9 Audit Risk, Including the Risk of Fraud

FRAUD IS ON THE RISE: RESULTS OF THE KPMG FRAUD SURVEY 2003

In the spring of 2003, KPMG Forensic commissioned phone interviews with 459 executives of public companies with revenues of $250 million or more, as well as individuals from state and federal government agencies. They found that 75 percent of these organizations had experienced fraud in the last 12 months, a 13 percent increase over the results of their 1998 survey.

Following is a brief summary of the frequency and magnitude of the types of fraud discovered.

Type of Fraud	Percentage Experiencing Fraud in the Last 12 mo.	Average Annual Cost of Fraud ($000)
Fraudulent financial reporting	7%	$ 257,932[a]
Medical/Insurance fraud	12%	$ 33,709
Consumer fraud	32%	$ 2,705
Vendor related, third-party fraud	25%	$ 759
Misconduct	15%	$ 732
Employee fraud	60%	$ 464
Computer crime	18%	$ 67

[a] One company reported costs of financial reporting fraud of $4 billion.

Assessing the risk of fraud is challenging because the types of fraud that are least frequent, fraudulent financial reporting and medical and insurance fraud, are also the most expensive. As a result, auditors need to develop skills at separating the ordinary from the unusual.

The 2003 KPMG Fraud Survey reports surprisingly high percentage rates for the incidence of fraud. Fraud is not something that happens less than 1 percent of the time. Even fraudulent financial reporting does not appear to be a rare event. One in 14 of the companies surveyed reported that they had experienced fraudulent financial reporting in the last 12 months, and the cost of this type of fraud is very high.

In addition, the survey identified factors that contributed to the fraud in the organization. The frequency of reporting underlying factors from fraud surveys in 2003, 1998, and 1994 is as follows.

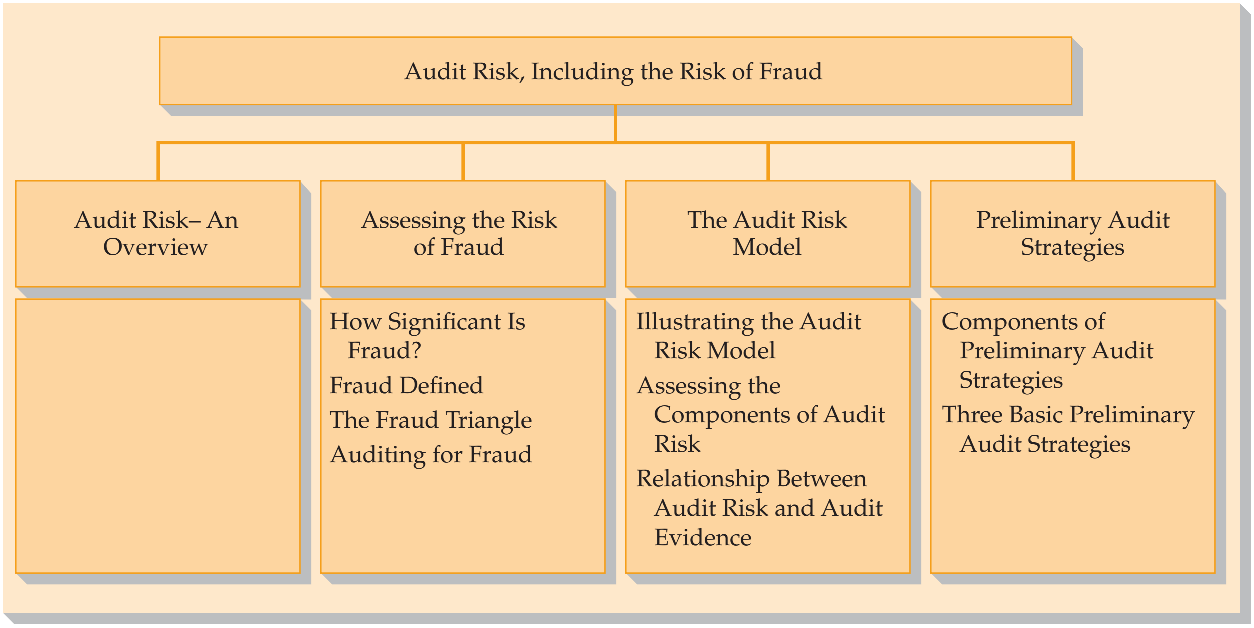
Factors Contributing to Fraud	2003	1998	1994
Collusion between employees and third parties	48%	31%	33%
Inadequate internal controls	39%	58%	59%
Management override of internal controls	31%	36%	36%
Collusion between employees and management	15%	19%	23%
Lack of control over management by directors	12%	11%	6%
Ineffective/Nonexistent ethics or compliance program	10%	8%	7%

The quality of procedures performed in the risk assessment process, including recognizing factors that are associated with the occurrence of fraud, has a significant influence on the effectiveness of audit tests in detecting material misstatements. Chapter 9 explores the audit risk model in more detail, including an emphasis on the risk of fraud.

Source: KPMG 2003 Fraud Survey.

[PREVIEW OF CHAPTER 9]

Figure 7-4 describes six key steps in performing risk assessment procedures. This chapter focuses on two of those steps: consider audit risk, including the risk of fraud, and develop preliminary audit strategies for significant financial statement assertions. The following diagram provides an overview of the chapter organization and content.



Audit Risk, Including the Risk of Fraud

Audit Risk– An Overview

Assessing the Risk of Fraud
- How Significant Is Fraud?
- Fraud Defined
- The Fraud Triangle
- Auditing for Fraud

The Audit Risk Model
- Illustrating the Audit Risk Model
- Assessing the Components of Audit Risk
- Relationship Between Audit Risk and Audit Evidence

Preliminary Audit Strategies
- Components of Preliminary Audit Strategies
- Three Basic Preliminary Audit Strategies

Chapter 9 focuses on risk assessment procedures associated with assessing the risk for fraud, other inherent risk, and using the audit risk model to develop preliminary audit strategies for various assertions. This chapter addresses the following aspects of the auditor’s knowledge and the auditor’s decision process.

focus on auditor knowledge

After studying this chapter you should understand the following aspects of an auditor's knowledge base:

K1. Know the importance of the concept of audit risk and its individual components.

K2. Know the definition of fraud and its two major components.

K3. Understand the relationship between inherent risk, control risk, analytical procedures risk, and test of details risk.

K4. Understand the relationship between detection risk and audit evidence.

focus on audit decisions

After studying this chapter you should understand the factors that influence the following audit decisions.

D1. What three conditions are generally present when fraud occurs?

D2. What risk assessment procedures should be used to assess the risk of fraud?

D3. What factors influence the auditor's assessment of inherent risk?

D4. How does an auditor develop a preliminary audit strategy for various assertions?

[AUDIT RISK—AN OVERVIEW]

Audit Risk and Materiality in Conducting an Audit, AU 312.02, defines audit risk as follows:

Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated.

Auditor Knowledge 1

■ Know the importance of the concept of audit risk and its individual components.

The overall concept of audit risk is the inverse of the concept of reasonable assurance. The more certain the auditor wants to be of expressing the correct opinion, the lower will be the audit risk he or she is willing to accept. If 99 percent certainty is desired, audit risk is 1 percent, whereas if 95 percent certainty is considered satisfactory, audit risk is 5 percent. Usually professional judgments regarding reasonable assurance and the overall level of audit risk are set as a matter of audit firm policy, and audit risk will be comparable from one audit to another.

Recall that the auditor controls neither inherent risk nor control risk. Inherent risk and control risk are client-related factors. The auditor performs risk assessment procedures to develop a knowledgeable perspective about the risk factors that are present in a client's situation. Armed with this knowledge, the auditor then designs further audit procedures that are responsive to the client's risk factors.

What does the auditor need to know about the client to develop a knowledgeable perspective? The auditor needs to know enough so that he or she can:

- Relate risk to potential misstatements in the financial statements, either at the financial statement level (risks that have a pervasive effect on the financial statements) or the assertion level (risks that relate to particular assertions).
- Consider whether risks are of a magnitude that will result in a material misstatement in the financial statements.
- Consider the likelihood that risks will result in material misstatements.

The next sections of this chapter devote substantial attention to the risk assessment procedures associated with understanding the risk of fraud and the assessment of inherent risk. It then discusses the audit risk model in more detail and explains how the auditor makes a preliminary assessment of risk in order to make preliminary decisions about the collection of audit evidence.

ASSESSING THE RISK OF FRAUD

HOW SIGNIFICANT IS FRAUD?

Fraudulent financial reporting got everyone's attention with the collapse of Enron and WorldCom when investors lost approximately $66 billion and $176 billion respectively. The evidence shows that these were not isolated instances. The KPMG Fraud Survey reported that 7% of the companies surveyed had problems with fraudulent financial reporting. The GAO *Report on Financial Statement Restatement* identified 919 restatements of public company financial statements (approximately 6 percent of all public companies) between January 1997 and June 30, 2002. The *2004 Report to the Nation* by the Association of Certified Fraud Examiners reports on 508 individual fraud cases that resulted in over $761 million in losses. The victims of fraud reported in this study appeared in every segment of our economy; 42 percent in privately held companies, 30 percent in publicly traded companies, 16 percent in government, and 12 percent in not-for-profit organizations.

Generally accepted auditing standards recognize a responsibility for finding these types of material misstatements and state that the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud (AU 110.02). GAAS (AU 316–SAS 99) requires auditors to perform specific risk assessment procedures *in every audit* to assess the risk of fraud, both due to fraudulent financial reporting and misappropriation of assets. These responsibilities are explained in more detail in the following sections.

FRAUD DEFINED

Auditor Knowledge 2

- Know the definition of fraud and its two major components.

Fraud is a broad legal concept. Auditors are not lawyers and do not make legal decisions about the legal specifications of fraud. However, auditors are interested in acts that result in a material misstatement of the financial statements. From the auditor's perspective, the primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional. Generally accepted auditing standards define fraud as follows:

Fraud is an intentional act that results in a material misstatement in financial statements that are the subject of an audit.

A footnote to this definition goes on to point out the difficulty of evaluating intent, "particularly in matters involving accounting estimates and the application of accounting principles. For example, unreasonable accounting estimates may be unintentional or may be the result of an intentional attempt to misstate the financial statements. Although an audit is not designed to determine intent, the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether the misstatement is intentional or not."

Source: AU 316.05.

Auditors are particularly concerned about two types of misstatements that are relevant to the auditor's consideration of fraud—misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets, which are defined as follows:

Misstatements arising from **fraudulent financial reporting** are intentional misstatements or omissions of amounts or disclosures in financial statements designed to deceive financial statement users where the effect causes the financial statements not to be presented, in all material respects, in conformity with generally accepted accounting principles (GAAP). Fraudulent financial reporting may be accomplished by the following:

- Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared
- Misrepresentation in or intentional omission from the financial statements of events, transactions, or other significant information
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure

Fraudulent financial reporting need not be the result of a grand plan or conspiracy. It may be that management representatives rationalize the appropriateness of a material misstatement, for example, as an aggressive rather than indefensible interpretation of complex accounting rules, or as a temporary misstatement of financial statements, including interim statements, expected to be corrected later when operational results improve.

