Chapter 24

Completing the Audit

- **Concept Checks**

P. 776

1. The auditor is particularly concerned with whether management has disclosed all required information (completeness objective for presentation and disclosure). Auditors often use a disclosure checklist to determine that all required disclosures are completely presented and disclosed in the financial statements and accompanying footnotes. This helps the auditor obtain sufficient appropriate evidence about the completeness objective for the presentation and disclosure-related audit objective.

2. A contingency is a potential future obligation to an outside party for an unknown amount resulting from activities that have already taken place. Material contingent liabilities must be disclosed in the footnotes. Three conditions are required for a contingent liability to exist:
   - There is a potential future payment to an outside party or the impairment of an asset that resulted from an existing condition
   - There is uncertainty about the amount of the future payment or impairment
   - The outcome will be resolved by some future event or events

3. The first type of subsequent event is one that has a direct effect on the financial statements and requires adjustment. Examples of this type of subsequent event are as follows:
   - Declaration of bankruptcy by a customer with an outstanding accounts receivable balance due to the deteriorating financial condition
   - Settlement of a lawsuit for an amount different from the amount recorded on the books
   - Disposal of equipment not being used in operations at a price below the current book value
   - Sale of raw material as scrap in the period subsequent to the balance sheet date

   The second type of subsequent event is one that has no direct effect on the financial statements but for which disclosure is advisable. Examples include the following:
   - Issuance of bonds or equity securities
   - Decline in the market value of inventory as a consequence of government action barring further sale of a product
   - Uninsured loss of inventories as a result of fire

P. 788

1. A client letter of representation is a written communication from the client to the auditor formalizing statements that the client has made about matters pertinent to the audit. The purposes of the letter of representation are to:

   - Impress upon management its responsibility for the financial statements
   - Remind management of potential misstatements or omissions in the financial statements
   - Document responses from management to inquiries about various aspects of the audit

   Auditing standards suggest four categories of items that should be included in the letter. Below are those four items with examples in each category (refer students to auditing standards for a comprehensive list):

   1. *Financial statements*
      - Management's acknowledgment of its responsibility for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles
      - Management's belief that the financial statements are fairly presented in conformity with generally accepted accounting principles

   2. *Completeness of information*
      - Availability of all financial records and related data
      - Completeness and availability of all minutes or meetings of stockholders, directors, and committees of directors
      - Absence of unrecorded transactions

   3. *Recognition, measurement, and disclosure*
      - Management's belief that the effects of any uncorrected financial statement misstatements are immaterial to the financial statements (a summary of these items should be included in or attached to the letter)
      - Information concerning fraud involving (1) management, (2) employees who have significant roles in internal control, or (3) others where the fraud could have a material effect on the financial statements
      - Information concerning related party transactions and amounts receivable from or payable to related parties
      - Unasserted claims or assessments that the entity's lawyer has advised are probable of assertion and must be disclosed in accordance with accounting standards

Concept Check, P. 788 (continued)

- Satisfactory title to assets, liens, or encumbrances on assets, and assets pledged as collateral
- Compliance with aspects of contractual agreements that may affect the financial statements

4. *Subsequent events*
   - Bankruptcy of a major customer with an outstanding account receivable at the balance sheet date
   - A merger or acquisition after the balance sheet date

For audits of public companies, PCAOB auditing standards require the auditor to obtain specific representations from management about internal control over financial reporting. Some of those representations are noted below:

5. *Internal controls*
   - Management's acknowledgement of its responsibility for establishing and maintaining effective internal controls over financial reporting.
   - Management's conclusion about the effectiveness of internal control over financial reporting as of the end of the fiscal period.
   - Disclosure to the auditor of all deficiencies in the design or operation of internal control over financial reporting identified as part of management's assessment, including separate disclosure of significant deficiencies and material weaknesses.
   - Management's knowledge of any material fraud or other fraud involving senior management or other employees who have a significant role in the company's internal control over financial reporting.

Auditors of accelerated filer public companies may obtain a combined representation letter for both the audit of the financial statements and the audit of internal control over financial reporting.

