

# Chapter 19



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## Chapter 19 Completing the Audit / Postaudit Responsibilities | Learning

Check | 19-1. The three categories of activities in completing the audit are (a) completing field work, (b) evaluating the findings, and (c) communicating with the client. 19-2. The activities involved in completing the field work are (a) making subsequent events review, (b) reading minutes of meetings, (c) obtaining evidence concerning litigation, claims, and assessments, (d) obtaining client representation letter, and (e) performing analytical procedures. 19-3. a. Subsequent events are events that occur between the balance sheet date and the issuance date of the auditor's report (which is not the same as the date of the report) that may affect the financial statements on which the report is rendered. The subsequent events period extends from the balance sheet date to the end of field work on the engagement. b. The types are: - Type 1 consists of those events that provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements. - Type 2 consists of those events that provide evidence with respect to conditions that did not exist at the date of the balance sheet but arose subsequent to that date. - Type 1 events require adjustment of the financial statements. Type 2 events require disclosure, and in very material cases, by attaching pro-form data to the financial statements. c. The auditor is required by GAAS to search for and to evaluate subsequent events up to the date of the auditor's report, which should be as of the end of field work. This responsibility is discharged by (1) being alert for subsequent events in performing year-end substantive tests after the balance sheet date, and (2) performing specific procedures at or near the completion of field work. 19-4. a. Regarding litigation, claims, and assessments (LCA), the auditor should

obtain evidential matter on - The existence of a condition, situation, or set of circumstances indicating an uncertainty as to the possible loss to an entity arising from the LCA. - The period in which the underlying cause for legal action occurred. - The degree of probability of an unfavorable outcome. - The amount or range of potential loss. b. A letter of audit inquiry is a letter sent by management to the company's outside legal counsel requesting the lawyer to send specified information directly to the auditor about LCA against the company. The letter is the auditor's primary means of obtaining evidence about LCA. c. When the lawyer fails to respond, the auditor has a scope limitation. Depending on materiality, the auditor will express either a qualified opinion or a disclaimer of opinion. 19-5. a. The objectives of a "rep" letter are: (1) confirm oral representations given to the auditor, (2) document the continuing appropriateness of such representations, and (3) reduce the possibility of misunderstandings concerning management's representations. b. When the auditor is unable to obtain a rep letter or support a management representation that is material to the financial statements by other audit procedures, there is a scope limitation. Depending on materiality, the auditor will express either a qualified opinion or a disclaimer of opinion 19-6. a. The objectives of an overall review are to assist the auditor in (1) assessing conclusions reached in the audit and (2) evaluating the financial statement presentation taken as a whole. b. The review should be made by an individual having comprehensive knowledge of the client's business and industry. Normally, either the partner in charge of the audit or the top manager on the engagement makes the review. c. Analytical procedures performed during the final stages of the audit should be - Applied to critical audit areas identified during the audit. - Based on financial statement data

after all audit adjustments and reclassifications have been recognized. As in other cases, the data may be compared to (1) expected company results, (2) available industry data, and (3) relevant nonfinancial data. 19-7. a. The two objectives in evaluating the findings are determining (1) the type of opinion to be expressed and (2) whether GAAS has been met in the audit. b. Four steps in meeting these objectives are: - Making a final assessment of materiality and audit risk. - Making a technical review of financial statements. - Formulating an opinion and drafting the audit report. - Making final review(s) of the working papers. 19-8. a. The purposes of the auditor's final assessment of materiality and audit risk are to determine whether (1) the auditor's preliminary judgments concerning materiality have been met and (2) audit risk is at an acceptable level to warrant the expression of an opinion. b. Known misstatement is an uncorrected misstatement in an account identified through substantive tests of details of transactions and balances. Likely misstatement is the total error in an account resulting from (1) known misstatements, (2) projected uncorrected misstatements estimated through audit sampling techniques, and (3) estimated misstatements detected through analytical procedures and quantified by other auditing procedures. Aggregate likely misstatement is the sum of likely misstatements in all accounts. 19-9. a. Professional standards establish a responsibility for the auditor to evaluate whether there is substantial doubt about the client's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited (generally one year from balance sheet date). Ordinarily, information that would raise substantial doubt about the going concern assumption relates to the entity's inability to continue to meet its

obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions. b. The auditor normally evaluates whether there is substantial doubt about the client's ability to continue as a going concern based on the results of normal audit procedures performed in planning, in gathering evidence to support various audit objectives, and in completing the audit. c. If the auditor concludes that substantial doubt exists, he or she should consider the need for the following disclosures: - Pertinent conditions and events giving rise to the assessment of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. - The possible effects of such conditions and events. - Management's evaluation of the significance of those conditions and events and any mitigating factors. - Possible discontinuance of operations. - Management's plans (including relevant prospective financial information). fn 3 - Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities. d. If, after considering identified conditions and management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the audit report is normally an unqualified audit opinion with an explanatory paragraph about the uncertainty (following the opinion paragraph) to reflect that conclusion. The auditor's conclusion about the entity's ability to continue as a going concern should be expressed through the use of the phrase "substantial doubt about its (the entity's) ability to continue as a going concern." If the auditor concludes that the entity's disclosures with respect to the entity's ability to continue as a going concern are inadequate, a departure from

generally accepted accounting principles exists. This may result in either a qualified (except for) or an adverse opinion. 19-10. The technical review of the financial statements includes matters pertaining to the form and content of each of the basic statements as well as to required disclosures. Most CPA firms use separate checklists for SEC and non-SEC clients. The auditor who performs the initial review of the financial statements completes the checklists. The manager and partner in charge of the engagement (in the case of a publicly held client then review the checklists, a partner who was not a member of the audit team) reviews them again. 19-11. a. The opinion to be expressed is determined by the partner in charge of the engagement. The decision is made on the basis of the findings made by the audit team during the audit. b. Proposed adjustments and disclosures are discussed with the client and differences are resolved. Ordinarily, agreement is reached and an unqualified opinion can be expressed. 19-12. a. The primary reviewers and the nature of their reviews are:

Reviewer	Nature of Review
Manager	Reviews working papers prepared by seniors and reviews some or all of the working papers reviewed by seniors.
Partner in charge	Reviews working papers prepared by managers and reviews other working papers on a selective basis.

b. The engagement partner's review of the working papers is designed to obtain assurance that -

- The work done by subordinates has been accurate and thorough.
- The judgments exercised by subordinates were reasonable and appropriate in the circumstances.
- The audit engagement has been completed in accordance with the conditions and terms specified in the engagement letter.
- All significant accounting, auditing, and reporting questions raised during the audit have been properly resolved.
- The working papers support

the auditor's opinion. - Generally accepted auditing standards and the firm's quality control policies and procedures have been met. c. The second partner may be more objective than the partner on the engagement. Thus, the second partner review provides additional assurance that GAAS have been met. Second partner reviews are mandatory for SEC registrants. 19-13. The auditor's communications with the client at the conclusion of the audit involve the audit committee of the board of directors (or the board directly) and management. 19-14. a. Reportable conditions represent significant deficiencies in the design or operation of the internal control structure, which could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The magnitude of a reportable condition determines whether it is also a material weakness. A material weakness is defined as a reportable condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned duties. b. A report issued on reportable conditions should: - Indicate that the purpose of the audit is to report on the financial statements and not to provide assurance on the internal control structure. - Include the definition of reportable conditions. - Include the restriction on distribution (e. g. restricted to the audit committee, management, and others within the organization). In addition, the reportable conditions should be described in one or more separate paragraphs. 19-15. When the auditor separately identifies and describes material weaknesses in his or her report,

