qualifications of auditors:

-Competence

- Adequate technical and training- education in accounting
- Use of judgment & professional skepticism

-Objectivity & Independence

- Independence in fact
- Independence in appearance- Public perceives the auditors
- Threats to independence: self-interest, self-review, advocacy, familiarity, intimidation

-Due Professional Care

- What auditors do and how well they do it

-Auditors have to find the balance between professionalism and commercialism- Potential conflict of interest situation

3. Discuss Management and Auditors Responsibilities

Auditor Responsibilities- Conduct an audit in accordance with CASs

-Overall Objectives:

- Obtain reasonable assurance about whether the FS are free from MM
- Express an opinion on whether the FS are prepared in accordance with acco. Stds. (IFRS/ASPE)
- Report on the FS in accordance with the auditor's findings

-Preconditions for an Audit:

- Determine if the financial reporting framework applied is acceptable
- Obtain the agreement of management that it acknowledges and understands its responsibility (audit engagement letter).
- System of quality control*- procedures and policies used to make sure that the audit firm meets its professional responsibilities and complies with GAAS on every audit
 - A. Leadership responsibilities for quality within the firm
 - B. Relevant ethical requirements
 - C. Acceptance and continuance of clients
 - D. Human resources
 - E. Engagement performance
 - F. Monitoring of the audit firm system of quality control

-Regarding Material Misstatements:

- Errors*- Unintentional
 - Responsibility to apply a risk based approach, proper methodologies and audit tests
 - When material errors are discovered- ask the client to fix them, if they don't issue a qualified audit report

-*Fraud & Other Irregularities*- Misappropriation of assets & Fraudulent Fin. Reporting

- Responsibility to evaluate the likelihood of fraud
- Primary responsibility for the prevention & detection of fraud is with mgmt.

Management Responsibilities

-Preparation of the FS in Accordance with the Applicable Fin. Reporting Framework

-Design the Internal Controls Necessary to Prepare FS that are free from MM

-Provide the Auditor with Access to all the Relevant Information & Unrestricted Access to Persons within the Entity

-For Listed Firms- CEO & CFO Must Certify the FS and MD&A

4. Introduce the Content of the Audit Report (Also in Lecture 11)

- *Unqualified Opinion* – FS are free of MM- The standard audit opinion
- *Qualified Opinion*- Significant, but not pervasive, GAAP Departure or Scope Limitation
- *Adverse Opinion*- Pervasive GAAP departure
- *Denial of Opinion*- No opinion can be issued because auditors have not been able to conclude (pervasive scope limitation)

-Standard Audit Report Contains the Following:

- Title
- Address- Normally addressed to those it is prepared for
- Introductory Paragraph- Should ID the FS & declare they were audited
- Responsibilities- State mgmt's responsibilities to prepare the FS and corporate governance responsibilities to oversee fin. Reporting, auditor responsibilities
- Description of the Audit
- Opinion-States whether the FS present fairly, in all material respects..... in accordance with GAAP
- Key Audit Matters- Auditors must ID the most significant issues during the audit
- Signature- By the auditor
- Date-No earlier than the date when the auditor obtained sufficient appropriate evidence supporting their opinion on the FS.

5. Define Auditing

- The verification of information by someone other than one providing it
- The accumulation and evaluation of evidence about an information to determine and report on the degree of correspondence between the information and established criteria (ie. IFRS, etc)
- Not only for FS- but the focus of the course
- Doesn't include FS preparation
- Important decisions are made based on accounting information. Audits reduce the risk of basing the decisions on inaccurate information. Reduces information risk.
- Objective*- Express an opinion on whether the FS are prepared, in all material respects, in accordance with the applicable financial reporting framework.

-Agency Theory & Accountability

-Three Party Accountability

- Asserter
 - Assurer
 - User(s) of the asserted information
- Regulators require public companies to hire an independent auditor to verify the annual FS

-*Attest Engagement*- A party affirms the validity of assertions made in writing (ie. FS)

-*Expectation Gap*- What the public expects from auditors and what auditors actually do

6. Explain the Sources of the Demand for Auditing

7. Describe Major Types of Audits and Auditors

-*Financial Statements*

-*Internal and Operational Auditing*- company employees that are independent from direct management.

-Evaluate the effectiveness of the company's risk management, internal controls and processes.

-Make recommendations for improvement.

-*Public Sector (government) Auditing*

-*Fraud Auditing*

-*Other- IT Audits, Environmental Audits, Compliance Audits*

-*Assurance Services*- Reports about the reliability of an assertion. Includes:

-Audits of FS

-Reviews of FS

-Reports on the effectiveness of internal controls

-IT Attestation services

-Vote counts (ie. Oscars)

-*Non Assurance Services* Includes:

-Compilation engagements

-Tax services

-Consulting/management advisory services

8. Provide a Quick Overview of the Public Accounting Profession

-Big Four Audit Firms

-Audit Team Includes:

-Partner

-Manager

-Senior/In-Charge Auditor

-Assistant/Junior Auditor

-How to Become a Professional Accountant?

-Education

-Exams

-Practical experience

-Provincial designation/license

Lecture 2- Client Acceptance, Understanding the Client Business, Preliminary Analytical Procedures

1. Present an Overview of the Audit Process

Steps	Elements	Chapters
Risk Assessment PLAN	Pre-engagement activities	Chapter 5
	Preliminary Audit Planning: Risk Identification	
	Risk Assessment Procedures to Plan Audit	Chapter 6, 7, 8
Response to Assessed Risks DO	Internal control documentation and testing	Chapter 9
	Sampling	Chapter 10
	Substantive procedures	Chapter 11, 12, 13, 14, 15 and 19
Concluding & Reporting CONCLUDE	Review audit findings	Chapter 16, Chapter 4
	Form opinion and issue report	

2. Describe the Client Acceptance Decision

-Pre-Engagement Activities -New Client Investigation vs. Recurring Audit

-New Client Investigation:

-Obtain & review FS

-Evaluate independence (lecture 1)

-Evaluate competency & availability of resources (ie. Experts needed?)

-Understand the business and the client risks

-Assess the integrity of mgmt.