2. A summary of unadjusted misstatement schedule is used by the auditor to accumulate any misstatements identified during the audit that may not be individually material, but may be material when aggregated. In addition, the auditor considers the impact on the current year financial statements of any misstatements that were identified in the prior year but not corrected. At the end of the audit, the auditor will evaluate all misstatements collectively to assess whether individual accounts or financial statement categories, such as total assets, liabilities, equity, revenues, expenses, or net income, are materially misstated.

Concept Check, P. 788 (continued)

If the auditor concludes that an account or financial statement category is materially misstated after aggregating individually immaterial misstatements, the auditor will request that the client correct at least some of the misstatements or issue a qualified or adverse opinion. A summary of unadjusted misstatement schedule should be included with management's representation that the uncorrected misstatements are immaterial.

■ Review Questions

24-1 There are four presentation and disclosure-related audit objectives:

PRESENTATION AND DISCLOSURE-RELATED AUDIT OBJECTIVES	DESCRIPTION
Occurrence and rights and obligations	Account-related information as described in the footnotes exists and represents the rights and obligations of the company.
Completeness	All required disclosures are included in the financial statement footnotes.
Accuracy and valuation	Footnote disclosures are accurate and valued correctly.
Classification and understandability	Account balances are appropriately classified and related financial statement disclosures are understandable.

The auditor performs many of the procedures to address presentation and disclosure-related audit objectives in conjunction with other tests. For example, information that must be disclosed related to fixed assets, such as classes of assets, asset lives, and depreciation methods is obtained during tests of balances for fixed assets.

A financial statement disclosure checklist is an audit tool that summarizes all disclosure requirements contained in accounting standards. Auditors use the disclosure checklist to determine that all required disclosures are completely presented and disclosed in the financial statements and accompanying footnotes. This helps the auditor obtain sufficient appropriate evidence about the completeness objective for the presentation and disclosure-related audit objective.

24-2 The auditor would be interested in a client's future commitments to purchase raw materials at a fixed price so that this information could be disclosed in the financial statements. The commitment may be of interest to an investor as it is compared to the future price movements of the material. A future commitment to purchase raw materials at a fixed price may result in the client paying more or less than the market price at a future time.

24-3 A contingent liability is a potential future obligation to an outside party for an unknown amount resulting from activities that have already taken place. Some examples would be:

- Pending litigation
- Income tax disputes
- Product warranties
- Notes receivable discounted
- Guarantees of obligations of others
- Unused balances of outstanding letters of credit

An actual liability is a real future obligation to an outside party for a known amount from activities that have already taken place. Some examples would be:

- Notes payable
- Accounts payable
- Accrued interest payable
- Income taxes payable
- Payroll withholding liabilities
- Accrued salaries and wages

24-4 If you are concerned about the possibility of contingent liabilities for a patent dispute, there are various procedures you could use for an intensive investigation in that area. One procedure is to review minutes from board of director meetings and look for discussion of any existing or possible patent lawsuits, such as patent infringement disputes. Another helpful procedure for uncovering potential patent disputes is to review the general correspondence file for communication with attorneys. This might give an indication that the potential for a liability exists even though no actual litigation has begun. Finally, following up on patent disputes noted in prior years would indicate whether the dispute was resolved or is still outstanding.

24-5 The analysis of legal expense is an essential part of every audit engagement because it may give an indication of contingent liabilities, which may become actual liabilities in the future and require disclosure in the current financial statements. Since any single contingency could be material, it is important to verify all legal transactions, even if the amounts are small. After the analysis of legal expense is completed, the auditor should consider requesting letters of confirmation about contingencies (attorney letters) from attorneys to whom payment was made.

24-6 Pyson should determine the materiality of the lawsuits by requesting from Merrill's attorneys an assessment of the legal situations and the probable liabilities involved. In addition, Pyson may have his own attorney assess the situations. Proper disclosure in the financial statements will depend on the attorneys' evaluations of the probable liabilities involved. If the evaluations indicate highly probable, material amounts, footnote disclosure will be necessary, assuming the amount of the probable material loss cannot be reasonably estimated. If the client refuses to make adequate disclosure of the contingencies, a qualified or adverse opinion may be necessary.

