

Planning the audit and understanding internal control

When the client has internal auditors then the major issue for independent auditors is to assess the competence and objectivity of the internal auditors.

As part of their regular work internal auditors may review, assess and monitor the entity's controls that are included in the various accounting cycles. Another part of their work may include confirming receivables or observing certain physical inventories.

Table 5-2 Factors for Assessing the Competence and Objectivity of Internal Auditors

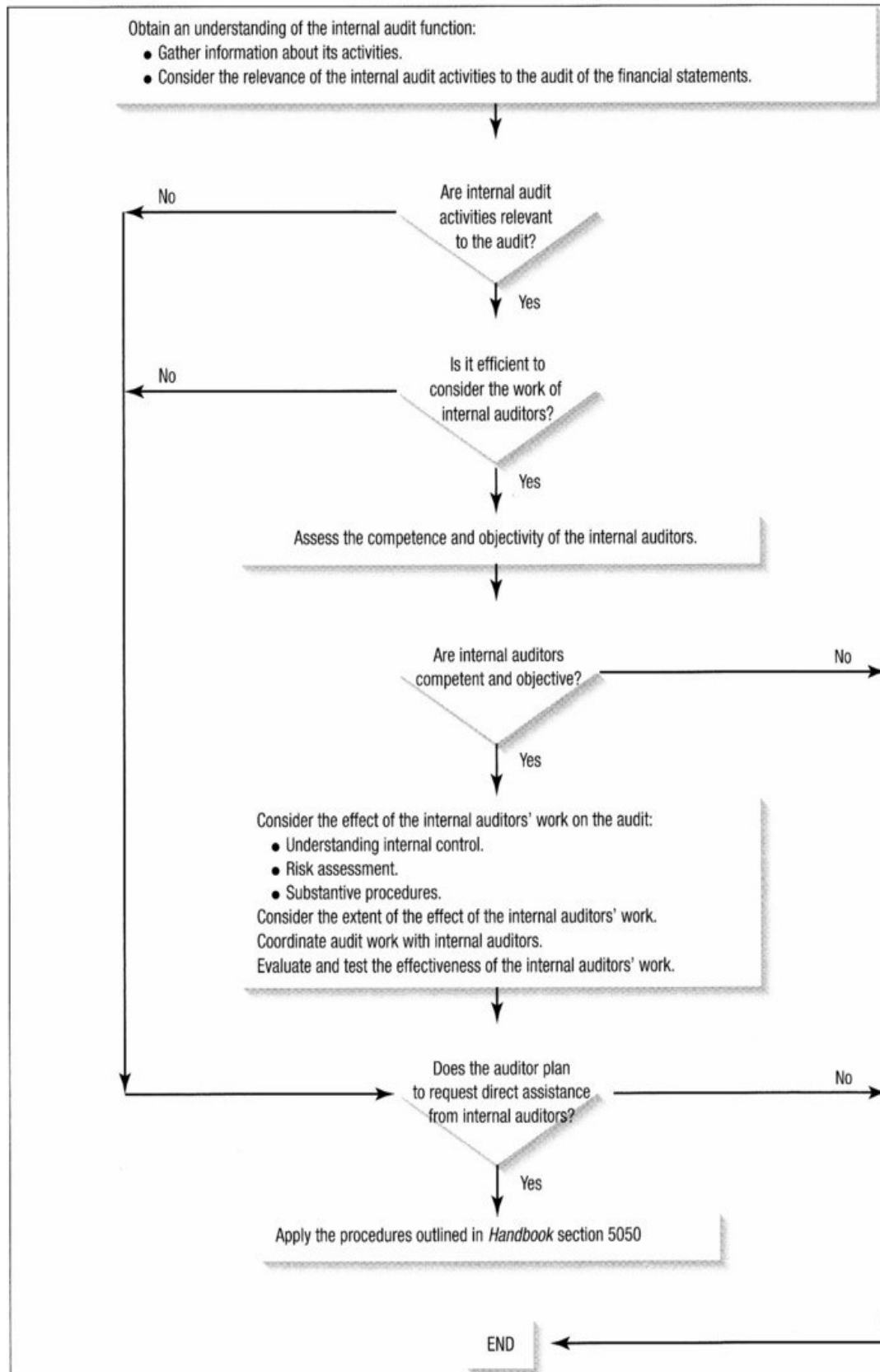
Competence:

- Educational level and professional experience.
- Professional certification and continuing education.
- Audit policies, procedures, and checklists.
- Practices regarding their assignments.
- The supervision and review of their audit activities.
- The quality of their working paper documentation, reports, and recommendations.
- Evaluation of their performance.