- Communicate with previous auditor
 - Rules of professional conduct require the new auditor to contact the predecessor auditor.
 - Enquire about the client's integrity, existence of disputes about accounting principles or audit procedures/fees
 - Enquire about the reasons for the change of auditors, if there are issues that should be considered in accepting the client
 - Obtain information from previous audit files about the opening balances
 - Predecessor auditor is required to respond to the communication, but they also have a duty to maintain confidentiality
 - Client consent is required, but the communication must happen.
 - Audit files belong to the auditor not the client
- Obtain an engagement letter
 - Reduces the risk that either the auditor or client/auditee misinterprets the needs or expectations of the other party.
 - Agreed upon terms of the engagement
 - Objective and scope of the audit
 - Responsibilities of the auditor and management
 - Applicable financial reporting framework

-Recurring Audit:

- Do circumstances require the terms of the audit engagement to be revised? I.e. A significant change in the nature or size of the entity's business
- Obtain an engagement letter
 - Reduces the risk that either the auditor or client/auditee misinterprets the needs or expectations of the other party.
 - Agreed upon terms of the engagement
 - Objective and scope of the audit
 - Responsibilities of the auditor and management
 - Applicable financial reporting framework

3. Explain the Importance of Understanding the Client's Business

- Auditor should obtain an understanding of the entity and its environment
- Important to understand the risks and risk the FS are MM & to evaluate the effect of these risks on the reporting & disclosures
- Basis for establishing the overall audit strategy

-Includes:

- External aspects*- Industry, regulation, economic environment, reporting specificities
- Nature of the entity*- Operations, ownership, governance, structure, investments, financing
- Entity's accounting policies & information system*
- Entity's objectives & strategies*
- Entity's main performance measures*

4. Explain Preliminary Analytical Procedures

-Audit tests consisting of the use of financial analysis techniques (ratios) in order to compare the results with predefined expectations to determine whether account balances are reasonable.

-To ID areas where misstatements are most likely to occur

-Most effective when integrated with a strong knowledge of the auditee's business

-Examples of Benchmarks:

-Prior-period data

-Industry data

-Client-determined expected results (ie. Budgets, forecasts)

-Auditor determined expected results

-Non-financial data (ie. Minutes, contracts, discussions, etc)

-Selected ratios

PURPOSE	PHASE		
	(Required) Planning Phase	Testing Phase	(Required) Completion Phase
Understand client's industry and business	X		
Assess going concern	X		
Indicate possible misstatements (attention directing)	X		X
Reduce detailed tests		X	

Lecture 3- Preliminary Audit Planning- Materiality, Assertions

1. Explain the Concept of Materiality

- A misstatement in the FS is considered material if it is probable that the decision of a user would be changed or influenced by such misstatement
- One of the first important judgments the auditor must make since it affects every other planning, examination and reporting decision of the audit.
- It is relative, not absolute. Based on the different users.

-3 Levels of Materiality:

A. Materiality for the FS as a whole- Overall Materiality

- Set before the detailed audit testing/Done at the audit planning stage
- Use professional judgment
- Depends on what the auditor perceives of what matters for FS users
- What is the largest amount of uncorrected monetary misstatement that might exist in FS that still fairly presents the auditee's financial position & results of operations under an acceptable financial reporting framework.
- Quantitative guidelines
- Cumulative effect of errors- must consider the sum of misstatements
- Must consider special circumstances ie. The effect the misstatement has on bonus, covenants, etc
- Even if small, intentional misstatements (fraud) are always material

B. Materiality for particular classes of transactions, account balances or disclosures

- Smaller materiality levels can be required when misstatements of lesser amounts could influence the economic decisions of users for one or more particular classes of transactions, balances or disclosures

C. Performance materiality

- Aggregated individual immaterial misstatements may cause the FS to be MM
- To reduce the probability of this occurring, need to determine a performance materiality.
- The difference between the performance materiality level and the overall materiality level = cushion
- In practice is set to 50-80% of the total materiality

D. Non-Significant Errors

- Very small amounts considered negligible

2. Identify Management Assertions & Audit Objectives

- Auditors must obtain sufficient appropriate audit evidence to verify all the management assertions

- Existence/occurrence
- Ownership
- Completeness
- Valuation
- Cut-off
- Presentation

- Management makes assertions about:
- Transactions throughout the year
 - Account balances at year-end
 - Disclosures at year-end

	Transactions	Year-end balances	Disclosures
Existence (E)	Occurrence (recorded transactions have occurred)	Existence (assets, liabilities and equity exist)	The disclosures correspond to real events
Ownership (O)	Recorded transactions pertain to the entity	The entity controls or has the rights to assets, liabilities and equity	Disclosed events pertain to the entity
Completeness (C)	All transactions are recorded	All assets, liabilities and equity are included in the F/S	All necessary disclosures are included
Valuation (V)	Recorded amounts are accurately measured	Assets, liabilities and equity are properly valued	The disclosed information is accurate
Cut-off (c-o)	Transactions are recorded at right dates	Assets, liabilities and equity are recorded in the proper period	
Presentation (P)	Amounts are classified in proper accounts	The presentation of the F/S is correct	Disclosures are understandable

Lecture 4- The Audit Risk Model

1. Explain the Audit Risk Model & Define its Components

- The auditor accepts some level of uncertainty- Complete assurance is impossible
- Audit procedures are designed to reduce the probability of misstatements to an “acceptable” level. But what is acceptable?
- Audit risk*- The probability that the audit will provide an unqualified opinion when a MM exists.
- Auditor wants to make sure that the audit risk is acceptably low before issuing a clean opinion.
- Auditor’s verification work provides assurance that the FS are not MM.
- Auditor’s overall objective is to get reasonable assurance to support their audit opinion.

-*Audit Risk*- Acceptable level will always be low = 1-5%.

-Usually don't give absolute numeric values, instead high, moderate, low

-A way for the auditor to be forced to consider each of the components separately and document the conclusions about the risk assessment and the effects on the design of audit procedures.

-A planning model

-Audit Assurance = 1 – Audit Risk (probability of audit success)

-*Factors Used to Assess Audit Risk:*

-External users' reliance on FS

-Likelihood of financial difficulties

-Management integrity

-+ New client

-*Audit Risk Model*

=*Audit Risk* = Inherent Risk X Control Risk X Detection Risk

-IR X CR= *RMM*- Risk of Material Misstatement

-*Inherent Risk*- Likelihood of MM in the FS (assuming no internal controls exist). MM could have occurred in the first place. Ie. MM in PY so IR will be higher.

