



GARY ZEUNE & ASSOCIATES

Training, Writing and Consulting in:
Fraud and Audit Failures
Leadership: Skills and Strategies
Productivity Performance Measures

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*VERSION 3 with 10 Steps
and blanks filled in*

Auditing: Implementing the NEW Risk Assessment Standards



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TRAINING AND CONSULTING

Using 35 years of experience in auditing, corporate finance, and investment banking, Gary D. Zeune, CPA, provides CPAs, attorneys and executives with hands-on experience in fraud and corporate strategy performance improvement. Mr. Zeune instructs courses for:

- ❑ FBI National Training Academy
- ❑ Office of the U.S. Attorney
- ❑ The SEC Institute
- ❑ National Association of Securities Dealers
- ❑ North American Securities Administrators Association
- ❑ American Society for Industrial Security
- ❑ Over 35 state CPA societies and bar associations
- ❑ American Institute of CPAs
- ❑ American Management Association
- ❑ Institute of Management Accountants
- ❑ Entrepreneurship Institute
- ❑ Treasury Management Association
- ❑ Private classes for numerous companies and accounting firms.

Mr. Zeune has instructed Strategy Formulation and Implementation in the Executive MBA Program and Accounting and Honors Finance at The Ohio State University. He is also a member of the Education Executive Council and is past chairman of the Education Marketing and Public Relations Committees of The Ohio Society of CPAs. His other memberships include: the American Institute of CPAs, and the Regulation of Public Offerings Committee of the Ohio Division of Securities.

Prior to forming his consulting practice in 1986, Mr. Zeune was an Assistant Vice President of Corporate Finance at The Ohio Company, a Columbus, Ohio investment banking firm. He also spent more than five years in Treasury and Finance at Wendy's International, where he was responsible for mergers and acquisitions, financial and SEC reporting, and corporate finance. He was on the audit staff of Ernst & Ernst from 1973 to 1977; and taught accounting at Ohio University from 1970 to 1973, where he received his bachelors in mathematics and masters in accounting, with honors.

ARTICLES AND BOOKS

Mr. Zeune is also widely published. He has published more than 40 professional articles and is the author of *The CEO's Complete Guide to Committing Fraud* and *Outside the Box Performance*. He has been a member of the Editorial Advisory Boards of the *Journal of Working Capital Management* and *The Ohio CPA Journal*.

For Deloitte & Touche, he authored *Financing Business Growth* and has completed the first draft of *The Complete Guide to Buying or Selling a Closely Held Business*, two books in the firm's Entrepreneurial Series. He has authored chapters for two books published by Warren Gorham Lamont, the world's largest financial publisher: *Accessing the Capital Markets* and *Options for Raising Capital*.

WHITE COLLAR CRIMINALS

Mr. Zeune has the ONLY speaker's bureau in the country specializing in white-collar criminals — The Pros & The Cons. Mr. Zeune's speakers tell their stories of how and they committed their crimes. Their frauds range from \$18,000 to \$350 million. Speakers include CPAs, attorneys, and business people. The frauds include:

- ❑ Mark Morze created 10,000 phony documents to steal \$100 million in the infamous ZZZZ Best Carpet Cleaning fraud (86% of the revenue was fake and no one found it)
- ❑ Fred Shapiro defrauded nearly every major financial institution in the City of Philadelphia to the tune of \$8.6M. He is a former attorney, accountant, educator and inmate. Fred worked undercover with the U.S. attorney's office and the FBI in a drug and money laundering operation in an effort to minimize his sentence.
- ❑ Nick Wallace committed a \$350 million fraud as the President of ESM Government Securities resulting in the collapse of the Ohio Saving & Loan Guarantee Fund, and the bankruptcy of 69 Ohio S&Ls
- ❑ Dunlap Cannon was the largest real estate closing attorney in Memphis. He went to prison for 32 months for stealing \$5 million from his clients.
- ❑ Suffering from medical expenses and family deaths, bookkeeper Teri Lynn Norwood stole \$18,000, promising to pay it back. She ran out of time.

100% No-Risk Guarantee

Mr. Zeune's executive education training is consistently rated at least a 4.7 on a 5-point scale. If you are not satisfied for any reason, if you don't learn at least 10 new things you can use the following day, there are no fees or expenses. PERIOD.



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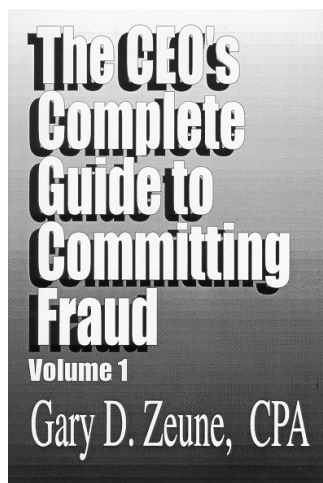
ACTION STEPS FROM GARY'S CLASS

#	Action Item
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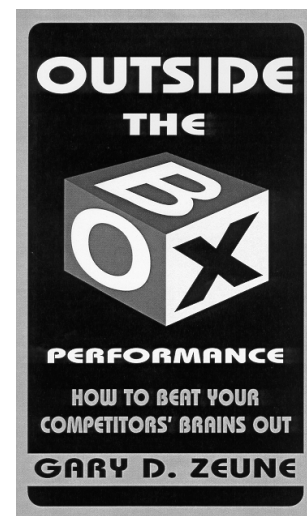
Thanks for attending. Don't hesitate to call or email if you have questions. . . .gdz

Want More Info? Order the Book!

Outside the Box Performance: How to Beat Your Competitors' Brains Out is packed with the techniques small and mid-size world-class companies use to become and stay competitive, and make a ton of money. Learn the secrets to unlock the multitude of new techniques which "drive" your profitability. This book compliments the class and provides new ideas to incorporate in your business. For example, do you know what the basis of competition will be in the next 10 years? It's around you ALL the time. You expect it everyday as a customer. Or, how to beat your competitors by asking your customers two simple questions? If not, sit back and learn how to "beat your competitors' brains out!"



Don't you want to know how Barry Minkow and Mark Morze stole \$100 million from investors in the ZZZZ Best Carpet Cleaning fraud, right under the noses of auditors, underwriters and lawyers? The first chapter of 100 pages in ***The CEO's Complete Guide to Committing Fraud*** tells you. It also has 8 chapters on other frauds: computer, real estate, fake financial statements, public company frauds, and a chapter by an auditor who became the target of a fraud investigation, just 4 weeks after becoming the engagement partner.



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I need the following copies of Mr. Zeune's books. Price: 1 @ \$19.95: 2 to 5 @ \$15.95 6+ @ \$12.95

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_____ *Outside the Box Performance* (200 pages)

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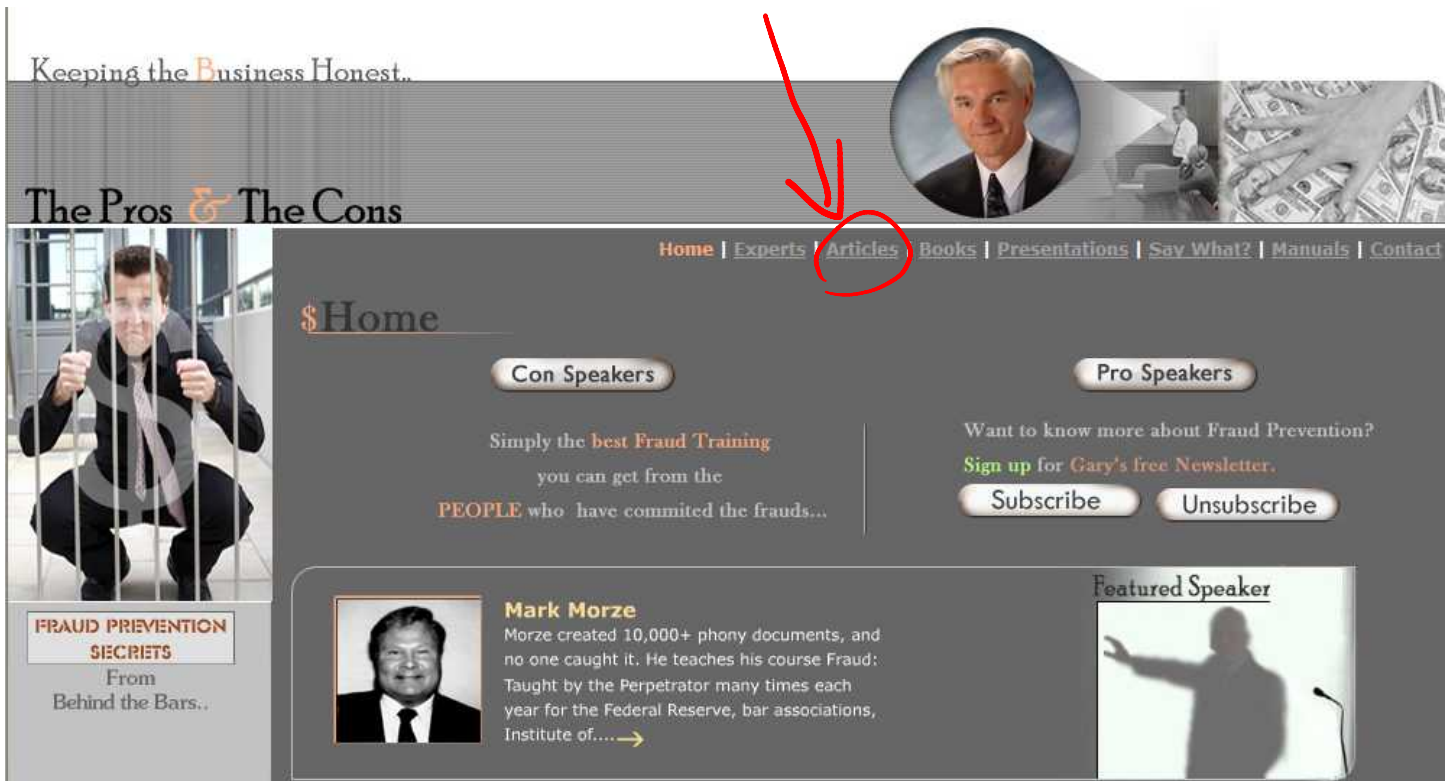
City _____ State _____ Zip _____

Phone _____ Fax _____

Email _____

Address is: ☐ Firm ☐ Home

ARTICLES



Articles at www.TheProsAndTheCons.com

Would your clients, staff, customers, vendors or another group you belong benefit from one of these articles?
Email Gary Zeune at gzfraud@bigfoot.com for reprint permission.

