

Assurance BROADEST

Assurance Def: are **independent** professional services

that **improve** the quality of information

or its **context**

for **decision makers**

assurance services:

quality of a business process

reliability of computer systems

(ICFR) Internal control over financial reporting

"Reliability" ⓪ AICPA's definition for Assurance services

Attestation MIDDLE

Definition in which a practitioner **issues a report** on **subject matter** or **assertion** that is the responsibility of **another party**

To provide assurance through a written report regarding reliability of management's assertion.

Examination = high assurance

Review = moderate assurance

non-issuers AICPA: SSAE / AT-C standards

issuers PCAOB: AT No.1 & 2, && Interim Standards ↑

financial attestation engagements

Agreed upon procedures

Pro forma financial information

Financial forecasts and projections

non-financial attestation engagements

Compliance with contractual requirements

Effectiveness of internal control systems

Inventory quantities and locations

General Audit Info

Steps

1. Assessing client acceptance and retention decisions
2. Understanding the client-planning
3. Obtain evidence about internal control and determine impact on the financial statements
4. Obtain substantive evidence about account assertions
5. Wrapping up the audit and making reporting decisions-do we have enough evidence

WHY?

User demands: reliable, relevant, timely info

conditions that increase user demand: Complexity, Remoteness, Time sensitivity, Consequences

AAA Definition

Auditing is a systematic process of objectively obtaining and evaluating evidence regarding **assertions** about economic actions and events to ascertain the degree of correspondence between the assertions and **established criteria** and **communicating** the results to **interested users**.

assertions → Financial Statements & footnotes

established criteria → GAAP

communicating the results → Auditor's Report/ Other Reports

interested users Creditors && Investors

Audit Purpose:

provide users with an **opinion** by the auditor on whether the F/S are **presented fairly**, in **all material respects** in accordance with the **AFRF**

Audit Premise:

those charged with governance have responsibility for

The preparation and presentation of the f/s in accordance with the AFRF

General Audit Info (cont)

IC over financial reporting

Providing auditor with ALL information necessary and unrestricted access.

Information risk is the risk (probability) that the information (mainly financial) disseminated by a company will be materially false or misleading.

Nature of the Company

- The company's organizational structure and management personnel.
- The sources of funding of the company's operations and investment activities.
- The company's significant investments
- The company's operating characteristics, including its size and complexity.
- The sources of the company's earnings, including the relative profitability of key products and services, and key supplier and customer relationships.

Where are the Risks of Material Misstatement

Preliminary Analytical Procedures

- | | |
|--|--|
| beginning of an audit | compare to industry and previous years |
| "reasonableness tests" | |
| 1) Develop an expectation | |
| 2) Define a significant difference. | % OR \$ |
| 3) Compare expectation with the recorded amount. | horizontal analysis // year to year |
| | vertical analysis // % of whole |
| 4) Investigate significant differences | "attention directing" |
| 5) Document each of the preceding steps | |

Stages of Audit "performance"

1. Obtain Engagement

(1) perform procedures regarding the acceptance or continuance of the audit client relationship

-must **attempt** contact w/ predecessor auditor

-when issuer changes auditors → Form 8-K

Generally Include: Obtaining and reviewing: annual reports, interim statements, registration statements, Form 10-Ks, reports to regulatory agencies

criminal background checks of senior managers

Considering the need for specialists

Evaluate the firm's independence

Requesting the client's bankers, legal counsel, underwriters, analysts to "spill the tea"

Considering if the engagement will involve **unusual risks**

(2) determine compliance with independence and ethics requirements

(3) reach a contractual understanding with the client for the terms and conditions of the audit engagement

engagement letter has:

-objectives of the engagement

-management's responsibilities

-auditors' responsibilities

-any limitations

optional = termination letter

2. Engagement Planning

Audit Plan → engagement partner

develop and document a plan (NTE) to assess RMM



Stages of Audit "performance" (cont)

THEN plan the (NTE) control and substantive tests that mitigate these risks to an acceptable level (**kinda step 3**)

Why audit plan?

