CHAPTER 3

Audit planning I

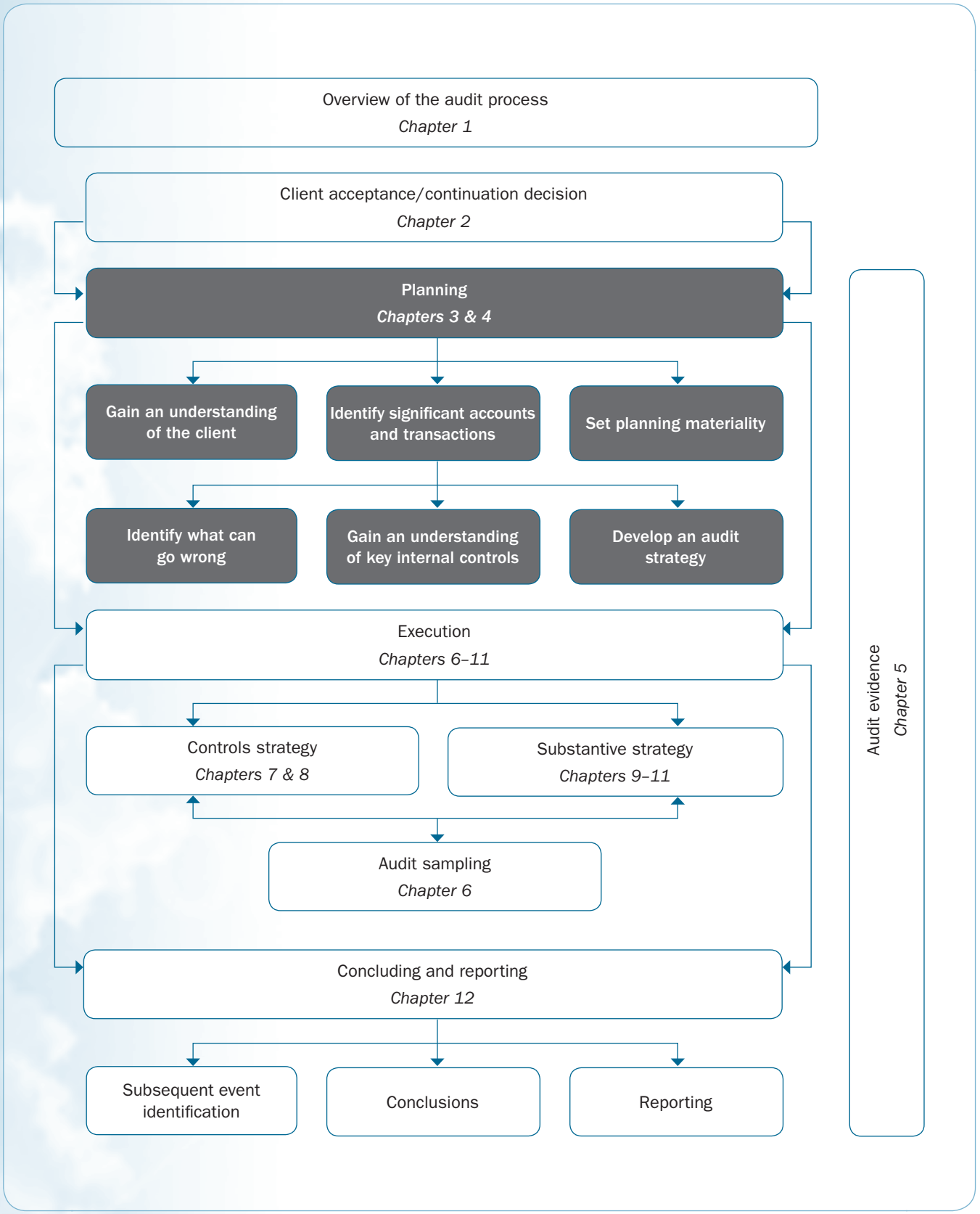
LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. identify the different stages of an audit
2. explain the process used in gaining an understanding of the client
3. explain how related parties can impact risk
4. define fraud risk and understand audit procedures to reduce this risk
5. explain the going concern assumption
6. describe corporate governance
7. explain how a client's information technology (IT) can affect risk
8. explain how client closing procedures can affect reported results.

AUDITING AND ASSURANCE STANDARDS

CANADIAN	INTERNATIONAL
CAS 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*	ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*
CAS 300 *Planning an Audit of Financial Statements*	ISA 300 *Planning an Audit of Financial Statements*
CAS 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*	ISA 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*
CAS 550 *Related Parties*	ISA 550 *Related Parties*
CAS 570 *Going Concern*	ISA 570 *Going Concern*


Overview of the audit process
Chapter 1
Client acceptance/continuation decision
Chapter 2
Planning
Chapters 3 & 4
Gain an understanding of the client
Identify significant accounts and transactions
Set planning materiality
Identify what can go wrong
Gain an understanding of key internal controls
Develop an audit strategy
Execution
Chapters 6–11
Controls strategy
Chapters 7 & 8
Substantive strategy
Chapters 9–11
Audit sampling
Chapter 6
Concluding and reporting
Chapter 12
Subsequent event identification
Conclusions
Reporting
Audit evidence
Chapter 5

Cloud 9

"Great news!" announces Sharon Gallagher at the weekly team meeting. "We have just had word that the audit engagement letter for Cloud 9 Ltd. (Cloud 9) has been signed. We are now officially their financial statement auditors and the planning phase starts now!"

Later, at the first planning meeting, Sharon and Josh Thomas focus on assigning the tasks for gaining an understanding of Cloud 9. Ian Harper, a first-year graduate, is not happy. He grumbles to another new member of the team, Suzie Pickering, as he leaves the room, "This is such a waste of time. Why did we sign an engagement letter if we don't understand the client? Why don't we just get on with the audit? What else is there to know?"

"Oh boy, are you missing the point!" Suzie says. "If you don't spend time planning, where are you going to start 'getting on with it'?"

"The same place you always start," replies Ian. Suzie realizes that she has a big job explaining to Ian, and invites him for a coffee so that they can talk. Although Suzie is new to the team, she has audit experience with other clothing and footwear clients, and will be helping Sharon and Josh manage the Cloud 9 audit. Her first question to Ian at coffee is "What do you think could go wrong with the Cloud 9 audit?"

AUDIT PROCESS IN FOCUS

Audit planning is an important topic that we will cover in this and the next chapter. In this chapter, we begin with a discussion of the different stages (or phases) of the audit: the planning stage, the performing stage (where the detailed work is conducted), and the reporting stage (where the audit opinion is formed). At the planning and reporting stages, the auditor adopts a broad view of the client as a whole and the industry in which it operates. An understanding of the client is gained in the early stages of each audit and that knowledge drives the planning of the audit. It informs the choice of where to focus the most attention throughout the audit. When forming an opinion on the fair presentation of the financial statements, consideration is given to the evidence gathered during the performing stage of the audit, placing that information within the context of the knowledge of the client gained from the planning stage.

During the planning stage, an assessment is made of the risk that a material misstatement (significant error or fraud) could occur in the client's financial statements. By understanding where the risks are most significant, an auditor can plan their audit to spend more time where the risks are greatest. During the planning stage, an auditor will gain an understanding of their client, their client's internal controls, their client's information technology (IT) environment, their client's corporate governance environment, and their client's closing procedures. An auditor will identify any related parties, factors that may affect their client's going concern status, and significant accounts and classes of transactions that will require close audit attention to gauge the risk of material misstatement.

Each of these important elements of the planning stage of the audit is considered in this chapter. The process adopted when gaining an understanding of a client is explained in detail. That explanation is followed by a discussion of the specific audit risks associated with related party transactions and the risk that a client's financial statements are misstated due to fraud. The audit procedures used to assess the risk that a fraud has occurred and common frauds are included in the discussion. That is followed by a discussion of the processes used to assess the going concern assumption.

Corporate governance is the rules, systems, and processes within companies used to guide and control. During the planning stage, an auditor will assess the adequacy of their client's corporate governance structure in assessing the risk that the financial statements are materially misstated.

A client's IT system is used to capture, process, and report on the accounting records. During the planning stage, an auditor will assess the adequacy of their client's IT system. This process is discussed in this chapter.

The final section of this chapter includes a discussion of the procedures used by an auditor to assess their client's closing procedures. Closing procedures aim to ensure that transactions are recorded in the appropriate accounting period. An auditor will assess the adequacy of their client's closing procedures to assess the risk that a material misstatement will occur in the financial statements as a consequence.

3.1 STAGES OF AN AUDIT

1 Identify the different stages of an audit.

Before commencing our discussion of audit planning, we provide an overview of the various stages of the audit, which is represented diagrammatically in figure 3.1. The main stages of an audit are planning, performing, and reporting. Once the client acceptance or continuation decision has been made (described in chapter 2), the first stage is planning the audit. Broadly, the **planning stage** involves gaining an understanding of the client, identifying factors that may impact the risk of a material misstatement in the financial statements, performing a risk and **materiality** assessment, and developing an **audit strategy**. The risk of a material misstatement is the risk that the financial statements include a significant error or fraud. The **execution stage** (or performing stage) of the audit involves the performance of detailed testing of controls and substantive testing of transactions and accounts. The **reporting stage** involves evaluating the results of the detailed testing in light of the auditor's understanding of their client and forming an opinion on the fair presentation of the client's financial statements. An overview of each stage of the audit follows.

planning stage gaining an understanding of the client, identifying risk factors, developing an audit strategy, and assessing materiality

materiality information that impacts the decision-making process of the users of the financial statements

audit strategy a strategy that sets the scope, timing, and direction of the audit and provides the basis for developing a detailed audit plan

execution stage detailed testing of controls and substantive testing of transactions and accounts

reporting stage evaluating the results of the detailed testing in light of the auditor's understanding of their client and forming an opinion on the fair presentation of the client's financial statements

3.1.1 Planning an audit

CAS 300 *Planning an Audit of Financial Statements* requires that an auditor plan their audit to reduce audit risk to an acceptably low level. Audit risk is the risk that an auditor issues an unmodified or clean audit opinion when the financial statements are in fact materially misstated. The planning stage involves determining the audit strategy as well as identifying the nature and the timing of the procedures to be performed. This is done to optimize efficiency and effectiveness when conducting an audit. Efficiency refers to the amount of time spent gathering audit evidence. Effectiveness refers to the minimization of audit risk. A well-planned audit will ensure

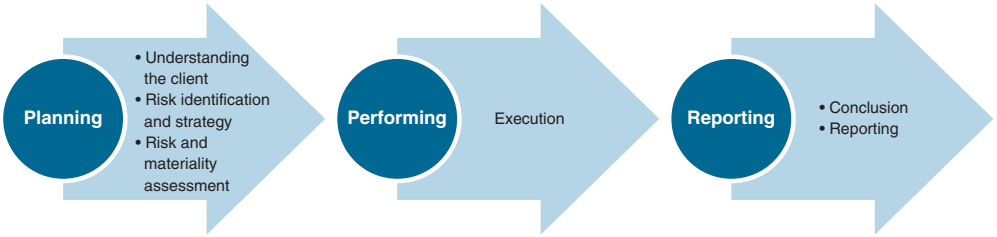


FIGURE 3.1 **Overview of the audit**

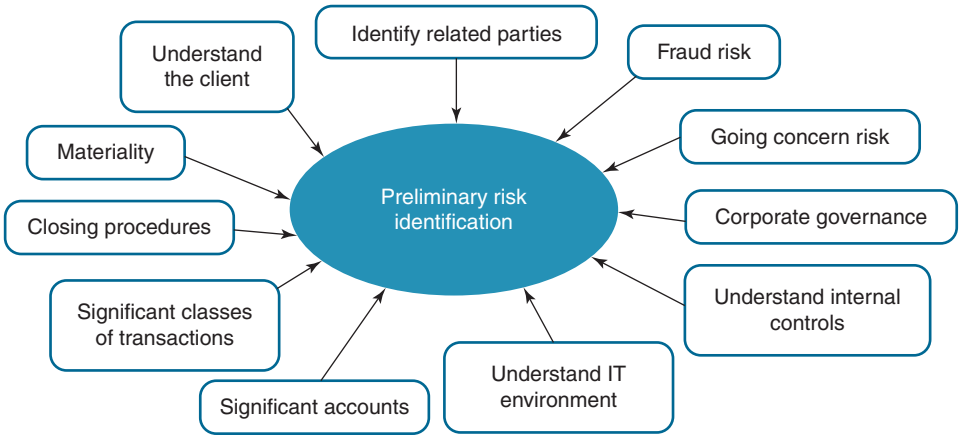


FIGURE 3.2 **Preliminary risk identification**

that **sufficient appropriate evidence** is gathered for those accounts at most risk of material misstatement. Figure 3.2 provides a graphical depiction of the preliminary risk identification process used during the planning stage of each audit.

sufficient appropriate evidence the quantity and quality of the evidence that has been gathered

Each element of figure 3.2 is now discussed in turn, starting with "understand the client" and proceeding clockwise. The process used by an auditor when gaining an understanding of their client is outlined in section 3.2. Part of that process includes the identification of a client's related parties to ensure that they are identified and appropriately disclosed following the relevant accounting standards. CAS 550 *Related Parties* provides audit guidance associated with related party transactions and disclosures. This is further discussed in section 3.3.