24-7 An asserted claim is an existing legal action that has been taken against the client, whereas an unasserted claim represents a *potential* legal action. The client's attorney may not reveal an unasserted claim for fear that the disclosure of this information may precipitate a lawsuit that would be damaging to the client, and that would otherwise not be filed.

24-8 If an attorney refuses to provide the auditor with information about material existing lawsuits or likely material unasserted claims, auditing standards require that the audit opinion be modified to reflect the lack of available evidence (a scope limitation). This has the effect of requiring management to give its attorneys permission to provide contingent liability information to auditors and to encourage attorneys to cooperate with auditors in obtaining information about contingencies.

24-9 The major considerations the auditor should take into account in determining the extent of the subsequent events review are:

- The company's financial strength and stability of earnings
- The effectiveness of the company's internal controls
- The number and significance of the adjustments made by the auditor
- The length of time between the balance sheet date and the completion of the audit
- Changes in key personnel

PCAOB auditing standards require auditors of public companies to also inquire about changes in internal control over financial reporting occurring subsequent to the end of the fiscal period that might significantly affect internal control over financial reporting.

24-10 Audit procedures normally performed as a part of the review for subsequent events are:

- Perform cutoff and valuation tests of various balances and related transactions; e.g., sales cutoff tests
- Inquire of management about any subsequent events
- Correspond with attorneys
- Review internal statements prepared subsequent to the balance sheet date
- Review records prepared subsequent to the balance sheet date

24-10 (continued)

- Examine minutes of meetings of board of directors and stockholders subsequent to the balance sheet date
- Obtain a letter of representation

24-11 This is a subsequent discovery of facts as the financial statements and audit opinion were issued five months ago. The auditor has an obligation to ensure that users of the financial statements are informed about the misstatement and that the audit opinion should no longer be relied upon. The client should inform the SEC and other regulatory agencies of the misstatement, and issue revised financial statements with an explanation of the reason for the revision. If the client refuses to disclose the misstatement, the auditor should inform the board of directors.

If the auditor's original opinion on internal controls concluded that controls were effective, then they would evaluate the new information related to the material weakness to determine whether the material weakness existed as of the balance sheet date. If it is determined internal controls over financial reporting were in fact not effective as of the balance sheet date, the auditor is obligated to ensure users of the financial statements are aware of the revised information and reissue a report on the effectiveness of internal controls to disclose the material weakness.

24-12 The weakness in Lawson's approach is the danger of discovering an inadequacy in one audit area that could affect other areas of the audit. For example, if misstatements were discovered as part of the tests of controls for sales, the initial plans for the tests of details of balances for accounts receivable may have been insufficient and should have been revised. Similarly, the audit of fixed assets is related to the contracts and notes payable whenever fixed assets are used as collateral.

Another difficulty with Lawson's approach is that there is no combining of the misstatements in different audit areas to determine if the combined misstatements are material. If the combined misstatements are considered material, it may be necessary to expand the testing in certain areas or require adjusting entries to some balances.

24-13 The accumulation of audit evidence is crucial to the auditor in determining whether the financial statements are stated in accordance with relevant accounting standards, applied on a basis consistent with the preceding year. The evaluation of the adequacy of the disclosures in financial statements is made to determine that the account balances on the trial balance are properly aggregated and disclosed on the financial statements.

Examples where adequate disclosure could depend heavily upon the accumulation of evidence are:

- The disclosure of declines in inventory values below cost
- The segregation of current from noncurrent receivables

24-13 (continued)

- The segregation of trade accounts receivable from amounts due from affiliates
- The disclosure of contingent liabilities that the auditor has not been informed of by the client

Examples where audit evidence does not normally significantly affect the adequacy of the disclosure are:

- Deciding whether a disposal of equipment should be recorded as an extraordinary item
- The disclosure of an acquisition made subsequent to year end
- The disclosure of contingencies that the auditor was informed of by the client

24-14 A management letter is a letter directed to the client to inform management of certain recommendations about the business that the CPA believes would be beneficial to the client. A letter about significant deficiencies and material weaknesses in the design or operation of internal control is required to be sent to those charged with governance. The management letter can be combined with the letter about internal control deficiencies. However, because of the differences in the nature and purposes of these communications, most auditors prefer to send the management letter separately.