Wrong Strategy + Wrong People = Fraud/Theft/Abuse – By Gary Zeune, CPA

Auditors And Airport Screeners Have Similar Blind Spots - By Gary Zeune, CPA

Should Auditors Be Airport Screeners? Or why they both miss what they're paid to detect. - By Gary Zeune, CPA

Ex-con: Cunningham Faces Rough Road In Prison - By William Finn Bennett

Walt Pavlo USA TODAY Ethics training -

Gary Zeune on Fraudsters Speaking Out on Fraud The Corporate Counsel - Podcast

OU alumnus examines corporate crime, criminals - By Ashley Ferguson

Ex-cons tout ethics through corporate speakers bureau - By Sarah Anderson

Man's Lifestyle Sold Investors - By Jim Woods

"The Pros of Cons" - By Michael Goldstein

Legal Audits: Does Your Borrower Need A Checkup? - Schottenstein, Zox & Dunn.

An Ex-Con Tells How to Avoid Being Conned. - By Fred Shapiro, in White-Collar Crime Fighter. December, 2004.

Does your compensation system encourage illegal activity? - By Gary D. Zeune, CPA, Published in White Color Crime Fighter in November 2004

Speaker explains how corporate con men get away with it - By Jim Phillips [Athens NEWS Senior Writer] in The Athens News in October 2004

How to Foster Fraud : Forget Ethics - By Gary D. Zeune in White Collar Crime Fighter in August 2004

Your Auditors Can Stop Fraud , If they know what to look for - By Stephen Pedneault published in White Collar Crime Fighter in August 2004

After Serving Time, Executives Now Serve Up Advice - by CHRISTOPHER S. STEWART in The New York Times

Local CPA, ex-cons attempt to spread word that crime doesn't pay - by SEAN CASEY [Daily Reporter Staff Writer] in Central Ohio Source " The Daily Reporter"

The costs of not securing personally identifiable Data - By Benjamin Wright "The Information Systems Audit and Control Assn." Site : www.isaca.org

Ex-Cons find peace and paycheck on the Burgeoning lecture circuit - By Joshua Harris Prager published in Wall Street Journal May 25th, 2004

Felons become educators for Business - By Mitch Moxley [Financial Post] Published in National Post July 17, 2004

A new regard for ethics on the job - By MEREDITH COHN [SUN STAFF] Originally Published JULY 9, 2004

The pros of preventing cons - White-collar criminals help companies avoid fraud in their midst By Chiree McCain, For Business First - June 25, 2004

Are You Teaching Your Employees to Steal? - By Founder Gary D. Zeune, CPA in Strategic Finance

When it's one of your own a first-person account of Fraud Inside A Bank - by ex-con Dave London in RMA Journal

FRAUD HAPPENS : How an honest employee crossed the line - by Teri Lyn Norwood Published in White - Collar Crime Fighter Magazine , November 2003

Internal theft can destroy years of small business owner's work - by Jane Applegate

Fraud and Theft Start Small - by Founder Gary Zeune in NJ CPA Society Journal

How to Predict When People Will Embezzle - by Founder Gary Zeune in White Collar Crime Fighter

Hubbell details life of fraud - September, 2000 in San Antonio Express

Speaking with Conviction - from Report on Fraud

Corporate crooks hit lecture circuit - from Denver Post

Ex-Con Tells How Auditors Failed to Help Clients Guard Against Fraud - by Mark Morze in White Collar Crime Fighter

Preventing Your Firm's "Enron" - by Founder Gary Zeune in Ohio CPA Journal

SAS 99 17 Ways to Protect Yourself From Malpractice - by Founder Gary Zeune in 7 CPA journals

Regulation SAS 99 Aimed at Curbing Company Fraud - from Bizjournals , March 2004

Business First Auditors' Alert: How NOT to Get Sued Under Fraud Auditing Standards - by Founder Gary Zeune in White Collar Crime Fighter

SAS 99 Friend or Foe - by Founder Gary Zeune in two publications

(SAS 99 RMA) Look Out! New fraud auditing standard holds worrisome implications for financial statement reliability : interview with Gary Zeune in RMA Journal (for banking industry)

Like an article.....Email Gary Zeune at gzfraud@bigfoot.com for reprint permission.

CHECK
VERSION → v3

Auditing: Implementing the NEW Risk Assessment Standards

Complex new tax law
without IRS regulations

Sarbanes-Oxley for
everyone else

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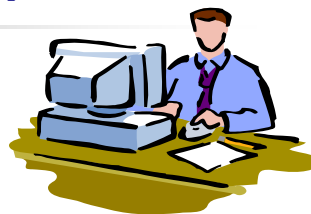
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"Just wanted to let you know that I appreciate being
on your distribution list. I have found that there are
many items that you refer to me that are helpful."
. . .Mike McGlynn





Agenda

1. Overview
2. SAS 102 Defining Professional Standards
3. SAS 103 Audit Documentation
4. SAS 104-111 Risk Assessment Standards



Accountants Under Fire

For decades the accounting profession basked in the highest kind of public confidence. Now all at once there are more than 50 major lawsuits pending against the big public accounting firms, charging irregularities and negligence in preparing earnings reports and other financial statements. With equal suddenness a barrage of public criticism has landed on the profession for its highly flexible "generally accepted accounting principles." Perhaps most worrisome of all to the CPAs and to the management that employ them, the Securities & Exchange Commission has been issuing thinly disguised threats to take unilateral action if the accountants themselves do not quickly tighten up their rules.

Under the present accounting rules, there is a very fine line between "maximizing" and plain, old-fashioned, manipulation.

FORBES, May 15, 19_

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Where Risk Comes From.....

"The vast majority [at 90% where the potential damages exceed \$10 million] of serious cases brought against accounting firms allege failures to comply with generally accepted auditing standards," *Accountants' Liability*, Practising Law Institute, Goldwasser, Arnold & Eickemeyer. Dan is a member of the Auditing Standards Board, past chair of the firm's Professional Liability Litigation Practice Group and has defended professionals in 200 liability cases.



Dan Goldwasser
212-407-7710

dgoldwasser@vedderprice.com

Risk Assessment Stds

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GAAP + GAAS Not Good Enough

1. Liability requires scienter
2. Scienter = intentional or reckless conduct evincing a deliberate disregard for the consequences
3. Failure to follow firm's professional standards often evidence of scienter

Accounting, Auditing & Financial Malpractice, page 189.

Risk Assessment Stds

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Are You Protected?



Question: If you miss a material fraud, get sued, and can show with a parade of experts that you performed a GAAS audit, that you put all the check marks in all the right boxes, is the jury bound to find you not liable?

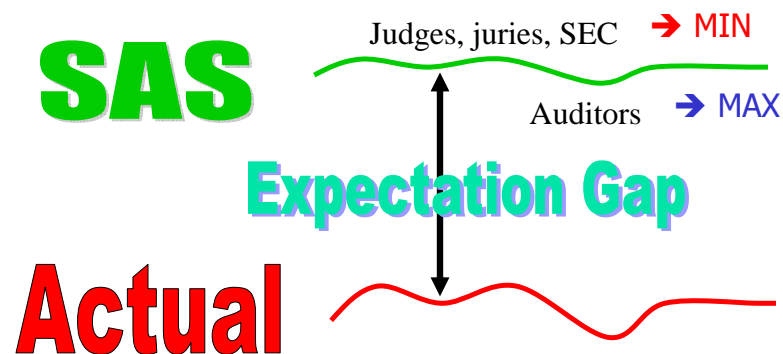
Yes No


Why?

GAAP and GAAS do
NOT have the weight of law.

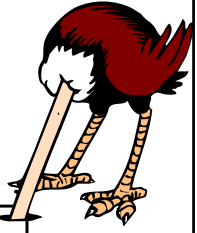


Auditing Standards Expectation Gap Risk






Looking the Other Way




Willful blindness	A person tries to avoid knowing something that will incriminate him. Defendant "knows" anyway because of the high probability of its existence.
Deliberate ignorance	People who, recognizing the likelihood of wrongdoing, consciously refuse to take basic steps to discern the truth.
Conscience avoidance	If a defendant claims a lack of knowledge, and the facts suggest a conscious course to avoid learning the truth, then the defendant may be charged with knowledge.
"Good soldier"	"I was just _____," doesn't _____. WHY _____.

Risk Assessment Stds


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CAMICO Statistics

These statistics are from CAMICO's own claims history. The following graphs will give you an idea of the frequency and severity of claims based on scope of services. Our intention is to raise the level of awareness and to offer CPAs advice to help them practice in a safer environment.



Risk Assessment Stds

Average Claim Size

	From Inception Through 12/31/05	Three Year Average 2003-2005
Audit	\$ 310,000	\$ 284,000
Bookkeeping	\$ 108,000	\$ 112,000
Compilation	\$ 115,000	\$ 73,000
Review	\$ 181,000	\$ 213,000
Tax	\$ 53,000	\$ 48,000
Invest Advice/PFP	\$ 172,000	\$ 189,000

CAMICO
SERVICES, INC.

Risk Assessment Stds

Average Claim Size

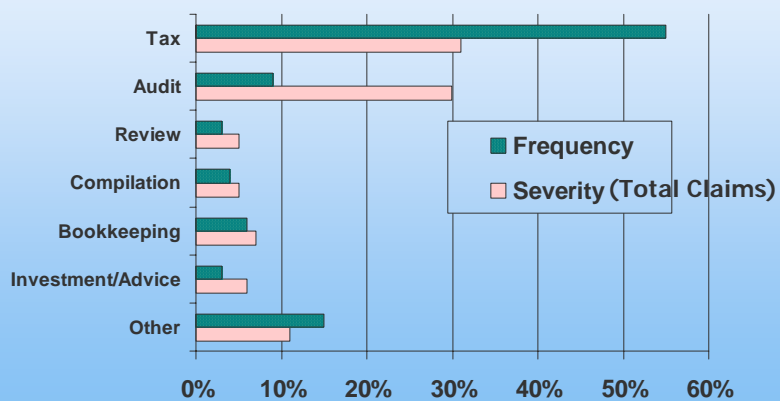
	From Inception Through 12/31/05	Three Year Average 2003-2005
Trust	\$ 134,000	\$ 162,000
Business Valuations	\$ 103,000	\$ 214,000
Other	\$ 57,000	\$ 54,000
All Scopes of Practice	\$ 94,000	\$ 93,000

CAMICO
SERVICES, INC.