When planning an audit, an auditor will assess the risk of material misstatement due to **fraud** (CAS 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*) and consider whether it is appropriate to assume that their client will remain as a **going concern** (CAS 570 *Going Concern*). Fraud risk is discussed in section 3.4 and going concern is discussed in section 3.5.

fraud an intentional act through the use of deception to obtain an unjust or illegal advantage

going concern the viability of a company to remain in business for the foreseeable future

A client's **corporate governance** structure is assessed when planning an audit. The Canadian Securities Administrators (CSA) have issued a policy statement for reporting issuers. This policy statement provides guidance on corporate governance practices; however, it does not prescribe any particular practices. The CSA's policy is discussed further in section 3.6.

corporate governance the rules, systems, and processes within companies used to guide and control

According to CAS 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment,* an auditor must gain an understanding of their client's system of internal controls. Elements of control risk are discussed in chapter 4, and chapter 7 contains a discussion of the procedures used by an auditor in gaining an understanding of a client's system of internal controls. When gaining an understanding of their client's system of internal controls, an auditor will consider the impact of IT (CAS 315). IT is discussed in more detail in section 3.7.

Significant accounts and classes of transactions are identified when planning so that an auditor can structure their audit testing to ensure that adequate time is spent testing these accounts and classes of transactions. During the planning stage, an auditor will also consider the adequacy of their client's **closing procedures**. An auditor's consideration of their client's closing procedures and the associated risks are discussed in section 3.8. An important task in the early stages of every audit is to set the planning materiality. This important concept is discussed in detail in chapter 4.

closing procedures processes used by a client when finalizing the books for an accounting period

Cloud 9

Ian thinks that all audits are pretty much the same and that W&S Partners must have an audit plan that they can use for the Cloud 9 audit. Suzie explains that if they tailor the plan to the client, the audit is far more likely to be efficient and effective. That is, they will get the job done without wasting time and ensure that sufficient appropriate evidence is gathered for the accounts that are most at risk of being misstated. If they can do this, W&S Partners will not only issue the right audit report, but make a profit from the audit as well. In other words, if the plan is good, performing the audit properly will be easier.

3.1.2 Performing an audit

The performance, or execution, stage of the audit involves detailed testing of controls, transactions, and balances. If an auditor plans to rely on their client's system of internal controls, they will conduct tests of control (discussed in chapter 8). An auditor will conduct detailed substantive tests of transactions throughout the year and detailed substantive tests of balances recorded at year end (discussed in chapters 9, 10, and 11). This detailed testing provides the evidence that the auditor requires to determine whether the financial statements are fairly presented (discussed in chapter 12).

3.1.3 Concluding and reporting on an audit

The final stage of the audit involves drawing conclusions based on the evidence gathered and arriving at an opinion regarding the fair presentation of the financial statements. The auditor's opinion is expressed in the audit report (see chapter 12). At this stage of the audit, an auditor will draw on their understanding of the client, their detailed knowledge of the risks faced by the client, and the conclusions drawn when testing the client's controls, transactions, and account balances.

BEFORE YOU GO ON

1.1 What are the three main stages of the audit?

1.2 List three factors that affect an auditor's preliminary risk identification.

1.3 What are related parties?

3.2 GAINING AN UNDERSTANDING OF THE CLIENT

2 Explain the process used in gaining an understanding of the client.

At the outset of every audit, an auditor must gain an understanding of their client. The purpose of this procedure is to assess the risk that the financial statements contain a material misstatement due to:

- the nature of the client's business
- the industry in which the client operates
- the level of competition within that industry
- the client's customers and suppliers
- the regulatory environment in which the client operates.

CAS 315 provides guidance on the steps to take when gaining an understanding of a client. It requires the auditor to do the following:

(a) Make inquiries of management and of others within the entity who may have information to help identify the risk of material misstatements. This includes making inquiries of both financial and non-financial staff at all levels of the organization, including those charged with governance, internal audit, sales, and operational personnel.

(b) Perform analytical procedures at the planning stage of the audit to identify any unusual or unexpected relationships that may highlight where risks exist. Analytical procedures are a study of plausible relationships between both financial and non-financial data.

(c) Perform observation and inspection procedures to corroborate the responses made by management and others within the organization. These procedures also provide information about the entity and its environment. Examples of such audit procedures include observation or inspection of the entity's operations, premises, and facilities; business plans and strategies; internal control manuals; and any reports prepared and reviewed by management (such as management reports, interim financial statements, and minutes of board of directors' meetings).

By performing these activities, the auditor will gain an understanding of the issues at the entity level, the industry level, and the economy level.

Cloud 9

Ian knows that there are many possible problems in an audit that would cause the auditor to issue the wrong type of audit report, but he is struggling to understand why the audit team will be spending time gaining an understanding of a client. How does this help? Why aren't audits all the same?

Suzie explains to Ian that issuing the wrong type of audit report is a risk the auditor always faces, but the risk varies across audits. The variation in the risk is partly related to how well the audit team performs its tasks, which is dependent on the team members' level of skill, effort, supervision, and so on. But the variation in risk is also related to the particular characteristics of the client and its environment. Some clients are more likely than others to have errors or deficiencies in their accounting and financial reporting systems, operations, or underlying data. Even within one client's business, some areas are more likely to have problems than, or will have problems different to, others. Suzie asks Ian to think about what sort of problems Cloud 9's draft financial statements are most likely to have, and why.

3.2.1 Entity level

It is important that an auditor gains a detailed knowledge of their client. Knowledge about the entity is gained through interviews with client personnel, including those charged with governance. The auditor will ask questions about what the client does, how it functions, how its ownership is structured, and what its sources of financing are. For new clients, this process is very detailed and time consuming. For a continuing client, this process is less onerous and involves updating the knowledge gained on previous audits. By gaining an understanding of the client, the auditor is in a stronger position to assess entity-level risks and the financial statement accounts that require closer examination. The following paragraphs outline some of the procedures followed by an auditor when gaining an understanding of their client at the entity level.

Major customers are identified so that the auditor may consider whether those customers have a good reputation, are on good terms with the client (that is, likely to remain a customer in future), and are likely to pay the client on a timely basis. Dissatisfied customers may withhold payment, which affects the allowance for doubtful accounts and the client's cash flow, or may decide not to purchase from the client in the future, which can affect the going concern assumption. If a client has only one or a few customers, this risk is increased. The auditor also considers the terms of any long-term contracts between their client and their client's customers.

Major suppliers are identified to determine whether they are reputable and supply quality goods on a timely basis. Consideration is given to whether significant levels of goods are returned to suppliers as faulty, and what the terms of any contracts with suppliers and the terms of payment to suppliers include. The auditor also assesses whether the client pays its suppliers on a timely basis. If the client is having trouble paying its suppliers, it may have trouble sourcing goods as suppliers may refuse to transact with a company that does not pay on time.

Whether the client is an *importer or exporter* of goods is identified. If the client trades internationally, the auditor considers the stability of the country (or countries) the client trades with, the stability of the foreign currency (or currencies) the client trades in, and the effectiveness of any risk management policies the client uses to limit exposure to currency fluctuations (such as hedging policies).

The client's *capacity to adapt to changes in technology and other trends* is assessed. If the client is not well positioned to adjust to such changes, it risks falling behind competitors and losing market share, which in the longer term can affect the going concern assumption. If the client operates in an industry subject to frequent change, it risks significant losses if it doesn't keep abreast of such changes and "move with the times." For example, if a client sells laser printers, the auditor will need to assess whether the client is up to date with changes in technology and customer demands for environmentally friendly printers.

The nature of any *warranties* provided to customers is assessed. If the client provides warranties on products sold, the auditor needs to assess the likelihood that goods will be returned and the risk that the client has underprovided for that rate of return (adequacy of the warranty provision). The auditor will pay particular attention to goods being returned for the same problem, indicating that there may be a systemic fault. For example, say a client sells quality pens and the auditor notices that a number of pens are being returned because the mechanism to twist the pen open is faulty. In this case, the auditor will assess the likelihood that other pens will be returned for the same reason, the steps being taken by the client to rectify the problem, and whether the provision for warranty is adequate in light of this issue.

The terms of *discounts* given by the client to its customers and received by the client from its suppliers are reviewed. An assessment is made of the client's bargaining power with its customers and suppliers to determine whether discounting policies are putting profit margins at risk, which may place the future viability of the client at risk.

An assessment is made of the client's *reputation* with its customers, suppliers, employees, shareholders, and the wider community. A company with a poor reputation places future profits at risk. It is also not in the best interests of the auditor to be associated with a client that has a poor reputation.

An understanding is gained of client *operations.* The auditor will note where the client operates, the number of locations it operates in, and the dispersion of these

locations. The more spread out the client's operations are, the harder it is for the client to effectively control and coordinate its operations, increasing the risk of errors in the financial statements. The auditor will need to visit locations where the risk of material misstatement is greatest to assess the processes and procedures at each site. If the client has operations in other provinces or overseas, the auditor may plan for a visit to those sites by staff from affiliated offices at those locations where risk is greatest. For example, an auditor is more likely to visit client operations if the client opens a new, large site, or if the business is located in a country where there is a high rate of inflation or where there is a high risk of theft.

An understanding is gained of the *nature of employment contracts* and the client's *relations with its employees.* The auditor will consider the way employees are paid, the mix of wages and bonuses, the level of unionization among the workforce, and the attitude of staff to their employer. The more complex a payroll system, the more likely that errors can occur. When staff are unhappy, there is greater risk of industrial action, such as strikes, which disrupt client operations.

The client's *sources of financing* are reviewed. An assessment is made of a client's debt sources, the reliability of future sources of financing, the structure of debt, and the reliance on debt versus equity financing. An auditor assesses whether the client is meeting interest payments on funds borrowed and repaying funds raised when they are due. If a client has a covenant with a debt provider, the auditor will need to understand the terms of that covenant and the nature of the restrictions it places on the client. Debt covenants vary. A company may, for example, agree to limit further borrowings. It may agree to maintain a certain debt-to-equity ratio. If the client does not meet the conditions of a debt covenant, the borrower may recall the debt, placing the client's liquidity position at risk, and increasing the risk that the client may not be able to continue as a going concern.