Misstatements arising from **misappropriation of assets** (sometimes referred to as theft or defalcation) involve the theft of an entity's assets where the effect of the theft causes the financial statements not to be presented, in all material respects, in conformity with GAAP. Misappropriation of assets can be accomplished in various ways, including embezzling receipts, stealing assets, or causing an entity to pay for goods or services that have not been received. Misappropriation of assets may be accompanied by false or misleading records or documents, possibly created by circumventing controls.

The standards go on to state that the auditor's primary concern is only with those misappropriations of assets for which the effect of the misappropriation causes the financial statements not to be fairly presented, in all material respects, in conformity with GAAP.

Source: AU 316.06.

Hence, when the auditor attempts to develop a knowledgeable perspective about the risk of fraud, the auditor is primarily concerned about intentional actions that cause the financial statements to be materially misstated. The auditor should be equally concerned about misstatements arising from fraudulent financial reporting and misappropriation of assets. It is essential that the auditor be alert to factors that increase the risk of material misstatement due to fraud. These risk factors are discussed in the next section.

THE FRAUD TRIANGLE

Audit Decision 1

■ What three conditions are generally present when fraud occurs?

In order to make decisions about the risk of fraud, the auditor should understand that three conditions are generally present when fraud occurs. These are known as the three corners of the "fraud triangle" depicted in Figure 9-1.

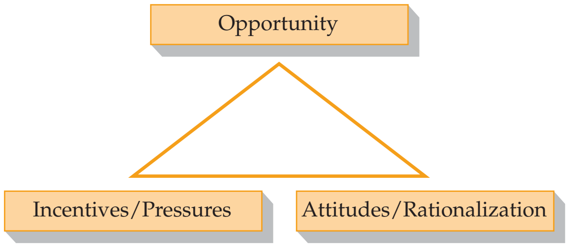
1. **Incentives/Pressures.** Management or other employees have an incentive or are under pressure, which provides a reason to commit fraud.
2. **Opportunity.** Existing circumstances provide an opportunity for fraud to be perpetrated, such as the ability of management to override controls, the absence of controls, or ineffective controls.
3. **Rationalization.** Those involved in committing fraud are able to rationalize the fraudulent behavior. In other words, some individuals possess an attitude, character, or set of ethical values that allow them to knowingly and intentionally commit a dishonest act.

These three characteristics also interact with each other. For example, individuals who might otherwise be honest might commit fraud and intentionally misstate financial information, in an environment that imposes sufficient pressure on them.

Fraudulent Financial Reporting

Fraudulent financial reporting is a serious problem for auditors of public companies and, in some cases, private companies. The problem goes beyond the few instances of WorldCom, Waste Management, and Enron. As previously noted, the 2003 KPMG Fraud Survey found that 7 percent of the respondents said that they experienced fraudulent financial reporting problems, and the GAO study found that nearly 6 percent of public companies reported restatements of previously reported earnings. The incentives and pressures on chief financial officers are sig-

Figure 9-1 ■ The Fraud Triangle



nificant. In a 1998 *Business Week* survey 67 percent of CFO's indicated that they had been asked to materially misstate earnings.[1] A similar survey by *CFO Magazine* found that 45 percent of CFOs indicated that they had been asked to materially misstate earnings.[2] These are extraordinarily high percentages. The incentives to achieve targets and attain bonuses, and the pressures associated with not meeting analysts estimates, are enormous in public companies. Auditors must be alert for the types of risk factors that are often associated with fraudulent financial reporting. Examples of these factors are presented in Figure 9-2.

The greatest opportunities for fraudulent financial reporting exist with complex transactions and accounting estimates that are difficult to corroborate. Perhaps the best way to mitigate the incentives and reduce the opportunity for fraud begins with the board of directors and its audit committee. Effective oversight of the financial reporting process by competent directors with significant financial reporting experience can create a tone at the top of the organization that expects representational faithfulness in financial reporting. This requires audit committee members who are capable of asking penetrating questions of management and auditors who are capable of identifying and understanding the economic substance of both complex transactions and accounting estimates. The opportunity is also reduced when senior management leads by example in making decisions that reinforce representational faithfulness in financial reporting. However, auditors must recognize that senior management is also in a position to make decisions that may not result in fair presentation in the financial statements, so this aspect of assessing the risk of fraudulent financial reporting needs careful review.

Finally, auditors should be alert to the signs of management attitudes or rationalizations that permit fraudulent financial reporting. This can reveal itself when nonfinancial management shows excessive participation in determining accounting results. When nonfinancial management shows an excessive preoccupation with the determination of accounting estimates, it may provide a signal that achieving earnings targets is more important than representational faithfulness in reporting results. Frauds rarely start with an original plot to materially misstate financial reports. Rather, there is significant evidence that fraudulent financial reporting begins with a series of immaterial misstatements that eventually result in bigger and bolder steps that lead to material misstated financial statement. When management feels that it is appropriate to justify marginal or inappropriate accounting based on the immateriality of items, it may signal a willingness to use accounting techniques (rather than underlying economic substance) to achieve financial goals. Figure 9-2 provides other examples of management attitudes or rationalizations that create situations allowing for fraudulent financial reporting.

Auditors must approach audits with a sufficient degree of professional skepticism and recognize the types of factors depicted in Figure 9-2. When even one or two of these factors are present, the auditor's knowledgeable perspective should lead to decisions to assess inherent risk or control risk at high levels.

[1] S. Shuster, "The Seventh Annual Business Week Forum of Chief Financial Officers," *Business Week*, July 13, 1998.

[2] S. Barr, "Misreporting Results," *CFO: The Magazine for Senior Financial Executives*, December, 1998, pp. 36–48.

Figure 9-2 ■ Risk Factors Associated with Fraudulent Financial Reporting

Risk Factors	Examples of High-Risk Conditions
Incentives/Pressures	Economic, Industry, and Operating Conditions ■ Low barriers to entry, high degree of competition combined with declining margins. ■ Vulnerability to technological change, product obsolescence, or interest rates. ■ Inability to generate operating cash flows. ■ Rapid growth in profitability compared to others in the industry.
	Pressure from third parties ■ There are optimistic or aggressive expectations regarding profitability, revenues, or other targets. ■ The company is close to debt covenants.
	Management's personal financial position is threatened by the entity's financial performance. ■ Management has significant financial interests in the entity. ■ A significant portion of management's compensation is based on bonuses tied to accounting numbers.
	Senior management places excessive pressure on other managers to meet financial targets.
Opportunity	The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following: ■ Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm. ■ Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate. ■ Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions.
	There is ineffective monitoring of management as a result of the following: ■ Domination of management by a single person or small group (in a nonowner-managed business) without compensating controls. ■ Ineffective board of directors or audit committee oversight over the financial reporting process.
	There is a complex or unstable organizational structure, as evidenced by the following: ■ Overly complex organizational structure involving unusual legal entities or managerial lines of authority. ■ High turnover of senior management, counsel, or board members.
	Internal control components are deficient as a result of the following: ■ Inadequate monitoring of controls, including automated controls. ■ High turnover rates or employment of ineffective accounting, internal audit, or information technology staff. ■ Ineffective accounting and information systems, including situations involving reportable conditions.

(continues)

Figure 9-2 ■ (Continued)

Risk Factors	Examples of High-Risk Conditions
Attitudes/Rationalization	■ Management and employees do not place a high priority on the entity's values or ethical standards. ■ Nonfinancial management shows excessive participation in, or preoccupation with, the selection of accounting principles or the determination of significant estimates. ■ Management shows an excessive interest in maintaining or increasing the entity's stock price or earnings trend. ■ Management is concerned about achieving commitments made to analysts, creditors, and other third parties regarding aggressive or unrealistic forecasts. ■ Management places a low priority on correcting known weaknesses in internal controls on a timely basis. ■ Management attempts to justify marginal or inappropriate accounting on the basis of materiality on a recurring basis.

Misappropriation of Assets

The KPMG 2003 Fraud Survey also shows a high frequency of problems such as vendor fraud (which usually involves collusion with employees), employee fraud, management and employee misconduct, and computer fraud. The goal of these behaviors is usually misappropriation of assets. Figure 9-3 provides examples of the types of risk factors that are often associated with misappropriation of assets.

The incentives and pressures that motivate employees to engage in fraud range from employees that have a grudge associated with management because an expected promotion or bonus was not earned, to those whose benefits or other compensation were lost, or who were exposed to the uncertainty associated with possible layoff. For example, a loyal bookkeeper denied a $100 monthly raise may find other ways to obtain the raise. Employees may have a variety of motivations that are difficult to identify, such as having to pay bills associated with gambling debts, sending children to private school, covering an investment loss, or living beyond one's means. Alternatively, an employee might invest in a business opportunity, the opportunity goes bust, and the employee makes up the loss by finding a way to embezzle assets from a company. Many of these motivations are not obvious, and the auditor often picks up clues by comments overheard in lunchrooms or in other casual conversations with employees.

Opportunity is the second, and critical, aspect of the fraud triangle. Employees involved in the misappropriation of assets usually have access to cash, inventory, or various assets that can be easily converted into cash. When employees see that internal controls are weak, it provides an opportunity for fraud. The *2002 Report to the Nation* by the Association of Certified Fraud Examiners reported that 86 percent of fraud cases were deemed to have insufficient internal control or to have allowed its controls to be ignored by its employees or management. For example, a purchasing agent might exploit weak controls to have assets shipped to a home rather than to the business and have the business pay the invoice. The opportunity for fraud can be mitigated by a strong system of internal control. The key

Figure 9-3 ■ Risk Factors Associated with Misappropriation of Assets

Risk Factors	Examples of High-Risk Conditions
Incentives/Pressures	Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets. Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following: ■ Known or anticipated future employee layoffs. ■ Recent or anticipated changes to employee compensation or benefit plans. ■ Promotions, compensation, or other rewards inconsistent with expectations.
Opportunity	Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following: ■ Large amounts of cash on hand or processed. ■ Inventory items that are small in size, of high value, or in high demand. ■ Easily convertible assets, such as bearer bonds, diamonds, or computer chips. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following: ■ Inadequate segregation of duties or independent checks. ■ Inadequate recordkeeping with respect to assets. ■ Inadequate system of authorization and approval of transactions (for example, in purchasing). ■ Inadequate physical safeguards over cash, investments, inventory, or fixed assets. ■ Lack of complete and timely reconciliations of assets. Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation such as inadequate access controls over automated records, including controls over and review of computer systems event logs.
Rationalization	■ Disregard for the need for monitoring or reducing risks related to misappropriations of assets. ■ Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies. ■ Behavior indicating displeasure or dissatisfaction with the company or its treatment of the employee. ■ Changes in behavior or lifestyle that may indicate assets have been misappropriated.

aspects of a good system of internal control are discussed in depth in the next chapter but (1) good segregation of duties, (2) appropriate authorization of transactions, and (3) accurate records that are regularly compared with assets minimize the opportunity for employee fraud.