-13 Key Factors for Assessing Inherent Risk:

1/ Level of judgment required to record transactions and complexity of the accounting policies and (subjectivity, complexity of accounting estimates)

2/ Accounting staff competency and experience

3/ Assets susceptible of misappropriation (theft)

4/ Nature of the business (complicated transactions, complex regulations, complex contracts, complex organizational structure, operations in multiple locations)

5/ Changes in technologies and organizational changes (new personnel, new systems, new processes)

6/ Economic conditions

7/ Actual or suspected fraud affecting the entity

8/ Management incentives to manipulate earnings (compensation packages)

9/ Doubts about management integrity

10/ Results of previous audits

11/ Related party transactions

12/ Non-routine transactions

13/ Initial engagement (new client)

-*Control Risk*- Likelihood that misstatements will not be detected or prevented by the internal control systems.

-Factors for Assessing Control Risk:

1. Quality of the corporate governance processes (affects the general control environment)

2. Effectiveness of the internal control procedures

-Detection Risk- Auditor's responsibility. Risk that the audit procedures will fail to detect MM. To reduce the risk, more audit evidence is needed.

2. Illustrate how Business Risk Analysis is Used to Assess the Risk of Material Misstatement at the F/S Level & Assertion Level

-Client Business Risk- The risk that the client will fail to achieve its business objectives and execute its strategies.

-Understanding helps the auditor to ID risky areas that may affect the amounts & relations among the numbers recorded in the acco. System and FS.

Understanding Business Risks Assess the Following:

-Industry & external environment

-Business operations & processes

-Management & governance

-Objectives & strategies

-Measurement & performance

3. Materiality & Audit Risk

-Materiality- Magnitude of a misstatement

-Based on how misstatement will affect FS users

-Audit Risk- Probability of undiscovered misstatements

-Determined by how much assurance the auditor requires

-Both decided independently of each other.

-Both deal with the sufficiency of evidence

-Both planned early in the engagement.

Lecture 5- Audit Evidence & Audit Documentation

-To achieve an acceptably low level of audit risk, auditors have to do audit work to lower their risk of not detecting a MM.

-Auditors assess the risk of MM at the assertion level, and this is the starting point for planning how to go about gathering evidence that is relevant to assessing if FS have MM.

-Audit Evidence- The information used by auditors to determine if the FS are fairly stated

-Must obtain independent evidence that supports the FS assertions.

-Decisions regarding evidence:

-Type of audit evidence to collect

-Select the items- sample or entire population

-The timing of evidence collection

-Audit program use

1. Explain the 7 Types of Evidence

1. Recalculation

2. Re-performance

3. Observation

4. Confirmation (lecture 10 bank/AR confirmations)

5. Enquiry- must be corroborated

6. Inspection of assets & documents

-Tracing & vouching

7. Analytical procedures

-Done throughout the audit- Risk assessment, Prelim understanding of client, Assess risks of MM, At conclusion to support the audit opinion

2. Characterize the Persuasiveness of Audit Evidence

-Auditor's objective is to collect sufficient & appropriate audit evidence (SAAE) to support the audit opinion

Factors that affect the persuasiveness:

-Sufficiency of evidence (quantity)

-Enough evidence so that most people would find it reasonable to support the conclusion

-Appropriateness (quality)

-The evidence is relevant to the assertions and reliable (depends on the source)

-Reliability Impacted By- its nature and the source- auditor's direct knowledge, independent external source, effectiveness of internal controls, qualification of provider, objectivity, consistent multiple sources

-External documents obtained by auditor directly are more reliable

-Written evidence is more reliable than oral evidence

-Original documents are more reliable than copies

-How independent is the evidence?

3. Explain the Objectives & Characteristics of the Audit Documentation

- Audit work not documented = audit work not done!
- Provides a record of the auditor's work for the purposes of: file reviews, practice/regulatory inspection, defence against a lawsuit, etc.
- Working papers are the auditor's record of compliance with GAAS. They must be retained.
- GAAS requires documentation of the planned procedures, as well as requiring the findings & conclusions of the audit staff to be retained in the files
- Has to be sufficient to enable an experienced auditor, with no previous connection with the audit engagement, to understand:
 - The nature, timing and extent of the procedures done
 - The results of the procedures and the audit evidence obtained

-Usually prepared & maintained electronically using audit software

-Examples of documentation:

- Audit programs
- Analyses
- Memos
- Summaries of significant matters
- Letters of confirmation and representation
- Checklists
- Correspondence (ie. Emails) concerning significant matters

-Working papers- A document which summarizes the work done and the analyses performed and supports the conclusion reached for a given audit test.

-They must be:

- Properly ID
- Well organized (indexed & cross-referenced)
- Indicate the work performed
 - Assertions that were audited
 - Explain the evidence gathered
 - Evaluate the MM found (if any)
 - Conclusion
- Show evidence that the work was planned & supervised
- Show that professional skepticism was used
 - IE. Procedures done to corroborate mgmt. statements
- Show that significant matters were reported to the auditee
 - Ie. Letters, notes, correspondence

-Preparing Working Papers:

- Index- Page numbers
- Cross-Referencing- Info connected to evidence
- Heading- Name of company, etc
- Initials- By preparer & reviewer
- Date- of preparation & review
- Tickmarks- indicate work performed

-*Permanent Files*- Documentation of a historical/continuing nature. Info that is used every year.
-Info. Source for new auditors to help them familiarize with the client

-*Current Files*-Working papers related to the current year audit. Includes audit administrative papers & audit evidence papers.

