

# AUDITING REFRESHER

STATE OF MAINE



May 23, 2016

# INTRODUCTION & RECAP OF ASSERTIONS



# Assertions recap

- **Existence or Occurrence (E0)**
- Completeness (C)
- Valuation or Allocation (VA)
- Presentation & Disclosure (PD)
- Right and Obligations (RO)

# Existence & occurrence

Assertions about account balances at the period-end include:

**Existence – Assets, liabilities, and equity interests exist.**

Assertions about classes of transactions and events for the period under audit include:

*Occurrence* – Transactions and events that have been recorded have occurred and pertain to the entity.

(AU-C 315.A128)



# BRAINSTORM EXERCISE – EXISTENCE



## Brainstorm exercise

Is the EXISTENCE assertion relevant for a particular financial statement account and how might we design our procedures to test it?

Cash

## Brainstorm exercise

Is the EXISTENCE assertion relevant for a particular financial statement account and how might we design our procedures to test it?

### Accounts Receivable

# Assertions Recap

- Existence or Occurrence (E0)
- **Completeness (C)**
- Valuation or Allocation (VA)
- Presentation & Disclosure (PD)
- Right and Obligations (RO)

# Completeness

Statement of Net Position— All transactions and events that should have been recorded have been recorded.

Financial Position – All assets, liabilities, and net position that should have been recorded have been recorded.

# Cutoff

Transactions and events have been recorded in the correct accounting period.

# BRAINSTORMING EXERCISE



# Payroll Expense

Is the **COMPLETENESS** assertion relevant for a particular financial statement account and how might we design our procedures to test it?

Is **CUTOFF** relevant for a particular financial statement account and how might we design our procedures to test it?

# Accounts Payable

Is the **COMPLETENESS** assertion relevant for a particular financial statement account and how might we design our procedures to test it?

Is **CUTOFF** relevant for a particular financial statement account and how might we design our procedures to test it?

## Brainstorming Session

# Cash

Is the **COMPLETENESS** assertion relevant for a particular financial statement account and how might we design our procedures to test it?

Is **CUTOFF** relevant for a particular financial statement account and how might we design our procedures to test it?

# Assertions Recap

- Existence or Occurrence (E0)
- Completeness (C)
- **Valuation or Allocation (VA)**
- Presentation & Disclosure (PD)
- Right and Obligations (RO)

# Valuation & Allocation

Assertions about an account balance at the period end:

*Valuation and allocation: Assets, liabilities, and net position are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments are appropriately recorded.*

# BRAINSTORM EXERCISE – VALUATION



## Brainstorm Exercise

Is the VALUATION assertion relevant for a particular financial statement account and how might we design our procedures to test it?

– Accrued Expenses

## Brainstorm Exercise

Is the VALUATION assertion relevant for a particular financial statement account and how might we design our procedures to test it?

– Self Insurance

# Assertions recap

- Existence or Occurrence (EO)
- Completeness (C)
- Valuation or Allocation (VA)
- **Presentation & Disclosure (PD)**
- Rights and Obligations (RO)

# Presentation & disclosure

Assertions about presentation and disclosure include the following:

Assertion	Definitions
Occurrence	Disclosed events, transactions, and other matters have occurred and pertain to the entity.
Completeness	All disclosures that should have been included in the financial statements have been included.
Classification and Understandability	Financial information is appropriately presented and described, and disclosures are clearly expressed.
Accuracy and Valuation	Financial and other information is disclosed fairly and in appropriate amounts.

*AU-C 0315.00 .A114*

## Brainstorm exercise

In the following scenario, what might management be asserting in relation to the presentation and disclosure of the transaction?

An agency issues a new Bond during the year. Management has included the Bond as a liability, split between long-term and short-term debt. They have included a separate note in the financial statements stating the major terms of the loan along with details of future commitments.