When assets are misappropriated, individuals usually find ways to rationalize the behavior by putting their personal well-being ahead of their responsibilities to their employers. Sometimes individuals rationalize their behavior by believing that they are only doing what others have done. Sometimes individuals start by believing that the amount is small and they will pay it back. Soon they find that the small amount goes undetected, and they forget about paying it back and find themselves "hooked" on their new source of cash. In some cases employees feel that their talents have been overlooked, and they see fraud as a form of compensation. An individual's ability to rationalize fraudulent behavior is difficult to detect because an auditor cannot audit someone's thoughts. Auditors should be alert to clues that might show up in an individual's behavior, such as not taking vacations so that they can continue to cover up fraud or not cooperating in correcting known deficiencies in internal controls.

Finally, auditors should not assume that all three conditions (incentives/pressures, opportunity, and rationalization) must be observed before concluding that there are identified risks of fraud. Incentives and rationalization may be difficult to observe. Management or employees may actively try to hide some of the risk factors and cover up the existence of fraud. Professional standards are clear that, although the risk of material misstatement due to fraud may be greatest when all three fraud conditions are observed or evidenced, the auditor cannot assume that the inability to observe one or two of these conditions means that the risk of material misstatement due to fraud is low.

AUDITING FOR FRAUD

Risk Assessment Procedures

Audit Decision 2

■ What risk assessment procedures should be used to assess the risk of fraud?

What procedures should auditors perform to support a decision about the risk of material misstatement due to fraud? Professional standards on the *Consideration of Fraud in the Financial Statement Audit* (AU 316–SAS 99) suggest that auditors should perform the following procedures to identify the risk of material misstatement due to fraud.

- Make inquiries of management and others within the entity to obtain their views about the risk of fraud and how it is addressed.
- Consider any unusual or unexpected relationships that have been identified in performing analytical procedures in audit planning.
- Consider other information obtained while planning the audit.

Auditors usually make a series of inquiries about management's views regarding the risk of fraud and policies that have been established to mitigate those risks. For example, auditors should inquire of management about whether management has knowledge of any fraud, suspected fraud, or allegations of fraud affecting the entity. The auditor should also understand how management communicates to employees its views on business practices and ethical behavior. Auditors usually begin by making inquiries of management about their awareness of fraud risk and programs that have been put in place to prevent or detect fraud. Auditors should also make direct inquiries of the audit committee (or at least its chair) regarding the audit committee's view of the risk of fraud and the audit committee's oversight in this area. Finally, auditors usually find that it is helpful to conduct discussions with employees with varying levels of authority, including operating

how is fraud detected? results of the KPMG Fraud Survey 2003

Companies discover fraud through a variety of means. For example, internal controls or anonymous tips might trigger an internal audit investigation. Good internal controls might create the opportunity for unusual transactions to be reported by vendors or customers. The following table summarizes a number of methods used to uncover fraud as reported in the KPMG Fraud Surveys of 2003, 1998, and 1994.

Methods of Uncovering Fraud	2003	1998	1994
Internal controls	77%	51%	52%
Internal audit	65%	43%	47%
Notification by employee	63%	58%	51%
Accident	54%	37%	28%
Anonymous tip	41%	35%	26%
Notification by customer	34%	41%	34%
Notification by regulator/law enforcement	19%	16%	8%
Notification by vendor	16%	11%	15%
External audit	12%	4%	5%

Companies regularly consider the types of policies and activities that they use to mitigate or prevent the occurrence of fraud. The following table summarizes a variety of fraud mitigation policies that companies instituted in the 12 months prior to the 2003 KPMG Fraud Survey.

Fraud Mitigation Policies Instituted in the Last 12 Months	%
Strengthened internal controls	75%
Instituted periodic compliance audits	44%
Created an employee hotline	42%
Appointed compliance personnel	41%
Established a code of conduct for all employees	40%
Conducted background checks for hires with budgetary responsibility	38%
Instituted fraud awareness training	28%
Tied employee evaluation to ethics or compliance objectives	24%
Other policies	19%

personnel not directly involved in the financial reporting process, and employees involved in initiating, recording, or processing complex or unusual transactions (e.g., sales transactions with multiple elements). Responses to inquiries might serve to corroborate management's representations, or they might provide information such as employees describing instances of management override of controls. When the auditor obtains inconsistent responses, he or she should obtain additional information to resolve the inconsistencies.

Analytical procedures performed in audit planning (discussed in the previous chapter) may be helpful in identifying accounts and assertions that are likely to contain misstatements. For example, an increase in gross margins combined with an increase in the number of inventory turn days may indicate that production costs have been capitalized that should be expensed. These results might also indicate problems with recording fictitious inventory. Furthermore, a comparison of revenues and sales returns by month during the year and shortly after year-end may indicate the existence of undisclosed side agreements with customers that preclude revenue recognition. However, the auditor should also be aware that analytical procedures that compare only financial numbers might be ineffective in finding fraudulent financial reporting. In the case of fraud, the numbers may have been made to look reasonable. As a result, auditors often attempt to compare financial results with nonfinancial measures of business activity, such as comparing inventory quantities and values with direct labor hours.

Finally, the auditor should consider other information obtained during audit planning. Auditors may, for example, pick up clues about the risk of fraud when performing client acceptance and retention procedures (Chapter 7), such as concerns about the integrity of management or challenges in recording complex transaction noted by the predecessor auditor. A continuing auditor might review the prior year's internal control letter to determine whether identified weaknesses in internal control have been corrected. Auditors might find that a company is very close to significant debt covenants when obtaining an understanding of the entity and its environment (Chapter 7). Finally, auditors have a professional requirement to understand the entity's system of internal control (discussed in Chapter 10). Weak internal controls provide the opportunity for fraud. The auditor should consider all the information acquired while performing risk assessment procedures in order to develop a knowledgeable perspective about the risk of fraud.

Brainstorming Session

GAAS (AU 316) requires the audit team members to discuss the risk of fraud as part of audit planning. This **brainstorming session** has several objectives. The brainstorming session should:

- Allow junior members of the audit team to benefit from more senior members' knowledge of the audit client and of how fraud might be perpetrated.
- Allow more seasoned personnel a fresh set of eyes that might identify risks that otherwise might be overlooked.
- Allows audit management to set the appropriate tone for the audit and to emphasize the importance of approaching the audit with a "questioning mind."
- Emphasize the possibility that fraud might exist in any audit.

The primary goal is to consider audit areas where the entity is most vulnerable to the risk that fraud could result in material misstatements in the financial statements. For example, the audit team might consider pressures faced by management to meet debt covenants or pressures from an owner-manager that expects certain levels of entity performance.

An important goal is to link the risk factors to specific account balances or assertions that are likely to be misstated. For example, one person's discussion with the purchasing agent, and a review of the purchases journal, may indicate that a high volume of business is directed to one vendor. However, another person's discussion with an owner-manager may provide no indication of establishing an exclusive supply relationship with a vendor. If there is a high volume of transactions that can be material to the financial statements, the audit team may want to design procedures to review the reasonableness of prices (the valuation and allocation assertion) in this aspect of the purchases cycle to evaluate the potential for vendor kickbacks to a purchasing agent. All three aspects of the fraud triangle may not be apparent. There may be valid business reasons for the situations. Nevertheless, the auditor needs to respond by assessing inherent or control risk as high, and by designing audit procedures that restrict detection risk to a low level.

Specific Risks

Fraudulent financial reporting often happens as a result of revenue misstatements (AU 316.41). Management may recognize revenue prematurely or record fictitious revenues in order to meet financial market expectations. Management may also understate revenues during periods of strong performance in order to shift sales to the subsequent period. As a result, auditors should approach the audit with a presumption that improper revenue recognition is a fraud risk.

Professional standards also state that even if the auditor does not identify specific fraud risks, there is a possibility that management override of internal controls could occur. Management is in a unique position to perpetrate fraud because of its ability to, directly or indirectly, manipulate accounting records and prepare fraudulent financial statements. As a result, auditors should perform certain procedures to address the risk of management override of controls. For example, auditors should examine journal entries and other adjustments for evidence of possible material misstatement due to fraud.

In summary, a significant aspect of developing a knowledge perspective about the risk involves explicit discussion and evaluation of fraud risk factors. Auditors should (1) perform procedures to understand the relevant aspect of the fraud triangle (see Figures 9-1, 9-2, and 9-3) so that they can make informed decisions about the risk of material misstatement due to fraud. Once specific risk factors are identified, the auditor should evaluate whether they are of a (2) magnitude and a (3) likelihood that they will result in material misstatements in the financial statements.

[LEARNING CHECK

9-1 Provide some of the evidence regarding the significance of fraud in the United States.

9-2 Define fraud and the two components of fraud that are relevant to the auditor's decisions about the risk of fraud in the financial statement audit.

9-3 a. What are the three elements of the fraud triangle?

b. Develop an example of a high-risk situation related to fraudulent financial reporting where all three elements of the fraud triangle are present.

c. Develop an example of a high-risk situation related to misappropriation of assets where all three elements of the fraud triangle are present. In parts (b) and (c) link your examples to specific risks at the financial statement level or the assertion level.

9-4 Describe the risk assessment procedures used by auditors to identify risks of material misstatements in the financial statements due to fraud.

9-5 Identify four objectives of the "brainstorming session" performed by the audit team in the risk assessment process.

9-6 Explain two specific risks of fraud that the auditor should always consider in every audit. How should the auditor respond to these risks when making decisions about the risk of material misstatement.

KEY TERMS

Audit risk, 352
Brainstorming session, p. 362
Fraud, p. 354
Fraudulent financial reporting, p. 354

Incentives/Pressures, p. 355
Misappropriation of assets, p. 354
Opportunity, p. 355
Rationalization, p. 355

THE AUDIT RISK MODEL

Chapter 5 introduced the three components of audit risk as inherent risk, control risk, and detection risk. The audit risk concept is particularly important for several reasons. First, it provides a framework for making decisions about the risk of financial statement misstatement. Second, the audit risk model provides a framework for making decisions about the appropriate level of detection risk. For a specified level of audit risk, there is an inverse relationship between assessed levels of inherent and control risks and the level of detection risk that an auditor can accept for an assertion. Thus, the lower the assessments of inherent and control risks, the higher the acceptable level of detection risk.

ILLUSTRATING THE AUDIT RISK MODEL

Auditor Knowledge 3

■ Understand the relationship between inherent risk, control risk, analytical procedures risk, and test of details risk.