Risk Assessment Stds

Frequency vs. Severity

All claims by scope from inception through 12/31/05

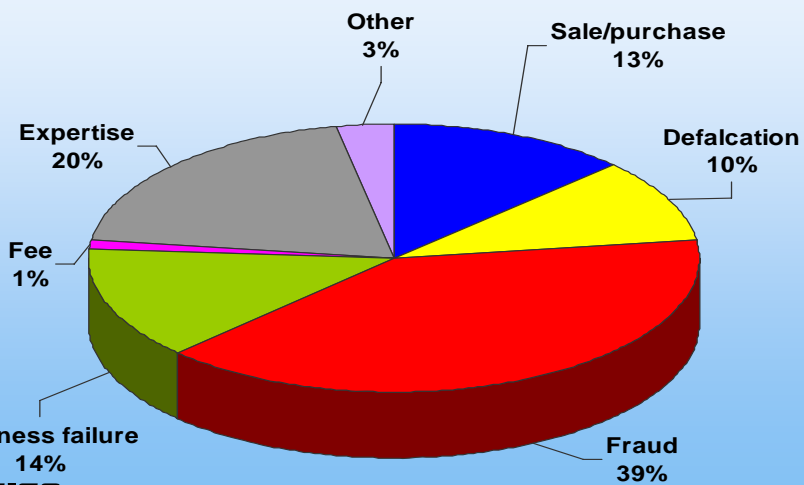


CAMICO
SERVICES, INC.

Risk Assessment Stds

Audit Claims

Three Year Average (2003-2005)

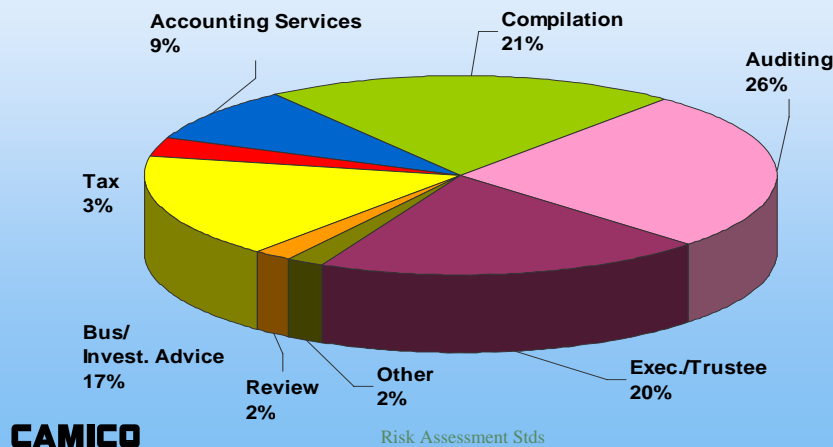


CAMICO
SERVICES, INC.

Risk Assessment Stds

Fraud Claims by Engagement

Three Year Average (2003-2005)



How Can This Happen



Suppose it's June 2001. . . .

Question: Can a handful of people in a Big-5 firm take the entire firm down over 1 audit client?

Answer: ABSOLUTELY NOT

BDO Siedman guilty of gross negligence awarding \$500+ million:
For failing to detect Bankst fraud
CEO says damages will "Threaten its operations".

NEW

Risk Assessment Stds

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Audit Tips



1. Jose Gomez, A&A Partner
South Florida
Alexander Grant
2. Audit Tip: Do you think this couldn't happen to YOU
3. Audit Tip: Not only do you have to watch your clients,
you have to watch your own STAFF



The "Enron" Effect

1. Pre-Enron – *It doesn't say I can't do this.*
2. Post-Enron – *Show me where it says it's OK to do this.*



Audit Tip: Don't let your client push you AROUND



At the END of EVERY Auditing Standard

Note: *Statements on Auditing Standards are issued by the Auditing Standards Board, the senior technical body of the Institute designated to issue pronouncements on auditing matters. Rule 202, Compliance With Standards, of the Institute's Code of Professional Conduct requires compliance with these standards in an audit of a non-issuer.*



This requirement to comply may be the most important paragraph in an auditing standard. If so, where else could it be located AT THE BEGINNING.



Complying with GAAS

STEP #1

~~Audit Tip:~~ If you don't comply with EVERY auditing standard on EVERY engagement, you have violated GAAS.

What are two other things you have violated.....

1. Professional ethics
2. AICPA and state accountancy board rules

Violating GAAS

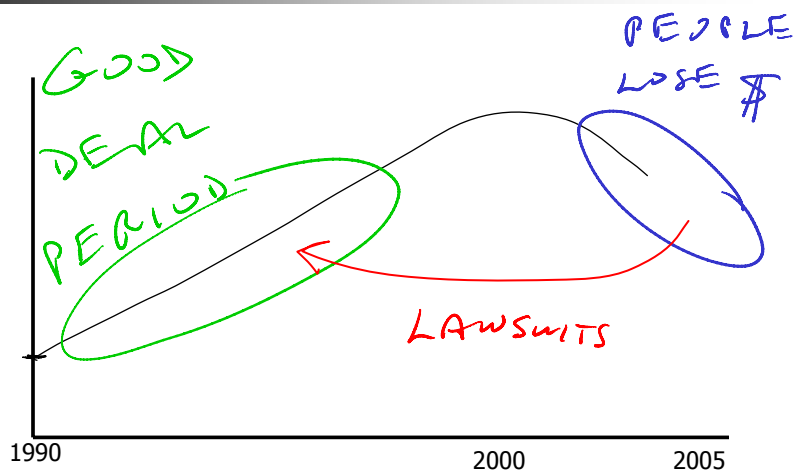
Q: If you have violated GAAS do you have to recall your report Y N

Why: Violating GAAS doesn't mean your report is wrong

Q: BUT, if you don't comply with an auditing standard will that provide plaintiff's atty a cause of action?

A: It's a legal question, but probably YES. A plaintiff will look for any failure to follow GAAS.

When We Get New Auditing Standards





SAS 102

Defining Professional Requirements In Statements On Auditing Standards



SAS 102 Must and Should

1. Effective on issuance December 2005
2. SAS 102 defines the degrees of responsibility that the requirements impose on the auditor/practitioner
3. Substantially similar to PCAOB Rule 3101



SAS 102 Must and Should

1. **MUST** = *Unconditional requirements* – The auditor or practitioner is required to comply with an unconditional requirement in all cases in which the circumstances exist to which the unconditional requirement applies.
2. **SHOULD** = *Presumptively mandatory requirements* – The auditor or practitioner is also required to comply with a presumptively mandatory requirement in all cases in which the circumstances exist to which the presumptively mandatory requirement applies; however, in rare circumstances the auditor or practitioner may depart from a presumptively mandatory requirement provided he or she documents the justification for departure and how alternative procedures performed in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement.

Risk Assessment Stds

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SAS 102 Must and Should

1. What do you consider a rare 2%,
2. Then you must perform 98% of *shoulds*
3. If you depart from a "should" you MUST document what you did and how the procedure was at least as effective as the procedure in the standard

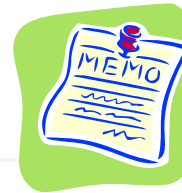
Audit Tip: Review EVERY audit program for

compliance with "SHOULDs"

Risk Assessment Stds

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SAS 103 Summary Audit Documentation



Risk Assessment Stds

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SAS 103

1. Work papers should be in sufficient detail for an *experienced* [internal or external] auditor *without* a connection to the audit to understand:
 1. Work performed
 2. Results of the work
 3. Evidence obtained
 4. Conclusions reached
 5. Accounting records agree or reconcile with the financial statements or other information

Auditing Tip: The work papers are REQUIRED TO
stand on their own.

Risk Assessment Stds

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SAS 103



Oral explanations on their own do not represent sufficient support for the work the auditor performed or conclusions the auditor reached but may be used by the auditor to clarify or explain information contained in the audit documentation.

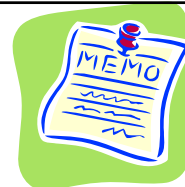


STEP #2

~~Auditing Tip:~~ Oral explanations are NOT **AUDIT EVIDENCE**.



SAS 103



1. Identify preparer and reviewer
 1. Who performed the audit work
 2. The date such work was completed
 3. Who reviewed specific documentation
 4. The date and extent of such review
2. Document specific items tested



SAS 103 FINISH The Work Papers

1. Assemble the final audit engagement file within 60 [calendar...gdz] days following the report release date
 1. After 60 days – no deletion or discarding of existing audit documentation is permitted
 2. After 60 days – appropriately document subsequent additions
2. Must retain files for at least five years from the report release date, or longer if otherwise required



Complying with SAS 103

Audit Behavior: Some will 'rationalize' not completing and 'locking down' the file....."Everything is OK. There's nothing wrong. I'll do it later."

Audit Tip: To maximize compliance, and minimize risk, adopt a firm policy that your report isn't released until work papers are **FINAL**.



SAS 104 – 111 Risk Assessment Standards

Risk Assessment Stds

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SAS 104 – 111 Why?

1. Loss of public trust
2. Public Oversight Board's Panel on Audit Effectiveness recommendation to ASB
3. Significantly strengthen auditing standards
4. Originated as a joint project between the ASB and IAASB to converge with international auditing standards
5. More rigorous audits consistent across firms and clients

Risk Assessment Stds

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SAS 104 – 111 Overview

1. Amends or revises or creates 8 existing standards
2. Most far-reaching change in standards in 20 years
3. Issued in March 2006
4. Effective for periods beginning on or after Dec. 15, 2006
5. SAS 99....RAS same concept
6. Started in 1999
7. 2001 scandals pushed SAS 99
8. Eliminates 'canned' audit programs and defaulting to maximum risk

STEP
3

Risk Assessment Stds

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SAS 104 – 111 Three Objectives

1. More in-depth understanding of client and its environment, including internal controls, to identify risk of material misstatement (error or fraud) and how the client mitigates them
2. More rigorous assessment of the risks of where and how the financial statements could be materially misstated
3. Improve linkage between the auditor's assessed risks and the nature, timing and extent of audit procedures performed in response to those risks

Risk Assessment Stds

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SAS 104 – 111 AICPA Comments

- “The standards will result in more effective audits as a result of better risk assessments and improved design and performance of audit procedures to respond to the risks. These standards will better help auditors focus on those areas where risk of misstatement is the greatest,” John Fogarty, Chairman, Auditing Standards Board.
- “These standards, along with our standard on fraud [SAS 99...gdz], get to the very heart of the audit process. Implementation of the new standards may require auditors to change their approach and perhaps the nature of the audit procedures performed. We believe that these standards, with support from the AICPA, will allow our members to find ways to improve the effectiveness of their audit engagements,” Chuck Landes, AICPA VP, Professional Standards and Services.