Objectivity:

- The organizational status of the internal auditor responsible for the internal audit function (for example, the internal auditor reports to an officer of sufficient status to ensure that the audit coverage is broad and the internal auditor has access to the board of directors or the audit committee).
- Policies to maintain internal auditors' objectivity about the areas audited (for example, internal auditors are prohibited from auditing areas to which they have recently been assigned or are to work upon completion of responsibilities in the internal audit function).

The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements



Planning the audit

the audit plan should also consider how to conduct the engagement in a cost-effective manner.

Additional steps to be performed include

- obtain knowledge of the client's business and industry, and assess inherent risk
 - it provides the auditor with a basis for:
 - assessing inherent risk
 - obtaining a sufficient understanding of internal control
 - designing audit procedures
 - understanding the substance of transactions
 - assessing whether sufficient appropriate audit evidence has been obtained
 - assessing the appropriateness of management's selection of accounting principles
 - assessing overall management's overall financial statement presentation
- establish materiality and consider audit risk
- assess a preliminary level for control risk
 - the auditor needs information on the following:
 - the extent to which information technology is used in each significant accounting system
 - the complexity of the client's computer operations
 - the organizational structure of the information technology activities
 - the availability of data
 - the need for information technology-assisted techniques to gather data and conduct audit procedures
- assess the possibility of fraud, errors, and illegal acts
 - fraud and error: errors are unintentional misstatements whereas fraud refers to intentional misstatements.
 - Illegal acts: these refer to violations of laws or governmental regulations.
- identify related parties
 - Some of the relationship are:
 - an entity that directly or indirectly controls, is controlled by, or is under common control with the reporting entity
 - an entity that is subject to significant influence by the reporting entity management
 - an individual who directly or indirectly controls the reporting entity
 - an individual having an ownership interest that results in significant influence

Audit procedure that may identify transactions with related parties:

- enquire of management
- review the minutes of the board of directors
- review conflict-of-interest statements
- review the extent and nature of business transacted with major customers, suppliers, borrowers, and lenders
- review accounting records for large, unusual, or nonrecurring transactions
- review confirmations of loans receivable and payable for indications of guarantees.

- conduct preliminary analytical procedures
 - The main objectives of analytical procedures are (1) to understand the client's business and transactions and (2) to identify financial statement accounts that are likely to contain errors.
 - For example, consider the inventory turnover:

$$\text{Inventory turnover} = \frac{\text{Cost of goods sold}}{\text{Inventory}}$$

Suppose that the auditor's analysis of inventory turnover for EarthWear for the past five years showed the following trend, which would be compared to industry data:

	2002	2003	2004	2005	2006
Client	8.9	8.8	8.5	8.0	7.9
Industry	8.8	8.7	8.8	8.6	8.6

The inventory turnover ratio in this case has declined steadily over the five-year period, while the industry turnover ratio shows only a minor decline over the same period. The auditor might suspect that the client's inventory contains slow-moving or obsolete inventory. The auditor would then plan additional testing for selected assertions such as valuation, completeness, and existence.

- develop an overall audit strategy and prepare audit programs

<i>Business Objectives and Strategy</i>	<i>Business Risks</i>	<i>Account(s): (Assertions)</i>	<i>Audit Risks</i>	<i>Controls</i>	<i>Effect on Audit Plan</i>
Increase market share through sales at new international locations (e.g., during the current year websites were developed for France, Italy, Ireland, and several eastern European countries)	Since EarthWear is in a non-EU country, trade laws may affect sales tactics.	<i>Revenue: accuracy and valuation</i>	Overstated due to pricing issues.	EwC has installed a special group to track compliance with local and international laws.	Observe and test group's policies and procedures (see workpaper R-11).
	Strong consumer protection laws in European countries.				
	Political instability in less developed countries (LDCs).	<i>Reserve for returns: completeness</i>	Understated due to failure to properly track returns in new locations.	EwC has placed more frequent review of returns in new locations.	Extend audit work on EwC's return tracking with emphasis on new locations (see workpaper R-15).
	Foreign currency risks.	<i>Gains/losses from currency hedging: valuation and accuracy</i>	Gains/losses not properly calculated or accrued on hedging activity.	EwC has strong controls in the Treasury Department to account for hedging activities.	Increase the number of hedging contracts tested with particular emphasis on contracts in currencies from LDCs (see workpaper S-14).