Lecture 6- Internal Controls: Assessment & Testing

1. Define the Objectives of an Effective Internal Control (IC) System

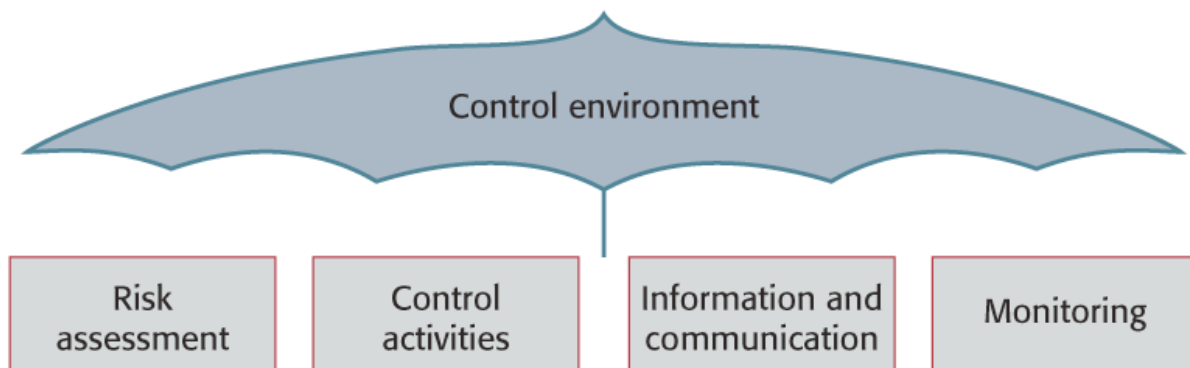
-*IC*- The process designed, implemented and maintained by mgmt. & other auditee personnel to provide reasonable assurance about the reliability of financial reporting, effectiveness & efficiency of operations & compliance with laws & regulations

-3 Objectives of IC:

1. Reliability of Financial Reporting
2. Efficiency & Effectiveness of Operations
3. Compliance with Laws & Regulations

2. Understand the 5 Components of the COSO IC Framework

-A model used to present the different elements of an organization's IC structure & how they fit.



-*Control Environment*-Management & directors attitudes, awareness and actions concerning the company's IC set the tone for the control environment.

-*Risk Assessment*- ID and analysis of risks by management. Helps management to decide how to manage the business risk efficiently & effectively.

-Control Activities- Activities to prevent, detect & correct misstatements.

-General controls:

- Capable personnel
- Performance reviews
- SOD
- Supervision
- Controlled access
- Periodic comparison
- IT controls

-Application controls:

- Revenues/receivables/cash receipts
- Purchases/payables/payments
- Production & payroll
- Investment & finance
- Other

-Information & Communication- Information system- a set of interrelated functions that collect, process, store and distribute information in an organization.

-Monitoring- Ongoing/periodic internal assessment of the IC's.

-Assesses the quality of IC performance over time & involves considering the design & operation of controls, including taking necessary corrective actions to ensure the controls continued effective operation.

EXHIBIT 9-5

Internal Control Objectives

OBJECTIVE	GENERAL STATEMENT OF CONTROL OBJECTIVE AND EXAMPLES OF RELATED CONTROL RISKS	MAIN RELATED FINANCIAL STATEMENT ASSERTIONS	SPECIFIC EXAMPLE (REVENUE PROCESS)
Validity	Control objective: Recorded transactions are valid and documented. Control risk: Fictitious sales are recorded; sales are recorded before shipment occurs.	Existence Ownership	Recorded sales are supported by invoices, shipping documents, and customer orders.
Completeness	Control objective: All valid transactions are recorded, and none are omitted. Control risk: Goods are shipped but sale is not recorded.	Completeness Ownership	All shipping documents are prenumbered and matched with sales invoices daily.
Authorization	Control objective: Transactions are authorized according to company policy. Control risk: Goods are sold on account to an unauthorized customer with poor credit rating.	Existence Valuation Ownership	Credit sales over \$1,000 are given prior approval by the credit manager.
Accuracy	Control objective: Transaction dollar amounts are properly calculated. Control risk: Incorrect prices or tax rates are used; calculation errors are made in extending and totalling the invoice amount.	Valuation	Sales invoices contain correct quantities and are mathematically correct.
Classification	Control objective: Transactions are properly classified in the accounts. Control risk: A sale to a subsidiary company is misclassified as a regular outside sale.	Valuation Presentation/ Disclosure	Sales to subsidiaries and affiliates are classified as intercompany transactions.
Proper period cutoff	Control objective: Transactions are recorded in the proper period. Control risk: The first sales of the new year are included in the current year; the shipments of goods on the last day of the year are not recorded until the next year.	Existence Completeness Ownership Presentation/ Disclosure	Sales of the current period are charged to customers in the current period, and sales of the next period are charged in the next period.

How Control Objectives Relate to Financial Statement Assertions

CONTROL OBJECTIVE	FINANCIAL STATEMENT ASSERTIONS				
	EXISTENCE	COMPLETENESS	VALUATION	OWNERSHIP	PRESENTATION AND DISCLOSURE
Validity	X			X	
Completeness		X		X	
Authorization	X		X	X	
Accuracy			X		
Classification			X		X
Proper Period	X	X		X	X

3. Explain the Assessment of Control Risk

-Obtain an understanding of IC's

-To conduct initial assessment of control risk & plan audit work

-Can use:

-Narratives

-Flow charts

-IC questionnaire

-Assess as:

-Maximum

-High

-Moderate

-Low

4. Explain Tests of Control

-Need to decide if will test the IC's or not. Affects the amount of substantive tests done.

-Usually done in interim periods if testing IC

-Procedures to Test ICs:

-Inquiries

-Inspection (of documents)

-Observation

-Transaction walk-through (samples)

-Re-performance of client procedures

-Determine if need to test ICs every year:

-Results of past audits

-If significant changes in IC system

-High RMM for an audit objective

-IC Letter- If auditors ID material IC weakness

-Management Letter- If auditors ID less significant IC matters/ways for improvement

Lecture 7-Audit Sampling Concepts & Sampling Applied to Tests of Control

1. Define & Explain Sampling Concepts

-*Audit Sampling*- Applying audit procedures to less than 100% of the items in a population.

-A method of estimating the value/quality of a population by examining only a portion of it.

-Can't audit 100% of everything- too time consuming & costly to do so.

-Goal is to reach a conclusion about all the items in a population.

A. *Representative Sampling*

-The characteristics of the sample must be approximately the same as those of the population

B. *Non-Representative Sampling*

-*Sampling Risk*-Risk that the sample doesn't represent the population

-Unavoidable. Can be reduced by increasing sample size & making sure to select an appropriate method to select the sample.

-The auditor's conclusion based on a sample might be different from the conclusion they would reach based on the entire population.

-Includes:

-*Alpha Risk*: Risk that the auditor will conclude the population is worse than it really is. Results in them doing extra work.

-*Beta Risk*: Risk that the auditor will conclude the population is better than it really is. Leads to the auditor issuing an incorrect audit opinion.

-*Non-Sampling Risk*- Cannot be measured.