SAS 104 – 111 New Requirement

Complying with the linkage requirements will require auditors to do one of the most difficult and time consuming tasks:

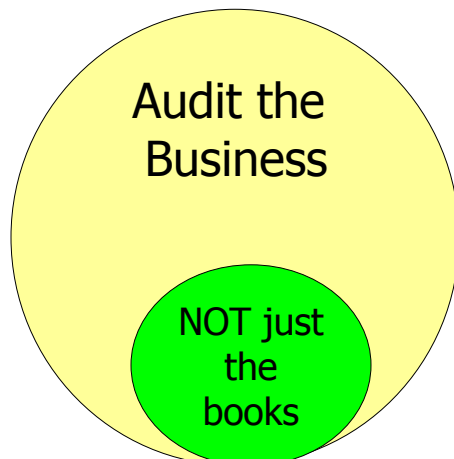
THINK

Re-Writing the Canon
Michael Ramos, AuditWatch.com





SAS 104 - 111



Risk Assessment Stds

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SAS 104 – 111 Protecting Yourself

Audit Tip: Who else has read these comments and will attempt to use them to set the level of audit quality?

Attorneys who sue auditors

Audit Tip: What's your best protection?

Don't accept audit just because client will pay you.

Audit Tip: What is next best protection?

Comply with the standards

Risk Assessment Stds

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SAS 104 – 111 External Results

1. Incorporate many current concepts and procedures
2. Significant new requirements leading to audit revisions and training
3. Increased work and FEES

STEP 4: Talk to clients BEFORE

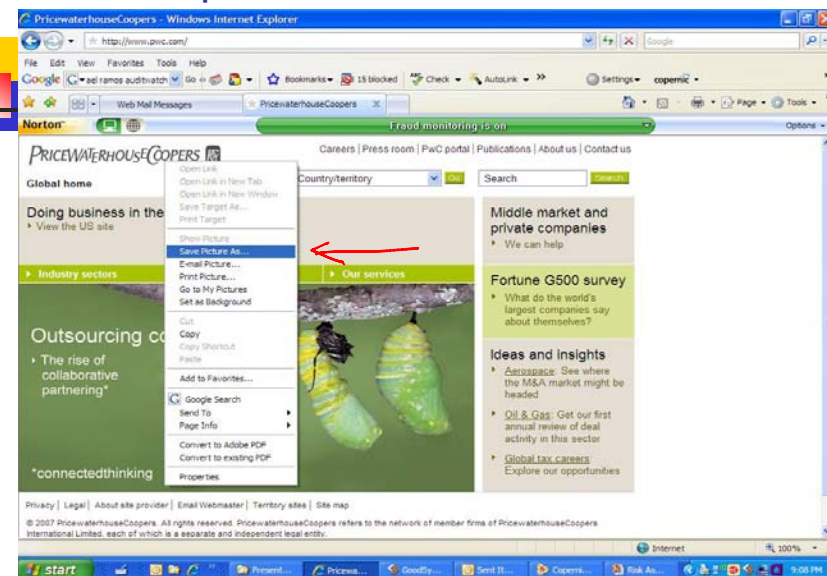
~~Audit Tip:~~ Some clients, afraid they can't 'pass' the new scrutiny, will FIRE your firm and send the user financial statements with a FAKE opinion.

~~Audit Tip:~~ Engagement letter paragraph that if you're fired or level of service changes you'll notify user.

Risk Assessment Stds

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Fake Opinions

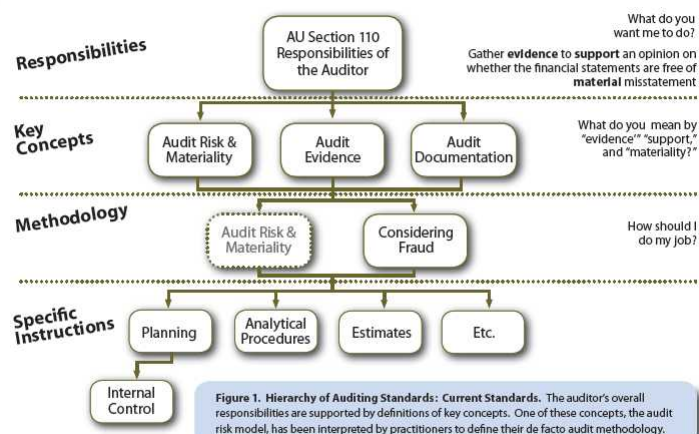


Risk Assessment Stds

44



SAS 104 – 111 Old Hierarchy



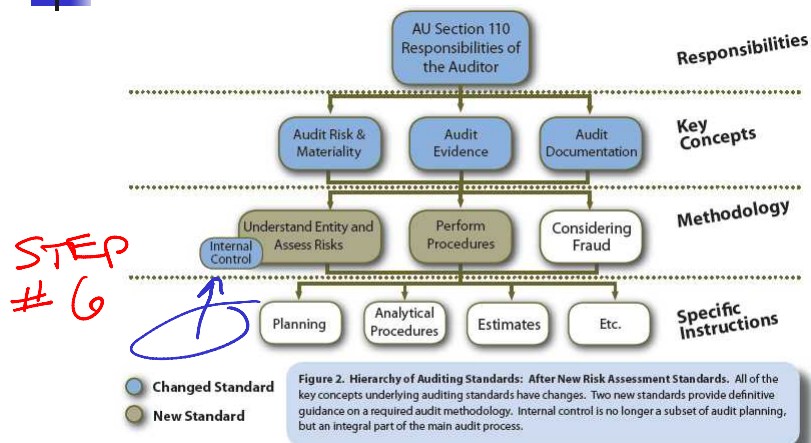
AuditWatch.com

Risk Assessment Std

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SAS 104 – 111 New Hierarchy



AuditWatch.com

Risk Assessment Std

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Risk Assessment Standards

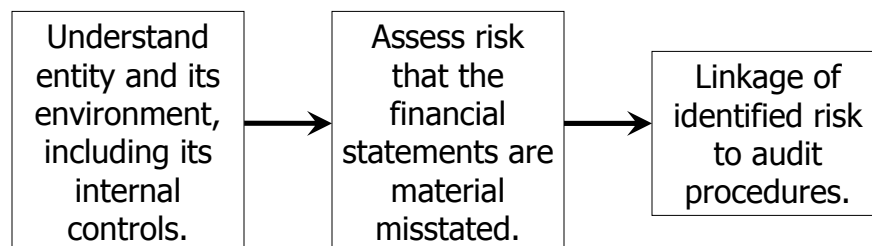
104	Amends SAS 1 Due Professional Care
105	Amends SAS 95 GAAS
106	Audit Evidence
107	Audit Risk and Materiality
108	Planning and Supervision
109	Understanding the Entity and It's Environment
110	Performing Audit Procedures in Response to Risk and Evaluating the Evidence
111	Amends SAS 39 on Auditing Sampling

Risk Assessment Stds

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Risk Assessment Procedures Overview



Risk Assessment Stds

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SAS 104

Amendment to Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures ("Due Professional Care in the Performance of Work")



SAS 104

1. Expands definition of *reasonable assurance* STEP# 7
2. Audit risk to be limited to low level
3. "...the auditor must plan and perform the audit to obtain sufficient appropriate audit evidence so that audit risk will be limited to a low level..."
4. High, but not absolute, assurance is now reasonable assurance in the opinion that statements are free of material misstatement due to error or fraud

Audit Tip: You have a POSITIVE, AFFIRMATIVE, duty to audit to a low level of risk



SAS 104 Dissent




1. Dissents to equating a "high level of assurance" with "reasonable assurance" in the opinion.....
2. No empirical evidence.....that a properly performed audit will necessarily convey a "high level of assurance"
3. Users will believe "high level of assurance" will virtually eliminate material misstatements and will forgo other efforts to protect their financial interests
4. Can't conclude that limiting risks "to a low level" will result in "high level of assurance"
5. Serious question if auditors can assess risks



SAS 105

***Amendment to Statement on
Auditing Standards No. 95,
Generally Accepted Auditing Standards***




SAS 105 Amends GAAS

STEP #8

Understanding the
New Auditing
Standards Related
to Risk Assessment,
AICPA

Key Provisions	Difference
Expands second standard of field work from understanding "internal controls" to "the entity and its environment including internal control"	<p>Understanding controls was part of planning</p> <p>Must understand client and environment to assess risk to form an opinion</p> <p>"Canned" audit programs not appropriate</p>

Risk Assessment Stds
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SAS 105 Amends GAAS

Key Provisions	Difference
Moving "internal control" from planning to "assessing the risk of material misstatement to design the nature, timing and further procedures" requires significantly increased quality and depth of understanding	<p>Understanding controls was part of planning</p> <p>Must understand client and environment to assess risk to form an opinion</p> <p>"Canned" audit programs not appropriate</p>

Risk Assessment Stds
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SAS 105 Amends GAAS

1. Expands second standard of field work from "internal control" to "the entity and its environment, including its internal control"
2. Extend from "planning the audit" to "assessing the risk of material misstatement of the financial statements whether due to error or fraud"
3. Revises third standard of field work to eliminate references to specific audit procedures
4. Replaces "evidential matter" with "audit evidence"



SAS 105 ASB Changes Voice

Standards of Field Work

1. *The auditor must* ~~The work is to be adequately planned the work and must properly supervise any assistants, if any, are to be properly supervised.~~
2. *The auditor must obtain a* ~~A sufficient understanding of the entity and its environment, including its internal control, is to be obtained to assess the risk of material misstatement of the financial statements whether due to error or fraud, plan the audit and to design determine the nature, timing, and extent of further audit procedures tests to be performed.~~
3. *The auditor must obtain* ~~Sufficient appropriate¹ audit evidence competent evidential matter is to be obtained by performing audit procedures inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.~~

Audit Tip: Why did ASB changed from passive to active voice? To leave no doubt what is REQUIRED.



SAS 105 Amends GAAS

General Standards

1. The audit **must** be performed by a person or persons having adequate technical training and proficiency as an auditor.