Items that might be included in a management letter are recommendations such as to:

- Switch inventory valuation methods
- Install a formal security system
- Prepare more timely bank reconciliations
- Segregate duties
- Have certain types of transactions authorized by specific individuals

24-15 Information accompanying basic financial statements is any and all information prepared by management for outside users included with the basic financial statements. Examples include detailed comparative statements supporting control totals in the basic statements, supplementary information required by the SEC, statistical data such as ratios and trends, and specific comments on the changes that have taken place in the financial statements.

The auditor can provide one of two levels of assurance for information accompanying basic financial statements. The auditor may issue a positive opinion indicating a high level of assurance or a disclaimer indicating no assurance.

24-16 A regular audit documentation review is the one that is done by someone who is knowledgeable about the client and the unique circumstances in the audit.

The purposes of this review are to:

24-16 (continued)

- Evaluate the performance of inexperienced personnel
- To make sure that the audit meets the CPA firm's standard of performance
- To counteract the bias that frequently enters into the auditor's judgment.

Examples of important potential findings in a regular audit documentation review are:

- Incorrect computations
- Inadequate scope or failure to perform procedures in the audit program
- Lack of proper documentation for audit decisions

An independent review is one done by a completely independent person who has no experience on the engagement. The purpose is to have a competent professional from within the firm, who has not been biased by the ongoing relationship between the audit engagement team and the client, perform an independent review. Examples of important potential findings in an independent review are:

- A number of small adjustments waived that should have been accumulated into an adjusting journal entry due to materiality
- Too narrow and too biased of a scope in an audit area
- Inadequate disclosure of contingencies

24-17 In addition to the required communications to those charged with governance required by auditing standards, the Sarbanes-Oxley Act expands these communications requirements by also requiring public company auditors to timely report the following items to the audit committee:

- All critical accounting policies and practices to be used.
- All alternative treatments of financial information within generally accepted accounting principles that have been discussed with management, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the auditor.
- Other material written communications between the auditor and management, such as any management letter or schedule of unadjusted differences.

As the audit of the public company is completed, the auditor should determine that the audit committee is informed about the initial selection of and changes in significant accounting policies or their application during the current audit period. When changes have occurred, the auditor should inform the committee of the reasons for the change. The auditor should also communicate information about methods used to account for significant unusual transactions and the effect of significant accounting policies in controversial or emerging areas.

■ Multiple Choice Questions From CPA Examination

24-18 a. (1) b. (2) c. (3) d. (4)

24-19 a. (3) b. (3) c. (2)

24-20 a. (3) b. (2) c. (3)

■ Multiple Choice Questions From Becker CPA Exam Review

24-21 a. (3) b. (2) c. (2)

■ Discussion Questions And Problems

24-22 a. A contingent liability is a potential future obligation to an outside party for an unknown amount arising from activities that have already taken place. A commitment is an agreement to commit the entity to a set of fixed conditions in the future, regardless of what happens to profits or the economy as a whole.

Knowledge of both contingencies and commitments is extremely important to users of financial statements because they represent the encumbrance of potentially material amounts of resources during future periods, and thus affect the future cash flows available to creditors and investors. Because of this, accounting standards require that material contingencies and commitments be disclosed. The auditor has an obligation to discover the existence of such items to determine that they are properly disclosed in order to have complied with auditing standards.

b. Three useful audit procedures for uncovering contingencies that Johnson would likely perform in the normal conduct of the audit, even if she had no responsibility for uncovering contingencies, are:

- Review internal revenue agent reports of income tax settlements
- Review minutes of meetings of board of directors and stockholders
- Confirm used and unused balances of lines of credit

c. Three other procedures Johnson is likely to perform specifically for the purpose of identifying undisclosed contingencies to help her obtain evidence about the completeness presentation and disclosure objective are:

- Make inquiries of management
- Analyze legal expenses for indication of contingent liabilities
- Request letters from attorneys regarding the existence and status of litigation and other potential contingent liabilities

24-22 (continued)

d. The search for unknown commitments is typically performed as part of individual audit areas. Three examples of procedures Johnson is likely to perform for the purpose of uncovering commitments are:

- As part of the audit of purchase transactions, be alert for commitments to purchase inventory or equipment
- As part of the audit of sales transactions, be alert for sales commitments
- Review minutes of meetings of board of directors and stockholders

24-23 a. A contingent liability is a potential future obligation to an outside party for an unknown amount resulting from activities that have already taken place. The most important characteristic of a contingent liability is the uncertainty of the amount; if the amount were known it would be included in the financial statements as an actual liability rather than as a contingency.

b. Audit procedures to learn about these items would be as follows:

The following procedures apply to all three items:

- Discuss the existence and nature of possible contingent liabilities with management and obtain appropriate written representations.
- Review the minutes of directors' and stockholders' meetings for indication of lawsuits or other contingencies.
- Analyze legal expense for the period under audit and review invoices and statements of legal counsel for indications of contingent liabilities.
- Obtain letters from all major attorneys performing legal services for the client as to the status of pending litigation or other contingent liabilities.

The following are additional procedures for individual items:

Lawsuit Judgment — no additional procedures; see above list of procedures applicable to all three items.

Stock dividend

- Confirm details of stock transactions with registrar and transfer agent.
- Review records for unusual journal entries subsequent to year-end.

24-23 (continued)

Guarantee of interest payments

- Discuss, specifically, any related party transactions with management and include information in the letter of representation.
- Review financial statements of affiliate, and where related party transactions are apparent, make direct inquiries of affiliate management, and perhaps even examine records of affiliate if necessary.

c. Nature of adjusting entries or disclosure, if any, would be as follows:

1. The lawsuit should be described in a footnote to the balance sheet. In view of the court decision, retained earnings may be restricted for $4,000,000, the amount of the first court decision. Also, in view of the court decision any reasonable estimate of the amount the company expects to pay as a result of the suit might be used in lieu of the $4,000,000. A current liability will be set up as soon as a final decision is rendered or if an agreement as to damages is reached. If liability is admitted to by Marco, and only the amount is in dispute, a liability can be set up for the amount admitted to by the company with a corresponding charge to expense or shown as an extraordinary item if the amount is material.

2. The declaration of such a dividend does not create a liability that affects the aggregate net worth in any way. The distribution of the dividend will cause a reduction in retained earnings and an increase in capital stock. No entry is necessary, but an indication of the action taken, and that such a transfer will subsequently be made, should be shown as a footnote or as a memorandum to retained earnings and common stock in the balance sheet.

3. If payment by Newart is uncertain, the $137,500 interest liability for the period June 2 through December 1, 2016, could be reflected in the Marco Corporation's accounting records by the following entry:

Interest Payments for Newart Company	$137,500	
Accrued Interest Payable — Newart Bonds		$137,500

The debit entry should be included as other assets. Collection is uncertain and the Marco Corporation may not have a right against the Newart Company until all interest payments have been met and the bonds retired. If this treatment is followed, the balance sheet should be footnoted

24-23 (continued)

to the effect that the Marco Corporation is contingently liable for future interest payments on Newart Company bonds in the amount of $2,200,000.

If the interest has been paid by the time the audit is completed, or if for other reasons it seems certain that the payment will be made by Newart on January 15, no entry should be made by Marco. In this circumstance a footnote disclosing the contingent liability of $2,337,500 and the facts as to the $137,500 should be included with the statements.