-Due to a failure to uncover exceptions in the sample due to:

-Failure to recognize them/misinterpreted

-Lack of professional skepticism

-The use of ineffective audit procedures

-Accounting risk

-Can be reduced by:

-Careful planning & design of audit procedures

-Proper supervision & review of audit

C. *Statistical Sampling*- Random selection of sample items

-Can quantify the sampling risk (sampling error)

-*Probabilistic Sample Methods* Include:

-*Unrestricted random selection*-random numbers, use of software generated numbers

-*Systematic sample selection*-Number intervals

-*Monetary unit sampling (MUS)*

Advantages	Disadvantages
<ul style="list-style-type: none"> • Provides for quantitative evaluation of the sampling error • Provides more rigorous test results 	<ul style="list-style-type: none"> • Requires random sample selection which may be more time consuming • Requires additional training for audit team members

D. *Non-Statistical Sampling/Judgmental Sampling*- Uses professional judgment to select the most useful items in the sample.

-*Non-Probabilistic Sample Methods* Include:

-*Directed sample selection* ie. Items most likely to contain errors, items containing certain characteristics, etc

-*Block sample selection*- Used for cutoff

-*Haphazard sample selection*- Manual selection

Advantages	Disadvantages
<ul style="list-style-type: none"> • Allows the auditor to inject subjective judgment in determining the sample size and selection process to audit items of greatest value and highest risk • May be designed so that it is equally effective and efficient as statistical sampling while being less costly 	<ul style="list-style-type: none"> • Cannot draw objectively valid statistical the sample results • Cannot quantitatively measure and express risk

2. Understand the Sampling Process Applied to Tests of Control

-Audit sampling is used for:

- Tests of Controls (TOC)*-To evaluate if IC's are effective
- Substantive Tests*- To gather audit evidence about YE balances

Sampling Applied to TOC's

-Step 1- State the Objectives of the Audit Test

-Are the key controls applied or are there control deviations/exceptions. Ie. Credit approval not given

-Step 2- Define Deviation/Exception Conditions

- Identify the attributes/characteristics to be tested Ie. Are sales approved for credit?
- A control deviation/exception is found when auditors find that a control is not applied or doesn't work properly. Ie. A sales transaction that has no credit approval

-Step 3- Define the Population of Items to be Tested

-Examples include- All sales invoices, all shipping documents, etc

-Step 4- Determine the Initial Sample Size

-Specify the *Tolerable Deviation Rate (TDR)/Tolerable Exception Rate (TER)*-The maximum deviation rate the auditors will permit in the population without changing their initial estimation of control risk

-Will be given

-Specify the *Acceptable Sampling Risk (ASR)/Acceptable Risk of Assessing Control Risk Too Low (ARACL)*-Probability that the sample will reveal few/no control deviations when in fact the population contains such deviation.

-Beta risk

-Acceptable risk of overreliance

-Will be given

-Specify the *Expected Population Deviation Rate (EPDR)/Estimated Population Exception Rate (EPEER)*- Before starting the tests, auditors get a certain idea of what to expect (ie. Based on prior year's findings)

-An estimate of the percentage of deviations in the population

-Calculate the sample size based on TDR, ASR, and EPDR.

-Use stats tables

-Will be given

-Step 5- Select the Sample

-Use the sample size calculated in step 4

-Use probabilistic or non-probabilistic methods to pick the sample items

-Step 6- Perform the Control Tests

-Examine each sample item for the attribute defined in step 2 and list the deviations found.

-Step 7- Evaluate the Evidence

-Calculate the *Sample Deviation Rate (SDR)/Sample Exception Rate (SER)* = Actual number of deviations in the sample/Actual sample size

-Find the achieved *Upper Error Limit (UEL)*- The estimation of the deviation rate projected at the population level.

-Can be done with formulas or stats tables

-Analyze the exceptions- Qualitatively

-Decide the acceptability of the tested control

-If the $UEL < TDR$ = Control is effective

-Auditors will not modify their initial estimation of the CR = low level

-If the $UEL > TDR$ = Control is ineffective

-Can do additional testing/larger sample

-Can revise the assessed CR to be higher

-Not rely on the control

-Increase the tests of details

-Report suggestions in a management letter/internal control letter

Lecture 8- Sampling Applied to Substantive Tests

1. Understand the Sampling Process Applied to Tests of Details of Ending Balances

- Done to obtain direct evidence about the dollar amounts & disclosures in the F/S
- Auditing assertions in account balances, monetary amount of the population unit is main interest, not the presence/absence of control deviations.

-*Variables sampling*- sampling for tests of details

-Sampling usually not used for:

- Cash
- AR- Usually sampling used when modest- large number of customers
- Inventory- usually sampling is used when modest – large number of different inventory items
- Fixed assets- Sampling can be used to audit numerous additions
- AP- Some sampling used, but normally a judgment to test for missing payables
- Notes payable- Usually not sampled bc not a large number of them

-*Substantive tests* = Tests of Details + Analytical Procedures

- Analytical procedures are optional at the testing stage, mandatory at the planning/completion stages
- Objective is to obtain evidence about YE balances

-*Detection Risk* = Risk of Incorrect Acceptance (RIA) X Analytical Procedure Risk (APR)

- DR- Auditor's risk of incorrectly concluding that a balance is materially accurate when it is not
- Beta risk
- RIA- Risk of incorrectly concluding that a balance is materially accurate when it is not (based on the tests of details)
- APR- Risk that the analytical procedures will fail to detect material misstatements

-Audit Risk = Inherent Risk X Control Risk X Detection Risk

$$=AR = IR \times CR \times RIA \times APR$$

$$=RIA = AR / (IR \times CR \times APR)$$

Sampling Applied to Test of Details

-*Step 1- State the Objectives of the Audit Test*

- Are the YE balance assertions correct?
- Must test each assertion for each balance

-*Step 2- Define the Population*

-*Step 3- Choice of the Sampling Method*

- Statistical or non-statistical
- Based on statistical MUS methods

-Step 4- Determine the Sample Size

- To prevent over/under auditing
- Specify the *Risk of Incorrect Acceptance (RIA)/Acceptable Risk of Incorrect Acceptance (ARIA)*
 - Depends on IR, CR, APR
 - Beta Risk
 - Find the corresponding confidence coefficient Z_a in Lakeside table
 - Will be given