- Occurrence
- Completeness
- Classification and Understandability
- Accuracy and Valuation

## Part 10.2.1a Suggested Solution

Disclosure	Detail
Occurrence	The Bond that is reported in the financial statements and disclosed in the footnotes is based on an actual transaction from a third-party prior to the date of the financial statements. The Bond was taken out in the Agency's name.
Completeness	All disclosures that should have been included in the financial statements in relation to the Bond agreement have been included.
Classification and Understandability	The classification between short and long-term debt is appropriate. The financial information in the financial statements and the footnotes relating to the Bond are appropriately presented and described. The details of the Bond agreement as required clearly expressed.
Accuracy and Valuation	The amounts classified as short-term and long-term liabilities are accurate. Financial information within the debt footnote (e.g., interest rates, five year maturity schedule) are also accurate.

# Assertions recap

- Existence or Occurrence (EO)
- Completeness (C)
- Valuation or Allocation (VA)
- Presentation & Disclosure (PD)
- **Rights and Obligations (RO)**

# Definition of Rights and Obligations

- Rights and obligations – The entity holds or controls the rights to assets, and liabilities are the obligations of the entity
- Right  $\neq$  ownership

# Auditing Rights and Obligations

## Debt

### Example:

- An agency and a private partner issue a revenue bond
- The private partner is using the proceeds of the revenue bond to build a building for the Agency
- The Agency leases the entire building from the private partner, with terms equivalent to the bond payments
- Question – Who should record the bond?

# Summary

- The same procedures used to test rights and obligations are often used to test other assertions, such as existence and completeness

# INTRODUCTION TO INTERNAL CONTROL AND CONTROL ACTIVITIES



# Business Processes

- An entity's business processes are the activities designed to:
- Develop, purchase, produce, sell, and distribute an entity's products and services;
- Ensure compliance with laws and regulations; and
- Record information, including **accounting and financial reporting information**

# Control Activities

- Control activities are the actions established through policies and procedures that help ensure that management's directives to mitigate risks to the achievement of their objectives are carried out
  - Control activities may be preventive or detective in nature
  - May encompass a range of manual and automated activities (e.g., authorizations and approvals, verifications, reconciliations)

## What is the Difference Between a Process and Control?

- Process relates to the activities that transform inputs into outputs. The process outlines the way things get done and may include when, by whom, and how
- Control relates to the specific steps within the process that reduce the risk that an error or inappropriate action occurs

# Process vs. Control

## Process

- Captures data
- Changes data
- Introduces possibility for error

## Words like:

- Makes
- Prepares
- Creates

## Control

- Does not change data
- Prevents or detects and corrects errors introduced by processes

## Words like:

- Reviews
- Approves
- Agrees

# Types of Controls

	Manual Control	Automated Control
Preventive Control	Manual Preventive Control	Automated Preventive Control
Detective Control	Manual Detective Control	Automated Detective Control

# Preventive Controls

- Preventive controls are intended to prevent the occurrence of an activity that is not consistent with the control objective ***before it occurs***
- For example:
  - Maintaining appropriate segregation of duties through use of passwords and access controls
  - Updates to financial reporting software are tested before deployment
  - Review and approval of invoices by management is required prior to recording



# Detective Controls

- Detective controls are intended to identify misstatements or unauthorized activities ***after they have occurred*** that are not consistent with the control objective
- For example:
  - The entity has a whistleblower hotline
  - The CEO obtains sales updates from the operations team and reviews the financial statements for unusual trends or results inconsistent with information received from the operations teams



## Detective Controls (cont.)

- Although detective controls are designed to identify misstatements or unauthorized activities *after they have occurred*, the identification happens before the process is completed
- A detective control that is operating effectively should identify a misstatement before the financial statements are made available to auditors or users

# Manual vs. Automated Controls



## The Use of IT in Internal Control

What are the benefits to our clients of using IT?