Audit Tip: Adequate technical training and proficiency is NOT handing someone last year's work papers and saying just follow last year's audit program



SAS 105 Amends GAAS

Field Work Standards are made unconditional requirements:

1. Planning and supervision (SAS 108)
2. Sufficient understanding of entity and environment (SAS 109)
3. Sufficient appropriate audit evidence (SAS 106)

Audit Tip: 105 is general requirement and 106, 108, 109 provide specific instructions



SAS 106

Audit Evidence

Supersedes Statement on Auditing Standards No. 31, Evidential Matter, as amended, AICPA, Professional Standards.



SAS 106 Audit Evidence

Key Provisions	Difference
Risk assessment procedures are performed on all audits but RAP by themselves are not sufficient to support the opinion	To understand client, its environment, including controls and assess risk of material misstatement, along with <i>further audit procedures</i> , provide audit evidence to support the opinion
Defines <i>relevant</i> assertions as those that are meaningful to fairly stated	New



SAS 106 Audit Evidence

Key Provisions	Difference
Defines <i>audit evidence</i> as "all the information used by the auditor in arriving at the conclusion on which the audit opinion is based."	First time defined. Includes basic definitions. <i>Sufficient appropriate audit evidence</i> replaces <i>sufficient competent evidence</i> .
Recategorizes assertions into classes of..... Transactions Account balances Presentation and disclosure	Presentation and disclosure includes new assertion that information should be 'expressed clearly'

Risk Assessment Stds

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SAS 106 Audit Evidence

Key Provisions	Difference
Guidance on uses and limitations of inquiry as an audit procedure	Inquiry alone is NOT sufficient to evaluate the design of control(s) and determine whether it has (they have) been implemented

Risk Assessment Stds

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SAS 106 Introduction

1. Defines audit evidence
2. Defines relevant assertions and use in assessing risks and designing procedures
3. How qualitative issues determine sufficiency and appropriateness of audit evidence
4. Types of audit procedures and why they are performed



SAS 106 Basic Concepts

1. Audit evidence is cumulative so team should TALK
2. Audit evidence.....
 - Replaces evidential matter
 - All the information to reach a conclusion
3. Sufficiency is quantity
4. Appropriateness is quality
5. Interrelated
 - Greater risk requires more evidence
 - Higher quality, less evidence
 - More low quality evidence isn't a substitute



SAS 106

1. Accounting records alone are NOT sufficient appropriate audit evidence
2. SHOULD obtain other audit evidence
 - Minutes of meetings
 - Confirmations from third parties
 - Industry analysts' reports
 - Benchmarking data
 - Controls manuals
 - Inquiry, observation, inspection



SAS 106 Reliability Improves

1. Reliability of evidence: source, nature, how obtained
 - Knowledgeable independent sources
 - Internal is more reliable when controls are effective
 - Rec'd directly is more reliable than indirectly
 - Documentary form more reliable
 - Paper/electronic vs. what client tells you
 - Original documentation more reliable than photocopies or facsimiles
2. If information is inconsistent, SHOULD resolve



SAS 106 Audit Evidence

1. Audit evidence supports some assertions but not others
2. Inventory observation supports existence but not rights and obligations assertion
3. Revenue
 - AR collections after YE supports existence and valuation but not cutoff

Audit Tip: Look at Purchase orders

P12 if there is no appropriate alternative, difficulty or expense is not a valid reason to omit an audit procedure

Risk Assessment Std

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SAS 106 Audit Evidence

13.....the auditor does not examine all ... available evidence the auditor may find it necessary to rely on audit evidence that is persuasive rather than conclusive; however, to obtain reasonable assurance, the auditor must not be satisfied with audit evidence that is less than persuasive. The auditor should use professional judgment and should exercise professional skepticism in evaluating the quantity and quality of audit evidence, and thus its sufficiency and appropriateness, to support the audit opinion.

Audit Tip: Don't believe it just because client TELLS YOU

Risk Assessment Std

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SAS 106 New Classification of Assertions

Classes of transactions and events	Account balances	Presentation and disclosure
Occurrence	Existence	Occurrence and rights and obligations
Completeness	Rights and obligations	Completeness
Accuracy	Completeness	Classification/ Understanding
Cutoff	Valuation/Allocation	Accuracy/Valuation
Classification		

Risk Assessment Stds

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SAS 106 Types of Procedures

1. Risk assessment procedures – understanding of the entity and the environment – unconditional requirement

Audit Tip: No longer audit just the financial records

1. Tests of controls (SAS 109, SAS 110)
2. Substantive tests (SAS 110)
 1. Tests of details
 2. Substantive analytical procedures

Risk Assessment Stds

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SAS 106 Some Audit Procedures

1. Inspection of records or documents
2. Inspection of tangible assets
3. Observation
4. Inquiry
5. Confirmation
6. Recalculation
7. Repperformance
8. Analytical Procedures



SAS 107

***Audit Risk and Materiality in
Conducting an Audit***
*(Supersedes Statement on Auditing
Standards No. 47, Audit Risk and
Materiality in Conducting an Audit)*



SAS 107 Audit Risk and Materiality

Key Provisions	Difference
Must consider audit risk and must determine materiality level	OLD: "should consider" NEW: "must consider" Explicitly states audit risk and materiality identify and assess risk of material misstatements
Inherent + control risks = risk of material misstatement	Separate assessment OK
Risk of material misstatement is basis of further procedures	Should document basis for overall audit approach

Risk Assessment Stds

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SAS 107 Audit Risk and Materiality

Key Provisions	Difference
Risk is judgment but SHOULD be documented	Effectively eliminates ability to "default" to maximum control risk
Must accumulate all known and likely misstatements, other than trivial, and communicate them	Specific guidance on when small amounts are material
SHOULD ask management to respond to known or likely misstatements	Specific guidance re: responding to known or likely misstatements

Risk Assessment Stds

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SAS 107 Audit Risk and Materiality

1. Audit Risk and Materiality are to be considered together to design the nature/timing/extent of audit procedures and evaluate the results
2. Audit risk = failure to detect material misstatement
3. Individually or in aggregate
4. Quantitative AND qualitative
5. What users EXPECT is your professional judgment
6. Users as a group

Audit Tip: Do you know what users are doing with the audited financial statements? Y N

Risk Assessment Stds

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SAS 107 Audit Risk and Materiality

Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*, defines *materiality* as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."

STEP 8

~~Audit Tip:~~ Note there is NO % OR \$\$\$

Risk Assessment Stds

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SAS 107 Audit Risk and Materiality

Users defined as.....

- a. Knowledgeable about business/economic activities, accounting, and takes time to understand
- b. Understands materiality
- c. Understands inherent uncertainties
- d. Rational decisions

Audit Tip: If users would make a different decision, then the amount/transaction/event is MATERIAL.



SAS 107 Nature/Causes of Misstatements

1. Misstatements are two types:
 - a. Known
 - b. Likely....different judgment or sample extrapolation
2. Misstatements have two sources: error or fraud
3. Errors are unintentional
4. Fraud is intentional

Audit Tip: How might you tell the difference ACTIONS



SAS 107 Nature/Causes of Misstatements

1. Inaccurate gathering or processing data
2. Amount, classification or presentation under GAAP
3. Omission of element, account or item
4. Disclosure not GAAP
5. Omission of disclosure
6. Incorrect accounting estimate from oversight, misinterpretation, unreasonableness or inappropriateness



SAS 107 Immaterial Misstatements

- 10 Although the auditor has no responsibility to plan and perform the audit to detect immaterial misstatements, there is a distinction in the auditor's response to detected misstatements depending on whether those misstatements are caused by error or fraud. When the auditor encounters evidence of potential fraud, regardless of its materiality, the auditor should consider the implications for the integrity of management or employees and the possible effect on other aspects of the audit.

~~Audit Tip:~~ By definition ANY misstatement due to fraud is material. No such thing as an immaterial illegal amount

STEP # 9



Adopt Zero Tolerance

What used to be OK isn't any longer....

Example: _____

**Immaterial,
but illegal,
tax deductions.**

Risk Assessment Stds

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SAS 107 Financial Statement Risk

1. Client size and complexity and auditor experience and knowledge
2. Should consider 'pervasive' risk Management override

Audit Tip: If you're asked to propose on a client in an industry or area you know little or nothing about, why would the company ask you to propose?

Risk Assessment Stds

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SAS 107 Aggregating and Netting Misstatements

1. Consider misstatements separately and in the aggregate
2. Effect of a material misstatement cannot be eliminated by other misstatements
3. Carefully consider offsetting precise measurements with estimates
4. Consider effect of cumulative prior period misstatements

Risk Assessment Stds

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SAS 107 Levels and Responsibility

1. Financial statement level (SAS 108 Planning/Supervision)
2. Assertion level for individual account balance, class of transactions, or disclosure level
 - High, medium or low risk
 - Materiality because of user decisions
 - Tolerable misstatement (SAS 111 Sampling)
 - Detection risk

Risk Assessment Stds

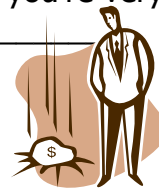
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SAS 107 Responsibility

1. Inherent risk and control risk are entity's
2. Audit risk is auditors
3. Auditor should not assume that a misstatement is an isolated occurrence

Audit Tip: When you find one misstatement, you're very likely to find more so look under the _____



Risk Assessment Stds

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Detection Risk and Audit Risk

1. Detection Risk....that a material misstatement will not be detected by the auditor
2. Audit risk = Detection risk x Risk of material misstatement
3. Detection risk cannot be ZERO

Risk Assessment Stds

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SAS 107 Qualitative Misstatements

- a. Trends, especially profitability
- b. Change loss to income or vice versa
- c. Compliance with loan agreements, contracts, regulations
- d. Statutory or regulatory reporting requirements
- e. Hides a change in earnings or other economic data
- f. Compensation...small amount could trigger a bonus
- g. Sensitivity: illegal payments, contract violations, conflicts
- h. Recurring vs. non-recurring
- i. Operating vs. non-operating

SAS 107 p60

Risk Assessment Stds

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SAS 107 Qualitative Misstatements

- j. Buy-sell agreements (+divorce....gdz)
- k. Precise amount is misstated
- l. Management motivation: pattern of bias, won't correct misstatements, intentionally not following GAAP
- m. Offsetting significant different misstatements
- n. Currently immaterial but consider future effect
- o. Has management incurred the cost to develop a system to calculate immaterial amounts
- p. Undetected misstatements would affect opinion

SAS 107 p60

Risk Assessment Stds

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SAS 107 Communication

1. Unconditional requirement to communicate all known and likely misstatements other than trivial (replaces de minimus)
2. Distinguish known from likely
3. Response by management



SAS 107 Consideration of Misstatements

1. MUST Aggregate identified uncorrected misstatements
2. Includes both known and likely
3. Uncorrected from prior periods since not then material
4. If client does not correct known and likely misstatements should consider qualitative effects and implications for the opinion

Audit Tip: If management won't correct a known misstatement of any amount, do you
want them as a client?