- Specify the *Risk of Incorrect Rejection (RIR)/Acceptable Risk of Incorrect Rejection (ARIR)*
 - Alpha risk
 - Find the corresponding confidence coefficient Z_r in Lakeside table
 - Will be given

- Define *Tolerable Misstatement (TM)*
 - Performance materiality

- Specify the Expected Dollar Misstatement
 - An anticipation of the population misstatement
 - “E” point estimate of the population

-Step 5- Select the Sample

- Determined in step 4 the sample size
- Use probabilistic or non-probabilistic methods to choose the sample items

-Step 6- Perform Tests of Details

- Examine each sample item for the assertion being tested
- Record any differences found

-Step 7- Evaluate the Evidence

- Analyze the number of errors and the total monetary error found in the sample (*known misstatement*).
- Project the known misstatement to the population to find the *likely misstatement (LM)*
 - Difference estimation
 - Ratio estimation
 - Mean-per-unit estimation
- Conclude by comparing the likely misstatement (LM) with the tolerable misstatement

Lecture 9- Revenues, Receivables & Cash Receipts- Tests of Controls

1. Understand the Revenue, Receivable & Receipts Process: Typical Activities, Accounts, Documents

- Page 557- Overall audit planning summary
- Revenue creation is the main focus of any organization
- The main control objectives for revenue:
 - Completeness, Accuracy, Authorization

-Auditor control testing in the revenue process is usually required when there is a high volume of revenue transactions.

-Results of the control testing will affect the nature of further substantive work to be done, as well as sample sizes & timing of further procedures.

-IC's include control activities designed to prevent things from going wrong:

- Custody of assets & records
- Properly recording transactions & events
- Performing reconciling procedures

Typical Activities:

- Receiving & processing customer orders
- Credit granting
- Delivery of goods & services to customers
- Billing customers & accounting for AR
- Collecting & depositing cash receipts in bank

Revenue Controls:

- Authorization-*
- Custody-* Physical custody of inventory
- Recording-*
- Periodic Reconciliation-*

Cash Receipts & Cash Balances Controls:

- Authorization-*
- Custody-*
- Recording-* Accountant who records cash should not also handle it
- Periodic Reconciliation-* ie. Bank reconciliations

Process for Tests of Controls:

- Step 1-** Understand general controls
- Step 2-** Understand internal controls & evaluate the design effectiveness for sales & cash receipts
 - For each control objective ID the key controls and ID the weaknesses
- Step 3-** The auditor must decide whether the controls will be tested or not

2. Describe the General Controls and the Application Controls

-Segregation of duties between:

- Authorization of sales (availability of inventory, FOB conditions, prices and discounts)
- Authorization of credit (credit worthiness of customers)
- Custody of inventory
- Custody of cash
- Recording
- Reconciliations
- Update of the customer master file, of the price list

-Restricted access

- Inventory and shipping area
- Secured access to documents (invoices), records and master files

-Adequate documents and records

- Use of pre-numbered documents
- Preparation of duplicate copies of supporting documents with appropriate circulation between departments and proper filing policies

-Controls over non-routine transactions and estimates

- Controls about sales returns and credit memos
- Clear procedure about AFDA calculation method and A/R write-offs
- Policy for special sales (employee and related parties sales)

EXHIBIT 9-5

Internal Control Objectives

OBJECTIVE	GENERAL STATEMENT OF CONTROL OBJECTIVE AND EXAMPLES OF RELATED CONTROL RISKS	MAIN RELATED FINANCIAL STATEMENT ASSERTIONS	SPECIFIC EXAMPLE (REVENUE PROCESS)
Validity	Control objective: Recorded transactions are valid and documented. Control risk: Fictitious sales are recorded; sales are recorded before shipment occurs.	Existence Ownership	Recorded sales are supported by invoices, shipping documents, and customer orders.
Completeness	Control objective: All valid transactions are recorded, and none are omitted. Control risk: Goods are shipped but sale is not recorded.	Completeness Ownership	All shipping documents are prenumbered and matched with sales invoices daily.
Authorization	Control objective: Transactions are authorized according to company policy. Control risk: Goods are sold on account to an unauthorized customer with poor credit rating.	Existence Valuation Ownership	Credit sales over \$1,000 are given prior approval by the credit manager.
Accuracy	Control objective: Transaction dollar amounts are properly calculated. Control risk: Incorrect prices or tax rates are used; calculation errors are made in extending and totalling the invoice amount.	Valuation	Sales invoices contain correct quantities and are mathematically correct.
Classification	Control objective: Transactions are properly classified in the accounts. Control risk: A sale to a subsidiary company is misclassified as a regular outside sale.	Valuation Presentation/ Disclosure	Sales to subsidiaries and affiliates are classified as intercompany transactions.
Proper period cutoff	Control objective: Transactions are recorded in the proper period. Control risk: The first sales of the new year are included in the current year; the shipments of goods on the last day of the year are not recorded until the next year.	Existence Completeness Ownership Presentation/ Disclosure	Sales of the current period are charged to customers in the current period, and sales of the next period are charged in the next period.

Key Controls for Revenues:

<u>Control objective</u>	<u>Examples of key controls</u>
<u>Validity</u>	<ul style="list-style-type: none"> Recording of sales supported by shipping documents and p/o
<u>Completeness</u>	<ul style="list-style-type: none"> Shipping documents and invoices are pre-numbered Periodic sequence checks for missing documents
<u>Authorization</u>	<ul style="list-style-type: none"> Credit is approved before shipment takes place Price lists and sales conditions (FOB, discounts) are approved Returned sales are documented and credit memos approved
<u>Accuracy</u>	<ul style="list-style-type: none"> Internal review of quantities and prices (invoices / shipping documents and p/o are 1 Periodic overall check of mathematical accuracy (e.g. product line analyses)
<u>Classification</u>	<ul style="list-style-type: none"> Use of specific policies for the classification of non-routine sales (sales to employee sales...) and of sales returns and allowances
<u>Accounting</u>	<ul style="list-style-type: none"> Subsidiary ledgers are periodically balanced with G/L Journal entries approved by a supervisor before posting
<u>Proper period</u>	<ul style="list-style-type: none"> Procedure to record sales invoices on the shipment date FOB terms are verified