# Risks Arising from IT

- Use of IT affects the way that control activities are implemented
- Controls over IT systems are effective when they:
  - Maintain the integrity of information
  - Maintain the security of data
  - Include effective IT general controls (ITGCs) and application controls

# COMPLETENESS, ACCURACY AND RELIABILITY OF AUDIT EVIDENCE



## Audit Evidence (AU-C 500)

*Sufficiency (of audit evidence) is the measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.*

*Appropriateness (of audit evidence) is the measure of the **quality of audit evidence** (that is, its **relevance and its reliability in providing support** for the conclusions on which the auditor's opinion is based).*

# Audit evidence – relevance & reliability

- Evidence should be **relevant**
  - Does the evidence help support the purpose of the audit procedure? (*remember availability bias*)
- Evidence should be **reliable**
  - What is the source of the evidence?
  - Who is providing the evidence?
  - What is the nature and circumstances under which the evidence was obtained?
  - What are the controls over the preparation and maintenance of the evidence?

# General rules – reliability of evidence

## GENERALLY, RELIABILITY INCREASES:



- When received from independent sources.
- When related controls, including those over its preparation and maintenance, imposed by the entity are effective.
- When obtained directly by the auditor (for example, observation of the application of a control) rather than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- When evidence in documentary form, whether paper, electronic, or other medium, rather than obtained orally.
- When evidence provided by original documents rather than photocopies, facsimiles, or documents that have been filmed, digitized, or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

# General rules – reliability of evidence

Generally, reliability INCREASES when:

- Received from independent sources.
- Related controls imposed by the entity are effective.
  - Preparation and maintenance
- Obtained directly by the auditor rather than audit evidence obtained indirectly or by inference.
  - Observation vs. Inquiry
- Evidence is in documentary form.
  - Paper/Electronic vs. Orally
- Evidence is provided by original documents rather than copies,
  - Reliability of copies depends on the controls over their preparation and maintenance



## Completeness & accuracy

- **General Rule:** Client prepared audit schedules and evidence should be tested as to their reliability, completeness and accuracy unless we have assessed we can rely on it due to our work on controls over their preparation and maintenance, or from testing elsewhere in the audit file.

# Examining audit evidence

- Examining audit evidence
  - Note pertinent details
  - Ask questions when in doubt
  - Use your judgment
- Never discount your instincts
- Remember the common traps and biases

# What Biases Should We Be Aware of When Testing?

Availability  
Bias

Relying too much on information that is most readily available, particularly memories most easily retrieved

Anchoring

Failing to adjust sufficiently from an initial estimate or amount

Confirmation

Seeking information that confirms our initial belief, while ignoring information that could potentially disconfirm