The **audit risk model** expresses the relationship among the audit risk components as follows:

$$AR = IR \times CR \times DR$$

The symbols represent audit, inherent, control, and detection risk, respectively. To illustrate the use of the model, assume that the auditor has made the following risk assessments for a particular assertion, such as the existence or occurrence assertion for inventories.

$$AR = 5\% \quad IR = 75\% \quad CR = 50\%$$

Detection risk can be determined as follows:

$$DR = \frac{AR}{IR \times CR} = \frac{0.05}{0.75 \times 0.50} = 13\%$$

A 13 percent detection risk means the auditor needs to plan substantive tests in such a way that there is an acceptable risk that they will have approximately a 13 percent chance of failing to detect material misstatements. This risk is acceptable if the auditor has evidence from risk assessment procedures and tests of controls to support the inherent and control risk assessments.

The Appendix to AU 350, *Audit Sampling* (SAS Nos. 39, 43, and 45), contains an expanded audit risk model that subdivides detection risk into two components: AP for analytical procedures risk and TD for the risk associated with substantive tests of details risk (tests of transactions and tests of balances). **Analytical procedures risk** is the risk that substantive analytical procedures will fail to detect material misstatements in the financial statements. **Test of details risk** is the risk that test of details of transactions and balances will fail to detect material misstatements in the financial statements. Hence, the relationship among audit risk components can be expressed as follows:

$$AR = IR \times CR \times AP \times TD$$

For purposes of illustration assume that the auditor has sufficient evidence to support the following risk assessments:

$$AR = 2\% \quad IR = 100\% \quad CR = 10\% \quad \text{and } AP = 50\%$$

Test of details risk can be determined as follows:

$$TD = \frac{AR}{IR \times CR \times AP} = \frac{0.02}{1.0 \times 0.10 \times 0.5} = 40\%$$

A 40 percent test of details risk means the auditor needs to plan tests of transactions and tests of balances in such a way that there is an acceptable risk that they will have approximately a 40 percent chance of failing to detect material misstatements. This risk is acceptable if the auditor has evidence from risk assessment procedures, tests of controls, and effective analytical procedures to support the inherent, control, and analytical procedures risk assessments. The expanded audit risk model provides the auditor with the tool to consider the assurance that is obtained by performing substantive analytical procedures. (The expanded audit risk model will be used throughout the remainder of the text.)

When the audit risk model is used in the planning phase to determine the planned detection risk for an assertion, CR is often based on the auditor's planned assessed level of control risk. If it is subsequently determined that the actual level of control risk for an assertion differs from the planned level, the model should be reapplied using the actual assessed level for CR. The revised detection risk is then used in finalizing the design of substantive tests of transactions or tests of balances.

In practice, many auditors do not attempt to quantify each of the risk components, making it impossible to mathematically solve the risk model. However, even when not solved mathematically, familiarity with the model makes the following relationships clear: to hold audit risk to a specified level, the higher the assessed levels of inherent, control, and analytical procedures risks, the lower will be the assessed levels of risk for tests of details.

Risk Components Matrix

Some auditors who use nonquantitative expressions for risk use a **risk components matrix** like the one shown in Figure 9-4. Study of the matrix indicates that

Figure 9-4 ■ Risk Components Matrix (Test of Details Risk in Bold)

Inherent Risk Assessment	Control Risk Assessment	Risk that Analytical Procedures Will Not Detect Material Misstatements			
		High	Moderate	Low	Very Low
Maximum	Maximum	Very low	Very low	Very low	Low
	High	Very low	Very low	Low	Moderate
	Moderate	Very low	Low	Moderate	High
	Low	Low	Moderate	High	X
High	Maximum	Very low	Very low	Low	Moderate
	High	Very low	Low	Moderate	High
	Moderate	Low	Moderate	High	X
	Low	Moderate	High	X	X
Moderate	Maximum	Very low	Low	Moderate	High
	High	Low	Moderate	High	[a]
	Moderate	Moderate	High	[a]	[a]
	Low	High	[a]	[a]	[a]
Low	Maximum	Low	Moderate	High	[a]
	High	Moderate	High	[a]	[a]
	Moderate	High	[a]	[a]	[a]
	Low	[a]	[a]	[a]	[a]

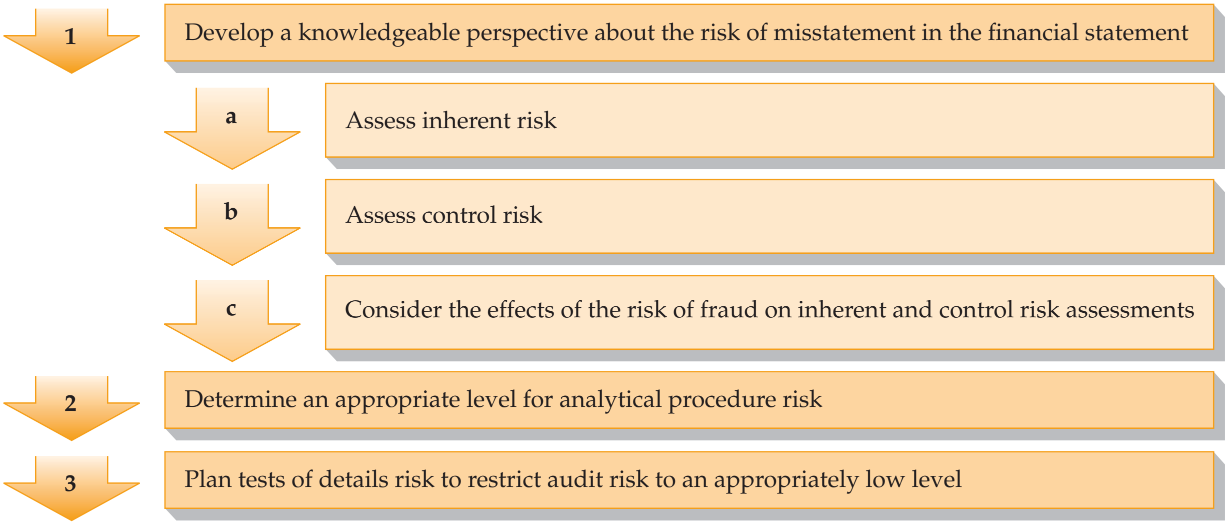
X—This strategy is not appropriate as it is unlikely that audit evidence from substantive analytical procedures alone will provide sufficient, competent evidence related to an assertion with significant inherent risks.

[a] Substantive tests of details may not be necessary.

it is consistent with the audit risk model in that the acceptable levels of test of details risk are inversely related to inherent, control, and analytical procedures risk assessments. The matrix assumes that audit risk is restricted to a low level. The matrix indicates, for example, that if inherent risk is assessed at the maximum, control risk at moderate, and analytical procedures risk at moderate, the acceptable level of detection risk for tests of details is low. If, however, inherent risk is assessed at moderate, control risk is assessed at low, and analytical procedures risk is assessed at low, other substantive tests may not be necessary. This assumes that sufficient, competent evidence is obtained by risk assessment procedures to support the auditor's risk assessments.

ASSESSING THE COMPONENTS OF AUDIT RISK

Figure 9-5 provides an overview of the steps involved in using the audit risk model. Before making decisions about the nature, timing, and extent of audit procedures, the auditor should develop a knowledgeable perspective about how misstatements in the financial statements might occur. The auditor does so by assessing inherent risk, control risk, and fraud risk. When considering the risk of fraud, Figure 9-5 ■ Steps Involved in Using the Audit Risk Model


1
Develop a knowledgeable perspective about the risk of misstatement in the financial statement
a
Assess inherent risk
b
Assess control risk
c
Consider the effects of the risk of fraud on inherent and control risk assessments
2
Determine an appropriate level for analytical procedure risk
3
Plan tests of details risk to restrict audit risk to an appropriately low level

many auditors consider issues of incentives/pressures and rationalization as inherent risks, and evaluate opportunity as part of assessing control risks. Hence, it is important to consider the combined effect of both inherent and control risks before planning substantive audit procedures. The auditor then proceeds to make decisions about the appropriate use of substantive analytical procedures and tests of details.

Assessing Inherent Risk

Statements on Auditing Standards defines inherent risk as follows:

> **Inherent risk** is the susceptibility of an assertion to a material misstatement, assuming that there are no controls.
>
> *Source:* AU 312.27.

Audit Decision 3

■ What factors influence the auditor's assessment of inherent risk?

A significant aspect of developing a knowledgeable perspective includes understanding the susceptibility of an assertion to misstatement. In making a decision about inherent risk, the auditor should consider two types of risks; (1) risks that have a pervasive effect on the financial statements and may affect many accounts and assertions and (2) risks that may pertain only to a specific assertion for a specific account. Figure 9-6 provides some examples of each type of inherent risk. Once specific risk factors are identified, the auditor should evaluate whether they are of a (1) magnitude and a (2) likelihood that they will result in material misstatements in the financial statements. In addition, if significant inherent risks are identified, the auditor should respond by obtaining evidence about internal control during the current audit period and by obtaining significant evidence through tests of details of transactions and balances.

Figure 9-6 ■ Examples of Inherent Risk Factors

Examples of Pervasive Inherent Risk Factors	Influence on the Financial Statements
Low profitability of the entity relative to the industry or sensitivity of operating results to economic factors	If management is under pressure to deliver profitability in competitive economic conditions, management may consider ways to achieve profitability through a variety of uses of management discretion in financial reporting.
A company's experience of going-concern problems such as lack of working capital	Management often believes that receiving a going-concern opinion will be the last straw that causes a company to fail. Management may consider the use of management discretion in financial reporting to make financial reports appear better than the underlying financial position, results of operations, and cash flows of the entity in order to avoid a going-concern opinion.
The impact of technological developments on the company's operations and competitiveness	Changes that make a company's products less competitive may impact a variety of accounting estimates ranging from an inventory obsolescence reserve to a reserve for sales returns, to the allowance for doubtful accounts (because customers cannot resell inventory)
Management turnover, reputation, and accounting skills	If management has poor accounting skills, the auditor might expect multiple problems with the application of GAAP. If management is new to the entity, even if that management has strong accounting background, it often takes a period of time to understand the true underlying substance of the entity and accounting choices may be misapplied.

Examples of Assertion Specific Inherent Risk Factors	Influence on the Financial Statements
Difficult-to-audit accounts or transactions	A difficult to audit transaction might include the use of a special-purpose entity to lease property or to sell receivables. Inherent risk would be high related to those specific assertions that are affected by the transactions (including whether the entity should be consolidated).
Contentious or difficult accounting issues	The auditor might have a contentious accounting issue such as the content of disclosures for a related party transaction. This might affect the presentation and disclosures assertion only, or it might affect measurement issues with respect to the specific transaction.
Susceptibility to misappropriation	Inherent risk might be higher for the existence of a gold inventory than it would be for the existence of cut timber because the former might be easily misappropriated.
Complexity of calculations	The calculations associated with a dollar value LIFO valuation or the valuation of a large retail inventory using the retail method represents a significant inherent risk that is focused on the valuation assertion for inventory.