The client's *ownership structure* is assessed. The auditor is interested in the amount of debt funding relative to equity, the use of different forms of shares, and the differing rights of shareholder groups. The client's dividend policy and its ability to meet dividend payments out of operating cash flow are also of interest.

Cloud 9

Ian is starting to think about Cloud 9 more closely. He can remember something being said about Cloud 9 importing the shoes from a production plant in China and then wholesaling them to major department stores.

"OK," says Suzie. "Let's just take that one aspect of the operations and think about the issues that could arise."

Ian realizes that the department stores would be customers of Cloud 9 (although they should check that the stores actually purchase the shoes rather than hold them on consignment). If there was a mistake or a dispute with one of the stores, or if the store was in financial difficulties, the collectability of the accounts receivable would be in doubt, so assets could be overstated. If the store disputed a sale, or a sale return was not recorded correctly, sales (and profit) could be overstated. Is Cloud 9 liable for warranty expenses if the shoes are faulty? Would the auditors need to read the terms of the contract to determine if a warranty liability should be recorded on the balance sheet? What about the balance of inventory? Do the shoes belong to Cloud 9 when they are being shipped from China, or only after they arrive at the warehouse?

Suzie points out that the answer to each of these questions could be different for Cloud 9 than for other clients because of its different circumstances. The auditors need to gain an understanding of these circumstances so that they can assess the risk that accounts receivable, sales, sales returns, inventory, and liabilities are misstated. Once they understand the risks, they are in a position to decide how they will audit Cloud 9.

3.2.2 Industry level

At the industry level, an auditor is interested in their client's position within its industry, the level of competition in that industry, and the client's size relative to competitors. The auditor evaluates the client's reputation among its peers and the level of government support for companies operating in that industry. Another consideration is the level of demand for the products sold or services supplied by companies in that industry and the factors that affect that demand. For example, a soft-drink manufacturer is affected by the weather; that is, revenue is seasonal. Also, competition is generally strong.

A comparison is made between the client and its close competitors nationally and internationally. When an auditor has a number of clients that operate in the one industry, this stage of the audit is more straightforward than if the client operates in an industry that the auditor is not already familiar with. The following paragraphs outline some of the procedures followed by auditors when gaining an understanding of their client at the industry level.

The *level of competition* in the client's industry is assessed. The more competitive the client's industry, the more pressure placed on the client's profits. In an economic downturn, the weakest companies in highly competitive industries face financial hardship and possible liquidation. A key issue for an auditor is their client's position among its competitors and its ability to withstand downturns in the economy.

An auditor also considers their client's *reputation* relative to other companies in the same industry. If the client has a poor reputation, customers and suppliers may shift their business to a competing firm, threatening their client's profits. The auditor can assess their client's reputation by reading articles in the press and industry publications.

Consideration is given to the level of *government support* for the client's industry. This issue is important if the industry faces significant competition internationally or the industry is new and requires time to become established. Support is sometimes provided to industries that produce items in line with government policy, such as manufacturers of water tanks, solar heating, and reduced-flow taps in the context of environmental policies.

An assessment is made of the impact of *government regulation* on the client and the industry in which it operates. Regulations include tariffs on goods, trade restrictions, and foreign exchange policies. Regulations can affect a client's viability and continued profitability. An auditor will consider the level of taxation imposed on companies operating in their client's industry. The auditor assesses the different taxes and charges imposed on their client and the impact these have on profits.

The level of *demand* for the goods sold or services provided by companies in the client's industry is considered. If a client's products or services are seasonal, this will affect revenue flow. If a client is an ice-cream producer, sales would be expected to increase in summer. However, if the weather is unseasonal, profits may suffer. If a client sells swimsuits, sales will fall in a cool summer. If a client sells ski equipment, sales will fall if the winter brings little snow. If a client operates in an industry subject to changing trends, such as fashion, the client risks inventory obsolescence if it does not keep up and move quickly with changing styles. When a product or process is subject to technological change, there is the risk that a client will quickly be left behind by its competitors. Either its products will become obsolete or its outdated processes

will mean that it may find it difficult to compete with competitors that stay abreast of technological innovations.

3.2.3 Economy level

Finally, when gaining an understanding of a client, an auditor assesses how economy-level factors affect the client. Economic upturns and downturns, changes in interest rates, and currency fluctuations affect all companies. An auditor is concerned with a client's susceptibility to these changes and its ability to withstand economic pressures.

During an economic upturn, companies are under pressure to perform as well as or better than competitors, and shareholders expect consistent improvements in profits. When conducting the audit in this environment, more focus is given to the risk of overstatement of revenues and understatement of expenses. During an economic downturn, companies may decide to "take a bath." This means that companies may purposefully understate profits. When the economy is poor, there is a tendency to maximize write offs, as a fall in profits can easily be explained to the investment community since most companies experience a decline in earnings. A benefit of "taking a bath" is that it provides a low base from which to demonstrate an improvement in results in the following year. Conducting the audit when the economy is in recession and clients may be tempted to "take a bath" means the auditor must focus more on the risk of understatement of revenues and overstatement of expenses.

Cloud 9

Suzie explains to Ian that the partner, Jo Wadley, has asked her to join the team for this audit because she has extensive experience in the clothing and footwear industry. Wadley wants to make sure that the team's industry knowledge is very strong. Several other members of the team also have experience in auditing clients in the retail industry, including Jo Wadley and manager Sharon Gallagher. In addition, Josh is highly regarded at W&S Partners for his knowledge of sales and cash receipts systems.

Suzie has the task of assessing the industry-specific economic trends and conditions. The documentation has to include an assessment of the competitive environment, including any effects of technological changes and relevant legislation. So that Ian can appreciate how understanding the client is an important part of planning the audit, Suzie asks him to help research the product and customer and supplier elements. Then, together, they will assess the specific risks arising from the entire report, including risks at the economy level, for the Cloud 9 audit.

BEFORE YOU GO ON

2.1 What is the purpose of gaining an understanding of a client?

2.2 What will an auditor consider if their client is an importer or exporter?

2.3 What does a client risk if it operates in an industry subject to changing trends?

3.3 RELATED PARTIES

As discussed, it is the responsibility of the auditor to ensure that related parties are identified and appropriately disclosed in accordance with relevant accounting standards. Therefore, related party transactions require some specific consideration throughout the audit.

3 Explain how related parties can impact risk.

According to the CICA Handbook (IAS 24, *Related Party Disclosures*, and ASPE s. 3840), related parties include parent companies, subsidiaries, joint ventures, associates, company management, and close family members of key management. Since related parties are not independent of each other, these transactions may not be in the normal course of business. Related party transactions not only increase the susceptibility of the financial statements to material misstatement due to fraud and error, they may also impact the overall financial statement results. Therefore, financial statement users need sufficient information to assess the impact of these transactions on the financial statements overall. Some examples of related party transactions that require disclosure are listed below:

- purchase and sales transactions between companies under common control or when one party has significant influence over another
- rent paid from one related party to another
- loans made to shareholders or senior management
- loan guarantees provided by a shareholder of the company.

As both the International Financial Reporting Standards (IFRS) and the Accounting Standards for Private Enterprises (ASPE) include specific reporting requirements for related party transactions, the auditor must consider the risk of material misstatement throughout the audit if such relationships are not appropriately accounted for or disclosed. Therefore, CAS 550 *Related Parties* requires the auditor to do the following:

- discuss with the engagement team the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions
- ask management to identity all related parties and to provide an explanation as to the nature, type, and purpose of transactions with these entities
- obtain an understanding of the processes and procedures management has in place to ensure all related party transactions are identified, authorized, accounted for, and disclosed in accordance with the chosen financial reporting framework
- remain alert when inspecting documents such as bank confirmations, unusual sales and purchase invoices, minutes of board of director and shareholder meetings, and contracts for indicators that related party transactions may not have not been identified or disclosed to the auditor
- identify and assess the risk that transactions may not be in the normal course of operations. For such transactions, inspect any underlying documents and determine the business rationale for such transactions to ensure that they are not an attempt to fraudulently misstate the financial results.

Figure 3.3 lists risk assessment procedures outlined in the *Canadian Professional Engagement Manual (C·PEM)*.

FIGURE 3.3 **Sample risk assessment procedures, *C·PEM*, Form 515**

Source: CICA, "Understanding Related Parties," *C·PEM*, Electronic Templates, Form 515, 2010-2011.

Preparation

(a) Review the entity's list of directors, managers, key staff, family members, and advisors to identify potential or existing related party transactions.
(b) Obtain or prepare a listing of related party transactions.
(c) Consider history (if any) of not disclosing related parties or transactions.

(*continued*)

(d) Inquire of management and document what internal controls (if any) or procedures exist to ensure that related parties are identified, approved (especially those outside the normal course of business), and accounted for in accordance with the applicable financial reporting framework. Assess the control design and implementation of any relevant internal controls.

2. Risk of unidentified transactions

(a) Identify where related party transactions could possibly occur. Consider existence of transactions designed to improve liquidity or profitability, reduce debt to equity leverage, avoid corporate or personal taxes, avoid breach of a bank covenant, shift income/expense to future periods, or conceal other financial statement manipulation or misappropriation of assets.
(b) Inquire of management, key employees, and any component auditors about the existence of:
- Related parties not already identified and details of such transactions.
- Agreements or loan guarantees not reflected in the financial statements.
- Any payments (kickbacks), preferential terms, or side deals not disclosed.

(c) Review minutes of corporate meetings and other relevant documentation.

BEFORE YOU GO ON

3.1 Define related parties.

3.2 How do related parties impact risk? Why?

3.3 What are three procedures the auditor should perform regarding related parties?

3.4 FRAUD RISK

4 Define fraud risk and understand audit procedures to reduce this risk.

As a part of the risk identification process during the planning stage of the audit, an auditor will assess the risk of a material misstatement due to fraud (CAS 240). When assessing fraud risk, an auditor will adopt an attitude of **professional scepticism** to ensure that any indicator of a potential fraud is properly investigated. This means that the auditor must remain independent of their client, maintain a questioning attitude, and search thoroughly for corroborating evidence to validate information provided by the client. The auditor must not assume that their past experience with client management and staff is indicative of the current risk of fraud.

professional scepticism maintaining an attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence

Fraud is an intentional act to obtain an unjust or illegal advantage through the use of deception (CAS 240, para. 11). An auditor can use red flags[1] to alert them to the possibility that a fraud may have occurred. Red flags include:

- a high turnover of key employees
- key finance personnel refusing to take leave
- overly dominant management
- poor compensation practices
- inadequate training programs
- a complex business structure
- no (or ineffective) internal auditing staff
- a high turnover of auditors
- unusual transactions
- weak internal controls.

There are two kinds of fraud. Financial reporting fraud is intentionally misstating items or omitting important facts from the financial statements. Misappropriation of assets generally involves some form of theft. Table 3.1 provides examples of financial reporting and misappropriation of assets frauds.

TABLE 3.1 **Examples of frauds**

Financial reporting frauds	Misappropriation of assets frauds
• Improper asset valuations • Unrecorded liabilities • Timing differences—bringing forward the recognition of revenues and delaying the recognition of expenses • Recording fictitious sales • Understating expenses • Inappropriate application of accounting principles	• Using a company credit card for personal use • Employees remaining on the payroll after ceasing employment • Unauthorized discounts or refunds to customers • Theft of inventory by employees or customers • Using a company car for unauthorized personal use

The responsibility for preventing and detecting fraud rests with those charged with governance at the client. Prevention refers to the use of controls and procedures aimed at avoiding a fraud. Detection refers to the use of controls and procedures aimed at uncovering a fraud should one occur. It is the responsibility of the auditor to assess the risk of fraud and the effectiveness of the client's attempts to prevent and detect fraud through their internal control system. When assessing the risk of fraud, an auditor can consider incentives and pressures to commit a fraud, opportunities to perpetrate a fraud, and attitudes and rationalizations used to justify committing a fraud (CAS 240, App. 1).