two additional paragraphs are required. The first paragraph should contain a definition of the term material weakness and a description of the reportable conditions that are material weaknesses. The second additional paragraph should describe the limitations of the auditor's work, noting specifically that the auditor's consideration of the internal control structure would not necessarily disclose all matters considered to be material weaknesses. 19-16. a. The communication may be oral or written, and it may occur during or shortly after the audit. b. The communication with the audit committee may include such matters as - Auditor's responsibilities under GAAS. - Significant accounting policies. - Management judgments and accounting estimates. - Significant audit adjustments. - Disagreements with management. - Consultation with other accountants. - Major issues discussed with management prior to retention. - Difficulties in performing the audit. In addition, the auditor must communicate reportable conditions. 19-17. a. The purpose of a management letter is to provide management with recommendations for improving the efficiency and effectiveness of its operations. b. A management letter may include comments on - Internal control matters that are not considered to be reportable conditions. - Management of resources such as cash, inventories, and investments. - Other value-added recommendations on how to improve organization performance. - Tax related matters. 19-18. a. The auditor has no responsibility to make inquiry or to perform any auditing procedures on subsequent events occurring after field work but before issuance of the report. When a situation comes to the auditor's attention, he or she is required to evaluate the item and consider its effect on the report that is being issued. b. The auditor may use the event date as the date of the



auditor's report provided all subsequent events review procedures are performed for the period between the original report date and the event date. Alternatively, the auditor may use dual dating in which the report contains two dates: (1) the original date of the report, and (2) a date that refers to the subsequent event that has occurred between the original date of the report and the date of its issuance. In this case, it is not necessary to extend performance of all subsequent events review procedures through the later date except as to the particular event giving rise to the dual dating. 19-

19. a. The auditor has no responsibility for the postaudit discovery of facts existing at the date of the audit report. However, when the auditor becomes aware of such facts and the facts may have affected the report that was issued, he or she must ascertain the reliability of the information. b. When the client refuses to make the necessary disclosures, the auditor should notify each member of the board of directors of such refusal and take the following steps to prevent further reliance on the audit report: - Notify the client that the audit report must no longer be associated with the financial statements. - Notify the regulatory agencies having jurisdiction over the client that the report should no longer be relied on. - Notify (generally via the regulatory agency) each individual known to be relying on the statements that the report should no longer be relied on. 19-20. a. When the auditor has been able to make a satisfactory investigation and has determined that the information is reliable, he or she should describe the effects the subsequently acquired information would have had on the financial statements and the auditor's report. b. When the client has not cooperated and the auditor has been unable to make a satisfactory investigation, without disclosing the specific information, the auditor should (1) indicate

the lack of cooperation and (2) state that if the information is true, the audit report should no longer be relied on. 19-21. a. The auditor has no responsibility to make any retrospective review of his or her work. However, when knowledge is obtained of possible omitted procedures, the auditor should assess their importance to his or her ability to support the previously expressed opinion. b. The auditor may find that he or she (1) can support the opinion or (2) cannot support the opinion. In the latter case, the auditor should perform the omitted procedures and if necessary prevent further reliance on the report. | Objective Questions | | 19-22. | 1. b | 2. a | 3. c | | | | 19-23. | 1. a | 2. b | 3. b | 4. c | | | | 19-24. | 1. a | 2. c | 3. b | | | |

Comprehensive Questions | 19-25. (Estimated time - 20 minutes) a. The first type of subsequent events includes those events that provide additional evidence concerning conditions that existed at the balance sheet date and affect the estimates inherent in the process of preparing financial statements. This type of subsequent events requires that the financial statements be adjusted by any changes in estimates resulting from the use of such additional evidence. The second type of subsequent events consists of those events that provide evidence concerning conditions that did not exist at the balance sheet date but arose subsequent to that date. These events should not result in adjustment to the financial statements but may be such that disclosure is required to keep the financial statements from being misleading. b. The auditing procedures Green should consider performing to gather evidence concerning subsequent events include the following: - Compare the latest available interim statements with the financial statements being audited. - Ascertain whether the interim statements were prepared on the same basis as the audited financial

statements. - Inquire whether there was any significant change in the capital stock, long-term debt, or working capital to the date of inquiry. - Inquire about the current status of items in the audited financial statements that were accounted for on the basis of tentative, preliminary, or inconclusive data. - Inquire about any unusual adjustments made since the balance sheet date. - Read or inquire about the minutes of meetings of stockholders or the board of directors. - Inquire of the client's legal counsel concerning litigation, claims, and assessments. - Obtain a management representation letter, dated as of the date of Green's report, as to whether any subsequent events would require adjustment or disclosure. - Make such additional inquiries or perform such additional procedures as Green considers necessary and appropriate. 19-26. (Estimated time - 30 minutes)