A Partial Audit Program for Substantive Tests of Accounts Receivable

<i>Audit Procedures</i>	<i>W/P Ref.</i>	<i>Completed by</i>	<i>Date</i>
1. Obtain the December 31, 2006, aged accounts receivable trial balance and	_____	_____	_____
a. Foot the trial balance and agree total to accounts receivable control account.	_____	_____	_____
b. Judgementally select 15 accounts from the aged trial balance; agree the information per the aged trial balance to the original sales invoice and determine if the invoice was included in the appropriate aging category.	_____	_____	_____
2. Confirm accounts receivable	_____	_____	_____
a. For all responses with exceptions, follow up on the cause of the error.	_____	_____	_____
b. For all nonresponses, examine subsequent cash receipts and/or supporting documents.	_____	_____	_____
c. Summarize the confirmation results.	_____	_____	_____
3. Test sales cutoff by identifying the last shipping advice for the year and examining five large sales for three days before and after year-end.	_____	_____	_____
4. Test the reasonableness of the allowance for doubtful accounts by the following:	_____	_____	_____
a. Test the reasonableness using past percentages on bad debts.	_____	_____	_____
b. For any large account in the aged trial balance greater than 90 days old, test for subsequent cash receipts.	_____	_____	_____
c. For the following financial ratios, compare the current year to prior year and internal budgets:			
• Number of days outstanding in receivable.	_____	_____	_____
• Aging of receivables.	_____	_____	_____
• Write-offs as a percentage of sales.	_____	_____	_____
• Bad debt expense as a percentage of sales.	_____	_____	_____
5. Prepare a memo summarizing the tests, results, and conclusions.	_____	_____	_____

Table 5-3 **Examples of Internal Controls and Tests of Controls**

<i>Internal Controls</i>	<i>Test of Controls</i>
Create a separation of duties between the shipping function and the order entry and billing functions.	Observe and evaluate whether shipping personnel have access to the order entry or billing activities.
Credit Department personnel initial sales orders, indicating credit approval.	Inspect a sample of sales orders for presence of initials of Credit Department personnel.
Billing Department personnel account for the numerical sequence of sales invoices.	Enquire of Billing Department personnel about missing sales invoices numbers.
Agree sales invoices to shipping document and customer order for product types, price, and quantity.	For a sample of sales invoices, check for agreement to shipping documents and to customer order. Recompute the information.

Table 5-4

Definitions of the Main Techniques of Analytical Procedures*

Trend analysis is the analysis of changes in an account over time. Simple trend analyses compare last year's account balance (the "expectation") with the current balance. Trend analysis can also encompass multiple time periods and includes comparing recorded trends with budget amounts and with competitor and industry information. The number of time periods used is a function of predictability and desired precision. The more stable the operations over time, the more predictable the relationship and the more appropriate the use of multiple periods. Generally, the more time periods used and the more disaggregated the data, the more precise the expectation. Because trend analysis relies on a single predictor (i.e., prior period information for an account balance), it does not normally yield as precise an expectation as the other two types.

Ratio analysis is the comparison, across time or to a benchmark, of relationships between financial statement accounts (e.g., return on equity) or between an account and nonfinancial data (e.g., cost per square foot or sales per item). Ratio analysis also includes "common-size" analysis, which is the conversion of financial statement amounts to percentages. Industry or competitor ratios are often used to benchmark the client's performance. The advanced module to this chapter illustrates selected financial ratios useful in analytical procedures. Ratio analysis is often more effective at identifying risks and potential misstatements than trend analysis because comparisons of relationships between accounts and operating data are more likely to identify unusual patterns than is an analysis only focused on an individual account. As with trend analysis, to gather substantive evidence effectively, ratio analysis should be performed on disaggregated data (e.g., by product, location, or month) over multiple periods where applicable.

Reasonableness analysis involves forming an expectation using a model. In many cases, a simple model may be sufficient. For example, ticket revenue can be modelled by taking average attendance by average ticket price. Similarly, depreciation expense can be modelled by taking book value divided by average useful life for a class of assets. Because it forms an explicit expectation, reasonableness analysis typically forms a more precise expectation than trend or ratio analysis. Of course the precision of an expectation formed with a reasonableness test depends on the other factors influencing precision (i.e., disaggregation, predictability and reliability).