Pervasive inherent risk factors represent risk factors that affect multiple account balances and assertions. Many small-business audits, for example, involve situations where management does not have adequate accounting skills, and it is likely that management and employees may unintentionally misapply GAAP. The lack of adequate accounting skills could affect multiple transactions and multiple assertions in many accounts. There is also some evidence that the rate and magnitude of misstatements increases with the turnover of accounting employees. New employees have a start-up period during which they are acquiring an understanding of the relationship between the underlying economic substance of the entity and the entity's accounting issues. Finally, many of the factors that increase the incentives/pressures for fraudulent financial reporting affect the use of management's discretion in financial reporting throughout the financial statements.

On the other hand, other risk factors are account balance or assertion specific. For example, many inventories have unique valuation issues. If an auditor is auditing grain in a grain elevator, the auditor may need the assistance of an expert to (1) identify the specific grain held by the company and (2) run tests to determine whether the grain is subject to any disease or other problem that could affect its value. Long-term construction contacts often require significant estimates that affect the value of a few specific accounts related to the contract. The auditor might also be aware of specific problems that have recurred in prior audits where the client does not have the expertise in the company to properly account for particular transactions. Each of these represents account-specific problems that are unlikely to have a pervasive impact on the financial statements.

Identifying Significant Inherent Risks

Generally accepted auditing standards[3] state that the auditor should determine which of the identified risks are, in the auditor's judgment, significant inherent risks that require special audit consideration. Examples of **significant inherent risks** include the risk of fraud; recent economic, accounting, or other developments that require special attention; or a complex transaction (e.g., a client might engage in a sale and lease back arrangement with a related party that has complex terms associated with the agreement). A significant inherent risk is a matter of professional judgment. They usually involve significant accounting estimates, nonroutine transactions, or the financial consequences of significant business risks. For example, underutilization of capacity could result in decreased profitability and cash flows compared to budgets or market expectations, and possible improper capitalization of excess capacity costs.

The auditor should identify significant inherent risks during audit planning, and the auditor should respond to significant inherent risks in ways that ensure that a high level of sufficient, competent evidence is obtained showing that these risks will not result in material misstatements in the financial statements. The auditor should respond to these significant inherent risks by (1) assessing inherent risk as maximum or high for relevant assertions, (2) obtaining evidence about

[3] The following discussion of significant inherent risks is based on an Auditing Standards Board Exposure Draft dated December 2, 2002 and recent exposure drafts that have been made public as part of the Auditing Standards Board agenda. A similar requirement was adopted by the International Auditing and Assurance Standards Board on October 31, 2003.

the effectiveness of design of internal controls related to the assertion, (3) ensuring that evidence about internal controls over significant inherent risks is obtained during the current audit period, and (4) obtaining significant evidence through tests of details of transactions and balances.

In addition, there may be some assertion where substantive tests alone will not reduce audit risk to a sufficiently low level. Increasingly, the initial information on a transaction is captured in electronic form. For example, banking transactions at automated teller machines (ATMs) do not leave a paper trail, and the only record that the bank has of the transaction is in electronic form. In these cases it is essential to test internal controls over the completeness and accuracy of ATM transactions.

Finally, inherent risks exist independently of the audit of financial statements. Thus, the auditor cannot change the actual level of inherent risk. Rather, the auditor performs risk assessment procedures to develop a knowledgeable perspective about the inherent risks that are present. The procedures performed to support the assessment of inherent risk include:

- Procedures associated with client acceptance and continuance decisions
- Procedures performed to understand the entity and its environment
- Analytical procedures
- Procedures performed to assess the risk of fraud
- Evidence obtained in performing previous audits
- Evaluation of other evidence obtained while performing the audit

In essence, the auditor uses all the information obtained while performing a variety of audit planning procedures to assess inherent risk.

Assessing Control Risk

Statements on Auditing Standards define control risk as follows:

> **Control risk** is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal controls.
>
> *Source:* AU 312.27.

Making a decision about control risk is a function of the effectiveness of the client's internal controls. Effective internal controls over an assertion reduce control risk, whereas ineffective internal controls increase control risk. A good system of internal controls also has a significant effect on reducing the opportunity for fraud. Control risk can never be zero because internal controls cannot provide complete assurance that all material misstatements will be prevented or detected.

Although the auditor cannot change the actual level of control risk for an assertion, he or she can vary the assessed level of control risk by modifying (1) the procedures used to obtain an understanding of the internal controls related to the assertion and (2) the procedures used to perform tests of controls. The factors that influence the auditor's assessment of control risk are explained in detail in Chapters 10 and 11 of this text. Generally, a more extensive understanding and testing of internal controls are required when the auditor wishes to support a low assessed level of control risk.

Normally, auditors determine a **planned assessed level of control risk** for each assertion in the planning phase of the audit. Planned assessed levels are based on assumptions about the effectiveness of the design and operation of the client's internal controls. In repeat engagements, the planned assessed levels are often based on information in prior years' working papers. An **actual assessed level of control risk** is subsequently determined for each assertion based on evidence obtained from the study and evaluation of the client's system of internal control when performing further audit procedures in phase IV of the audit as explained in Chapter 5.

Assessing Detection Risk

Statements on Auditing Standards define detection risk as follows:

> **Detection risk** is the risk that the auditor will not detect a material misstatement that exists in an assertion.
>
> *Source:* AU 312.27.

Decisions about detection risk can be expressed as a combination of analytical procedures risk and test of details risk. Analytical procedures risk and tests of details risk are controlled by the effectiveness of auditing procedures and their application by the auditor. Unlike inherent and control risk, the actual level of analytical procedures risk or test of details risk can be changed by the auditor by varying the nature, timing, and extensiveness of substantive tests performed on an assertion. Recall from Chapter 6 the factors that influence the reliability of audit evidence. The use of more effective audit procedures results in a lower detection risk than is possible with less effective audit procedures. Similarly, substantive tests performed at or near the balance sheet date rather than at an interim date, or the use of a larger rather than smaller sample result in lower levels of detection risk.

In the planning phase of the audit, a **planned acceptable level of detection risk** for analytical procedures and for tests of details is determined for each significant assertion using the audit risk model discussed above. These planning decisions about the design of substantive tests are discussed extensively in Chapter 12. The planned levels of detection risk should be revised, when necessary, based on evidence obtained about the effectiveness of internal controls or specific audit findings.

It is not appropriate under GAAS for the auditor to conclude that inherent and control risks are so low that it is not necessary to perform any substantive tests for all of the assertions pertaining to an account. Some evidence must always be obtained from substantive tests for each material assertion in the financial statements.

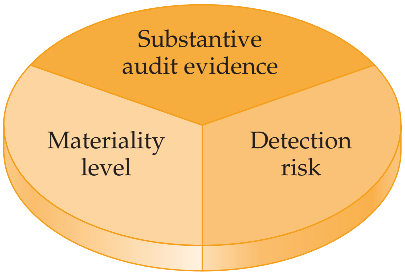
RELATIONSHIP BETWEEN AUDIT RISK AND AUDIT EVIDENCE

Auditor Knowledge 4

■ Understand the relationship between detection risk and audit evidence.

The audit risk model is used to help the auditor develop a knowledgeable perspective about the risk of misstatement and make decisions about the sufficiency of evidential matter. In making generalizations about the audit risk model, care must be taken in specifying the risk term about which a generalization is being made.

Figure 9-7 ■ Interrelationship among Materiality, Detection Risk, and Substantive Audit Evidence



There is an inverse relationship between detection risk and the sufficiency and competency of evidence needed to support the auditor's opinion on the financial statements. That is, for a particular client, the lower the level of detection risk to be achieved, the greater the amount of evidence needed. For a particular assertion, the lower the acceptable level of analytical procedures risk or tests of details risk determined by the auditor, the greater the sufficiency and competency of substantive tests needed to restrict overall detection risk to that level.

Interrelationships among Materiality, Detection Risk, and Substantive Audit Evidence

In separate sections, we previously explained that there is an inverse relationship between materiality and audit evidence, and an inverse relationship between detection risk and the evidence obtained from substantive audit procedures. Figure 9-7 illustrates these relationships, as well as the interrelationships among all three concepts. For example, if in Figure 9-7, we hold detection risk constant and reduce the materiality level, more substantive audit evidence should be obtained. Similarly, if we hold the materiality level constant and increase detection risk (because of evidence obtained about low inherent risk or effective internal controls), less substantive audit evidence needs to be obtained. In general, if we wish to reduce detection risk, the auditor will normally obtain more persuasive evidence from substantive audit tests while holding the materiality level constant.

In addition, there is also an inverse relationship between the detection risk (or the combined assessments analytical procedures risk and test of details risk) and the sufficiency and competency of evidence needed to support a conclusion about an assertion. If the combined assessment of analytical procedures risk and tests of details risk results in a low risk that substantive tests will fail to detect a material misstatement, the auditor needs more sufficient and more competent evidence from analytical procedures and tests of details to support an audit conclusion about fair presentation of the assertion.

LEARNING CHECK

9-7 Explain two distinct reasons why the audit risk concept is important.

9-8 a. Define inherent risk.

b. Explain the difference between pervasive inherent risk factors and account balance or assertion-specific inherent risk factors. Provide an example of each.

9-9 a. Define control risk.
b. Can control risk be zero? Explain.
c. What must the auditor do to support a control risk assessment below the maximum?

9-10 a. Define analytical procedures risk.
b. What influences the planned assessed level of analytical procedures risk for an assertion?
c. For assertions that represent significant inherent risks, can the auditor design effective analytical procedures that preclude the performance of tests of details of transactions?

9-11 a. Define test of details risk.
b. What influences the planned assessed level of test of details risk for an assertion?

9-12 What is the relationship among the components of audit risk?

9-13 Generally, the auditor specifies an overall audit risk level for the financial statements as a whole and then uses the same level for each assertion. However, the levels of inherent risk, control risk, analytical procedures risk, and tests of details risk can vary by assertion. Explain.

9-14 Is it ever appropriate under GAAS for the auditor to conclude that inherent and control risks are so low that it is unnecessary to verify any assertion for a material account balance? Explain.

9-15 Explain the relationship between materiality, detection risk, and substantive audit evidence.

[KEY TERMS

Actual assessed level of control risk, p. 371
Analytical procedures risk, p. 365
Audit risk model, p. 364
Control risk, p. 370
Detection risk, p. 371
Inherent risk, p. 367
Planned acceptable level of detection risk, p. 371
Planned assessed level of control risk, p. 371
Risk components matrix, p. 365
Significant inherent risks, p. 369
Test of details risk, p. 365

[PRELIMINARY AUDIT STRATEGIES]

Audit Decision 4

■ How does an auditor develop a preliminary audit strategy for various assertions?