a. 1. A subsequent events review is used to provide reasonable assurance that the auditor is aware of significant events that have a material effect on financial statements. These are events that have occurred after the date of the financial statements but before the issuance of the audit report. 2. If the subsequent event is one that provides additional evidence concerning conditions existing at the date of the financial statements, then the financial statements must be adjusted. If the subsequent event is one that provides evidence concerning conditions that arose after the date of the financial statements, disclosure is required.

b. 1. The auditor obtains written representations from the client as part of the evidence gathered to meet the third standard of field work. The purpose of these written representations by management is to - Confirm oral representations given to the auditor. - Impress on management that it has the primary responsibility for the financial statements. 2. The client representation letter may include statements concerning the following

matters: - Completeness and availability of the accounting records and minutes of meetings of shareholders, directors, and committees. - Absence of unrecorded transactions and errors and irregularities in the financial statements. - Existence of related party transactions or contingencies. - Plans or intentions that may affect the carrying value of assets and liabilities.

c. 1. The purpose of the management letter is to communicate to management the auditor's recommendations regarding improvements in the efficiency and the effectiveness of matters that came to the auditor's attention during the audit. 2. Three major subjects that may be addressed in the management letter include the following. - Internal control structure weaknesses that are considered immaterial. - Improvements to the accounting and information system. - Improvements to the internal controls related to achieving the objectives of the organization. 19-27. (Estimated time - 25 minutes) | Item No. | | Required Disclosure or | | | Audit Procedures | Entry and Reasons | | 1. | Goods in-transit would be detected in the course of the | The receipt of the goods provides additional evidence with | | | auditor's review of the year-end cutoff of purchases. The | respect to conditions that existed at the date of the balance | | | auditor would examine receiving reports and purchase invoices| sheet and hence the financial statements should be adjusted to| | | to make certain that the liability to suppliers had been | take into account such additional information. | | | recorded for all goods included in inventory, and that all | | | | goods for which the client was liable at year end were | | | | recorded in inventory. | | | 2. | Settlements of litigation would be revealed by requesting | Settlements of litigation would require an adjustment of the | | | from the company's legal counsel a description and evaluation| financial statements since the events



footnotes to the financial statements would be adequate. Occasionally, a situation of this type may have such a material impact on the entity that the auditor may wish to include in the audit report an explanatory paragraph directing the reader's attention to the event and its effect. 4. Inventory losses attributable to a flood would be brought to the auditor's attention through inquiries and discussions with corporate officers and executives. Moreover, the auditor would know the location of the plants and warehouses of the financial statements is not required. However, because the clients and upon becoming aware of any major floods in such a location, he or she would investigate to determine if the client's facilities had suffered any damage. Occasionally, situation of this type may have such a material impact on the entity that the auditor may wish to include in the audit report an explanatory paragraph directing the reader's attention to the event and its effect. 5. The sale of bonds or other securities would require a filing with the SEC in which the auditor would presumably be involved. In addition, the sale would be revealed by reading the minutes of directors and finance committee's meetings, by corresponding with the client's attorneys and by examining the minutes of directors and finance committee's meetings, by

the cash receipts books in the period subsequent to the | disclosure.