24-24 a. In this situation, Little need only send requests for letters to those attorneys who are involved with legal matters directly affecting the financial statements. The letters should be sent reasonably near to the completion of the field work, but the follow-up on nonresponses and unsatisfactory responses should not be deferred until the last day of field work. She should have examined the letters when they were returned and performed follow-up work at that time. Furthermore, the third letter should have addressed the lawsuit if the client informed the auditor of its existence.

b. The auditor would be required to follow up on the first attorney's letter by sending a second request or by calling the attorney to solicit a response. The second letter would not require any additional follow-up due to the nature of the work performed by this attorney. Regarding the third attorney's letter, it is necessary to have a conference with the attorney, client, and auditor to determine the nature and significance of the lawsuit.

It would be a serious violation of due care to ignore the information in the third attorney's letter. In rare circumstances, a disclaimer of opinion is necessary if the information cannot be obtained.

24-25

a. 2 — The cause of the bankruptcy took place after the balance sheet date, therefore the balance sheet was fairly stated at 6-30-16. Most auditors would probably require that the account be written off as uncollectible at 6-30-16, but they are not required to do so. Footnote disclosure is necessary because the subsequent event is material.

b. 3 — Amount should have been determined to be uncollectible before end of field work, but it was discovered after the issuance of the statements. The financial statements should have been known to be misstated on 8-19-16.

24-25 (continued)

c. 4 — The amount appeared collectible as of the date of the audit report.

d. 1 — The uncollectible amount was determined before end of field work.

e. 1 — The settlement should be reflected in the 6-30-16 financial statement as an adjustment of current period income and not a prior period adjustment.

f. 4 — The financial statements were believed to be fairly stated on 6-30-16 and 8-19-16.

g. 2 — The cause of the lawsuit occurred before the balance sheet date and the lawsuit should be included in the 6-30-16 footnotes. Note: If the loss is both probable and can be reasonably estimated, then answer 1 is correct: adjust the 6-30-16 financial statements for the amount of the expected loss.

h. 2 — The lawsuit originated in the current year, but the amount of the loss is unknown.

24-26 a. Auditing standards require the auditor to evaluate whether there is substantial doubt about a client's ability to continue as a going concern for at least one year beyond the balance sheet date. Auditors make this evaluation during the planning phase, but also update their assessment throughout the audit using information obtained from analytical procedures, discussions with management, their knowledge of the client's business, and other information that comes to light during the audit.

b. The auditor is required to consider whether the client is able to continue as a going concern for at least one year beyond the balance sheet date.

c. For the audit of MakingNewFriends.com, the relevant information includes the fact that MakingNewFriends.com has had difficulty establishing a loyal client base and generating advertising revenues. This suggests the company may continue to have difficulty generating revenues over the next 12 months. The recurring operating losses and decline in working capital also suggest financial difficulties and a possible inability to remain a viable going concern. Callie Peters will also consider management's plan to obtain debt financing as a means to fund operations for the next year, although they have not yet secured such financing. In addition, Callie will consider management's plan to increase advertising revenues by 20%. The additional information that Callie would consider includes any other plans by management to generate

24-26 (continued)

revenue or other financing for the coming year, knowledge of industry trends and possibly analyst forecasts related to this market segment, and performance of competitors.

d. The auditor is required to evaluate the feasibility of management achieving their plans. For example, the auditor may discuss with the bank the likelihood of the company obtaining financing. The auditor will also assess market conditions and the feasibility of MakingNewFriends.com being able to achieve an increase in advertising revenues of 20% by considering the factors discussed in part c.

24-27 a. A typical additional information report includes the financial statements associated with a short-form report on the basic financial statements plus additional information likely to be useful to management and other statement users. The statements included with short form audit reports are defined by the profession, but the additional information included in additional information reports varies considerably.

b. The purpose of additional information reports is to provide management and other users information that is useful for their decision making that has not been included in the basic financial statements.

c. It would be appropriate to include all of the items as additional information except the following:

2. The adequacy of insurance coverage. The auditor is not an insurance professional, and any comments about the insurance coverage should be factual. For example, it would be appropriate to state that the insurance coverage is less than the recorded book value.
3. Adequacy of the allowance for uncollectible accounts. Comments that an account balance is correctly stated are inappropriate. The auditor has already issued an auditor's opinion on the statements as a whole. If an opinion on a specific account balance is desired, it should be done in accordance with a special report.
5. Material weaknesses in internal control. These should be identified and communicated to management as a part of the auditor's internal control deficiencies letter to those charged with governance (e.g., the audit committee).