Distortion

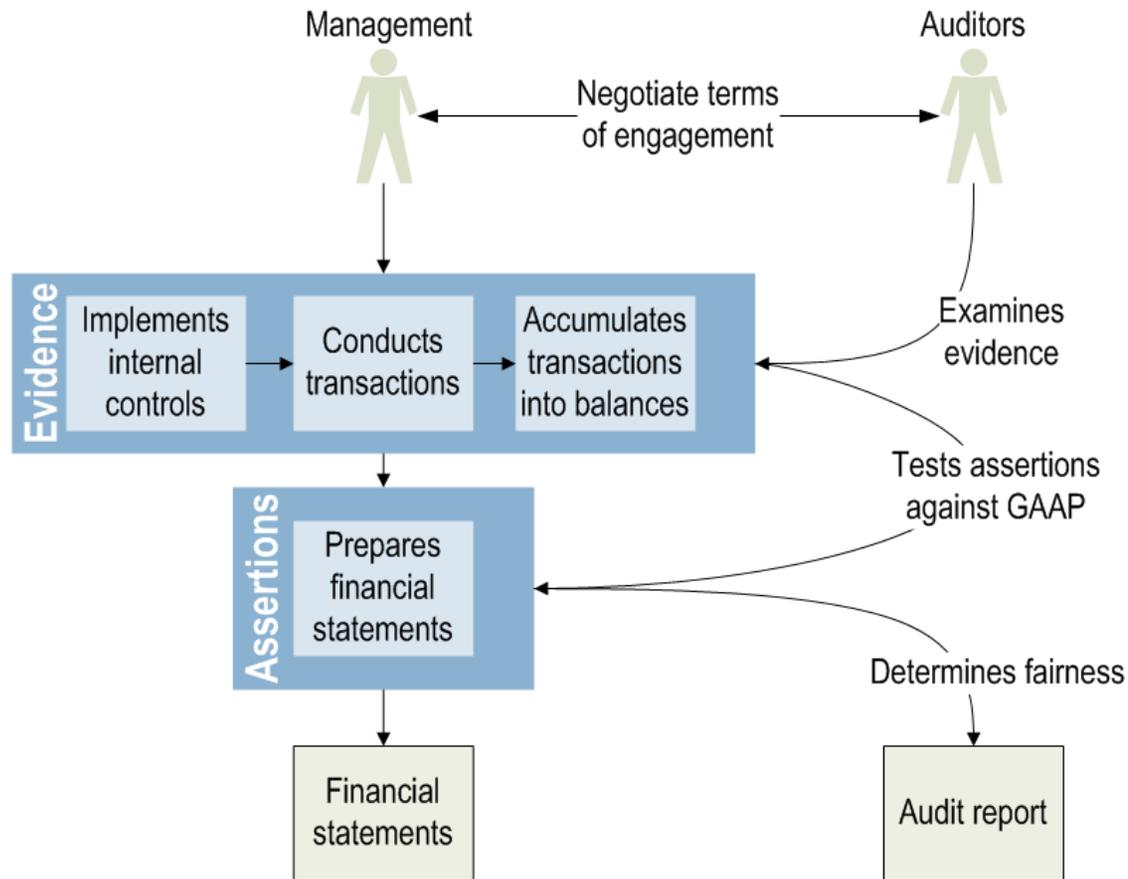
Interpreting information to favor a preferred alternative or expectation



# AUDIT DOCUMENTATION



# The financial statement audit process



# Audit Documentation

- *AU-C 230 Audit Documentation* requires that audit documentation should be sufficient to enable an experienced auditor, having no previous connection to the audit, to understand:
  - The **nature, timing, and extent of procedures** performed to comply with GAAS and applicable legal and regulatory requirements;
  - The **results** of the audit procedures performed, and the audit evidence obtained; and
  - **Significant findings or issues** arising during the audit, the **conclusions** reached thereon, and **significant professional judgments** made in reaching those conclusions.

# Audit Documentation

- *AU-C 230 Audit Documentation* requires that audit documentation should be sufficient to enable an experienced auditor, having no previous connection to the audit, to understand:
  - Nature, timing, and extent of procedures
  - Results of the audit procedures the audit evidence obtained
  - Significant findings or issues
  - Conclusions reached
  - Significant professional judgments made

# Types of documentation

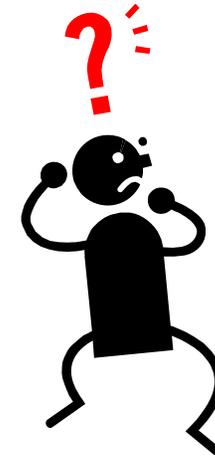
- Tickmarks
- Memos
- Notes
- Conclusions
- Audit Program Sheets
- Analyses and schedules
- Abstracts or copies of documents
- Letters of confirmation or representation



## Key trap

*Remember availability and rush to solve bias – don't just follow last years without considering if the testing approach or evidence to be obtained is appropriate.*

(But it can be a good place to start!)



# Basis for conclusion

- What was done?
  - How was evidence gathered
- What was found?
  - What was the outcome of our evaluation of the evidence
- What that means?
  - What conclusions can we draw from the evidence obtained

# Conclusion

- No exceptions noted.
- No further testing deemed necessary.
- Based on testing performed, \_\_\_\_\_ is fairly stated.
- Based on testing performed, \_\_\_\_\_ is materially correct.
- Based on procedures performed, \_\_\_\_\_.

Note: If there are exceptions or differences, further audit procedures must be performed.