Occasionally, a situation of this type may have | | | balance sheet date for evidence of unusually large receipts. | such a material impact on the entity that the auditor may wish | | | to in the audit report an explanatory paragraph directing the | | | reader's attention to the event and its effect. |

19-28. (Estimated time - 15 minutes) The substantive audit procedures that

Young should apply when testing for loss contingencies relating to litigation, claims, and assessments include the following: - Read minutes of meetings

of stockholders, directors, and committees. - Read contracts, loan

agreements, leases, and other documents. - Read correspondence with

taxing and other governmental agencies. - Read correspondence with

insurance and bonding companies. - Read confirmation replies information

concerning guarantees. - Discuss with management the entity's policies and procedures for identifying, valuating, and accounting for litigation, claims,

and assessments. - Obtain from management or the client's general counsel

a description and evaluation of litigation, claims, and assessments. - Obtain

written assurance from management that the financial statements include all

accruals - and disclosures required by Statement on Financial Accounting

Standards No. 5. - Examine documents in the client's possession concerning

litigation, claims, and assessments, including correspondence from lawyers. -

Obtain an analysis of professional fee expenses and review supporting

invoices for indications of contingencies. - Request the client's management

to prepare for transmittal a letter of inquiry to those lawyers consulted by

the client concerning litigation, claims, and assessments. - Compare the

lawyer's response to the items in the letter of inquiry to the description and

evaluation of litigation, claims, and assessments obtained from

management. - Determine that the financial statements include proper accruals and disclosures of the contingencies. 19-29. (Estimated time - 25 minutes)

1. Disagree. Generally letters silent on particular aspects of the request letter require follow-up. The auditor should contact the attorney and confirm that he or she intended the letter to completely respond to the request letter and was silent because there were no issues to discuss. Documentation of this confirmation should be included in the working papers.

2. Disagree. A useful evaluation is not always possible. For instance, it may include an element difficult to predict or to which the lawyer may not have paid sufficient attention to make an evaluation. If the matter involved constitutes a material or contingent liability, the auditor will likely conclude there is an uncertainty with effects on the financial statements that can't be determined, and he or she should consider the effects of that uncertainty on the audit report.

3. Disagree. The attorney's opinion is an example of a marginally acceptable opinion. If such an opinion is issued on litigation where loss would seriously impair the company's operations, the auditor must give a qualified opinion and possibly consider a disclaimer of opinion.

4. Disagree. In some cases, attorneys, auditors, and clients discuss matters involving litigation, and during such informal discussions some attorneys express their opinions as to the outcome of disputed matters. Such oral opinions should be expressed in writing by the attorney, and if they are not reduced to writing, the discussions generally should not be considered audit evidence.

5. Disagree. The law firm derives all or substantially all of its fees from the client. This is, in essence, analogous to in-house counsel. Evidence from in-house counsel may provide the auditor with the necessary corroboration in some cases. However, since the liability here is great, complete reliance on

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such evidence is not justified. 19-30. (Estimated time - 25 minutes) Other matters that Alderman's representation letter should specifically confirm that:

- The financial statements referred to above are fairly presented in conformity with generally accepted accounting principles.
- We have made available to you all-
- Financial records and related data.
- Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
- There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
- There has been no-
- Fraud involving management or employees who have significant roles in internal control.
- Fraud involving others that could have a material effect on the financial statements.

- Management believes that the effects of any uncorrected financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

- The following have been properly recorded or disclosed in the financial statements:

- Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
- Guarantees, whether written or oral, under which the company is contingently liable.
- Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6, Disclosure of Certain Significant Risks and Uncertainties.
- There are no other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.
- The company has

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satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral. - The company has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance. - Debt securities that have been classified as held-to-maturity have been so classified due to the company's intent to hold such securities, to maturity and the company's ability to do so. All other debt securities appropriately have been classified as available-for-sale or trading. - Provision has been made to reduce excess or obsolete inventories to their estimated net realizable value. - Capital stock reserved for options, warrants, conversions, or other requirements have been properly disclosed. 19-31. (Estimated time - 30 minutes) a. The use of overall analytical review at the final stages of an audit has two general advantages to the CPA: (1) a broad view is obtained of the data of the financial statements, and (2) the CPA's attention is focused on exceptions or variations in the data. A broad view of the data under audit is needed by the CPA to draw conclusions about the data as a whole. Merely looking at individual transactions may lead the auditor to overlook important variations in the underlying data. The application of analytical procedures to the final data to obtain this broad view requires a discerning analysis of the data, which results in overall conclusions upon which the CPA's audit satisfaction rests. The CPA is thus able to satisfy him or herself as to the reasonableness, validity, and consistency of the data in view of the surrounding circumstances. The focusing of the CPA's attention on exceptions or variations in the data results in a more efficient and economical audit because there is a reduction in the amount of detailed testing which would be required, in the absence of overall checks, to uncover

these exceptions or variations. Furthermore, manipulations of accounts may be revealed because the double-entry bookkeeping system extends the effects of manipulations to additional accounts, which will then bear a changed relationship to other accounts. In addition, managerial problems and trouble spots will be highlighted for the CPA and may lead to the opportunity to be of additional service to the client.