-quality control, supervision, (provable) documentation

goals of audit planning

-firm has the requisite staff

-determine materiality

-outline the specific audit procedures to lessen RMM

3. Risk Assessment

-Internal control

-risk of material misstatement

-inherent risk and control risk

4. Audit Evidence

-"sufficient appropriate"

-minutes of meetings, confirmations with independent third parties, invoices, analyst reports, and all other information that permits auditors to reach valid, logical conclusions

-Detection risk!!

5. Reporting (reporting principle)

Audit procedures for obtaining evidence

Why?

1) understand the client (& risks)

"risk assessment procedures"

2) to test the operating effectiveness of IC

"tests of controls"

3) produce evidence about management's assertions

evidence for PERCV/ASB assertions

Procedures

Audit procedures for obtaining evidence (cont)

1) Inspection of Records and Documents **completeness (T/S), existence (v), occurrence (V)**

vouching, tracing, scanning

hierarchy of evidence

2) Inspection of Tangible Assets **existence**

3) Observation "test of controls"

a general awareness of events in the client's offices

4) Inquiry "risk assessment procedures" / documentation

written representations or management representations

"inquiry alone" is never enough

early planning stages of the engagement

5) Confirmation **existence, R/O, Valuation, Cut-off** depends on the info requested

Confirmation letters: ● printed on the client's letterhead and signed by a client officer

● seek information the recipient can supply

● audit firm should control confirmations

● responses → the audit firm || ⓧ client

6) Recalculation **existence & valuation**

recalculation of computations || "test of controls" & potential evidence

7) Reperformance any client control procedure

8) Analytical Procedures **REQUIRED** during planning && final evaluation

optional: substantive testing phase



Auditors are REQUIRED to Document

Risk Assessment process → in the workpapers

Discussions with engagement personnel.

Procedures to identify and assess risk.

Significant decisions during discussion (team brainstorming sessions)

Specific risks identified and audit team responses.

Explanation of why improper revenue recognition is not a risk, if so deemed.

Results of audit procedures, particularly procedures regarding management override.

Other conditions causing auditors to believe that additional procedures are required.

Communications to management and those charged with governance, such as the audit committee.

Audit Documentation

PCAOB-AS 1215 "audit documentation": The written record of the basis for the auditor's conclusions that provides the support for the auditor's representations, whether those representations are contained in the auditor's report or otherwise

Permanent Files

"continuing audit significance"

- corporate or association charter, bylaws, or partnership agreement

Audit Documentation (cont)

- continuing contracts such as leases, bond indentures, and royalty agreements

- A history of the company, its products, markets, and background.

- minutes of meetings of stockholders and/or directors on matters of lasting interest.

- Continuing schedules of accounts with balances that are carried forward for several years, such as owners' equity, retained earnings, partnership capital, ect.

- prior-years' financial statements and audit reports

- Client organization chart.

Current Files

"the year under audit"

planning memorandum = summary of current files

lead schedule = summary of accounts in "account group"

Indexing = docs get index number

Cross-referencing = basically a Foreign Key

Heading = name of the company, the balance-sheet date, and a descriptive title

Signatures and initials = auditor who performs the work and the supervisor who reviews it must sign the audit documentation



Audit Documentation (cont)

Dates of audit work = dates of performance and review are recorded
 Audit marks (tick marks) and explanations = auditor's shorthand comments about work performed

Materiality &

Lower the materiality level if high complexity + low balance = higher risk
 if materiality is lower → test more
 RMM and detection risk are inversely related
 IC risk won't change. Firm sets this.
 control risk goes up detection risk goes down
 we control Detection risk

Cycles

Voucher packet approvals, accounts, and amounts to be recorded supporting purchase order
 receiving report
 vendor invoice

Entities

PCAOB Public Company Accounting Oversight Board
 Public
 ASs-Auditing Standards

AICPA American Institute of Certified Public Accountants
 Private
 ASB - Auditing Standards Board
 SASs - Statements on Auditing Standards

GAO Gov. U.S. Government Accountability Office
 The "Yellow Book" - Government Auditing Standards

IFAC International Federation of Accountants
 Foreign
 IAASB - International Auditing and Assurance Standards Board

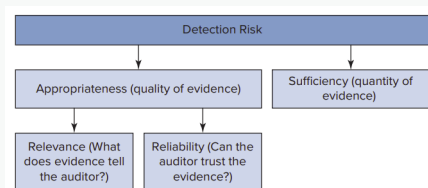
Entities (cont)