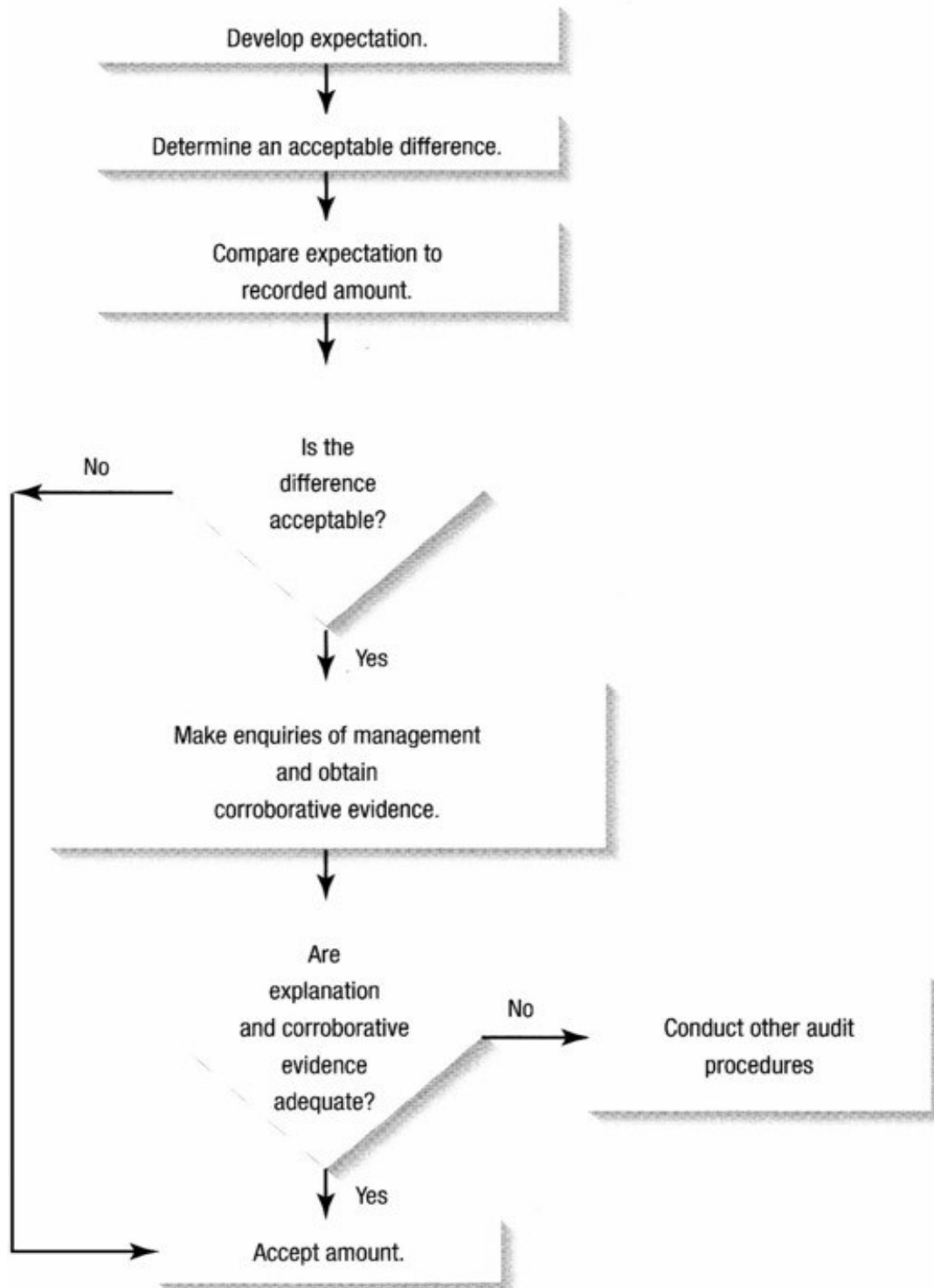
*Regression analysis is another type of analytical procedure. Because it involves relatively complex statistical modelling in audit settings, we do not discuss it in this text. See footnote 7 for further information.