b. The ratios that a CPA may compute during an audit as overall checks on balance sheet accounts and related nominal accounts may include the following:

- Accruals of individual expenses to related total expenses.
- Calculations of the entity's operating cycle.
- Individual components of return on assets and return on equity.
- The impact of an entity's financing and investing activities.
- The ability of cash flow from operations to service debt and dividends.
- Other measures of the entity's liquidity and solvency.

c. 1. The possible reasons for a decrease in the rate of inventory turnover include the following:

- Decline in sales.
- Increase in inventory quantities, intentional or unintentional.
- Incorrect computation of inventory because of errors in pricing, extensions, or taking of physical inventory.
- Inclusion in inventory of slow-moving or obsolete items.
- Erroneous cutoff of purchases.
- Erroneous cutoff of sales under the perpetual inventory accounting method.
- Unrecorded purchases.
- Change in inventory valuation method.

2. The possible reasons for an increase in the number of days' sales in receivable include the following:

- Change in credit terms.
- Decreasing sales.
- Change in the sales mix of products with different sales terms.
- Change in mix of customers.
- Improper sales cutoff.
- Unrecorded sales.
- Lapping.
- Slower collections caused by tighter economic conditions or lowering of the quality of the receivables.

19-32. (Estimated time - 20 minutes) a. Reportable conditions are matters that

come to an auditor's attention, which, in the auditor's judgment, should be communicated to the client's audit committee or its equivalent because they represent significant deficiencies in the design or operation of the internal control structure, which could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Material weaknesses are reportable conditions in which the design or operation of specific internal control structure elements do not reduce, to a relatively low level, the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. b. An auditor is required to identify reportable conditions that come to the auditor's attention in the normal course of an audit, but is not obligated to search for reportable conditions. The auditor uses judgment as to which matters are reportable conditions. Provided the audit committee has acknowledged its understanding and consideration of such deficiencies and the associated risks, the auditor may decide certain matters do not need to be reported unless, because of changes in management or the audit committee, or because of the passage of time, it is appropriate to do so. Conditions noted by the auditor that are considered reportable should be reported, preferably in writing. If information is communicated orally, the auditor should document the communication. The report should state that the communication is intended solely for the information and use of the audit committee, management, and others within the organization. The auditor may identify and communicate separately those reportable conditions the auditor considers to be material weaknesses, but may not state that no

reportable conditions were noted during the audit. Reportable conditions may be communicated during the course of the audit rather than after the audit is concluded., depending on the relative significance of the matters noted and -the urgency of corrective follow-up action. 19-33. (Estimated time - 30 minutes) | a. | Deficiency | Proper Wording | | 1. | In completing our audit | In planning and performing our audit | | 2. | Its internal control environment | Its internal control structure | | 3. | Not to express an opinion | Not to provide assurance | | 4. | The design and effectiveness | The internal control structure and its operation | | of the system Of internal control | | | 5. | Under GAAS | Under standards | | 6. | Potential weaknesses | Significant | | 7. | To prepare financial | To record, process, summarize, and report financial data consistent| | statements in conformity | with the assertions of management in the financial statements. | | 8. | For the audit committee | For the information and use of the audit committee, management, and| | and others | others | b. A reportable condition may be of such magnitude as to be a material weakness. Thus, all material weaknesses are reportable conditions, but all reportable conditions are not material weaknesses. The two terms are defined as follows: - Reportable conditions represent significant deficiencies in the design or operation of the internal control structure, which could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. - A material weakness is a reportable condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a