SAS 107 Documentation

1. Materiality and Tolerable misstatement determinations
2. Summary of uncorrected misstatements other than trivial
3. Conclusion about individual and aggregate
4. Summary of corrected misstatements other than trivial



Newspaper Materiality

A little number is material when it gets you or your company or firm on the front page of the paper.





Little Numbers That Are Material

Bank loan covenant requires minimum income	\$1,000,000
1 st pass at income	\$980,000
Reduced bad debt expense	+\$31,000
Income	\$1,011,000



Company
gets clean
opinion



Goes
bankrupt



Bank sues



Firm
'conspired'
with
borrower

STEP #10

Little numbers are material if they accomplish a **SIGNIFICANT EVENT**

Risk Assessment Stds

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SAS 108

Planning and Supervision

(Supersedes "Appointment of the Independent Auditor," as amended, of Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures, AICPA, Professional Standards; and supersedes Statement on Auditing Standards No. 22, Planning and Supervision)

Risk Assessment Stds

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SAS 108

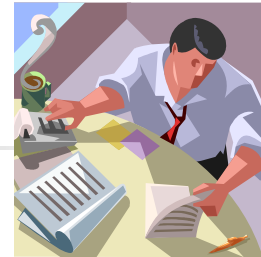
Key Provisions	Difference
Guidance on..... Appointment of the auditor Establish an understanding Preliminary activities Overall strategy Audit plan Specialized skills IT assistance First engagement issues Supervision	Guidance from existing SASs "Audit approach" replaced by overall audit strategy Broad approach re: scope, deadlines, financial reporting issues Audit plan = detailed audit program SHOULD obtain written understanding

Risk Assessment Stds

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SAS 108

The first standard of field work,
 "The auditor must adequately plan the work and must properly supervise any assistants."



Audit Tip: Proper planning and supervision is NOT

"Here's last year's work papers. Go forth and audit."

Risk Assessment Stds

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SAS 108 Planning Includes

1. Protect yourself from risky clients DON'T ACCEPT
2. Planning is not a discrete phase but starts with acceptance and continues throughout
3. Appointment, including successor/predecessor communications and acceptance
 - Early vs. last minute appointment
4. Understanding with the client

Audit Tip: Why might client appoint you auditor at last minute Pressure to meet a deadline



SAS 108 Planning Includes (cont'd)

5. Continuance of client relationship
6. Overall audit strategy
7. MUST have a written audit plan
8. Need for specialized skills
9. Communications may be held with management or those responsible for governance, but do not affect auditor responsibility to plan and perform the audit

Audit Tip: Although it's very difficult to acknowledge you need help are you willing to risk a MALPRACTICE SUIT



SAS 108 Supervision Includes

1. Audit team communication about fraud
2. Assignment of individuals
3. Review of work (SAS 103)
4. Responsibility of assistants for disagreements or concerns and documentation

Audit Tip: Do you have a formal documented process for staff to voice their concerns and resolve professional differences



SAS 109

***Understanding the Entity
and Its Environment and
Assessing the Risks of
Material Misstatement***



SAS 109 Entity and Environment

Key Provisions	Difference
Purpose of understanding entity and its environment is to assess risk of material misstatement	Directly links understanding to audit evidence to assess risk
Describes procedures to understand the entity and its environment, including controls	SHOULD perform RAP (Risk Assessment Procedures) Old standards did not describe Directs performing RAP and limitations
Team required to 'brainstorm' susceptibility to material misstatement	Old standard did not require Combine with SAS 99

Risk Assessment Stds

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SAS 109 Entity and Environment

Key Provisions	Difference
Should assess risk at both financial statement level and assertion level	Expanded and explicit guidance Determine how risk at statement level may cause risk at assertion level
Requires evaluation of design of controls and if client has implemented	OLD: understand to plan the audit NEW: Requires determination if controls will prevent or detect and correct material misstatements to support the opinion MORE WORK

Risk Assessment Stds

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SAS 109 Entity and Environment

Key Provisions	Difference
Special consideration for significant risks where substantive procedures do not provide sufficient appropriate audit evidence	Old: significant risk not included Most engagements Perform substantive procedures for all identified significant risks Analytic procedures not enough



SAS 109 Overview

1. "Can't audit what you don't understand"
2. Financial statements are the result of operations
3. Requires linkage between material risk and client operating environment
4. Requires understanding beyond acct/financial issues
5. Requires understanding the risk of industry, regulatory, legal, political and environmental issues
6. If significant risk exist, required to evaluate the design of control system, implemented and effectively operating

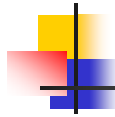


SAS 109 Understanding Controls

Audit Tip: Understanding controls is NOT having the controller the complete the checklist.

Audit Tip: If you can't complete the checklist then you don't understand the controls and you are violating GAAS

Audit Tip: No matter how strong controls are, management can ALWAYS override them.



SAS 109 Entity and Environment

1. "Per Joyce, controls are strong" is no longer acceptable
2. No longer default to MAXIMUM risk and perform only substantive procedures
3. Can you still do a purely substantive audit Y N
4. If risk is high must explain/document WHY



SAS 109

1. Additional information understanding of the entity and its environment (SAS 105 unconditional requirement) and assessing the risk of material misstatement
2. Additional information about assessing the risk of material misstatement (SAS 107)
3. Much of this SAS repeats information from the COSO document which has been previously in SAS 55



SAS 109 Risk Assessment Procedures

1. Unconditional requirement (SAS 106)
2. Types (presumptively mandatory in carrying out SAS 106):
 1. Inquiries of management and others
 2. Analytical procedures (SAS 56)
 3. Observation and inspection
 4. Fraud risk factors (SAS 99)
 5. Provides additional information about the discussion of the audit team



SAS 109 Understanding Includes

1. Industry, regulatory and other factors
2. Nature of the entity – operations, ownership, governance, legal form
3. Objectives and strategies and business risks
4. Financial performance
5. Internal control, including accounting policies



SAS 109 Internal Control Understanding

1. Requires documentation of understanding of all five elements of internal control
 1. Control environment
 2. Risk assessment by entity
 3. Information and communication systems
 4. Control activities
 5. Monitoring
2. Requires documentation of the entity's selection and application of accounting policies



SAS 109 Internal Controls

1. Design
2. Implementation (replaces “placed in operation”) – may be less formal in smaller organizations
3. Operation – not part of understanding (SAS 110)
4. Understanding not sufficient for testing control effectiveness

Audit Tip: Even if you ‘understand’ controls it does NOT mean they are actually OPERATING



SAS 109 Documentation

1. Specifics for the documentation of the audit team fraud risk meeting (SAS 99, SAS 108)
2. Key elements of each of the aspects of entity and its environment
3. Risks identified and related controls
4. Assessments of the risk at the financial statement and assertion level (SAS 107)



SAS 109 Summary of Procedures

Objective	Guidance
Understand the entity, environment and controls should perform these RAP (Risk Assessment Procedures)	Inquire of management / others Analytic procedures Observation and inspection
May consider other internal inquiries for material risks	Those charged with governance Internal audit Complex or unusual transactions In-house counsel Operations

SAS 109

Risk Assessment Stds

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SAS 109 Summary of Procedures

Objective	Guidance
May consider external inquiries for material risks	Outside counsel Valuation specialists Analysts, banks, rating agencies Industry and regulatory journals
Auditor normally includes these procedures	Observe activities and operations Inspect docs, records, manuals Read reports Visit premises and facilities Transaction 'walk-throughs'

SAS 109

Risk Assessment Stds

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SAS 109 Understanding the Entity and Environment

Objective	Guidance
Understand industry conditions, regulatory environment, external factors, may consider	<ul style="list-style-type: none"> Competition/economic factors Supplier and customer Technology Legal and political factors Environmental requirements
Understand nature of client may consider	<ul style="list-style-type: none"> Operations Ownership Governance Investments Capital sources

SAS 109 Appendix A
Risk Assessment Stds

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SAS 109 Understanding the Entity and Environment

Objective	Guidance
Client objectives and strategies and business risks	<ul style="list-style-type: none"> Economic conditions Interest rates and financing sources Inflation and currency valuations
Understand client measurements may consider	<ul style="list-style-type: none"> Key ratios and operating statistics Key performance indicators Client and industry trends Forecasts, budgets, variance analysis Competitor analysis Analyst and credit ratings reports Period-on-period analysis

SAS 109 Appendix A
Risk Assessment Stds

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SAS 109 Understanding Controls

Objective	Guidance
To understand controls, SHOULD consider these	Integrity and ethics Commitment to competence Management philosophy and style Org structure, authority, responsibility HR policies and practices
To understand risk-assessment process, SHOULD consider	Changes in operating environment New or changed personnel, IT, rapid growth, business model, products Disruptive technology Foreign competition/operations

SAS 109 Appendix B
Risk Assessment Stds

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SAS 109 Understanding Controls

Objective	Guidance
To understand information and communication systems relevant to financial reporting SHOULD consider	Identify / record all valid transactions Timely and sufficient detail for proper classification Proper measurement of transactions Proper accounting period Proper presentation and disclosure Communicate roles and responsibilities

SAS 109 Appendix B
Risk Assessment Stds

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SAS 109 Understanding Controls

Objective	Guidance
To understand controls for the audit SHOULD consider	Performance reviews Information processing Physical controls Segregation of duties
To understand client's monitoring of controls SHOULD consider	Management review of reconciliations Internal audit's compliance reviews Legal dept oversight Monitoring design of controls and taking corrective action

SAS 109 Appendix B
Risk Assessment Stds

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SAS 54

Illegal Acts by Clients



Risk Assessment Stds

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SAS 54 Definitions



1. Violations of laws or governmental regulations
2. Two types for audits
 - Direct and material effect on financial statements
 - Other illegal acts that are indirect/operational
3. By the entity/management/employees for the entity
4. Does NOT include personal misconduct unrelated to their business activities