ISAs - International Standards on Auditing
 Domestic AFRF (applicable financial reporting framework) → GAAP
 Foreign AFRF (applicable financial reporting framework) → IFRS

Detection risk

	Need for Suff. & App.	Detection Risk
Poor Controls	↑	↓
Good Controls	↓	↑

Detection Risk (pic)



ASB Assertions

ASB Assertions	Evaluates what?	Procedures
Existence	do assets exist?	assets Inspection of tangible assets
Occurrence	transactions actually occur?	Inspection of records or documents (vouching)
Rights and obligations	ownership & legal responsibilities	independent Confirmations
Completeness	financial statements (footnotes too) complete?	Inspection of records or documents (tracing)
Cutoff	proper period	Inspection of records or documents (tracing or vouching)
Valuation or allocation	accounts valued correctly?	Reperformance
Accuracy	transactions recorded accurately?	Inspection of records or documents (tracing or vouching)



ASB Assertions (cont)

Present- ation	appropriately presented & clearly described?	Management Inquiry
Classific- ation	in the proper accounts?	Analytical procedures

PERCV

Presentation & Disclosure

Presentation footnotes

Disclosure disclose inventory methods

Existence && Occurrence

Existence ● assets

● inspection of tangible assets

● Balance sheet (vouch)

Occurrence ● transactions

● push/pull revenue

● income statement

Purchase Journal → Receiving Reports

Vouching

Rights && Obligations

Rights ● Balance sheet

● inventory consignment

Obligations ● Balance sheet

● consignment

Completeness

● liabilities and revenue

● accrued liabilities

Receiving Reports → Purchase Journal

Tracing

Valuation OR Allocation

Valuation ● credit ratings

● ASC 606 accuracy

Allocation

GAAS "Principles"

Responsibilities

1. Competence education, training, experience

2. Independence fact and appearance

GAAS "Principles" (cont)

3. Due professional performance of the audit AND the prepar- care (GAAS) ation of the report

Performance

*To express an **opinion**, Obtain **reasonable assurance** that financial statements are free of **material misstatement** whether due to **error or fraud***

obtain reasonable assurance:

Planning and supervision

Prepare an audit program & plan including timing

Supervise the audit work

Obtain knowledge of the client

Have a system in place to settle disagree- ments

Determining materiality Nature, Timing, Extent

Risk assessment risk of material misstatement

inherent risk and control risk

based on an understanding:

● the entity

● operating environment

● internal control

in order to determine the Nature, Timing, Extent

Evidence Gathering sufficient & appropriate

Sufficient → #

Appropriate → quality (R&R)

relevance - the assertion being tested

GAAS "Principles" (cont)

Reliability — source and nature of the evidence

obtained through audit procedures

to afford a reasonable basis for an opinion

Reporting *conclusion and communication*

State whether financial statements follow GAAP **Explicit** The report shall state whether the financial statements are presented in accordance with GAAP

Identify inconsistencies

Address adequacy of disclosures

Express an opinion or explain why none is given

appropriate: Relevance & Reliability

Relevance — the assertion being tested

Reliability — source and nature of the evidence

Fraud

What is FRAUD

- 1) **knowingly** making material misrepresentations of fact
- 2) with the **intent** of inducing someone to believe the falsehood && and **act** on it
- 3) causing victim to **suffer** a loss or damage

Types

Employee Fraud

"misappropriations of assets"

Embezzlement → employees or nonemployees wrongfully taking money or property entrusted to them, by cover-up

Larceny → theft of an employer's property that is not entrusted to an employee

Defalcation → Misuse of funds by a fiduciary

Fraud (cont)

Management fraud

"Fraudulent financial reporting"

deliberate fraud committed by management that injures investors and creditors through materially misstated information.

(1) overstating revenues and assets

(2) understating expenses and liabilities

(3) giving disclosures that are misstated or that omit important information

Prevention

Tone at the top

Deterrent

Internal Controls

Motives

Psychological for the hell of it

Egocentric prove they can

Ideological moral justification

Economic need for \$\$

Triangle

Incentive

Opportunity

Attitude/Rationalization

Capability

Susceptibility

Dollar size of the account.