timely period by employees in the normal course of performing their assigned functions. c. Two additional paragraphs are required when the auditor refers to material weaknesses in the audit report. The first paragraph should include a definition of a material weakness and a description of reportable conditions that are material weaknesses. The second paragraph should describe the limitations of the auditor's work; i. e., that the work would not necessarily disclose all reportable conditions that are also material weaknesses. 19-34. (Estimated time - 20 minutes) a. Independent auditors use a management letter to call to management's attention matters that the auditor has noted during the course of the audit engagement but which did not fall within the scope of the opinion. The management letter provides an excellent vehicle for suggesting value-added services that can assist the business in improving organizational performance. A management letter is rendered as a constructive service to suggest improvements as well as point out deficiencies. b. Many types of information can be covered in a management letter. The major, broad areas which are presented and discussed in the management letter include: - Suggestions for modifying and improving a client's internal controls. - Recommendations for changes and improvements in accounting systems to better meet management's information needs. - Suggestions for improving the management of resources such as cash, inventories, and investments. - Comments regarding tax related matters. A detailed example of a suggestion for improving business practices follows: We understand that your accounting system offers discounts to customers who purchase in significant volumes. The program that grants these volume discounts as it prices a sales invoice does so after important information on gross margins has been reported to

department managers. While sales invoices and underlying accounting information is correct, it does not agree with management information that is provided to sales managers as they make pricing decisions. As soon as possible you need to change the program that calculates the sales discounts so that gross margins and other information used by sales management includes the volume discounts offered customers. (Answer updated from original ICMA answer.) 19-35. (Estimated time - 30 minutes) a. 1. 1--subsequent event during the subsequent event period requiring adjustment. 2. 1--subsequent event during the subsequent event period requiring adjustment. 3. 2--subsequent event during the subsequent event period requiring disclosure. 4. 2--subsequent event during the subsequent event period requiring disclosure 5. 1--subsequent event during the subsequent event period requiring adjustment. 6. 4--subsequent event occurring after field work but before issuance of report. 7. 4--subsequent event occurring after field work but before issuance of report. 8. 5--postaudit discovery of facts existing at date of report. The date field work is completed is not specifically given. This answer is based on the customary practice of dating the audit report as of the end of field work (i. e., February 26). b. For categories (1) and (2) the auditor has the responsibility for identifying and evaluating subsequent events up to the date of the auditor's report. In discharging this responsibility, the auditor should be alert for subsequent events in performing substantive tests, and also perform specific auditing procedures at or near the completion of field work. For categories (3) and (4), the auditor has no responsibility to make inquiry or to perform any auditing procedures during this time period to discover subsequent events. However, if knowledge of such an event comes to the auditor's attention, he

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or she should determine whether the event requires adjustment of or disclosure in the financial statements. For category (5), the auditor has no responsibility for their discovery. However, if the auditor becomes aware of such facts and the facts may have affected the report that was issued, the auditor is required to ascertain the reliability of the information. c.

Information about the items would be obtained from the following: 1. Inquiry of management; client "rep" letter. 2. Review of bad debt write-offs in January. 3. Reading of minutes. 4. Observation of fire; newspaper account of fire; inquiry of management. 5. Inquiry of management; lawyer's letter; and client "rep" letter. 6. Reading of minutes. 7. Newspaper story on takeover; inquiry of management. 8. Inquiry of management; lawyer's letter; and client "rep" letter. If the client fails to make required disclosure, the auditor should notify each member of the board of directors of such refusal and take the following steps to prevent further reliance on the audit report and: - Notify the client that the audit report must no longer be associated with the financial statements. - Notify regulatory agencies having jurisdiction over the client that the report should no longer be relied on. - Notify (generally via the regulatory agency) each individual known to be relying on the statements that the report should no longer be relied on. | Cases | 19-36. See separate file with answers to the comprehensive case related to the audit of Mt. Hood Furniture that is included with this chapter. | NOTE: Several revisions were made to this problem to correct printing errors. The revised problem is posted on the student resources website. | 19-37. (Estimated time - 25 minutes) a. and b. 1. The state government's approval of a plan for the construction of an express highway would have come to the CPA's attention through inquiries of officers and key personnel, examination of the minutes