If someone will cheat on his/her spouse, what makes you think they won't COOK THE BOOKS



SAS 54 Judgment and AFS



1. Normally beyond auditor's expertise but may recognize acts that may be illegal but ask an expert
2. More remote act is from AFS less likely auditor will become aware or recognize
3. Act's legality relative to the audit, not legality *per se*
4. OTHER illegal acts that have indirect effect: securities, OSHA, FDA, EPA, EEOC, price-fixing, antitrust
5. Indirect effect usually disclose contingent liability
6. Usually unaware unless informed or see evidence



SAS 54 OTHER Illegal Acts



1. SHOULD be aware of the possibility that such illegal acts may have occurred
2. Auditor is responsible when
 - Aware of specific information
 - Material indirect effect
 - SHOULD determine if illegal act has occurred
3. GAAS audit provides no assurance other illegal acts will be detected or contingent liability disclosed

SAS 54 .07

Risk Assessment Stds

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SAS 54 AFS Effect



1. Illegal act has or is likely to have occurred
2. SHOULD consider quantitative and **qualitative** effect
3. "an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or material loss of revenue" SAS 47
4. SHOULD consider effect on amounts in AFS
5. SHOULD evaluate adequacy of disclosure
 - Material revenue or relationship from illegal acts

SAS 54 .13 - .15

Risk Assessment Stds

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SAS 54 Effect on Opinion



1. Material and not properly accounted for or disclosed SHOULD issue qualified or adverse
2. If client prevents obtaining sufficient competent evidence SHOULD issue disclaimer
3. If client refuses to accept the opinion, auditor SHOULD withdraw



What are some of the pressures that make the above responses difficult _____?

Getting paid, friends, long-time client

SAS 54 .18 - .21

Risk Assessment Stds

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SAS 110

*Performing Audit Procedures in
Response to Assessed Risks and
Evaluating the Audit Evidence Obtained*

Risk Assessment Stds

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SAS 110 Performing Procedures

Key Provisions	Difference
Guidance on overall responses to risk of material misstatement at financial statement level and nature of the responses	Previous standards had responses in audit planning 110 'repositions' risk consideration to make assessment as a result of and in conjunction with risk assessment procedures Requires consideration of how risk at statement level affects individual assertions to design and perform further audit procedures

Risk Assessment Stds

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SAS 110 Performing Procedures

Key Provisions	Difference
Further audit procedures include tests of controls or substantive tests, SHOULD respond to risk of material misstatement	Previous standard embedded responsive procedures in audit risk Requires clear linkage from understanding the entity to risk assessment to further audit procedures Required to document linkage

Risk Assessment Stds

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SAS 110 Performing Procedures

Key Provisions	Difference
Guidance to determine nature, timing, and extent of audit procedures	Addresses issues not previously in standards States further audit procedures is most important in responding to risk of material misstatement Increased audit procedures will not compensate if they do not specifically address risk

Risk Assessment Stds

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SAS 110 Performing Procedures

Key Provisions	Difference
Continued	Perform substantive procedures on all audits <ul style="list-style-type: none">■ Each material class of transactions, account balances and disclosure regardless of risk of material misstatement■ Agree statements and notes to accounting records■ Examine material journal entries and other adjustments

Risk Assessment Stds

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SAS 110 Performing Procedures

[SAS 110] provides guidance about implementing the third standard of field work, as follows: The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.



SAS 110 Overview

1. Overall responses
2. Audit procedures responsive to risk of material misstatement at the relevant assertion level
3. Evaluating the sufficiency and appropriateness of the audit evidence
4. Documentation



SAS 110 Overall Responses to Risk

1. Professional skepticism in gathering and evaluating
2. More experienced staff
3. Specialized skills or specialists
4. Supervision
5. Unpredictability
6. Change nature, timing or extent of further audit procedures



SAS 110 Responses at Assertion Level

1. Design and perform further audit procedures to provide a clear linkage between risk of material misstatement and nature, timing and extent of audit procedures
2. May perform only substantive tests if no effective controls for specific assertions but must be satisfied will reduce detection risk to low level
3. "The auditor often will determine that a combined audit approach using both tests of the operating effectiveness of controls and substantive procedures is an effective audit approach."



SAS 110 Procedures at Assertion Level

1. Even effective controls do not eliminate material risks
2. Tests of controls reduce but do not eliminate need for substantive tests
3. Analytical procedures usually not enough
4. Management override and subjectivity
5. Allowance for doubtful accounts / HealthSouth
6. Very small clients not many controls so further audit procedures primarily substantive and auditor SHOULD consider if possible to obtain sufficient appropriate
audit evidence

Risk Assessment Stds

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SAS 110 Nature of Further Audit Procedures

1. Purpose (test controls or substantive) and type including inspection, observation, inquiry, confirmation, analytical procedures
2. Audit procedure based on risk of material misstatement
3. Example.....contracts
 - Inspect
 - Confirm with independent 3rd party
 - Management representation
4. Use of nonfinancial or budget data

Risk Assessment Stds

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SAS 110 Timing of Further Audit Procedures

1. Higher risk perform at or near end of period
2. If in doubt whether controls are effective consider performing before period end to identify significant issues so can be resolved
3. What procedures are necessary to "roll forward"?
4. Audit procedures only at or near period end
 - Agree statements to accounting records
 - Improper sales contracts or transactions not final
 - Individually material transactions or cutoff error

Risk Assessment Stds

137



SAS 110 Extent of Further Audit Procedures

1. Quantity of audit procedures
 - Examples Sample sizes or inventory counts
2. Audit procedure effective ONLY IF
 - Relevant to the risk and is Reliable
 - Example: sampling....size, selection, exceptions

Audit Tip: No longer acceptable to 'comply' with GAAS by simply meeting the WEIGH-IN TEST

Risk Assessment Stds

138



SAS 110 Tests of Controls Overview

1. Test controls when relying to reduce risk or substantive tests not enough (many transactions over time period)
2. SAS 109, ¶117, *Understanding the Entity and Its Environment*...if substantive tests don't reduce detection risk to a low level, then perform tests of controls
3. Testing effectiveness ≠ implemented
4. Example AR billing controls look good on paper but what's the error rate
5. Variance analysis to prevent/detect material misstatements

Risk Assessment Stds

139



SAS 110 Nature of Tests of Controls

1. Inquiry alone not enough to obtain sufficient appropriate audit evidence
2. SHOULD perform other audit procedures
3. One person opens mail/process cash receipts, inquiry, observation
4. Recommend lock box but bookkeeper/office manager might have BRE envelopes printed with his/her address
5. AR....does owner/manager review/approve write-offs

Risk Assessment Stds

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SAS 110 Nature of Tests of Controls

34. The absence of misstatements detected by a substantive procedure does not provide audit evidence that controls related to the relevant assertion being tested are effective; however, ... A material misstatement detected by the auditor's procedures that was not identified by the entity SHOULD be regarded as at least a significant deficiency and a strong indicator that a material weakness in internal control exists and SHOULD be communicated to management and those charged with governance.

Audit Tip: Don't get lulled into a false sense of security

Risk Assessment Stds

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SAS 110 Timing of Tests of Controls

1. Test for all periods you intend to rely on
2. If test at an interim period what has changed
 - Personnel or processes
 - Is there a log of IT program changes
 - Ex. Can bookkeeper/controller turn off audit trail
3. Relying on prior period controls
 - Must test at least once every 3 years
 - NOT every control in Year 1, then Skip 2 years
4. MUST test every year if the control mitigates a significant risk

Risk Assessment Stds

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SAS 110 Extent of Tests of Controls

SHOULD design sufficient tests of controls to obtain sufficient appropriate audit evidence that the controls are operating effectively throughout the period of reliance

1. Frequency
2. Length of time of reliance
3. Evidence the control prevents, or detects and corrects, material misstatements
4. Reliance to reduce substantive procedures
5. Expected deviation

Risk Assessment Stds

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SAS 110 Extent of Tests of Controls

1. High volume controls (match POs to invoices) sampling
2. Low volume/high risk periodic controls (reconcile subsidiary ledgers to general ledger) might audit two months then review other months that control operated looking for unusual items
3. IT processing is inherently consistent but
 - Is there a record of program changes
 - Look for unusual programs

Audit Tip: MiniScribe inventory fraud tracked by computer program named COOKBOOK

Risk Assessment Stds

144

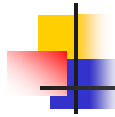


SAS 110 Substantive Procedures Overview

- 50 Auditor **SHOULD** plan and perform substantive procedures to be responsive to the risk of material misstatement.
- 51 Regardless of the assessed risk of material misstatement, the auditor **SHOULD** design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. This reflects the fact that the auditor's assessment of risk is judgmental and may not be sufficiently precise to identify all risks of material misstatement. Further, there are inherent limitations to internal control, including management override, and even effective internal controls generally reduce, but do not eliminate, the risk of material misstatement.

Risk Assessment Stds

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SAS 110 Substantive Procedures Overview

- 52 The auditor's substantive procedures **SHOULD** include the following audit procedures related to the financial statement reporting process:
 - Agreeing the financial statements, including their accompanying notes, to the underlying accounting records; and
 - Examining material journal entries and other adjustments made during the course of preparing the financial statements.