3.4.1 Incentives and pressures to commit a fraud

In assessing the risk of fraud, an auditor will consider incentives and pressures faced by their client to commit a fraud. While the examples provided below indicate that a client may be inclined to commit a fraud, they in no way indicate that a fraud has definitely occurred. When an auditor becomes aware of any of these risk factors, in isolation or combination, they will plan their audit to obtain evidence in relation to each risk factor.

Examples of incentives and pressures that increase the risk of a client committing fraud include:

- operation in a highly competitive industry
- a significant decline in demand for products or services
- falling profits
- a threat of takeover
- a threat of bankruptcy
- ongoing losses
- rapid growth
- poor cash flows combined with high earnings
- pressure to meet market expectations
- planning to list on a stock exchange
- planning to raise debt or renegotiate a loan
- about to enter into a significant new contract
- a significant proportion of remuneration tied to earnings (that is, bonuses, options).

3.4.2 Opportunities to perpetrate a fraud

After identifying one or more incentives or pressures to commit a fraud, an auditor will assess whether a client has an opportunity to perpetrate a fraud. An auditor will

utilize their knowledge of how other frauds have been perpetrated to assess whether the same opportunities exist at the client. While the examples below of opportunities to commit a fraud suggest that a fraud may have been carried out, their existence does not mean that a fraud has definitely occurred. An auditor must use professional judgement to assess each opportunity in the context of other risk indicators and consider available evidence thoroughly.

Examples of opportunities that increase the risk that a fraud may have been perpetrated include:

- accounts that rely on estimates and judgement
- a high volume of transactions close to year end
- significant adjusting entries and reversals after year end
- significant related party transactions
- poor corporate governance mechanisms
- poor internal controls
- a high turnover of staff
- reliance on complex transactions
- transactions out of character for a business (for example, if a client leases its motor vehicles it should not have car registration expenses).

3.4.3 Attitudes and rationalization to justify a fraud

Together with the identification of incentives or pressures to commit a fraud and opportunities to perpetrate a fraud, an auditor will assess the attitudes and rationalization of client management and staff to fraud. Attitude refers to ethical beliefs about right and wrong, and rationalization refers to an ability to justify an act. While the examples below indicate that a fraud may occur in companies where these characteristics are identified, they do not mean that a fraud has occurred.

Examples of attitudes and rationalizations used to justify a fraud include:

- a poor tone at the top (that is, from senior management)
- the implementation of an effective internal control structure not seen as a priority
- an excessive focus on maximization of profits and/or share price
- a poor attitude to compliance with accounting regulations
- rationalization that other companies make the same inappropriate accounting choices.

Cloud 9

Suzie explains that fraud risk is always present and that auditors must explicitly consider it as part of their risk assessment. Being aware of the incentives and pressures, opportunities, and attitudes within the client relating to fraud helps the auditor make the assessment. Ian admits that he has a little trouble understanding the difference between incentives and attitudes; he thinks he understands the concept of opportunity. Suzie explains that incentives relate to what pushes (or pulls) a person to commit a fraud. Examples include a need for money to pay debts or gamble. Attitudes or rationalization relate to the thinking about the act of fraud. For example, a person believes it is acceptable to steal from a nasty boss; that is, the theft is justified by the boss's "nastiness."

3.4.4 Audit procedures relating to fraud

Besides assessing the fraud risk factors noted above, the following are some of the specific procedures the auditor should perform to comply with CAS 240:

1. The auditor should ask management and those charged with governance if they are aware of a known fraud or suspect there has been a fraud. If the company being audited has an internal audit department, it should also be asked this question. The results of these enquiries should be documented.
2. All members of the audit team, including the partner, should attend a team planning meeting. During this planning meeting, the significant fraud risk factors and where the financial statements may be particularly susceptible to fraud should be reviewed. This allows the more experienced team members to share their knowledge with the less experienced members.
3. The auditor should perform preliminary analytics (these are discussed in more detail in chapter 4) to identify any unusual relationships that may indicate fraud and thus require further investigation during the audit.
4. The auditor must consider the risk of management override. As management is in a position to manipulate the accounting records or override the controls designed to prevent such fraud, the auditor should test a sample of journal entries, review accounting estimates for reasonableness, contemplate the risk of earnings management (particularly in the area of revenue recognition), and carefully examine unusual business transactions to ensure that they have business substance.

If during the course of the audit, the auditor finds fraud, then they should contemplate their legal and professional responsibilities. As the auditor remains bound by confidentiality, they should seek legal advice to determine if there is a requirement to report the fraud to an outside third party. The auditor may also consider withdrawing from the engagement. Finally, the auditor must report the fraud to the level of management above that under which the fraud occurred and report the fraud to the audit committee.

BEFORE YOU GO ON

4.1 What are the responsibilities of the client and the auditor when it comes to fraud?

4.2 List four incentives and pressures that increase the risk of fraud.

4.3 What is management override and what procedures should the auditor perform to address it?

3.5 GOING CONCERN

5 Explain the going concern assumption.

When planning an audit, performing an audit, and evaluating the results of an audit, an auditor will consider whether it is appropriate to assume that their client will remain as a going concern (CAS 570). The concept of going concern is introduced here and will appear again at various stages throughout this book. The going concern assumption is made when it is believed that a company will remain in business for the foreseeable future (CAS 570, para. 2). Under this assumption, assets are valued on the basis that they will continue to be used for the purposes of conducting a business, and liabilities are recorded and classified as current and non-current on the basis that the

client will pay its debts as they fall due in the years to come. It is the responsibility of management and those charged with governance to assess whether their company is likely to remain a going concern. It is the responsibility of the auditor to obtain sufficient appropriate evidence to assess the validity of the going concern assumption made by their client's management and those charged with governance when preparing the financial statements.

3.5.1 Going concern risk—indicators

For each client, an auditor will use their professional judgement to assess whether the going concern assumption is valid. There are a number of indicators that, alone or combined, can suggest that the going concern assumption may be at risk. A comprehensive list of events and conditions that place doubt on the going concern assumption is provided in CAS 570. Indicators include:

- a significant debt-to-equity ratio
- long-term loans reaching maturity without alternative financing in place
- prolonged losses
- an inability to pay debts when they fall due
- supplier reluctance to provide goods on credit
- the loss of a significant customer
- overreliance on a few customers or suppliers
- high staff turnover
- the loss of key, long-standing personnel
- staff regularly out on strike
- uncertainty around the future availability of a key input or raw material
- rapid growth with insufficient planning
- inadequate risk management procedures
- being under investigation for non-compliance with legislation
- falling behind competitors
- significant rapid increase in competition
- prolonged drought for the agricultural sector.

If the auditor identifies risk factors that indicate that the going concern assumption is in doubt, they will undertake procedures to gather evidence regarding each risk factor. For example, if a client has lost a number of key, long-standing personnel, an auditor may assess the quality of the remaining staff and the likelihood that the client will be able to hire suitable replacements in the near future. If the auditor believes that there is an unresolved going concern issue outstanding, an assessment is made of the appropriateness of management disclosures in the notes to the financial statements regarding that issue. An auditor will assess the process used by management to evaluate the extent of the going concern risk. If a company has a history of losses and difficulties, an auditor will expect management to take a great deal of time and care in their going concern assessment. Once the auditor has an understanding of the process used by management, which may include the careful preparation of detailed cash flow projections and budgets, they will assess the adequacy of that process and conduct additional procedures if necessary.

If the auditor concludes that the going concern assumption is in doubt, further procedures are undertaken. CAS 570 provides a list of appropriate audit procedures. They include:

- assessment of cash flows
- assessment of revenue and expense items
- assessment of interim financial statements
- review of debt contracts
- review of board and other meetings
- discussions with client management and lawyers
- identification and assessment of mitigating factors.

3.5.2 Going concern risk—mitigating factors

Mitigating factors reduce the risk that the going concern assumption may be in doubt. For example, if a client is experiencing a severe cash shortage but has a letter from its bank agreeing to provide additional financing, the letter reduces (but does not remove) the risk that the going concern assumption may be invalid. Other mitigating factors include:

- a letter of guarantee from a parent company
- the availability of non-core assets, which can be sold to provide needed cash, without interrupting the company's operating capacity
- the ability to raise additional funds through the sale of shares
- the ability to raise additional funds through borrowings
- the ability to sell an unprofitable segment of the business.

Cloud 9

Going concern is another type of audit risk. When management adopts the going concern assumption, it records assets and liabilities on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business. If the going concern assumption is not valid, the financial statements should include adjustments to the recoverability and classification of recorded assets and liabilities. If these adjustments are not made, the auditor must express an adverse opinion.

Suzie explains that in most cases the assessment of going concern is not clear-cut. Sometimes there are questions about the going concern assumption and various circumstances that mitigate such questions. The auditor's job is to gather evidence about the issues in order to make a judgement about the nature of the uncertainties surrounding the going concern assumption and decide if, and how, these affect the audit report.

PROFESSIONAL ENVIRONMENT

Soccer as a going concern

Auditors are required to assess the ability of an entity to continue as a going concern for approximately the next 12 months. In Canada, CAS 570 requires the auditor to add a paragraph to the audit report drawing attention to any material uncertainty regarding the entity's continuation as a going concern. There is a similar requirement in the United Kingdom, and, as a result, the auditor of the parent company of Liverpool Football Club,

KPMG, warned in its 2009 audit report that there was a material uncertainty that may cast significant doubt on the company's ability to continue as a going concern.

KPMG was forced to make this statement because of uncertainty about the parent company's ability to refinance certain debts. There was no indication at the balance sheet date that the debt would definitely be refinanced, and the state of world credit markets in 2009 made it tougher for all companies to borrow large amounts.

Kop Football Holdings (KFH) purchased Liverpool FC in February 2007 using mostly borrowed funds. The company's 2008 financial report showed that interest on this debt was £36.5 million, contributing to a loss of £42.6 million. KFH had to refinance borrowings of £350 million, which were due to expire on July 24, 2009.

Liverpool fans were reportedly angry about the situation. Liverpool FC itself is profitable, with a record turnover for the 2009 year of £159.1 million and profit of £10.2 million. This meant that any financial problems faced by the group were not due to the performance of the club itself. Some fans were so angry that they tried to end the control of their club by George Gillett and Tom Hicks, the U.S. sports tycoons behind KFH. They started a campaign to try to persuade the banks not to refinance the debt and to encourage fans to approach their local members of Parliament to urge them to stop the refinancing arrangements.

It was feared that KFH's financial problems would affect Liverpool FC's performance on the football field. Staying competitive on the field means being able to buy the right players and pay the large transfer fees. However, the U.S. backers of the club were confident that the fundamentals of the club were sound and they would continue to provide substantial personal guarantees to satisfy the banks.

Despite the personal guarantees, the company continued to struggle with its debt load. In April 2010, Hicks and Gillett put the club up for sale. After some legal wrangling with the board of directors regarding the sale of the club, it was sold in October 2010 to New England Sports Ventures (NESV), the company that also owns the Boston Red Sox. The transaction valued the club at £300 million and eliminated all of the acquisition debt placed on LFC by its previous owners, reducing the club's debt servicing obligations from £25 million–£30 million a year to £2 million–£3 million.