The auditor's ultimate objective is to perform a high-quality audit. He or she does so by collecting and evaluating evidence concerning the assertions contained in management's financial statements. Because of the interrelationships among materiality and the components of audit risk discussed earlier, the auditor may choose from among alternative preliminary audit strategies in planning the audit of individual assertions. In the remainder of this chapter, we identify the components of preliminary audit strategies, describe three alternative strategies, and explain their application in the context of long-term debt.

A **preliminary audit strategy** is not a detailed specification of audit procedures to be performed in completing the audit. Instead, it represents the auditor's preliminary decisions about an audit approach. In an initial audit, for example, the auditor is developing tentative conclusions about the relative emphasis to be given to various types of audit tests. In a repeat engagement, the specification of various components of a preliminary audit strategy might include a presumption by the auditor that risk assessments, analytical procedures, tests of controls, or tests of details used in the prior year will be appropriate for use in the current year as well. Final decisions on these matters are made as the audit progresses.

COMPONENTS OF PRELIMINARY AUDIT STRATEGIES

In developing preliminary audit strategies for assertions, the auditor specifies four components as follows:

1. The assessed level of inherent risk.
2. The planned assessed level of control risk considering:
   - The extent of understanding the internal controls to be obtained.
   - Tests of controls to be performed in assessing control risk.
3. The planned assessed level of analytical procedures risk considering:
   - The extent of the understanding of the business and industry to be obtained.
   - Analytical procedures to be performed that provide evidence about the fair presentation of an assertion.
4. The planned level of tests of details that, when combined with other procedures, reduces audit risk to an appropriately low level.

The manner in which the auditor specifies the four basic components of an audit strategy is explained in the following sections.

THREE BASIC PRELIMINARY AUDIT STRATEGIES

Figure 9-8 describes three common preliminary audit strategies in terms of the audit risk model. The following discussion illustrates each of these audit strategies for different assertions associated with the audit of long-term debt.

Figure 9-8 ■ Preliminary Audit Strategies and the Audit Risk Model

Audit Strategy	IR	CR	AP	TD
A response to lower inherent risk	Moderate or low	Moderate or low	Moderate or low	High or very high
A lower assessed level of control risk approach	Maximum	Low	Moderate, high, or maximum	Moderate or high
A primarily substantive approach	Maximum	High or maximum	Moderate, high, or maximum	Moderate to very low

Response to Lower Inherent Risk

Many assertions are not subject to complex calculations, misappropriation of assets, or accounting estimates. Consider the valuation assertion for long-term debt. The auditor is concerned about both the valuation of debt instruments (notes and bonds) and the valuation of interest expense. These calculations are not complex, and once the auditor is confident that all debt is recorded, the valuation assertion is relatively straightforward. This is not a high-inherent-risk assertion.

In this case, the auditor might attempt to emphasize the use of substantive analytical procedures in designing substantive tests. The emphasis on substantive analytical procedures assumes (1) reliable data is available for analytical procedures, (2) a reliable predictive model for estimating an account balance (e.g., interest expense is a function of interest rate, principle outstanding, and time outstanding), and (3) analytical procedures are less costly than other audit procedures. Hence, **a response to lower inherent risk** might specify the components of the audit strategy as follows:

- Assess inherent risk below the maximum for low-risk assertions.
- Use the knowledge of the entity and its environment to develop reliable analytical models that capture the underlying business drivers. For example, knowledge of the entity's need for external financing helps the auditor develop an expectation of outstanding principle amounts.
- Use a planned assessed level of analytical procedures risk that is as low as feasible. For example the auditor will often analytically test the reasonableness of interest expense by determining the average cost of financing.
- Use a planned assessed level of control risk that may be at moderate or low to provide assurance that the data used for analytical procedures is reliable. For example, the auditor may want to know that controls over the recording of principle outstanding are effective.
- Plan less extensive substantive tests of transactions and balances as a result of the risk reduction available from lower inherent risks, control risks, and effective analytical procedures.

The auditor might also use this strategy for lower inherent risk areas such as the valuation of prepaid expenses or accrued payroll liabilities. The auditor often obtains a significant understanding of the business and its underlying economic drivers when gaining an understanding of the entity and its environment. Auditors often use this information when developing expectations regarding account balances. For example, an auditor might have developed an analytical model from examining the relationship between nonfinancial measures of the volume of business activity, gross payroll, and accrued payroll taxes. If gross payroll and payroll taxes are consistent with expectations, the auditor may appropriately restrict the level of substantive tests of details.

A Lower Assessed Level of Control Risk Approach

Many audit assertions represent significant inherent risks. In this circumstance it is not appropriate for an auditor to consider an audit strategy that relies primarily on analytical procedures. Most public companies also have strong systems of internal control, and the auditor will usually plan to test those controls. If the controls are effective, the auditor will use the evidence obtained from tests of controls to modify the nature, timing, or extent of substantive tests. In this case the auditor will often follow a lower assessed level of the control risk approach.

Through **a lower assessed level of control risk approach,** the auditor specifies the components of the audit strategy as follows:

- Use a planned assessed level of control risk at moderate or low.
- Plan to obtain an extensive understanding of relevant portions of internal controls, particularly control activities.
- Plan tests of controls, probably testing computer controls embedded in the client's system.
- Plan restricted substantive tests of transactions or balances based on a moderate or high planned acceptable level of detection risk.

For example, companies often have strong controls over the existence of various debt instruments. Usually someone in the treasury function ensures that recorded debt instruments are the obligations of the entity. When debt is added to most financial statements, directors often want to know the underlying reason for the debt. As a result, controls are often strong in this area. As a result, the auditor will usually perform tests of controls to obtain evidence that controls are in fact effective. With evidence that internal controls are strong for an assertion, the auditor is justified in moving the timing of substantive tests to an interim date and reducing the extensiveness of substantive tests.

The auditor might choose this strategy anytime when he or she believes that controls related to an assertion are well designed and highly effective. This strategy usually means that the auditor will understand internal controls in considerable depth, including the effectiveness of computer general controls, and the specific characteristics of programmed control procedures. This will often be the case for assertions pertaining to accounts that are affected by a high volume of routine transactions such as sales, accounts receivable, inventory, purchases, accounts payable, and payroll expenses.

PCAOB
Public Companies
Accounting Oversight Board

audit strategies for public companies

Auditors of public companies must perform a dual-purpose audit. They must perform an audit that will allow them to issue opinions on both the entity's financial statements and its system of internal control. Hence, the auditor must obtain a thorough understanding of internal controls as they relate to every material assertion in the financial statements. Furthermore, the auditor must test the operating effectiveness of controls related to each assertion in the financial statements. This positions the auditor to follow a lower assessed level of control risk approach for most financial statements assertions. This is particularly true for assertions associated with the processing of routine transactions. However, the auditor might still follow a primarily substantive approach when auditing accounting estimates or assertions that involve a high level of complexity, such as determining whether special-purpose entities should be consolidated in the company's financial statements, in spite of the fact that the auditor has tested controls related to that assertion. In these cases, the auditor might choose to follow a primarily substantive approach in order to obtain sufficient evidence that the assertions are free of material misstatement.

A Primarily Substantive Approach

In many audits of small businesses, internal controls may not be sufficiently effective to allow for the effective use of a lower assessed level of control risk approach. The auditor may know in advance, perhaps from prior experience dealing with the client, that internal controls related to the assertion do not exist or are ineffective. In other cases, there may be such a significant inherent risk that the auditor might choose to emphasize substantive testing. For example, the primary risk with respect to most liabilities is a risk that liabilities are understated. With respect to long-term debt, the auditor is often concerned about the appropriateness of off-balance sheet financing, whether the debt and assets in special-purpose entities should be consolidated, and whether all debt is in fact recorded. As a result, the auditor may plan a primarily substantive approach. Under **a primarily substantive approach,** the auditor specifies the components of the audit strategy as follows:

- Use a planned assessed level of control risk at a high level (or at the maximum).
- Plan to obtain a minimum understanding of relevant portions of internal controls that is sufficient to plan an audit.
- Plan few, if any, tests of controls.
- Plan extensive substantive tests based on a low planned acceptable level of detection risk.

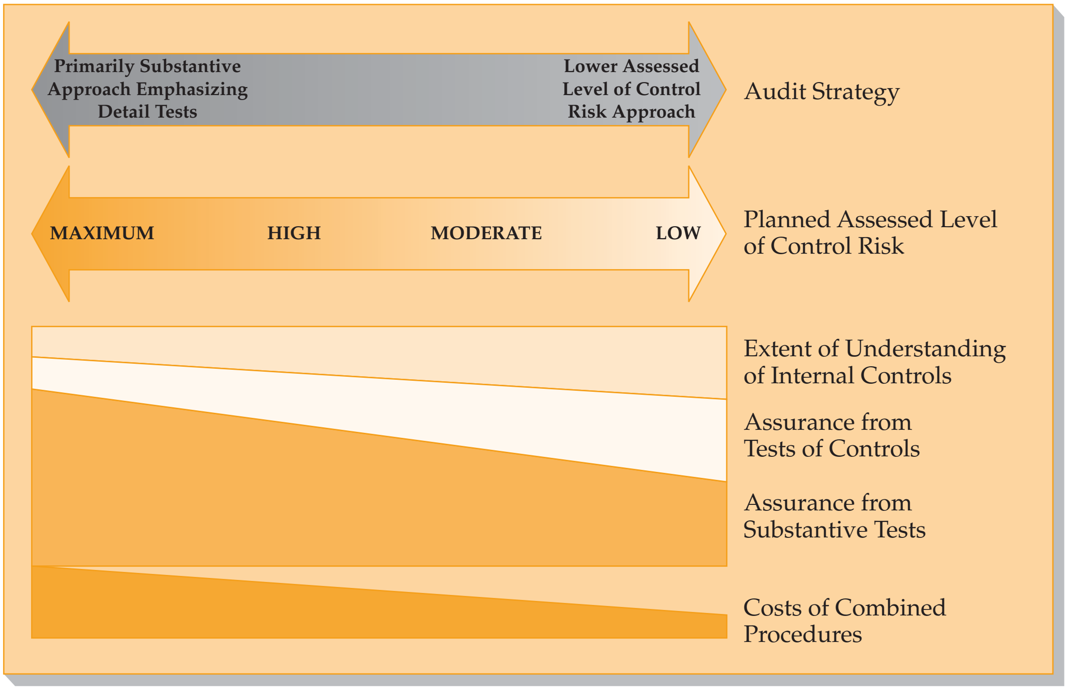
With respect to long-term debt, the auditor might confirm the outstanding balances on notes payable, even when a note has been paid off and reduced to zero. This is often a cost-effective means of testing for understatement.