An Example of Industry Data Available from Published Sources

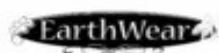
SIC 5961 CTLG, ML-ORDER HSES (No Breakdown) (451 Establishments)			
		\$	%
Cash		101,474	16.6
Accounts receivable		94,139	15.4
Notes receivable		3,668	0.6
Inventory		236,570	38.7
Other current		48,292	7.9
Total current		484,142	79.2
Capital assets		82,524	13.5
Other noncurrent		44,624	7.3
Total assets		611,291	100.0
Accounts payable		125,315	20.5
Bank loans		1,834	0.3
Notes payable		14,671	2.4
Other current		97,195	15.9
Total current		239,015	39.1
Other long-term		59,907	9.8
Deferred credits		—	—
Net worth		312,370	51.1
Total liab and net worth		611,291	100.0
Net sales		2,386,410	100.0
Gross profit		925,927	38.8
Net profit after tax		78,752	3.3
Working capital		245,127	—
RATIOS	UQ	MED	LQ
<i>Solvency:</i>			
Quick ratio (times)	1.6	0.8	0.3
Current ratio (times)	3.9	2.1	1.4
Curr liab to nw (%)	25.1	68.6	142.6
Curr liab to inv (%)	45.8	92.0	146.8
Total liab to nw (%)	29.7	84.1	178.9
Fixed assets to nw (%)	9.3	22.3	49.4
<i>Efficiency:</i>			
Coll period (days)	4.4	14.1	34.1
Sales to inv (times)	14.6	7.9	5.3
Assets to sales (%)	21.2	31.2	47.3
Sales to nwc (times)	19.6	8.6	4.4
Acct pay to sales (%)	3.8	6.2	9.3
<i>Profitability:</i>			
Return on sales (%)	6.9	2.9	0.6
Return on assets (%)	21.2	7.4	1.2
Return on nw (%)	47.7	17.5	4.9

Source: Dun & Bradstreet, Inc.

Overview of the auditor's decision process



Comprehensive EarthWear Example Suppose we want to use substantive analytical procedures to test the reasonableness of interest expense reported by EarthWear Clothiers (i.e., a “reasonableness test”). Consider the following example:

 EarthWear’s 2006 income statement shows \$983,000 of interest expense. To conduct a substantive analytical procedure on this account, the auditor could develop an expectation using reasonableness analysis by building a model in the following manner: Obtain the ending monthly balance for the short-term line of credit from the monthly bank loan statement and calculate the average monthly ending balance. Trace the monthly loan balances to the general ledger. Determine the average interest rate for the year for the short-term line of credit based on the bank’s published rate in the monthly bank loan statement. Multiply the average monthly balance previously calculated by the average interest rate, and compare the result to the recorded interest expense. Suppose that the auditor obtained the following information from EarthWear’s general ledger:

<i>Month</i>	<i>Balance (in thousands)</i>
January	\$ 21,500
February	18,600
March	18,100
April	17,900
May	16,100
June	15,500
July	14,200
August	20,200
September	34,500
October	28,100
November	15,200
December	11,000
Total	<u>\$230,900</u>
Average	<u>\$ 19,240</u>

Further, assume that interest rates recorded on the loan statements have remained stable over the year, fluctuating between 5 and 5.5 percent. If the auditor uses 5.25 percent as the average interest rate, the expectation for interest expense is \$1,010,000 ($\$19,240,000 \times 0.0525$).

As shown in Figure 5–5, once an expectation is developed, the next step is to determine the tolerable difference. Because interest expense is a predictable account and because the information used to form the expectation is deemed reliable, the expectation is fairly precise. Accordingly, the acceptable difference is set at 5 percent of recorded interest expense or \$49,150 ($0.05\% \times \$983,000$). The next step is to compare the expectation of \$1,010,000 to the recorded value of \$983,000 to determine if the difference is greater than can be accepted. Because the difference between the auditor’s expectation and the recorded amount, \$27,000, is less than the acceptable difference, the auditor would accept the interest expense account as fairly stated. However, if the difference

between the recorded amount and the expectation is greater than the acceptable difference, the auditor will need to investigate the difference. In the example above, the auditor would likely carefully examine loan activity within each month to determine if there was significant variation in the balance that was not accounted for by the month-end model used to form the expectation. If the difference could still not be explained, the auditor would enquire of management about the cause of the difference. If the client provides a plausible explanation (e.g., interest expense reported in the financial statements also includes interest paid for other short-term loans that were only outstanding for a few days at a time), auditing standards require the auditor to obtain corroborating evidence. If the client's explanation and the corroborating evidence are not adequate, or if no corroborative evidence is available, the auditor will need to conduct additional substantive audit procedures. If the explanation and evidence are adequate for resolving the difference, the auditor can accept the amount as being fairly presented.