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of the meetings of the board of directors and stockholders, and reading local newspapers. The details of the item would not have to be disclosed as a separate footnote because all fixed assets of the corporation, including the right to the condemnation award, were to be sold as of March 1, 19X1. 2. It is improbable that the CPA would learn the source of the \$25, 000 unless it were revealed in a discussion with the president or his personal accountant, or unless the auditor prepared the president's personal income tax return, in which case the interest charges would have led to his investigation of the use to which the funds were put. Setting out the loan in the balance sheet as a loan from an officer would be sufficient disclosure. The source from which the officer obtained the funds would not be disclosed because it is the officer's personal business and has no effect upon the corporation's financial statements. Indeed, disclosure of the funds' source might be construed as detrimental to the officer. 3. The additional liability for the ore shipment would have been revealed by CPA's scanning of January transactions. The CPA's regular examination of 19X0 transactions and related documents such as purchase contracts would have caused him or her to note the item for subsequent follow-up to determine the final liability. In addition, the client's letter of representation might have mentioned the potential liability. The item would not require separate disclosure by footnote or otherwise and would be handled by adjusting the financial statement accounts payable by the amount of the additional charge, \$9, 064 4. The CPA might learn of the agreement to purchase the treasurer's stock ownership through inquiries of management and legal counsel, examination of the minutes of the meetings of the board of directors and stockholders, and subsequent reading of the agreement. The absence of the treasurer might also arouse the CPA's

curiosity. The details of the agreement would be disclosed in a footnote because the use of company cash for the repurchase of stock and the change in the amount of stock held by stockholders might have a heavy impact on subsequent years' financial statements. Usually a management change, such as the treasurer's resignation, does not require disclosure in the financial statements. The details underlying the separation (personal disagreements and divorce) should not be disclosed because they are personal matters.

5. Through inquiries of management, review of financial statements for January, scanning of transactions, and observations, the CPA would learn of the reduced sales and of the strike. Disclosure would not be made in the financial statements of these conditions because such disclosure might create doubt as to the reasons therefore and misleading inference might be drawn.

6. The contract with Mammoth Industries would come to the CPA's attention through inquiries of management and legal counsel, reading the minutes of the meetings of the board of directors and stockholders, and examination of the contract. All important details of the contract should be disclosed in a footnote because of the great effect upon the corporation's future. The factors contributing to the entry into the contract need not be disclosed in the statements; while they might be of interest to readers, they are by no means essential to make the statements not misleading.

19-38. (Estimated time - 25 minutes) The omissions, ambiguities, and inappropriate statements and terminology in Brown's letter are as follows: - The action that Consolidated intends to take concerning each suit (for example, to contest the matter vigorously, to seek an out-of-court settlement, or to appeal an adverse decision) is omitted. - A description of the progress of each case to date is omitted. - An evaluation of the likelihood of an unfavorable outcome

of each case is omitted. - An estimate, if one can be made, of the amount or range of potential loss of each case is omitted. - The various other pending or threatened litigation on which Young was consulted is not identified and included. - The unasserted claims and assessments probable of assertion that have a reasonable possibility of an unfavorable outcome are not identified. - Consolidated's understanding of Young's responsibility to advise Consolidated concerning the disclosure of unasserted possible claims or assessments is omitted. - Materiality (or the limits of materiality) is not addressed. - The reference to a limitation on Young's response due to confidentiality is inappropriate. - Young is not requested to identify the nature of and reasons for any limited response. - Young is not requested to include matters that existed after December 31, 1992, up to the date of Young's response. - The date by which Young's response is needed is not indicated. - The reference to Young's response possibly being quoted or referred to in the financial statements is inappropriate. - Vague terminology such as "slight" and "some chance" is included where "remote" and "possible" are more appropriate. - There is no inquiry about any unpaid or unbilled charges, services, or disbursements. | Research Questions | For the reasons specified in the introduction to this manual, solutions are not provided for this category of questions.