A primarily substantive approach is usually chosen when the auditor concludes that the costs of performing additional procedures to obtain a more extensive understanding of internal controls and tests of controls to support a lower assessed level of control risk would exceed the cost of performing more extensive substantive tests. The auditor might also use this approach when auditing assertions that are affected by a high degree of subjectivity or involve highly complex transactions. Nevertheless, the auditor should still obtain a sufficient understanding of internal control to be able to identify the potential for material misstatement. In some cases, the auditor may feel more confident in the results of the audit by directly testing assertions with substantive tests, even if the client has designed internal controls related to those assertions. These circumstances might pertain to assertions for accounts that have relatively small populations or infrequent transactions, such as plant assets or capital stock. The primarily substantive approach may also be used for more assertions in initial audits than in recurring audits.

A primarily substantive approach emphasizing tests of details and a lower assessed level of control risk approach are on opposite ends of a continuum of possible decisions about:

- The planned assessed level of control risk
- The extent of understanding of internal controls
- The assurance desired from tests of controls (e.g., the sufficiency and competency of evidence obtained from tests of controls)
- The planned level of substantive tests to be performed to reduce audit risk to an appropriately low level

Figure 9-9 ■ Two Common Preliminary Audit Strategies


Primarily Substantive Approach Emphasizing Detail Tests
Lower Assessed Level of Control Risk Approach
Audit Strategy
MAXIMUM
HIGH
MODERATE
LOW
Planned Assessed Level of Control Risk
Extent of Understanding of Internal Controls
Assurance from Tests of Controls
Assurance from Substantive Tests
Costs of Combined Procedures

The contrast between these two approaches is depicted in Figure 9-9, which provides a graphic overview of the varying degrees of emphasis given to different components of these two audit strategies. The bottom segment of the figure indicates the potential for cost savings under the lower assessed level of control risk approach.

In the next three chapters, we explain in greater detail how auditors apply these basic audit strategies in planning and organizing the audit within the transaction cycle framework. Chapter 10 focuses on obtaining the understanding of internal controls required under each approach. Chapter 11 explains the methodology for testing controls, usually computer controls, and how the information is used in determining control risk assessments for specific assertions. Chapter 12 explains how those assessments affect the determination of detection risk and the design of substantive tests. The general framework developed in these chapters is then applied to each of the cycles and transaction classes in the chapters comprising Part 4 of this text.

LEARNING CHECK

9-16 What is the auditor's ultimate objective in planning and performing the audit?

9-17 a. What is a preliminary audit strategy?
b. Identify the four components of audit strategies.

9-18 a. Identify three audit strategies.

b. Explain the relative cost and effectiveness of each audit strategy.

9-19 Why may a common strategy be used for a group of assertions affected by the same transaction class?

KEY TERMS

A lower assessed level of control risk approach, p. 376

A primarily substantive approach, p. 377

A response to lower inherent risk, p. 375

Preliminary audit strategy, p. 374

FOCUS ON AUDITOR KNOWLEDGE AND AUDIT DECISIONS

This chapter focuses on several critical aspects of audit planning: (1) assessing inherent risk, including the risk of fraud, and (2) using the audit risk model, and (3) developing preliminary audit strategies. In making decisions to support high-quality audit work, the auditor must be able to use the knowledge summarized in Figure 9-10 and address the decisions summarized in Figure 9-11. Page references are provided indicating where these issues are discussed in more detail.

Figure 9-10 ■ Summary of Auditor Knowledge Discussed in Chapter 9

Auditor Knowledge	Summary	Chapter References
K1. Know the importance of the concept of audit risk and its individual components.	The audit risk model provides a practical way for auditors to think about the combined inherent and control risks that a material misstatement will affect the financial statements being audited. Auditors use the audit risk model to (1) relate specific risks to potential misstatements in the financial statements and consider whether specific risks are of a (2) magnitude and a (3) likelihood that they will result in material misstatements in the financial statements. The auditor uses this knowledge of inherent risk and control risk to determine detection risk and to design audit procedures to ensure that overall audit risk is reduced to an appropriately low level.	pp. 352–353
K2. Know the definition of fraud and its two major components.	Auditors define fraud as an intentional act that results in a material misstatement in financial statements that are the subject of an audit. The two major components of fraud are (1) fraudulent financial reporting, which represents intentional misstatements or omissions of amounts or disclosures in financial statements designed to deceive financial statement users, and (2) misappropriation of assets that involves the theft of an entity's assets where the effect of the theft cause misstatements of financial statements.	pp. 353–355

(continues)

Figure 9-10 ■ (Continued)

Auditor Knowledge	Summary	Chapter References
K3. Understand the relationship between inherent risk, control risk, analytical procedures risk, and test of details risk.	The chapter provides a discussion of an expanded audit risk model where detection risk is divided into two components; (1) analytical procedures risk and (2) test of details risk. Figure 9-4 provides a risk components matrix that explains the relationship between the four elements of the audit risk model. In general, as inherent and control risks increase, the auditor must design analytical procedures and substantive tests that have a lower combined risk of failing to detect a material misstatement in the financial statements.	pp. 364–366
K4. Understand the relationship between detection risk and audit evidence.	There is an inverse relationship between detection risk and the amount of evidence needed to support an opinion on the financial statements. The lower the level of detection risk to be achieved, the greater the amount of evidence is needed. The lower the acceptable level of analytical procedures risk or test of details risk determined by the auditor, the greater the sufficiency and competency of substantive tests needed to restrict audit risk to an appropriate level.	pp. 371–372

Figure 9-11 ■ Summary of Audit Decisions Discussed in Chapter 9

Audit Decision	Factors that Influence the Audit Decision	Chapter References
D1. What three conditions are generally present when fraud occurs?	The three conditions that are generally present when fraud occurs are known as the three points of the fraud triangle. They are (1) incentives and pressures that provide the reason to commit fraud, (2) the opportunity to commit fraud, such as the ability of management override controls or the absence of effective controls, and (3) the ability to rationalize the fraudulent behavior. Figures 9-2 and 9-3 provide numerous examples of these factors as they relate to both fraudulent financial reporting and misappropriation of assets. Finally, because some of these conditions are difficult to observe, auditors should not assume that all three conditions must be observed before concluding that there are identified risks of fraud.	pp. 355–360
D2. What risk assessment procedures should be used to assess the risk of fraud?	The major audit procedures used to assess the risk of fraud include (1) inquiries of management and others within the entity, (2) analytical procedures, and (3) other risk assessment procedures such as client acceptance and retention procedures or procedures used to understand the entity and its environment. In every audit the audit team should engage in a brainstorming session to consider various possible risks of fraud. This often lets more junior staff obtain the experience and wisdom of more seasoned members of the audit team, and people who are new to the engagement may identify items that other staff members might overlook. The chapter provides a number of examples of how this information can be used to assess the risk of fraud.	pp. 360–363

(continues)

Figure 9-11 ■ (Continued)

Audit Decision	Factors that Influence the Audit Decision	Chapter References
D3. What factors influence the auditor's assessment of inherent risk?	An important aspect of developing a knowledgeable perspective regarding the risk of material misstatement involves assessing the inherent risk that a misstatement will occur in an assertion, before considering the system of internal control. Figure 9-6 outlines the factors that influence the inherent risk of misstatement in an assertion, both (1) risks that have a pervasive effect on the financial statements and (2) risks that are assertion specific. This chapter also provides guidance on identifying significant inherent risks that require particular audit responses.	pp. 367–370
D4. How does an auditor develop a preliminary audit strategy for various assertions?	A preliminary audit strategy represents the auditor's preliminary decisions about an audit approach for various assertions being audited. Three preliminary audit strategies are discussed and illustrated in the chapter: (1) an approach that responds to lower inherent risks, (2) a lower assessed level of control risk approach, and (3) a primarily substantive approach. Figure 9-8 relates all three approaches to the audit risk model, and Figure 9-9 explains the difference between the second and third approaches (where inherent risk is often assessed at or near the maximum).	pp. 373–378

objective questions

Objective questions are available for the student at www.wiley.com/college/boynton

comprehensive questions

9-20 **(Risk of fraud)** Following are a number of factors recognized by the auditor as having an effect on the risk of fraud.

1. Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.
2. A company has significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions.
3. A company experiences rapid growth or unusual profitability, especially compared to that of other companies in the same industry.
4. A company has an inadequate system of authorization and approval of transactions (for example, in purchasing).
5. Employees show disregard for the need to monitor or reduce risks related to misappropriations of assets.
6. Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

7. There is excessive pressure on management or operating personnel to meet financial targets set up by the board of directors or management, including sales or profitability incentive goals.
8. Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties are difficult to corroborate.
9. Nonfinancial management shows an excessive participation in or preoccupation with the selection of accounting principles or the determination of significant estimates.
10. Management shows a domineering behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement.
11. Employees anticipate future layoffs.
12. An employee's behavior indicates displeasure or dissatisfaction with the company or its treatment of the employee.
13. A company has significant related-party transactions not in the ordinary course of business or related entities not audited or audited by another firm.

Required

For each of the foregoing risk factors, use the following codes to identify the risk component that is most directly related to (a) fraudulent financial reporting or misappropriation of assets and (b) incentives/pressures, opportunity, or rationalization.

FFR = Fraudulent Financial Reporting I/P = Incentives/Pressures
MA = Misappropriation of Assets O = Opportunity
R = Rationalization

9-21 **(Fraud risk)** Consider the following situation. Company A is a public company that competes in the highly competitive market for manufactured household products. The company is dominated by Rob Bigbucks, the chairman and chief executive officer who has guided the company since it was a private company and has extensive influence on all aspects of company operations. Rob is known to have a short temper and in the past has threatened individuals in the accounting department with the lack of pay raises if they failed to assist him in achieving company goals. Furthermore, the company has extended its influence over customers and has dictated terms of sale to ensure that customers are able to obtain desired quantities of their most popular products. Bonuses based on sales are a significant component of the compensation package for individual product sales managers. Sales managers who do not meet sales targets three quarters in a row are often replaced. The company has performed well up until a recent recession, but now the company is having difficulty moving inventory in most product lines as retailers have difficulty selling in a down economy.

Required

1. Identify the fraud risk factors that are present in the case above.
2. Identify the accounts and assertions that are most likely to be misstated based on the fraud risk factors noted in the case.

9-22 **(Detection risk and audit evidence)** Shown below are seven situations in which the auditor wishes to determine planned acceptable levels of detection risk and the planned levels of evidence needed for specific financial statement assertions. The auditor has used judgment in arriving at the quantitative expressions for various risk factors.

	Situation						
	A	B	C	D	E	F	G
Desired audit risk	1%	1%	5%	5%	5%	5%	10%
Assessed inherent risk	20%	50%	20%	100%	100%	50%	50%
Planned assessed level of control risk	50%	50%	80%	10%	80%	25%	25%
Planned assessed level of analytical procedures	50%	50%	25%	75%	15%	50%	50%
Planned assessed level of tests of details risk							
Planned evidence							

Required

a. Using the audit risk models, determine the acceptable level of tests of details risk for each situation.

b. Rank the seven situations from the most evidence required from substantive tests (1) to least evidence required from substantive tests (5). You may have ties.

c. What do the results obtained for situations C and G mean with respect to procedures designed to obtain evidence to achieve the planned assessed level of test of details risk?

d. Is situation E an acceptable audit strategy? Explain your answer.

e. Identify two alternative audit strategies, assuming that inherent risk is at the maximum. What level of understanding is important to each of these audit strategies?