24-27 (continued)

d. The following would be added to the standard audit report:

Our audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying information on pages x through y is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, we express no opinion on it.

24-28 a. AU-C 450 identifies three types of misstatements:

1. *Factual misstatements* are misstatements about which there is no doubt.
2. *Judgmental misstatements* are differences arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection or application of accounting policies that the auditor considers inappropriate.
3. *Projected misstatements* are the auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire population from which the samples were drawn. Guidance on the determination of projected misstatements and evaluation of the results is included in section 530, *Audit Sampling*.

Evidence that a misstatement is not an isolated occurrence and other misstatements may exist include situations when the auditor identifies that a misstatement arose from a breakdown in internal control or from inappropriate assumptions or valuation methods that have been widely applied by the entity.

b. AU-C 450 indicates the auditor should determine whether uncorrected misstatements are material, individually or in the aggregate. In making this determination, the auditor should consider:

- the size and nature of the misstatements, both in relation to particular classes of transactions, account balances, or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence, and
- the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances, or disclosures and the financial statements as a whole.

24-28 (continued)

c. AU-C 450 requires the auditor to document the following:

- the amount below which misstatements would be regarded as clearly trivial;
- all misstatements accumulated during the audit and whether they have been corrected; and
- the auditor's conclusion about whether uncorrected misstatements are material, individually or in the aggregate, and the basis for that conclusion.

24-29 a.

		POSSIBLE MISSTATEMENT — OVERSTATEMENT (UNDERSTATEMENT)				
Item	**Total Amount**	**Current Assets**	**Noncurrent Assets**	**Current Liabilities**	**Noncurrent Liabilities**	**Income Before Tax**
1	$125,000			($125,000)		$125,000
2	85,000	(85,000)	60,000			(25,000)
3	44,000	(44,000)				(44,000)
4	52,000		52,000			52,000
5	43,000					0
6	Not known		0		0	
		(129,000)	112,000	(125,000)	0	108,000

b. The net effect of the adjustments to the balance sheet and income statement are material to the financial statements. Pretax income would be overstated by $108,000, which is in excess of the income statement materiality, as a result of these items if they are not properly reflected in the accounting records. Likewise, current assets are misstated by more than materiality. Even though the net effect of adjustments to current assets and noncurrent assets is less than materiality for total assets, the fact that a major financial statement line item, such as current assets, is misstated by more than materiality, indicates the adjustments would need to be made for the financial statements to be fairly stated. Note that the problem fails to provide information about the dollar amounts involved in Item 6. Most likely the nature of that item consists of a large dollar amount, which would need to be reflected in the financial statements given the impact it would have on noncurrent assets and noncurrent liabilities.

24-30 a. Schwartz's legal and professional responsibility in the issuance of management letters is only to make sound recommendations based on his professional interpretation of the audit evidence accumulated and to not omit information of serious systems deficiencies. He must follow due care in management letters and management services in the same manner as is required for audits.

b. Major considerations that will determine whether Schwartz is liable in this situation are whether the client installed the system according to Schwartz's instructions or whether they deviated from his instructions and whether they could have foreseen the possibility of the erased master file based on their understanding of the system. Another major consideration is the degree to which Schwartz followed due care considering the needs of the client and the competence of existing employees of Cline Wholesale Co.

■ **Case**

24-31 a. See the "Summary of Possible Adjustments" on page 24-20 that follows.

b. Aviary's management may refuse to make some or all of the proposed adjustments because all of the adjustments except (4) reduce net income. Management will most likely be reluctant to make any adjustments that will make the company look less profitable. Aviary's management may also refuse to make some or all of the proposed entries because they do not want to admit that their records contain misstatements.

c. As indicated on the "Summary of Possible Adjustments" on page 24-20, you should attempt to have Aviary's management record all of the potential adjustments found. Entries (2) and (3) should definitely be recorded because of their size and because they are actual misstatements. Management should also be encouraged to record entries (5) and (6). One positive way for you to convince Aviary's management to make these entries would be to stress that (1) considerable judgment is required to determine the allowances for inventory obsolescence and doubtful accounts and (2) it is not uncommon for auditors to assist clients in adjusting these accounts. This may help minimize management's reluctance to admit making a mistake.