Liquidity.

Volume of transactions

Complexity of the transactions

Subjective estimates.

Control Stages

Custody

Authorization

Recording

Reconciliation



Confirmations

Types

Positive

small number of accounts are involved

Individual balances are large

large number of errors are anticipated

Negative

a large number of small balances are involved

the combined assessed level of inherent and control risk is low

the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration.

Blank

should be used if the recipient is likely to return a positive confirmation without verifying the accuracy of the information.

considerations

positive and blank confirmations > negative non-responses

Recipients of accounts receivable confirmations might not report understatements

Non-response to Positive/-blank

Follow up with 2nd & 3rd

lower than expected response rate = fictitious customer accounts

Non-response to negative

Alternative procedures are not necessary

Only limited evidence

Assertions

Confirmations (cont)

existence

occurrence

Inspection of Firms

Issuers

PCAOB is charged with *monitoring* → "inspections"

>100 issuer audits annual inspections

<100 issuer audits triennial inspections

Non-Issuers

AICPA → "peer reviews"

AICPA National Peer Review Committee Triennial peer reviews

Plans

audit plan a comprehensive list of the "specific audit procedures" that the audit team needs to perform to gather sufficient appropriate evidence

internal control audit plan a list of "specific procedures" needed to obtain an understanding of the client's internal control system and test that understanding for those controls

substantive audit plan a list of "audit procedures" for gathering evidence

(1) substantive analytical procedures

-more efficient

(2) tests of details

-more effective

System of Quality Control // AICPA // Audit firm

quality control standards QC

Purpose provide the firm reasonable assurance that the firm and its personnel

1. Leadership responsibilities "tone at the top"



System of Quality Control // AICPA // Audit firm (cont)

- | | |
|---|--|
| 2. Relevant ethical requirements | independence, Competence, Due professional care, Skepticism |
| 3. Acceptance and continuance of client relationships | adequately perform the engagement, integrity of the client, firm's ability to comply with legal and ethical requirements |
| 4. Human resources (audit firm) | Hire quality personnel, Assign staff to engagements based on their capabilities, Provide professional development opportunities, Effectively evaluate, compensate, and promote staff |
| 5. Engagement performance | engagement quality control reviews |
| 6. Monitoring. | either an ongoing postissuance review of engagement documentation or targeted inspection procedures for a sample of engagements |
- appropriateness of the firm's guidance materials
 - compliance with policies and procedures on independence
 - effectiveness of continuing professional education
 - decisions regarding the acceptance and continuance

Directions

- | | | |
|-----------------|--------------|-----------------|
| Source | → TRACING → | Accounting Docs |
| Accounting Docs | → VOUCHING → | Source |
| CAATs | 👁 Scanning 👁 | Accounting Docs |

Control Signals

- | | |
|-----------------------------------|---------------------|
| "absence of controls" | inherent risk |
| "internal control effectiveness" | control risk |
| "sufficient appropriate evidence" | detection risk |
| "more internal control" | lower control risk |
| "less effective controls" | increase procedures |

Balance-Sheet / Operations Ratios

Balance-Sheet Ratios	Formula*
Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$
Days' sales in receivables	$\frac{\text{Ending net receivables}}{\text{Credit sales}/360}$
Doubtful account ratio	$\frac{\text{Allowance for doubtful accounts}}{\text{Ending gross receivables}}$
Days' sales in inventory	$\frac{\text{Ending inventory}}{\text{Cost of goods sold}/360}$
Debt-to-equity ratio	$\frac{\text{Current liabilities and long-term debt}}{\text{Stockholder equity}}$
Operations Ratios	
Receivables turnover	$\frac{\text{Credit sales}}{\text{Ending net receivables}}$
Inventory turnover	$\frac{\text{Cost of goods sold}}{\text{Ending inventory}}$
Cost of goods sold ratio	$\frac{\text{Cost of goods sold}}{\text{Net sales}}$
Gross margin ratio	$\frac{\text{Net sales} - \text{Cost of goods sold}}{\text{Net sales}}$
Return on stockholder equity	$\frac{\text{Net income}}{\text{Stockholder equity (beginning balance)}}$

Assessing the Client