Sources: "KPMG Issues Going Concern Warning on Liverpool FC," *Accountancy Age*, June 5, 2009; A. Weston, "Fans React with Dismay over State of Liverpool FC's Finances," *Liverpool Echo*, June 6, 2009; P. Kelso, "Debt Hits Liverpool FC," *The Age*, June 7, 2009; "Liverpool FC Sold to NESV," Liverpoolfc.tv, October 15, 2010. (Access date: July 2011)

BEFORE YOU GO ON

5.1 What is the going concern assumption?

5.2 List three factors that indicate that the going concern assumption may be at risk.

5.3 List three factors that mitigate the risk that the going concern assumption may be in doubt.

3.6 CORPORATE GOVERNANCE

6 Describe corporate governance.

Corporate governance is the rules, systems, and processes within companies used to guide and control. Governance structures are used to monitor the actions of staff and assess the level of risk faced. Controls are designed to reduce identified risks and ensure the future viability of the company. The CSA published national policy guidelines on corporate governance to help improve performance and enhance accountability to shareholders. Figure 3.4 presents an excerpt from those guidelines. While these guidelines do provide a framework for corporate governance practices, they do

Board Composition

- The board should have a majority of independent directors.
- The chair of the board should be an independent director.

Meetings of Independent Directors

- The independent directors should hold regularly scheduled meetings at which non-independent directors and members of management are not in attendance.

Board Mandate

- The board should adopt a written mandate in which it acknowledges responsibility for the stewardship of the issuer, including responsibility for:
  (a) satisfying itself as to the integrity of senior management;
  (b) adopting a strategic planning process that takes into account the opportunities and risks of the business;
  (c) identifying the key risks to the business, and ensure there are appropriate systems in place to manage these risks;
  (d) ensuring succession planning;
  (e) adopting a communication policy;
  (f) overseeing the internal control and management information systems; and
  (g) developing the issuer's approach to corporate governance, including outlining a set of corporate governance principles and guidelines to be followed.

The written mandate of the board should also set out:
(i) establishing methods for receiving feedback from stakeholders (whistleblowers);
(ii) setting expectations and responsibilities of directors.

Position Descriptions

- The board should develop job descriptions for the chair of the board and the chair of each board committee.

Orientation and Continuing Education

- The board should ensure all new directors receive a comprehensive orientation so they fully understand their role and the nature and operation of the business.
- The board should provide continuing education opportunities for all directors.

Code of Business Conduct and Ethics

- The board should adopt a written code of business conduct and ethics to address conflicts of interest, protection and proper use of corporate assets, confidentiality of corporate information, fair dealing with investors, customers, suppliers, competitors and employees; compliance with laws, rules and regulations; and reporting of any illegal or unethical behaviour.
- The board should monitor compliance with this code.

FIGURE 3.4 **Excerpt from the CSA's *Corporate Governance Guidelines***
Source: CSA, *National Policy 58-201: Corporate Governance Guidelines,* June 30, 2005.

not dictate any particular requirements. However, reporting issuers must disclose their corporate governance practices and why they believe these practices are appropriate for the entity.

From an auditor's perspective, considering a client's corporate governance principles is an important part of gaining an understanding of that client. A client that does not take its corporate governance obligations seriously may not fulfill its obligation to ensure its financial statements are fairly presented.

BEFORE YOU GO ON

6.1 What is corporate governance?

6.2 Why is the auditor concerned with an entity's corporate governance?

6.3 List three guidelines that should be included in a board of directors' mandate.

3.7 INFORMATION TECHNOLOGY

7 Explain how a client's information technology (IT) can affect risk.

When gaining an understanding of a client, an auditor will consider the particular risks faced by the client associated with **information technology** (IT). IT is a part of most companies' accounting processes, which include transaction initiation, recording, processing, correction as necessary, transfer to the general ledger, and compilation of the financial report. CAS 315 requires that the auditor gain an understanding of the client's IT system and the associated risks.

information technology the use of computers to store and process data and other information

Risks associated with IT include unauthorized access to computers, software, and data; errors in programs; lack of backup; and loss of data. Unauthorized access to data can occur when there is insufficient security or poor password protection procedures. Unauthorized access can result in data being lost or distorted. Unauthorized access to computer programs can result in misstatements in the financial statements. Access can be limited in a number of ways, such as through the use of security (such as locked doors) and passwords.

Errors in computer programming can occur if programs are not tested thoroughly. It is important that new programs and changes to programs are tested extensively before being put into operation. Errors can also occur if mistakes are made when writing a program or if programs are deliberately changed to include errors. Deliberate changes may be made by staff or outsiders who gain unauthorized access to a client's IT system. For example, unhappy staff may purposefully change a program, causing errors to embarrass their employer. It is therefore important that access be limited to authorized staff. Errors can also occur if programming changes are not processed on a timely basis. Programs need to be changed from time to time for a variety of reasons, such as to change sales prices, update discounts being offered to customers, and so on. It is important that these changes be made by authorized personnel on a timely basis to avoid errors.

New programs can be purchased "off the shelf" from a software provider or developed internally by a client's staff. When a client purchases a general-purpose program off the shelf, there is a risk that it will require modification to suit the client's operations, which can lead to errors. An advantage of purchasing general-purpose programs from reputable companies is that they will have been tested before being made available for sale. In contrast, when a client's staff develop a program internally, the program is more likely to have the features required, but there is a risk of errors if the program is written by inexperienced staff or the program is not adequately tested before being put into operation.

When a client installs a new IT system, there are a number of risks. There is the risk that the system may not be appropriate for the client and its reporting requirements. After installation, there is the risk that data may be lost or corrupted when transferring information from an existing system to the new system. There is the risk that the new system does not process data appropriately. There is the risk that client staff are not adequately trained to use the new system effectively. It is important that a client

has appropriate procedures for selecting new IT systems, changing from an old to a new system, training staff in using the new system, and ensuring that a new system includes embedded controls to minimize the risk of material misstatement.

When a client has an established IT system, an auditor will gain an understanding of the risks posed by that system as part of their assessment of the risk of a material misstatement in the client's financial statements. An auditor will assess whether their client has the processes and procedures in place required to reduce IT risk to an acceptably low level. The two broad categories of controls used to reduce IT risk are general controls and application controls.

general controls controls that apply to a company's IT system as a whole. They include policies and procedures for the purchase, maintenance, and daily operations of an IT system, security, and staff training

General controls are policies and procedures that relate to many applications and support the effective functioning of application controls (CAS 315). They include procedures for purchasing, changing, and maintaining new computers; procedures for purchasing, changing, and maintaining new software; the use of passwords and other security measures to minimize the risk of unauthorized access; and procedures to ensure appropriate segregation of duties between, for example, the staff who amend and maintain the programs and the staff who use the programs.

application controls manual or automated controls that operate at a business process level and apply to the processing of transactions by individual applications

Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of transactions by individual applications (CAS 315). These controls are designed to prevent and/or detect a material misstatement in the financial statements by ensuring all transactions are recorded only once, and rejected transactions are identified and corrected. Application controls impact procedures used for data entry, data processing and output, or reporting. They include reconciliations between input and output data and automated checks on data entered to ensure accuracy; for example, a check that a customer number entered is valid. A more detailed discussion of general and application controls is included in chapters 7 and 8.

When an auditor has identified an IT risk, they will assess the adequacy of their client's general and application controls in mitigating that risk. If an auditor believes that their client's general and application controls appear adequate, their audit strategy is to test those controls with a view to relying on the client's procedures to minimize IT risk exposure. If an auditor believes that a client's general and application controls do not appear to be adequate, their audit strategy is to rely more heavily on their own tests of the transactions and balances produced by the client's IT system.

Cloud 9

Suzie explains to Ian that her experience in the clothing and footwear industry has taught her to be very inquisitive about the systems used to manage orders. She has seen a few clothing businesses fail because they could not get their goods to retail outlets in time. Fashion is such a fickle market that even being a few weeks late means that stores run out of inventory, and, when inventory does arrive, stores have to discount it to sell it. After this situation occurs a couple of times, retailers turn to more reliable suppliers, even if the designs aren't as imaginative.

Suzie has heard that Cloud 9 is very reliant on an inventory management software program developed by their parent company. Because it is not a widely used package, she does not know anything about it and is concerned about its ability to provide reliable data. Suzie and Ian decide to allocate extra time in the audit plan to assessing the reliability of this software.

BEFORE YOU GO ON

7.1 What are some of the risks associated with the purchase of a new IT system?

7.2 What are two common sources of new computer programs?

7.3 What are application controls?

3.8 CLOSING PROCEDURES

8 Explain how client closing procedures can affect reported results.

When finalizing the financial statements, a client will close its accounts for the financial reporting period. Revenue and expense items must include all transactions that occurred during the period and exclude transactions that relate to other periods. Asset and liability balances must include all relevant items, accruals must be complete, and contingent liabilities must accurately and completely reflect potential future obligations. From an audit perspective, there is a risk that the client's closing procedures are inadequate.

An auditor is concerned that transactions and events have been recorded in the correct accounting period. This is the responsibility of those charged with governance. It is the responsibility of the auditor to ensure that their client has applied its closing procedures appropriately.

An auditor will determine the risk associated with their client's closing procedures. In addition to the annual financial statements, clients prepare monthly and quarterly financial statements for internal and/or external purposes. An auditor can check these reports to assess the accuracy of their client's closing procedures when preparing those reports. If there are significant errors, where closing procedures are inadequate and transactions are not always recorded in the appropriate reporting period, an auditor will plan on spending more time conducting detailed testing around year end.

There are a number of ways that an auditor can assess the adequacy of their client's closing procedures. Clients that report monthly are more likely to have in place well-established closing procedures than clients that only report annually. An auditor will check the accuracy of accrual calculations around year end. An auditor can look at earnings trends to assess whether the reported income is in line with similar periods (months or quarters) in prior years. For example, revenues are generally higher for an ice-cream seller in warmer months, and wages are generally higher during the months when a client holds its annual sales and extra staff are hired to help out with the increased activity.

If an auditor believes that their client is under pressure to report strong results, there is a risk that revenues earned after year end will be included in the current year's income and expenses incurred before year end will be excluded. If the auditor believes that their client is under pressure to smooth its income and not report any unexpected increases, there is a risk that revenues earned just before year end will be excluded from current income and expenses incurred after year end will be included. In both cases, the auditor will trace transactions recorded close to year end to source documentation and confirm that all transactions are recorded in the appropriate accounting period.

Figure 3.5 lists additional recommended risk assessment procedures from the *Canadian Professional Engagement Manual (C·PEM)*.

FIGURE 3.5 **Excerpt of risk assessment procedures, *C·PEM*, Form 435**

Source: CICA, "Risk Asessment Procedures—Planning & Execution" ***C·PEM***, Form 435, April 2010.

Procedure	WP	Comments	Completed by and date
OBSERVATION AND INSPECTION			
Identify potential risk factors from reading key entity documents such as the following: a) Business plans, budgets and most recent financial results. b) Minutes of directors'/audit committee meetings. c) Reports/letters, etc. from regulators or government agencies. d) Internet/magazine/newspaper articles on the entity or industry. e) Details of actual or threatened litigation including correspondence with external legal counsel. f) Significant contracts and agreements. g) Communications with staff on changes in entity-level control matters. h) Tax assessments and correspondence.			
INQUIRY			
Make inquiries of management and those responsible for financial reporting. Who Interviewed By whom Date Ask about: a) Business objectives, industry trends, management's assessment of current and potential risk factors and their planned responses. b) Major events or changes that took place during the period. Consider · economic conditions · changes in products and services · new technologies, contracts · funding · operating results · ownership · organizational structure · key personnel, bonus plans · IT infrastructure or applications · internal control processes and financial reporting. c) Any instances of alleged, suspected or actual fraud (Forms 511 and 512). d) Any performance bonuses or incentive plans. e) The identity of and nature and amount of related party transactions during the period (Form 640). f) Any going-concern events or conditions (complete Form 527 and, if necessary, Form 625). g) Transactions, events and conditions that give rise to accounting estimates (Form 635). h) Nature, extent and status of litigation/claims against the entity or key personnel. i) Whether the entity is in compliance with required filings (tax returns, etc.), declarations and other regulatory requirements.			
Where applicable, make inquiries of members of the governance board (directors and audit committee members, etc.). Who interviewed By whom Date Ask about: a) The composition, mandate and meetings of the board of directors and any audit committee. b) Any knowledge of management override, fraud or suspected fraud.			