When analytical procedures are used as direct substantive tests, the auditor is testing one or more assertions. For example, in the interest expense example, the auditor is testing primarily the completeness assertion. The effectiveness and efficiency of analytical procedures in identifying material misstatements depend on

- the nature of the assertion
- the plausibility and predictability of the relationship
- the availability and reliability of the data used
- the precision of the expectation

5-46 At December 31, 2006, EarthWear had \$5,890,000 in a liability account labelled "Reserve for returns." The footnotes to the financial statements contain the following policy: "At the time of sale, the company provides a reserve equal to the gross profit on projected merchandise returns, based on prior returns experience." The client has indicated that returns for sales that are six months old are negligible, and gross profit percentage for the year is 42.5 percent. The client has also provided the following information on sales for the last six months of the year:

<i>Month</i>	<i>Monthly Sales (000s)</i>	<i>Historical Return Rate</i>
July	\$73,300	0.4%
August	82,800	0.6%
September	93,500	1.0%
October	110,200	1.5%
November	158,200	2.5%
December	202,500	3.2%

- 1) Develop an expectation for the reserve for returns account.
- 2) What procedure should the auditor perform if the difference between the expectation and the book value is greater than tolerable misstatements?

5-50 Rashed Balti is auditing the RCT Manufacturing Company as of February 28, 2007. As with all engagements, one of Balti's initial procedures is to make overall checks of the client's financial data by reviewing significant ratios and trends so that he better understands the business and can determine where to concentrate his audit efforts.

The financial statements prepared by the client with audited 2006 figures and preliminary 2007 figures are presented below in condensed form.

RCT MANUFACTURING COMPANY
Condensed Income Statements
Years Ended February 28, 2007 and 2006

	2007	2006
Net sales	\$ 1,684,000	\$ 1,250,000
Cost of goods sold	927,000	710,000
Gross margin on sales	\$ 757,000	\$ 540,000
Selling and administrative expenses	682,000	504,000
Income before federal income taxes	\$ 75,000	\$ 36,000
Income tax expense	30,000	14,400
Net income	<u>\$ 45,000</u>	<u>\$ 21,600</u>

RCT MANUFACTURING COMPANY
Condensed Balanced Sheets
February 28, 2007 and 2006

Assets	2007	2006
Cash	\$ 12,000	\$ 15,000
Accounts receivable, net	93,000	50,000
Inventory	72,000	67,000
Other current assets	5,000	6,000
Plant and equipment, net of amortization	60,000	80,000
	<u>\$242,000</u>	<u>\$21,600</u>
Equities		
Accounts payable	\$ 38,000	\$ 41,000
Federal income taxes payable	30,000	15,000
Long-term liabilities	20,000	40,000
Common stock	70,000	70,000
Retained earnings	84,000	52,000
	<u>\$242,000</u>	<u>\$218,000</u>

Looking at asset and liability accounts identify the audit procedures that should be included.

Table 6-8
Summary of Carter Chemical's Ratios

Ratio	Formula for Calculation
Liquidity	
Current	$\frac{\text{Current assets}}{\text{Current liabilities}}$
Quick, or acid test	$\frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$
Asset management	
Inventory turnover	$\frac{\text{Sales}}{\text{Inventory}}$
Average collection period (ACP)	$\frac{\text{Receivables}}{\text{Sales}/360}$
Fixed assets utilization	$\frac{\text{Sales}}{\text{Fixed assets}}$
Total assets utilization	$\frac{\text{Sales}}{\text{Total assets}}$
Debt management	
Debt to total assets	$\frac{\text{Total debt}}{\text{Total assets}}$
Times interest earned (TIE)	$\frac{\text{Earnings before interest and taxes}}{\text{Interest charges}}$
Profitability	
Profit margin on sales	$\frac{\text{Net profit after taxes}}{\text{Sales}}$
Return on total assets (ROA)	$\frac{\text{Net profit after taxes}}{\text{Total assets}}$
Return on common equity (ROE)	$\frac{\text{Net profit after taxes}}{\text{Common equity}}$
Market value	
Price/earnings (P/E)	$\frac{\text{Price per share}}{\text{Earnings per share}}$
Market/book	$\frac{\text{Market price per share}}{\text{Book value per share}}$