You should also stress that it would be wise to adjust the allowance accounts in a year with substantial net income. The allowance accounts will most likely increase in future years, especially if entries (5) and (6) are not made in the current year. Since management cannot be sure that the company will generate

24-31 (continued)

substantial net income in future years, it would be best to adjust the allowance accounts in the current year and avoid a substantial reduction to net income in a future year that is not as profitable as the current year.

d. Your responsibility related to unadjusted misstatements that management has determined are immaterial individually and in the aggregate is to determine *for yourself* whether the combined effect of these unadjusted misstatements are material for the audit. The combined effect of the unadjusted misstatements must be compared to overall materiality. Assuming that the remaining unadjusted misstatements are well below your materiality threshold, you do not need to qualify your audit opinion. You should have the client include a summary of this audit schedule in the management representation letter, along with management's representation that the uncorrected misstatements are immaterial.

e. Auditors of larger public companies must evaluate the noted adjustments to determine their impact on the auditor's report on internal control over financial reporting. As discussed in Chapter 12, the audit of the financial statements and the audit of internal control over financial reporting for a large public company are to be integrated. Public company auditors must consider the results of audit procedures performed to issue the audit report on the financial statements when issuing the audit report on internal control. For example, if the possible adjustments identified by Aviary Industries' auditor are deemed to be material misstatements that were not initially identified by the company's internal controls, the auditor should consider this as at least a significant deficiency, if not a material weakness for purposes of reporting on internal control. In this case, the auditor's report on Aviary's financial statements would be unqualified as long as management corrected the misstatement before issuing the financial statements. However, the auditor's report on internal control over financial reporting would include an adverse opinion if the auditor concludes that it is a material weakness.

24-31 (continued)

a.

Client Name Aviary Industries

SUMMARY OF POSSIBLE ADJUSTMENTS

Year-ended December 31, 2016

DESCRIPTION	A/C DR. A/C CR.	TOTAL AMOUNT	POSSIBLE ADJUSTMENTS – DR (CR)						
			CURRENT ASSETS	NON-CURRENT ASSETS	CURRENT LIABILITIES	NON-CURRENT LIABILITIES	BEGINNING EQUITY	INCOME	EXPENSES
(1) Unrecorded credit memos*	Sales R&A A/R	26,451	(26,451)					26,451	
(2) Unrecorded inventory purchases	Purchases A/P	25,673			(25,673)				25,673
(3) Sales recorded in wrong period	Sales A/R	41,814	(41,814)					41,814	
(4) Held checks	Cash A/P	43,671	43,671		(43,671)				
(5) Obsolete inventory**	Loss A/C Inventory Allow. A/C	15,000	(15,000)						15,000
(6) AFDA understated**	Bad debt exp. AFDA	35,000	(35,000)						35,000
Totals			(74,594)		(69,344)			68,265	75,673

Conclusions:

The net effect of the above items is as follows:

Working capital	$143,938 decrease
Total assets:	$ 74,594 decrease
Net income:	$143,938 decrease

Opinion as to need for AJE: Preliminary materiality was $100,000. However, revised materiality based on 5% of actual income before taxes = $1,508,929 x 5% = $75,446.45. Rounded = $75,000. The combined effect of the above proposed entries on net income exceeds revised materiality. Propose that all entries be recorded. However, at a minimum, entries (3) and (6) should be recorded in order to decrease the effect of the above entries to a level below revised materiality of $75,000. Entry (1), (2), or (5) may also have to be recorded in order to have some cushion between the net income misstatement and revised materiality after recording entries (3) and (6).

* Entry assumes that items were returned prior to 12-31-16 and counted in inventory at year-end (no COGS/inventory misstatement).

** Because entry deals with an accounting estimate, the lower end of the range would be sufficient.