(*continued*)

c) Their opinion on: • The effectiveness of management oversight. • The control environment (culture, competence, attitudes, etc.). • What financial statement areas are susceptible to fraud (Form 512).			

PROFESSIONAL ENVIRONMENT

Top management compensation

Just how big are the incentives for good performance by chief executive officers (CEOs) of publicly traded Canadian companies? A survey of Canadian executives shows that they can be very big indeed. The top paid CEO in Canada in 2008, Thomas Glocer of Thomson Reuters Corp., was paid a total of $36.6 million (comprising cash and bonuses, perks, options, and equity grants). Most of Glocer's pay, $28.2 million, came from equity rather than cash.

Second on the list was Ted Rogers, head of Rogers Communications Inc., who was paid $21.5 million. Overall, the top five Canadian executives had total compensation of more than $100 million in 2008.

Academic research suggests that auditors need to be aware of the potential effects of incentives related to compensation packages. For example, Paul Healy provided evidence that when top executives are paid a bonus according to a formula incorporating minimum and maximum profit levels, profits appear to be "managed" in predictable ways. Healy's evidence suggests that if the minimum profit is not likely to be reached, managers will take action to increase accruals (such as closing entries) to reduce the current year's profit. When the over accrual reverses in the next year, there will be a boost to profit, and therefore managers will receive a bonus on the amount that they are able to "shift" into the next year. Managers take the same action to reduce profit if it is likely to be above the required maximum; therefore, deferring the profit and bonus to the following year. However, if profit is between the required minimum and maximum, managers will try to increase profit to increase their bonus.

The lesson from the academic research is that if auditors understand how the bonus arrangement works, they will be more alert to the type of profit shifting likely to be attempted by managers.

Sources: Hugh MacKenzie, "A Soft Landing, Recession and Canada's 100 Highest Paid CEO's," Canadian Centre for Policy Alternatives, January 2010; P. Healy, "The Effect of Bonus Schemes on Accounting Decisions," *Journal of Accounting and Economics*, April 1985, pp. 85–107.

Cloud 9

The partner, Jo Wadley, has learned of pressure from the parent company on Cloud 9's management to increase revenue by 3 percent this year. Jo is also aware of cost increases associated with a new store and sponsorship deals. Jo believes that this places additional pressure on Cloud 9's management to meet targets resulting in additional risks for closing procedures, and has instructed Suzie to allocate additional time to auditing closing procedures on the Cloud 9 audit.

BEFORE YOU GO ON

8.1 Explain how an auditor can assess the risk associated with their client's closing procedures.

8.2 Outline how an auditor can assess the adequacy of their client's closing procedures.

8.3 What is the particular risk when an auditor believes that their client is under pressure to report strong results?

SUMMARY

1 Identify the different stages of an audit.

The stages of an audit include planning, performing, and reporting. During the planning stage, an auditor will gain an understanding of their client, identify risks, develop an audit strategy, and set their planning materiality. During the performing stage, an auditor will execute their detailed testing of account balances and transactions. The final stage of every audit involves reviewing all of the evidence gathered throughout the audit and arriving at a conclusion regarding the fair presentation of the client's financial statements. The auditor will then write an audit report that reflects their opinion based upon their findings.

2 Explain the process used in gaining an understanding of the client.

An auditor will gain an understanding of their client to aid in the risk identification process. This process involves consideration of issues at the entity level, the industry level, and the broader economic level. At the entity level, an auditor will identify the client's major customers, suppliers, and stakeholders (that is, banks, shareholders, and employees). The auditor will also determine whether their client is an importer or exporter, who the client's competitors are, what the client's capacity is to adapt to changes in technology, and what the nature of any warranties provided to customers is. At the industry level, an auditor is interested in their client's position within its industry. At the economic level, an auditor will assess how well positioned the client is to cope with current and changing government policy and economic conditions.

3 Explain how related parties can impact risk.

Related parties include parent companies, subsidiaries, joint ventures, associates, company management, and close family members of key management. Since related parties are not independent of each other, these transactions may not be in the normal course of business. This increases the risk of material misstatement and may impact the overall financial results. Therefore, related party transactions require some specific consideration throughout the audit and specific procedures should be performed and documented.

4 Define fraud risk and understand audit procedures to reduce this risk.

Fraud is an intentional act through the use of deception to obtain an unjust or illegal advantage. The two kinds of fraud are financial reporting fraud and misappropriation of assets fraud. There are a number of techniques the auditor uses to assess the risk of fraud. The audit file must document the fraud risk assessment and procedures performed to support that assessment.

5 Explain the going concern assumption.

The going concern assumption is made when it is believed that a company will remain in business for the foreseeable future. An auditor will consider the appropriateness of this assumption during the planning stage and then throughout the audit.

6 Describe corporate governance.

Corporate governance is the rules, systems, and processes within companies used to guide and control. Among other things governance structures are used to assess the level of risk faced and to design controls to reduce identified risks.

7 Explain how a client's information technology (IT) can affect risk.

There are a number of risks associated with IT. During the planning stage of the audit, the auditor will assess the likelihood that their client's financial statements are misstated due to limitations in its IT system.

8 Explain how client closing procedures can affect reported results.

There are a number of risks associated with a client's closing procedures. Closing procedures are the processes used by a client at year end to ensure that transactions are recorded in the appropriate accounting period. From an audit perspective, there is a risk that the client's closing procedures are inadequate.

KEY TERMS

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MULTIPLE-CHOICE QUESTIONS

3.1 When gaining an understanding of the client, the auditor will identify the geographic location of the client because:

(a) more spread-out clients are harder to control.
(b) the auditor will need to visit the various locations to assess processes and procedures at each site.
(c) the auditor will plan to use staff from affiliated offices to visit overseas locations.
(d) all of the above.

3.2 When gaining an understanding of the client's sources of financing, the auditor:

(a) is not interested in debt covenants because all debt contracts are the same.
(b) will assess if the client is meeting interest payments when they are due.
(c) will ignore the relative reliance on debt versus equity funding because that is a management decision not an audit issue.
(d) none of the above.

3.3 When gaining an understanding of the client at the industry level the auditor:

(a) will not ignore information about the client's industry.
(b) will not consider the level of demand for the goods and services provided by other companies in the client's industry.
(c) will not consider government taxes on the industry because they are out of the client's control.
(d) will not listen to bad news reports about the client firm because the client's reputation in the press is not important.

3.4 The CSA's *Corporate Governance Guidelines* are designed to help companies:

(a) improve their corporate structure.
(b) improve performance.
(c) enhance their accountability to shareholders and other interested third parties.
(d) all of the above.

3.5 An attitude of professional scepticism means:
(a) the auditor can rely on past experience to determine current risk of fraud.
(b) any indicator of fraud is properly investigated.
(c) the auditor can rely on management assertions.
(d) all of the above.

3.6 An example of an incentive or pressure that increases the risk of fraud is:
(a) the client operates in a highly competitive industry.
(b) the client has a history of making losses.
(c) a significant percentage of management remuneration is tied to earnings.
(d) all of the above.

3.7 The auditor must consider whether it is appropriate to assume that the client will remain as a going concern:
(a) because this means that assets are valued on the basis that they will continue to be used for the purposes of conducting a business.
(b) only if the client is facing bankruptcy, and long-term debt is likely to be withdrawn.
(c) only if the client is listed on a stock exchange.
(d) because mitigating circumstances are not important.

3.8 The planning stage of an audit does not include:
(a) gaining an understanding of the client.
(b) identifying factors that may affect the risk of a material misstatement in the financial statements.
(c) developing an audit strategy and a risk and materiality assessment.
(d) executing and reporting on an audit.

3.9 When gaining an understanding of the client, the auditor will consider:
(a) related party identification.
(b) the appropriateness of the client's system of internal controls to mitigate identified business risks.
(c) controls over the technology used to process and store data electronically.
(d) all of the above.

3.10 Client closing procedures:
(a) are routine transactions that do not have an impact on audit risk.
(b) are the responsibility of those charged with governance who must ensure that transactions are recorded in the correct accounting period.
(c) affect expense accounts only.
(d) all of the above.

REVIEW QUESTIONS

3.1 Explain the relationship between the planning, executing, and reporting stages of an audit. Why is risk identification in the first stage?

3.2 Explain the importance of the planning stage of a financial statement audit.

3.3 When gaining an understanding of a client, an auditor will be interested in an entity's relationships with both its suppliers and customers. What aspects of these relationships will the auditor be interested in and how would they affect the assessment of audit risk?

3.4 List and briefly explain the key factors that the auditor would consider during preliminary risk identification with respect to related parties.

3.5 In the context of fraud, explain the differences between (1) incentives and pressures, (2) opportunity, and (3) attitudes and rationalization. Why is it important for an auditor to consider client systems relevant to all three concepts?

3.6 What procedures should the auditor perform with respect to fraud?

3.7 What does it mean when we say that a business is a "going concern" or, alternatively, has "going concern issues"? Why must an auditor specifically consider evidence about the going concern assessment for each client?

3.8 What are mitigating factors in the context of the going concern assessment? Give some examples of mitigating factors for a loss-making client.

3.9 Why does an auditor need to understand a client's IT system? Explain how IT affects the financial statements.

3.10 Give an example of a client closing procedure. Using your example, explain the accounts that would be affected if the closing procedure is performed inadequately.

PROFESSIONAL APPLICATION QUESTIONS

Basic ★ Moderate ★★ Challenging ★★★

3.1 Audit planning ★

1 2

Michael has drafted an audit plan for a new client. The client is Countrywide Capers, a party rental business. Countrywide Capers earns 80 percent of its revenue from renting out tents, tables, dishes, cutlery, napkins, and tablecloths. Michael's plan shows that audit time is divided to reflect this revenue pattern (that is, 80 percent of the audit time is spent on the rental business and 20 percent of the time is spent on the retail business). Michael believes that the significance of the revenue activities should be the only driver of the audit plan because the client has no related parties and has a simple, effective corporate governance structure.

Required

What questions would you have for Michael before accepting his audit plan?

3.2 Understanding the client and its governance ★

2 5

Ajax Ltd. is a listed company and a new client of Delaware Partners, a medium-sized audit firm. Jeffrey Nycz is the engagement partner on the audit and has asked the members of the audit team to start the process of gaining an understanding of the client in accordance with CAS 315. One audit manager is leading the group investigating the industry and economic effects, and another is helping Jeffrey consider issues at the entity level. Jeffrey is holding discussions with members of the audit committee, and his talks will cover a wide range of issues, including the company's corporate governance principles. He has a meeting arranged for next week with the four members of the audit committee, including the chair of the committee, Stella South, who, like the other members of the audit committee, is an independent director.

Required

(a) Make a list of the main factors that will be considered by each audit manager's group.

(b) What are the required disclosures related to Ajax Ltd. corporate governance practices?

3.3 Understanding the client and its risks—audit planning ★★

1 2

Ivy Bishnoi is preparing a report for the engagement partner of an existing client, Scooter Ltd., an importer of scooters and other low-powered motorcycles. Ivy has been investigating certain aspects of Scooter Ltd.'s business given the change in economic conditions over the past 12 months. She has found that Scooter Ltd.'s business, which experienced rapid growth over its first five years in operation, has slowed significantly during the last year. Initially, sales of scooters were boosted by good economic conditions and solid employment growth, coupled with rising gas prices. Consumers needed transport to get to work and the high gas prices made the relatively cheap running costs of scooters seem very attractive. In addition, the low purchase price of a small motorcycle or scooter, at between $3,000 and $8,000, meant that almost anyone who had a job could obtain a loan to buy one.