Cash Receipts & Cash Balances Key Controls

<u>Control objective</u>	<u>Examples of key controls</u>
<u>Validity</u>	<ul style="list-style-type: none"> Recording of cash receipts supported by deposit slips and remittance lists A bank reconciliation is performed monthly by an “independent” person (e.g. intern)
<u>Completeness</u>	<ul style="list-style-type: none"> The person who opens the mail makes a pre-listing of the cash received (remittance) Use of pre-numbered invoices and deposit slips Periodic sequence checks for missing documents
<u>Authorization</u>	<ul style="list-style-type: none"> Discounts taken by customers for early payments are approved
<u>Accuracy</u>	<ul style="list-style-type: none"> A bank reconciliation is performed monthly by an “independent” person (e.g. intern) The deposit slips amounts are compared with the remittance list
<u>Classification</u>	<ul style="list-style-type: none"> The accounting manual includes a policy for proper classification of credit memos
<u>Accounting</u>	<ul style="list-style-type: none"> Subsidiary ledgers are periodically balanced with G/L Journal entries approved by a supervisor before posting
<u>Proper period</u>	<ul style="list-style-type: none"> Policy requiring that cash receipt entries are dated on the date of receipt

Exceptions Found During Control Testing

-Is it due to a particular circumstance?

-It can be isolated? For a certain reason? For a specific time period?

-Is it Systematic?

-Cannot be isolated and occurs throughout the period

-If so, look for a *compensating control*

-If no compensating control- need to determine whether there is potential for this weakness to result in material errors.

-The initial estimate of CR as low is not supported by TOC

-CR is increased because controls cannot be relied upon

-More tests of details will be conducted for the related account balances at YE

-If the results of the weakness could result in an *immaterial error* = report the weakness in a management letter. Extended tests of details may not be needed.

-If the results of the weakness could result in a *material error* = Report to the audit committee. Tests of details need to be sufficient to provide a reasonable range for the extent of the error.

Lecture 10- Revenues, Receivables & Cash Receipts- Substantive Tests

1. Discuss the Risk of Material Misstatement

-Inherent Risk:

- For assets & revenues – Risk emphasis is on completeness
- IR is usually high for:
 - Cut-off & existence*: Sales
 - Valuation*: AFDA & AR write-offs
 - Returns/allowances
 - Discounts for early payments
 - Existence*: Cash
 - Presentation*: AR & Cash

-Control Risk:

- Controls over sales & cash collection are usually good
- Important controls include:
 - Controls to prevent/detect defalcation of cash receipts
 - Independent bank reconciliations
 - Controls over sales cut-off
 - Controls related to AFDA

2. Describe Substantive Audit Programs for AR, Cash & Sales

-Analytical Procedures- AR & Sales

- Comparing the following with benchmarks:
 - Sales by month, by line of products
 - Sales returns and allowances
 - Individual customer balances
 - Bad debt expense to credit sales
 - Number of days in A/R
 - Aging categories
 - Comparison of current receivable write-offs with prior year AFDA estimate
 - Re-computation of an estimation of the AFDA
 - Analysis of the physical quantities sold * average sales price

-Analytical Procedures- Cash

- Usually limited for cash as will usually audit it 100%

-Audit Program for AR- Page 580-581

- Existence, valuation, cut-off & completeness*
 - Confirm AR
 - Perform alternative procedures if necessary
- Valuation*
 - AFDA- Discuss w/credit manager likelihood of collecting older accounts
 - Examine subsequent cash receipts on older accounts to assess collectibility
- Ownership*
 - Analyze BOD minutes
- Presentation*

-Audit Program for Sales- Page 581

- Completeness & valuation*-Select a sample of shipping documents & trace to recorded sales. Verify the quantities, prices & extensions are accurate.
- Existence/ownership & valuation*- Select a sample of recorded sales & vouch to supporting documents. Verify the quantities, prices & extensions are accurate
- Cut-off*- Select the last 25 sales transactions of the year and first 25 sales transactions of the next year and vouch to the related shipping documents, checking for the date of actual shipment and the FOB terms to ensure the sales were recorded in the correct period.

-Audit Program for Cash- Page 576-578

- Existence, Completeness, Ownership, Valuation, Cut-Off & Presentation*- Obtain & review the bank confirmation
- Obtain & test the year end bank reconciliation
- Fraud Related*-Test for lapping & kiting
- Valuation*- Count the petty cash, test FX balances
- Presentation*-

3. Explain the Confirmation of AR

- Letters addressed to a sample of customers requesting them to confirm the balance owed
- Use sampling to select
 - Can use statistical sampling
 - Can use directed (judgmental) sampling
- A specific account can be selected to obtain additional evidence about the balance
 - The balance appears to be with a related party
 - The account is quite large in relation to other AR
 - The account is far overdue- indicates a possible bad debt to W/O or that payment wasn't recorded properly
 - The activity within the account has been unusual
- Provide evidence of existence of AR. Additional procedures required for other assertions (ie. Ownership)
- Positive Confirmations*-Response is required in all cases to indicate if the balance is correct or not
- Negative Confirmations*-Response is required only in the case of a disagreement
 - Less reliable

Comparison of confirmations

- | | |
|---|--|
| <ul style="list-style-type: none">• Positive<ul style="list-style-type: none">– More reliable evidence– Possible to conduct follow-up if not answered• Use When<ul style="list-style-type: none">– Individual balances relatively large– Fewer debtors– Evidence or suspicion of fraud or serious error | <ul style="list-style-type: none">• Negative<ul style="list-style-type: none">– Failure to reply must be regarded as a correct response– Less expensive• Use When<ul style="list-style-type: none">– Many homogenous balances– Small amounts owing– Internal controls strong– No evidence/suspicion of fraud or serious error |
|---|--|

AR Confirmation Process:

-Step 1- Send the Confirmations

- Auditor must mail them
- Return envelopes should be to the auditor

-Step 2- Procedures for Those Accounts the Client Does Not Want Confirmed

- Do alternative procedures

-Step 3- Handling Returned Confirmations

- Should be returned to the auditor's office
- Differences between the client and the confirmation are listed & assessed. Could be:
 - Payment was already made by the client- Timing differences? Cut-off?
 - Goods not received by client- Cut-off? Timing? Goods in transit?
 - Goods were returned- Credit note/memo
 - Amounts are in dispute- Allowance is required?