9-23 **(Detection risk and audit evidence)** Shown below are five situations in which the auditor wishes to determine planned acceptable levels of detection risk and the planned levels of evidence needed for specific financial statement assertions. The auditor has used judgment in arriving at the nonquantitative expressions for various risk factors.

	Situation				
	A	B	C	D	E
Desired audit risk	Very low	Very low	Very low	Very low	Very low
Assessed inherent risk	Maximum	High	Moderate	Low	Maximum
Planned assessed level of control risk	Low	High	High	Moderate	High
Planned assessed level of analytical procedures	Moderate	Moderate	Low	Low	High
Planned assessed level of tests of details risk					
Planned evidence					

Required

a. Using the risk components matrix in Figure 9-4, determine the acceptable level of tests of details risk for each situation.

b. Rank the five situations from the most evidence required from substantive tests (1) to the least evidence required from substantive tests (5). You may have ties.

c. Explain your ranking of situation D.

9-24 **(Inherent risk)** Following are 10 pairs of assertions:

1. a. Existence or occurrence of inventory.
   b. Existence or occurrence of building.
2. a. Valuation or allocation of cash.
   b. Valuation or allocation of deferred income taxes.
3. a. Existence or occurrence of accounts payable.
   b. Completeness of accounts payable.
4. a. Rights and obligations of accrued wages payable.
   b. Rights and obligations of liability under warranties.
5. a. Presentation and disclosure of repairs and maintenance expense.
   b. Presentation and disclosure of telephone expense.
6. a. Valuation or allocation of long-term investments.
   b. Valuation or allocation of land.
7. a. Existence or occurrence of accounts receivable.
   b. Completeness of accounts receivable.
8. a. Existence or occurrence of cash.
   b. Valuation or allocation of cash.
9. a. Valuation or allocation of bad debts expense.
   b. Valuation or allocation of depreciation expense.
10. a. Valuation or allocation of receivable due from affiliate.
    b. Valuation or allocation of note payable to bank.

Required

a. For each pair of assertions, indicate whether (a) or (b) would typically have the higher inherent risk and state why.

b. In addition to factors that affect individual assertions, the assessment of inherent risk requires consideration of matters that may have a pervasive effect on many or all accounts or assertions in an entity's financial statements. State five examples of matters that may have such pervasive effects.

9-25 **(Inherent risk)** Following are examples of inherent risk factors:

1. The original CFO for a company in the entertainment industry just retired, and a new CFO, with modest industry experience, was hired from a CPA firm.
2. During the last year the company's most profitable product has experienced significant competition, and inventory quantities are building.
3. A software company has recently changed its product and is now selling a site license bundled with consulting services to tailor the software to the client's needs.
4. Financial difficulties during a recent economic slowdown have put the company in a position where it is close to violation of debt covenants.
5. A larger diversified retailer has just made a decision to put a high-end jewelry line in its stores.
6. A pharmaceutical company recently invested $500 million in research and development over the last five years in a product that failed to receive FDA approval.

Required

Evaluate the inherent risks noted above using the following framework.

Inherent Risk Factor	Pervasive Effect (yes/no)	Accounts Affected	Assertions Affected
1.			
2.			
Etc.			

9-26 **(Risk components)** Following are a number of factors recognized by the auditor as having an effect on one or another of the components of audit risk for one or more of management's financial statement assertions:

1. Manufactured equipment is leased to customers under a variety of lease terms tailored to the customers' needs.
2. The company's control policies and procedures for receiving and depositing cash are ineffective.
3. The company's management is under intense pressure to meet projected annual growth in revenues of 20 percent.
4. The availability of external nonfinancial data that are highly correlated with the company's sales causes the auditor to believe that analytical procedures will be effective in determining whether revenue is misstated.
5. The company has experienced high turnover in key management positions.
6. The auditor decides to confirm accounts receivable at the balance sheet date rather than at an interim date.
7. The company suffers from inadequate working capital.
8. High levels of overtime experienced by clerical employees have resulted in numerous errors in processing accounting information due to fatigue and carelessness.
9. To ensure that audit risk is kept to an acceptably low level, the auditor plans to make extensive use of tests of details of balances.
10. The company's primary activities are in the field of genetic engineering.

Required

Using the following codes, identify the risk component that is directly affected by each of the foregoing factors:

IR = Inherent Risk	AP = Analytical Procedures Risk
CR = Control Risk	TD = Test of Details Risk

9-27 **(Preliminary audit strategies)** A major part of audit planning is selecting an appropriate audit strategy for obtaining sufficient competent evidence for each significant financial statement assertion. These strategies are based on the interrelationship among evidence, materiality, and the components of audit risk.

Required

a. Define the term *preliminary audit strategy.*

b. What components should be specified in developing a preliminary audit strategy? How do they relate to the audit risk model?

c. Identify two alternative strategies, assuming that inherent risk is at the maximum. What level of understanding is important to each of these audit strategies?

d. State the circumstances that favor the use of each strategy, including how cost considerations affect the choice of a strategy.

9-28 **(Preliminary audit strategies)** Several significant financial statement assertions and related circumstances (not necessarily for a single client) are listed below:

1. Occurrence of sales revenue—the client operates a chain of music video stores.
2. Valuation or allocation of property, plant, and equipment—the client had only two acquisitions and two disposals during the year.
3. Occurrence of sales revenues—all the client's revenues are based on a flat per diem rate for each person receiving service daily, in monthly billings to a government agency under one large account. The client systems carefully track the number of individuals receiving service.
4. Accuracy of sales revenues—all the client's revenues are based on a flat per diem rate for each person receiving service daily, in monthly billings to a government agency under one large account.
5. Completeness of cash disbursements—the company processes approximately 2,000 checks per month for payments to vendors based on approved vouchers.
6. Existence of long-term investments—for the past eight years, the company has owned a 30 percent interest in two subsidiary companies.
7. Valuation or allocation of liability under warranties—all of the company's products are warranted for 12 months.
8. Occurrence of salaries and wages expense—the client is a university that hires 90 percent of its faculty on annual contracts, many with tenure.
9. Valuation or allocation of deferred income taxes—timing differences relate primarily to differences in depreciation and inventory costing methods used for book and tax purposes.
10. Valuation or allocation of common stock—the company had a significant number of stock transactions, but the auditor believes it will not be cost effective to perform tests of controls.

Required

Based on the limited information given, indicate the preliminary audit strategy that the auditor would likely choose for each of the foregoing assertions.

cases

Refer to the information presented in Chapter 7 associated with Cases 7-25 and 7-26. This information will be used with Case 9-29. This case is part of a set of cases related to the audit of Mt. Hood Furniture, Inc., which is coordinated with a number of chapters in the book.

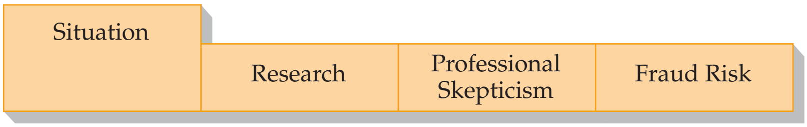
9-29 **(Mt. Hood Furniture: inherent risk)** Complete the following requirements based on the information presented at the end of Chapter 7 related to Mt. Hood Furniture as part of Case 7-25.

Required

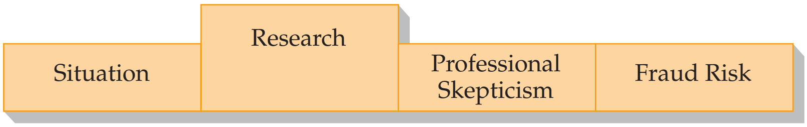
Prepare a memo for the working papers that summarizes the key conclusions regarding inherent risks. Use the following the format in your summary.

Inherent Risk Factor	Pervasive Effect (yes/no)	Accounts Affected	Assertions Affected
1. Management's goal to increase sales to $50 M	No	Sales, Accounts Receivable	Existence or occurrence
2.			
Etc.			

professional simulation

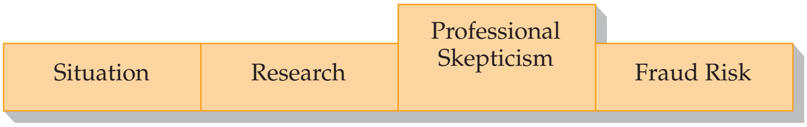


You are auditing the financial statements of Queen Manufacturing, Inc. (QMI). QMI has been a client for a number of years, the entity has a sound system of internal controls, and management has been cooperative in the audit process. The company has had a series of years with solid growth in both revenues and earnings. Due to a recent recession, performance in the fourth quarter is critical to whether QMI will report a profit or a loss.



You have been discussing the auditor's responsibility to design audit procedures to look for fraud with a colleague. Your colleague states that an audit must assume that management is honest. The firm's clients are screened annually as part of the firm's client acceptance and retention policies, which should provide the auditor with assurance that management is honest. Further, an audit relies on the cooperation of management, to provide evidence in the form of documents retained as part of the accounting system.

Is your colleague correct? Can the auditor assume that management is honest? What do the professional standards say about the auditor's responsibility to evaluate management? Cut and paste the standard sections that apply to this issue.



You have been asked by the engagement partner to participate in the "brainstorming session" as part of audit planning and the discussion of the risk of fraud in the audit of QMI. In particular, the partner has asked you to prepare a presentation for the audit team on the professional standards regarding professional skepticism. You should address two specific issues. First, how do the auditing standards define professional skepticism? Second, assume that you have completed the brainstorming session and that you have identified few significant fraud risks. The firm believes that in many audit areas you will plan on testing internal controls so that you might modify the nature, timing, and extent of audit tests accordingly. What do professional standards require in terms of exercising professional skepticism, even if the auditor has assessed detection risk as high in an given audit area. Include relevant citations in a memo to the audit team.

To: Audit Team

Re: Professional Skepticism

From: CPA Candidate

Situation	Research	Professional Skepticism	Fraud Risk

Following is list of various fraud risks. Identify whether the following situations represent incentives/pressures, opportunity, or attitudes/rationalizations.

	Incentive/ Pressure	*Opportunity*	*Attitude/ Rationalization*
1. Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate	○	○	○
2. Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend	○	○	○
3. Lack of complete and timely reconciliations of assets	○	○	○
4. High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates	○	○	○
5. Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft	○	○	○
6. Behavior indicating displeasure or dissatisfaction with the company or its treatment of the employee	○	○	○
7. Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions	○	○	○
8. A practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts	○	○	○