However, Ivy has found that the sales of small motorcycles and scooters have slowed significantly and that all importers of these products, not just Scooter Ltd., are being adversely affected. The onset of an economic recession has restricted employment growth, and those people who still have jobs are less certain of continued employment. In addition, the slowdown in the world economy has caused oil prices to fall, further reducing demand for this type of economical transport. Ivy has also discovered that, due to the global financial crisis, the finance company used by Scooter Ltd.'s customers to finance the purchase of scooters and motorcycles has announced that it will not be continuing to provide loans for any type of vehicle with a purchase price of less than $10,000.

Required

(a) Identify the issues that potentially have an impact on the audit of Scooter Ltd.
(b) Explain how each issue affects the audit plan by identifying the risks and the financial statement accounts that require closer examination.

3.4 Financial reporting fraud risk ★★

4

Vaughan Enterprises Ltd. has grown from its beginnings in the steel fabrication business to become a multinational manufacturer and supplier of all types of packaging, including metal, plastic, and paper-based products. It has also diversified into a range of other businesses, including household appliances in Europe, the United States, and Asia. The growth in the size of the business occurred gradually under the leadership of the last two CEOs, both of whom were promoted from within the business.

At the beginning of last year, the incumbent CEO died of a heart attack and the board took the opportunity to appoint a new CEO from outside the company. Despite the company's growth, returns to shareholders have been stagnant during the last decade. The new CEO has a reputation of turning around struggling businesses by making tough decisions. The new CEO has a five-year contract with generous bonuses for improvements in various performance indicators, including sales/assets, profit from continuing operations/net assets, and share price.

During the first year, the new CEO disposed of several segments of the business that were not profitable. Very large losses on the discontinued operations were recorded and most non-current assets throughout the business were written down to recognize impairment losses. These actions resulted in a large overall loss for the first year, although a profit from continuing operations was recorded. During the second year, recorded sales in the household appliances business in the United States increased dramatically, and, combined with various cost-saving measures, the company made a large profit.

The auditors have been made aware through various conversations with middle management that there is now an extreme focus on maximizing profits through boosting sales and cutting costs. The attitude toward compliance with accounting regulations has changed, with greater emphasis on pleasing the CEO than taking care to avoid breaching either internal policies or external regulations. The message is that the company has considerable ground to make up to catch up with other companies in both methods and results. Meanwhile, the share price over the first year and a half of the CEO's tenure has increased 65 percent, and the board has happily approved payment of the CEO's bonuses and granted the CEO additional options over the company's shares in recognition of the change in the company's results.

Required

(a) Discuss the incentives, pressures, and opportunities to commit financial statement fraud, and the attitudes and rationalizations to justify a fraud in the above case.
(b) What financial statement frauds would you suspect could have occurred at Vaughan?
(c) What are the procedures surrounding the fraud risk assessment that should be performed and documented?

3.5 Going concern ★★

5

The Wellington Plaza Hotel is located close to the main railway station in a large regional city. Its main client base is business people visiting the city for work-related purposes. The second largest group of clients consists of groups of (mainly) women visiting the city for its great shopping. All major department stores have a presence in the city and there are also lots of specialty shops and factory outlets. Another large group of clients are groups of (mainly) men visiting the city for various sports events, including several important hockey games during the winter.

Occupancy rates have been reasonable but stagnant for several years, providing a steady but unsatisfactory rate of return for the owners of the hotel. Revenues have been sufficient to cover operating costs, but no substantial progress has been made on repaying the large, long-term loans used to finance the hotel. In an effort to increase the hotel's profitability, a major renovation program was undertaken and completed earlier this year. The renovation was predicted to increase the relative attractiveness of the hotel to guests. It was also undertaken to earn additional revenue from the rent of a new coffee shop on the ground floor. The coffee shop is run by a separate company that has purchased a franchise of a major international brand.

The global financial crisis has hit the hotel business very hard this financial year. Business travel is down by 25 percent across the country. Further, discretionary retail spending is down by 40 percent. Several specialty shops in the city have already shut down and others are cutting their opening hours. In addition, the hockey series was won by the local team in four games (instead of the possible seven games). Thousands of visitors left the city early once the game was over. Just before the hockey games began, the coffee-shop owners went bankrupt and closed down, breaking their lease. The hotel owners are seeking legal advice on whether they can claim penalty fees on the broken lease.

Finally, the hotel owners' bank is warning that the short-term financing obtained for the renovations will not be renewed when it is due (one month after year end). The hotel managers had expected to repay the debt from this year's bookings and the coffee-shop lease. The hotel owners are still hopeful that the summer will bring a large lift in occupancy (and revenue) as the weather is expected to be nice. This expected summer trade is essential to meet repayments on the long-term debt and to convince the bank to extend the short-term debt.

Required

(a) Is there a going concern issue in this case? Explain.

(b) Are there mitigating factors? Explain them and how they would affect the auditor's conclusion.

3.6 Assessing the risks associated with information technology ★★

7

Shane Whitebone is getting to know his new client, Clarrie Potters, a large discount electrical retailer. Ben Brothers has been the engagement partner on the Clarrie Potters' audit for the past five years, but the audit partner rotation rules have meant that the engagement partner has had to change this year. Shane discovers that toward the end of last year, Clarrie Potters installed a new IT system for inventory control. The system was not operating prior to the end of the last financial year, so its testing was not included in the previous audit. The new system was built for Clarrie Potters by a Montreal-based software company, which modified another system it had designed for a furniture manufacturer and retailer.

Required

What audit risks are associated with the installation of the new inventory IT system at Clarrie Potters?

3.7 Audit planning in an EDP environment ★★★

7

Farm Fresh Foods Inc. (FFF) is a new food distribution company that has been profitable since the second month of operations. It has arranged with Smith LLP, a certified general accounting firm, to conduct an external audit of its first year of operations. FFF has a large electronic data processing (EDP) installation with six EDP employees, including the EDP manager, a former accountant who is taking courses to upgrade her skills in computer operations and programming. Mary Heston of Smith LLP is in charge of designing an audit plan for the EDP function, and Ahmed Khan is auditing receivables, purchases, and payroll.

Required

What information does Smith LLP need to obtain about the EDP function when developing its audit plan for FFF? State six examples.

Source: Adapted from the Certified General Accountant Canada, Auditing 1 Exam, June 2006.

3.8 Impact of closing procedures on performance ★★

8

Dunks Holdings Ltd. (Dunks) is an importer of hardware goods and distributes the goods to hardware retailers around the country. The growth in the do-it-yourself (DIY) market, which has accompanied the boom in house prices in most capital cities over the past five years, has provided consistent sales growth for both hardware retailers and wholesalers like Dunks. However, the recession that began last year has cast doubt on the ability of this sector to keep growing. Some analysts believe that the DIY market will not be affected by the recession because, in tough economic times, homeowners increase their "nesting" behaviour; that is, they spend even more on improving their homes and retreat from outside activities such as holidays, the theatre, and restaurants. This view is disputed by other analysts who believe that job losses and general pessimism in the economy will impact adversely on all company profits, including Dunks.

Dunks' share price has fallen over the last year as doubt about its ability to grow its profits in the current year spreads. The CEO and other senior management have large bonuses linked to both share prices and company profitability, and there is a mood within the company that achieving sales and profit targets this year is vital to avoid job losses at the company.

You have been brought into the audit team for Dunks this year and given the responsibility for auditing Dunks' closing procedures. Dunks has a monthly reporting system for internal management, but you notice that the reports are being issued later in the following month this year than they were last year.

Required

(a) Explain why and how the circumstances described above could affect your risk assessment.

(b) How do you plan to audit Dunks' closing procedures? What potential errors would you be most interested in?

Questions 3.9 and 3.10 are based on the following case.

Featherbed Surf & Leisure Holidays Ltd. (Featherbed) is a resort company based on Vancouver Island. Its operations include boating, surfing, diving, and other leisure activities; a backpackers' hostel; a family hotel; and a five-star resort. Justin and Sarah Morris own the majority of the shares in the Morris Group, which controls Featherbed. Justin is the chairman of the board of directors of both Featherbed and the Morris Group, and Sarah is a director of both companies as well as the CFO of Featherbed.

In February 2012, Justin Morris approached your audit firm, KFP Partners, to carry out the Featherbed audit for the year ending June 30, 2012. Featherbed has not been audited before but this year the audit has been requested by the company's bank and a new private equity investor group that has just acquired a 20 percent share of Featherbed.

Featherbed employs 30 full-time staff. These workers are employed in administration, accounting, catering, cleaning, and hotel/restaurant duties. During peak periods, Featherbed also uses part-time and casual workers.

Justin and Sarah have a fairly laid back management style. They trust their workers to work hard for the company and reward them well. The accounting staff, in particular, are very loyal to the company. Justin tells you that some of the accounting staff enjoy their jobs so much that they have never taken any holidays, and hardly any workers ever take sick leave.

There are three people currently employed as accountants, the most senior of which is Peter Pinn. Peter heads the accounting department and reports directly to Sarah. He is in his fifties and plans to retire in two or three years. Peter prides himself on his ability to delegate most of his work to his two accounts staff, Kristen and Julie. He claims he has to do this because he is very busy developing a policy and procedures manual for the accounting department. This delegated work includes opening mail, processing payments and receipts, banking funds received, performing reconciliations, posting transactions, and performing the payroll function. Julie is a recently designated chartered accountant. Kristen works part-time—coming into the office on Mondays, Wednesdays, and Fridays. Kristen is responsible for posting all journal entries into the accounting system and the payroll function. Julie does the balance of the work, but they often help each other out in busy periods.

Source: Adapted from the Australian CA Program's Audit and Assurance Exam, May 2008.

3.9 Gaining an understanding of a new client ★★ 2

You have access to the following information for Featherbed:

- prior period financial statements
- anticipated results for the current year
- industry comparisons.

Required

Explain how you would use this information to understand your new client.

3.10 Assessing fraud risk ★★ 4

Required

(a) Identify and explain any significant fraud risk factors for Featherbed.

(b) For each fraud risk factor you identify, explain how the risk will affect your approach to the audit of Featherbed.

3.11 Fraud risk ★★★ 4

Fellowes and Associates Chartered Accountants is a successful mid-tier accounting firm with a large range of clients across Canada. During 2012, Fellowes and Associates gained a new client, Health Care Holdings Group (HCHG), which owns 100 percent of the following entities:

- Shady Oaks Centre, a private treatment centre
- Gardens Nursing Home Ltd., a private nursing home
- Total Laser Care Limited, a private clinic that specializes in laser treatment of skin defects.

Year end for all HCHG entities is June 30.

The audit partner for the audit of HCHG, Tania Fellowes, has discovered that two months before the end of the financial year, one of the senior nursing officers at Gardens Nursing Home was dismissed. Her employment was terminated after it was discovered that she had worked in collusion with a number of patients to reduce their fees. The nurse would then take secret payments from the patients.

The nursing officer had access to the patient database. While she was only supposed to update room-located changes for patients, she was able to reduce the patient period of stay and the value of other services provided. The fraud was detected by a fellow

employee who overheard the nurse discussing the "scam" with a patient. The employee reported the matter to Gardens Nursing Home's general manager.

Required

(a) Which accounts on the balance sheet and income statement are potentially affected by the fraud?

(b) Describe how Gardens Nursing Home's business could be affected as a result of the fraud.

Source: Adapted from the Australian CA Program's Audit and Assurance Exam, December 2008.

3.12 Motives and opportunities to commit fraud ★ 4

Required

From the list below, identify what you would consider as

(1) a motive for fraud, and

(2) an opportunity for fraud.

a) college or university tuition
b) gambling debts
c) nobody counts the inventory, so losses are not known
d) the petty cash box is often left unattended
e) drugs
f) the finance vice-president has investment authority without any review
g) alimony and child support
h) expensive lifestyle (homes, cars, boats)
i) business or stock speculation losses
j) upper management considered publishing a written statement of ethics but decided not to
k) taxation on good financial results
l) supervisors set a bad example by taking supplies home
m) an employee was caught and fired, but not prosecuted.