-Step 4- Second Requests/Alternative Procedures

- Send additional requests if there is time in the audit to do so
- Alternative procedures include:
 - Review subsequent cash receipts
 - Examine supporting sales invoices, shipping documents, purchase orders
 - Review correspondence b/w the client & auditee

4. Explain the Confirmation of Cash Balances (Bank Confirmations)

- Communication sent to the auditee bank to confirm deposits & loan deposits
- Use of a standard form
- Auditors control the sending of the confirmations
- Returned to the auditor's office
- Provide information about general cash accounts, loans, guarantees, interest rates, overdrafts.

5. Explain the Audit of Bank Reconciliations

- The YE reconciliation is audited in detail
- Trace the bank balance to the bank confirmation
- Trace the book balance to the trial balance/GL
- Vouch the reconciling items (ie. o/s cheques & deposits in transit) to subsequent deposits & cashed cheques (in the cut-off bank statement/subsequent month's bank statement)
- Exercise to prepare bank reconciliation

6. Discuss the Risk of Fraud & Fraud Oriented Procedures

AR & Fraud Risk

- Because of the constant cash inflows, employees could commit fraud

-Common AR Frauds:

- Unjustified W/Os*
- Incorrect/Fraudulent Discounts*
- Lapping*

-Common Cash Frauds:

- Kiting*
- Window dressing*

Lecture 11- Auditor Reporting

1. Describe the Association Framework

-*Association*- Indicates a public accountant's involvement with an enterprise or with information issued by that enterprise.

-Association can arise when:

- A. Through some action, the PA associates themselves with information issued by the enterprise.
- B. Without the PA's knowledge/consent, the enterprise indicates that the PA was involved with information issued by them
- C. A 3rd party assumes the PA is involved with information issued by an enterprise

2. Determine Whether a Public Accountant is Associated with FS

-The PA should ensure that the information they are associated with is accurate, accurately reproduced and not misleading

-If the client attempts to make inappropriate use of the PA's name, the PA should amend the information or get legal advice.

-A PA is Associated with FS When:

- They consent to the use of their name in connection with the FS
- They have prepared or performed some other services with respect to the FS, even if their name is not used in any written report.
- Statements are produced on the PA's letterhead
- Statements result from computerized bookkeeping services performed by the PA
- A document containing FS IDs an accountant as the PA/auditor for the company

-A report is required in these cases of the association because most users of FS will assume that an audit has been done and that everything is ok.

-An obligation exists to inform the users about the nature of the work done (if any) & the conclusions that the PA made

-Done through the audit report

3. Describe the 3 Levels of Assurance

-*Audit*- Positive assurance given, highest level of assurance

-*Review*- Negative assurance given, moderate level of assurance

-*Compilation*- No attempt to verify the accuracy or completeness of the information. No assurance given.

4. Compare & Contrast the Scope & Opinion Paragraphs in an Independent Auditor's Report

-The standard unmodified report contains 5 basic segments. Example Page 137

-*Opinion segment*

-Users most interested in this paragraph

-Indicates an audit was done, the FS audited, the auditor's conclusion

-*Basis for opinion segment*

-*Key audit matters segment*

-Auditor is required to ID key audit matters in the engagement

-*Management & governance responsibility segment*

-Mgmt is responsible for the preparation & fair presentation of the FS

-*Auditor responsibility segment*

-Nature of the work in the audit

5. Qualified, Adverse & Disclaimer Audit Reports

-Variations on the standard audit report

-Depends on materiality & pervasiveness/effect on the FS

A. Departure from GAAP

-*Modified/Qualified opinion*

-*Adverse opinion*

B. Scope limitation- Auditors not able to obtain sufficient & appropriate audit evidence on a particular account balance/disclosure

-*Modified/Qualified opinion*

-*Denial of opinion*

6. Explain the Purpose of Significant Matter Paragraphs

-To draw FS users attention due to the additional communication in the auditor's report

-*Emphasis of Matter (EOM) Paragraphs-* Refers only to information presented/disclosed in FS

-*Other Matter (OM) Paragraphs-* Relates to information not required to be disclosed in the FS

Lecture 12- Professional Rules of Conduct

1. Explain the CPA Profession Practice

- CPA Order is a professional order whose members practice an exclusive profession.
 - CPAs are qualified to practice as professional accountants, including in PA.

- Professional activity of CPAs includes public accountancy (PA).
 - Expressing an opinion on the FS (ie. Audit, review, etc)

- CPAs have societal responsibilities:
 - Moral responsibilities*
 - Professional responsibilities*
 - Legal responsibilities*

Professional Ethics Needed For:

- To obtain the respect & confidence of the public
- To distinguish the profession from the general public
- To achieve order within the profession
- To provide a way of self-policing the profession

Professional Responsibilities:

-Independence

- Needed for review & audit engagements
- Financial interests prohibited
- Objectivity
 - Independence in fact
 - Independence in appearance
 - 5 Threats to independence:
 - Self-interest
 - Self-review
 - Advocacy
 - Familiarity
 - Intimidation

-Competence & Due Care

- CPA must ensure they have enough proficiency, knowledge & resources
- CPAs have to stay current with professional accounting & assurance standards
- Competence
 - Adequate technical & on the job training
 - Use of judgment
 - Use of professional skepticism
- Due care- What auditors do & how well they do it
 - Proper understanding of the client's business, ICs & risks
 - Proper planning & supervising of the audit
 - Obtaining sufficient & appropriate evidence

-Confidentiality- Information obtained during the engagement

-Fees

-Fees charged should be fair & reasonable and reflect:

- Time spent
- Complexity of the tasks
- Exceptional delays of expertise
- Experience
- Responsibilities taken

-Client should be informed in advance of the budget

-Prohibited to:

- Request payment in full in advance
- Charge flat fees that do not take into consideration all important information from the client
- Charge fees that are unrealistically low to obtain a new client

-Contingent fees

-Prohibited except for some tax services or personal financial planning services

-Commissions & referral fees

-Prohibited except in the case of the sale/purchase of the clientele of a member

-Advertising

-Shouldn't be false, misleading, deceptive or compare the quality of one's services with the services offered by a competitor

-Discreditable Acts

-Violation of the code of conduct

-Violation of the tax act

-Fraud, criminal offenses, employment discrimination

-CPA Order needs to be notified of:

-If CPA member is personally in a bankruptcy situation

-If they believe someone is practicing the profession in a manner that is detrimental to their clients, employer or to the public, or has violated the code of conduct or is incompetent.