3.13 The fraud triangle ★ 4

Francine Rideau, controller of Quatco Company, is reviewing the year-end financial statements with Tonya Kowalski, the company president. The financial statements currently report a net income of $563,480. Tonya is applying for a very substantial bank loan for a plant expansion, and thus would like to report a net income of at least $700,000.

Toward this end, Tonya suggests accruing several sales based on orders received, even though the goods will not be shipped at year end, and thus are technically sales of the following year. She said, "If we record sales revenue for these two large orders, our net income should be more than $700,000. This should not be a problem even next year, as we will never notice the loss of these sales then, since our sales revenue will dramatically increase once the expanded plant is in place."

Required

Identify the incentives or pressures to commit a fraud, the opportunity to perpetrate a fraud, and the rationalizations used to justify committing a fraud.

CASES

3.14 Cool Look Limited—Integrative Case Study ★★★

Cool Look Limited (CLL) is a high-end clothing design and manufacturing company that has been in business in Canada since 1964. CLL started as an owner-managed enterprise created and run by Hector Gauthier. Its ownership has stayed within the family, and Martin Roy, Hector's grandson, is the newly appointed president, chief executive officer, and chairman of the board of CLL.

You are a chartered accountant and the audit senior on the CLL audit for its fiscal year, which ended November 30, 2012. Today is December 9, 2012, and you are reviewing correspondence from CLL's bank. You come upon a letter dated November 1, 2012, from the bank's credit manager that causes you some concern (Exhibit I). You pull out your notes from your review of the board's minutes (Exhibit II) to clarify your thoughts.

EXHIBIT I

LETTER TO CLL FROM BANK

November 1, 2012

Dear Sir:
We have reviewed CLL's internal third-quarter financial statements, dated August 31, 2012. As a result of this review, we have determined that your financial ratios continue to decline and that you are in default of the covenants in our agreement for the second consecutive quarter.

However, since the bank and CLL have a long history, and because CLL continues to make required debt payments on time, we are willing to extend the $6,000,000 secured operating line of credit until the end of February 2013.

Based on CLL's February 28, 2012, internal financial statements, we will expect CLL to meet the following financial ratios. If this is not done, we reserve the right to call the loan at that time.

Ratios:
Current ratio no less than 1:1
Maximum debt-to-equity ratio (Debt/Debt + Equity) of 80%; debt is defined as total liabilities.

We thank you for your business.

Yours truly,

Mr. Charles Burbery
Credit Manager

EXHIBIT 2

EXCERPTS FROM NOTES TAKEN DURING REVIEW OF BOARD MINUTES

- August 7, 2012. Management presented a document discussing the temporary cash crunch at CLL. Management presented options to conserve cash until the Christmas buying season, when a new large contract with a U.S. chain of stores begins. One alternative was to delay remitting HST and employee withholdings. The board passed a resolution to temporarily delay remitting HST and employee withholdings until cash flows improved.
- September 5, 2012. The board received information from management regarding an incident at the factory. Some dirty rags had caught fire in a metal garbage can. The fire was put out quickly and no damage was done. Management and the board were quite relieved that the fire had not spread because CLL has not renewed its fire and theft insurance this year due to the need to conserve cash. For the same reason, CLL has not renewed the directors' liability insurance. The board decided that the renewals would be done immediately after cash flows improved.
- November 10, 2012. The board passed a motion to allow Martin Roy to postpone repayment of his interest-free shareholder loan by another six months to May 31, 2013. He owes CLL $500,000.

Financial facts

- The November 30, 2012, unadjusted financial statements show CLL's current ratio is 1.64:1.
- If the long-term debt is re-classified as a current liability, the current ratio would be 0.42:1.
- The $500,000 shareholder loan to Martin Roy is also classified as long term; however, if it is classified as current, the ratio would decline further.
- The debt-to-equity ratio is 85.8%.
- The company has traditionally had a history of positive earnings; however, in the last two years, it has reported a net loss.
- Cash on hand is $1,094,000.
- Accounts payable has increased by more than 100%.
- Share capital is reported on the 2012 balance sheet at $10,386, 000.
- CLL's long-term debt includes the $6,000,000 secured operating line of credit. The line of credit is a revolving loan, which the bank can call on three months' notice if certain financial covenants are not met. It had been classified as long-term debt in 2011 because the bank waived its right to call the loan before December 1, 2012.

Required

(a) What facts indicate that CL may not be a going concern? What facts indicate that CL may be a going concern? Make a conclusion on whether you believe it is appropriate to assume the company will remain a going concern.

(b) What are the risks related to the shareholder loan? What are three recommended procedures the auditor should perform related to the shareholder loan?

(c) What type of report should be issued if management refuses to disclose the shareholder loan as required by IFRS and ASPE? Why?

(d) Discuss the decisions made by the board. Are they ethical? Do they comply with the requirements of CSA's *Corporate Governance Guidelines*?

Source: Adapted from the Uniform Final Exam (UFE), The Institutes of Chartered Accountants in Canada and Bermuda, Paper 3, 2005.

CASE STUDY—CLOUD 9

You are a graduate working for W&S Partners, a Canadian accounting firm with offices located in each of Canada's major cities. W&S Partners has just been awarded the December 31, 2012, statutory audit for Cloud 9 Ltd. (Cloud 9). The audit team assigned to this client is:

- Jo Wadley, partner
- Sharon Gallagher, audit manager
- Josh Thomas and Suzie Pickering, audit seniors
- Mark Batten, IT audit manager
- Ian Harper and you, graduates.

As a part of the planning process for the new audit, the audit team needs to gain an understanding of Cloud 9's structure and its business environment. By understanding the client's business, the audit team can identify potential risks that may have a significant effect on the financial statements. This will assist the team in planning and performing the audit.

Required

Answer the following questions based on the additional information about Cloud 9 presented in the appendix to this book and in this and earlier chapters. You should also consider your answer to the case study questions in earlier chapters where relevant.

Your task is to research the retail and wholesale footwear industries and report back to the audit team. Your report will form part of the overall understanding of Cloud 9's structure and its environment.

You should concentrate your research on providing findings from those areas that have a financial reporting impact and are considered probable given Cloud 9's operations. In conducting your research, you should consider the following key market forces as they relate to Cloud 9's operations.

General and industry-specific economic trends and conditions

(a) What is the current condition of the economy?
(b) Is the business affected by developments in other countries, foreign currency fluctuations, or other global forces?
(c) If the industry is labour intensive, are there unusual or unique labour relations issues?
(d) How does the company's growth and overall financial performance compare with the industry, and what are the reasons for any significant differences?
(e) What is the volume and type of transactions in the business?
(f) Are the client's operations centralized or decentralized?
(g) Is the client's business cyclical in nature or influenced by seasonal fluctuations in the market?
(h) What is the susceptibility to fraud/theft? (Is the product something that can easily be stolen and has a sale market?)

Competitive environment

(i) What products does the client sell and have there been significant changes with respect to:
  i. major products or brands?
  ii. selling strategies?
  iii. sales/gross margin by product?
(j) Who are the client's major competitors, and what share of the market does each hold?
(k) Is there significant differentiation between the client's and competitors' merchandise?
(l) What is the effect on the client of potential new entrants into the market? Are there any significant barriers to entering the market?

Product information

(m) Is there a specific life cycle for the product?
(n) Is the product dependent on trends or styles?

Customer information

(o) Are there specific customers on whom the client is highly dependent?
(p) What is the overall profile of the client's customers? Have there been significant fluctuations in the client's customer base?

Supplier information

(q) Who are the key suppliers?
(r) Are the materials subject to significant price movements or influenced by external market forces?

Technological advances and the effect of the Internet

(s) How does the industry use technology?
(t) What technological trends are impacting the industry?

Laws and regulatory requirements

(u) Are the client's operations affected significantly by local or foreign legislation?
(v) What new laws and regulations recently enacted (or pending) may have significant effects on the company?

RESEARCH QUESTION

The auditor and the Ponzi scheme

Bernard Madoff was convicted in 2009 of running a Ponzi scheme, the biggest in U.S. history. A Ponzi scheme is essentially the process of taking money from new investors on a regular basis and using the cash to pay promised returns to existing investors. The high and steady returns received by existing investors are the attraction for new investors, but they are not real returns from investments.

As long as new investors keep contributing and existing investors do not seek redemptions, or the return of their money, the scheme continues. However, eventually, as in the Madoff situation, circumstances change, the scheme is discovered, and the remaining investors find that their capital has disappeared.

At age 71, Madoff was sentenced to prison for 150 years and will die in jail. Now that Madoff is behind bars, attention has turned to Madoff's auditor, David G. Friehling. Friehling is accused of creating false and fraudulent audited financial statements for Madoff's firm, Bernard L. Madoff Investment Securities LLC. Prosecutors allege that these fraudulent reports covered the period from the early 1990s to the end of 2008.

Required

(a) Research the progress of the case against David Friehling. Write a report explaining his alleged role in the Madoff Ponzi scheme and the current (at the time you write your report) state of the legal action against him.

(b) Friehling was subject to U.S. auditing standards and legislation. Explain if, and how, Friehling's alleged actions would violate Canadian auditing standards and professional ethics.

Sources: D. Searcey and A. Efrati, "Sins and admission: getting into top prisons," *The Wall Street Journal: Europe* 17–19, July 2009, p. 29; C. Bray and A. Efrati, "Madoff ex-auditor set to waive indictment," *The Wall Street Journal: Europe* 17–19, July 2009, p. 29.

RESEARCH QUESTION

Public company financial statements

The financial statements for public companies are available through the website SEDAR (www.sedar.com). This is the official site that provides access to information filed by public companies and investment funds with the CSA. The statutory objective in making public this filed information is to enhance investor awareness of the business and affairs of public companies, and to promote confidence in the transparent operation of capital markets in Canada. Achieving this objective relies heavily on the provision of accurate information on market participants.

Required

Go to www.sedar.com and select the most recent set of *audited annual* financial statements for a Canadian public company. Using this set of financial statements, answer the following:

(a) When planning the audit, the auditor needs to gain an understanding of the entity's structure and its business environment. To do this, the auditor focuses on identifying potential risks that may have a significant effect on the financial statements. Prepare a memo for the audit planning file and discuss the entity, industry, and economy-level factors that the auditor should consider to plan the audit for this entity.

(b) Review the financial statement notes. Are there any related parties? If so, who are the related parties? Are there many or just a few? What is disclosed in the related party note? What impact will this have on the auditor's preliminary risk assessment?
(c) With the information provided, discuss the entity's ability to continue as a going concern using the going concern indicators discussed in this chapter.

Source: www.sedar.com

FURTHER READING

Canadian Securities Administrators. (2005). *National Policy 58–201: Corporate Governance Guidelines*. www.osc.gov.on.ca/en/SecuritiesLaw_rule_20050617_58–201_corp-gov-guidelines.jsp

Chartered Accountants of Canada. (2011). *Canadian Professional Engagement Manual*. www.castore.ca/product/canadian-professional-engagement-manual-members/5

Wilson, J.D. & Root, S.J. (2000). *Internal Auditing Manual.* Warren, Gorham and Lamont Inc. www.knowledgeleader.com.

SOLUTIONS TO MULTIPLE-CHOICE QUESTIONS

1. d, 2. b, 3. a, 4. d, 5. b, 6. d, 7. a, 8. d, 9. d, 10. b.

NOTE

1. Wilson, J.D. & Root, J.J. *Internal Auditing Manual* 2nd ed. (1989), Warren Gorham & Lamont.