Audit Tip: Where did these come from



Risk Assessment Stds

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SAS 110 Substantive Procedures Overview

- 53 If identify a significant risk of material misstatement SHOULD perform specific procedure to respond
- Earnings expectations look for inflating revenue
 - Invoicing before shipment
 - Confirm details with customer including
 - Dates, rights of return, nonfinancial personnel

Audit Tip: Why talk to nonfinancial personnel.....BECAUSE the financial folks KNOW WHAT YOU WANT TO HEAR

Risk Assessment Stds

147

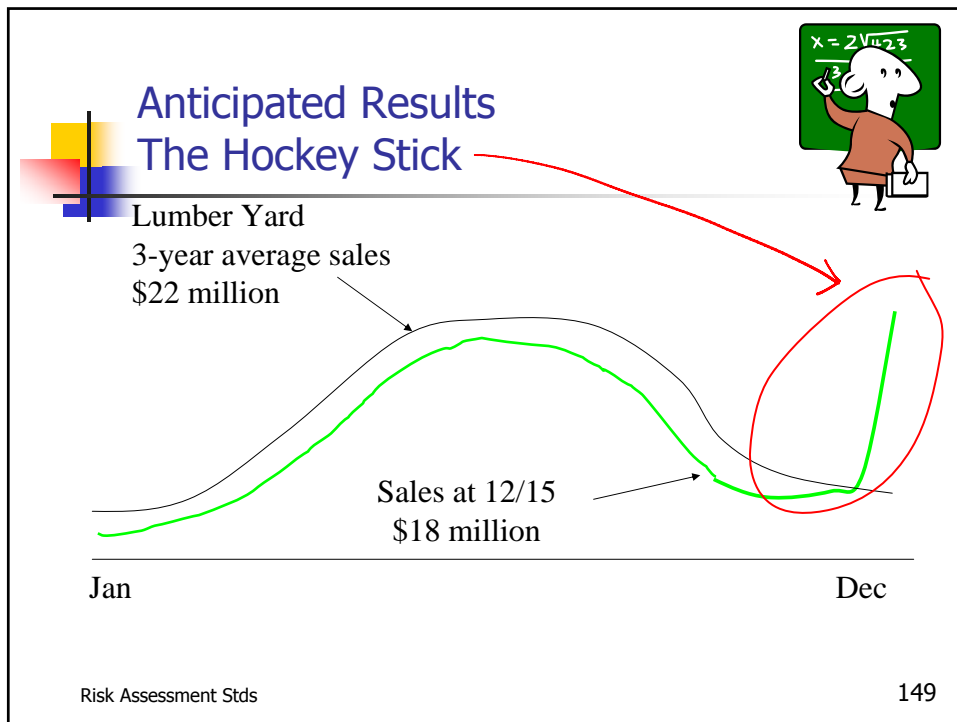


SAS 110 Nature of Substantive Procedures

1. Includes tests of details and analytic procedures
2. Analytic procedures for large transaction volumes
 - Hockey stick
3. Tests of details for account balances, their existence and valuation
4. To test existence or occurrence select from statement amounts and obtain audit evidence eg accounts receivable
5. To test completeness select items that SHOULD be in the financial statements eg accounts payable

Risk Assessment Stds

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- ## SAS 110 Nature of Substantive Procedures
1. Should consider testing controls over the preparation of the information used in analytic procedures
 2. Should consider the risk of management override allowing adjustments to the statements outside system
- Audit Tip: These 'adjustments' are usually to make everything look NORMAL.
- Risk Assessment Stds 150



SAS 110 Timing of Substantive Procedures

1. If substantive procedures are performed at interim date, then must update with further substantive procedures
2. Compare interim balances/results with period end
3. If identify risk of material misstatement due to fraud consider changing timing ie, don't rely on Interim work
4. If detect misstatements in interim, SHOULD consider modifying risk assessment

Audit Tip: If detect INTENTIONAL misstatements in interim, or period end, that involves management consider withdrawing.

Risk Assessment Stds

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SAS 110 Nature of Substantive Procedures

- 64 The use of audit evidence from ... substantive procedures in a prior audit is not sufficient to reduce detection risk to an acceptably low level in the current period. In most cases, [it] evidence provides little or no audit evidence for the current period. [T]he audit evidence and the related subject matter must not fundamentally change.

Example: Cost of a long-lived asset

Risk Assessment Stds

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SAS 110 Final Conclusion

1. Evaluate whether the audit evidence provides sufficient appropriate evidence to maintain low risk of material misstatement from planning
2. ANY finding of fraud SHOULD impact risk assessment and requires specific consideration of need for additional procedures



SAS 110 Documentation

1. Overall response to risk assessment at the financial statement level
2. Nature, timing and extent of ADDITIONAL audit procedures (audit plan includes the other procedures)
3. Linkage of additional procedures to relevant assertion level
4. Results of audit procedures (this repeats the requirement of SAS 103)
5. The conclusions in the audit about the use of operating effectiveness of controls from prior audits



SAS 111

Amendment to Statement on Auditing Standards No. 39 Audit Sampling

Risk Assessment Stds

155



SAS 111 Audit Sampling

Key Provisions	Difference
Guidance on judgment establishing tolerable misstatement for specific audit procedures and application of sampling to test controls	Tolerable misstatement should be less than materiality to allow for <u>aggregation in final assessment</u>

Risk Assessment Stds

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SAS 111 Audit Sampling

1. Amends SAS 39 substantively by:
2. Referring to aggregation of amounts of tolerable misstatement to materiality at the financial statement level
3. Referring to statistical sampling (but with a footnote)
4. Sampling techniques may not apply for some tests of controls
5. See Table 1 for sample sizes



SAS 111 Audit Sampling

1. Allows for dual purpose tests more explicitly – tests of operating effectiveness and tests of details
 2. Incorporates more guidance from the Appendix into the standard
- P24** Missing documents
- If no effect on evaluation of the sample not necessary to examine
 - If considering the missing items to be misstated would cause account or class to be materially misstated then alternate audit procedures, including consideration of FRAUD



Understanding the Client



1. What business is Xerox in _____ **COPIER BUSINESS**
2. 1970 The COPIER Company is _____ **INTERNAL**
3. 1995 The DOCUMENT Company is _____ **EXTERNAL**
4. Early 2000s Xerox nearly went bankrupt **Internet**
5. WHY _____ which is a **Disruptive Technology**
6. What business is Xerox in _____ **INFORMATION DISTRIBUTION**

Auditing Tip: Simply adding up the numbers does NOT mean you **UNDERSTAND** the business.

Risk Assessment Std

159



Do You Understand Your Client's Business?



1. Do you know what business your client is in?
Yes No
2. What business is your favorite client in _____?
3. What are the 3 major reasons your client's customers do business with your client instead of a competitor?
 1. _____
 2. _____
 3. _____

Attendee fills these in.

Risk Assessment Std

160



Gross Margin



1. Mark Morze, CFO, ZZZZ Best Carpet Cleaning
2. Pepperdine University
3. Toastmaster Speaking Champion
4. Fraud: Ex-Con Tells All Part II
5. 10,000 phony documents
6. \$50 million revenue, 86% was **fake**
7. "If you were my auditor, **what's wrong with this???**"
8. Reported 50 to 60% gross margins, but the industry average was **8½%**.

Risk Assessment Stds

161



Understanding Client and Environment



Capitol Bank Bldg

Risk Assessment Stds

ZZZ BEST CARPET AND FURNITURE CLEANING COMPANY
1811 CAMINO DEL RIO - SOUTH, SUITE 104, SAN DIEGO, CA 92108 - (619) 822-1901
7040 DARBY AVE., SUITE 208, REDDING, CA 96001 - (530) 244-7815
8218 THOUSAND OAKS BLVD., THOUSAND OAKS, CA 91320 - (805) 495-0652
7008 SOUTH FULD RD., SUITE 104, ANAHEIM, CA 92801 - (714) 491-2677
8480 CALLE REAL, GOLETA, CA 93117 - (805) 682-4140

WORK ORDER CONTROL
CHECKS PAYABLE TO
ZZZZ BEST OR
BARRY MARSHOW

CUSTOMER'S NAME Interstate Appraisal Services
ADDRESS 3430 Van Nuys Blvd., Suite #308
CITY & ZIP Van Nuys, Ca 91401
ATTENTION: Tom Paggett

Age of Carpet: 3+ / 2+ / 3+
Age of Upholstery: 3+
Carpet D. Check D. MC D. BA D. 4-8
Cleaner's Name: B/H

NO- 18886

ITEM	THE FOLLOWING ARTICLES ARE TO BE CLEANED SUBJECT TO THE PRICES STATED HEREON AND THE CONDITIONS STATED BELOW	PRICE PER	ESTIMATE	AMOUNT
1	CARPET CLEANING			
2	REPAIRS			
3	FURNITURE MOVING (emergency)	62,425.00		62,425.00
4	FURNITURE CLEANING AND REPAIR (all)	563,750.00		563,750.00
5	PRE-CONDITIONING			
6	STORE ALL FURNITURE DURING REMODELING	147,175.00		147,175.00
7	REMOVE NEW UNDERLAYMENT (pub floor) & PLANK	1,022,078.34		1,022,078.34
8	FLOORING INCLUDES CARPET/VINYL/TILE/LINOLEUM	1,819,579.70		1,819,579.70
9	PAINTING			
10	CEILING TILES AND TILES	933,828.00		933,828.00
11	SHAMPOO			
12	CRACK MOLDINGS/BASEBOARDS, FLOOR CASTING	1,031,043.75		1,031,043.75
13	SUPERVISION/MANAGEMENT RENTAL OF SPECIAL EQUIPMENT	1,145,250.00		1,145,250.00
	SUB TOTAL			6,716,128.64
	SALES TAX			301,122.22
	ADJUSTMENTS			
	TOTAL			7,017,250.86

OTHER FLOORS MAY BE SLIPPERY WHEN WET. 375,000 cash on spot

TERMS: 30% DOWN, 70% ON DELIVERY

CONDITIONS: ZZZZ BEST agrees to perform the service indicated in a clean and workmanlike manner, using the best materials and equipment available. The customer agrees that ZZZZ BEST shall not be liable for the return to the customer of any items or materials that are damaged or lost during the cleaning process. The customer agrees to pay for any damage to the property of the customer that is caused by the cleaning process. The customer agrees to pay for any damage to the property of the customer that is caused by the cleaning process. The customer agrees to pay for any damage to the property of the customer that is caused by the cleaning process.

ZZZZ BEST WILL NOT BE RESPONSIBLE FOR ANY INJURY OR DAMAGE THAT MAY OCCUR FROM FLOORS THAT MAY BE LEFT DAMP OR WET.

DATE: 4-13-86
CUSTOMER'S SIGNATURE: [Signature]

TO OUR CUSTOMER: Servicemen are required to have work slips signed. This is done to protect you, the Servicemen and ourselves and to assure you a good and satisfactory service. You are respectfully requested to examine this contract before the servicemen leave the house, and if you find everything satisfactory, okay this ticket. If service is unsatisfactory, in any way, please phone our office immediately.

ESTIMATED COMPLETION: AUGUST 29th 1986
CUSTOMER'S SIGNATURE: [Signature]



Gross Margin



1. Fraud 5+ years
2. Sole practitioner, local firm, Big-8
3. E&W WHY _____ **knew the least about the industry**
4. E&W would be _____ **the easiest to fool** _____
5. Failure to understand cost E&W **\$3 million**



Next time you are asked to propose on a client that you know little or nothing about the industry, ask

_____ **WHY are they asking us?** _____




False Sign-Off Survey Results




Signing off on work when in fact _____ **it wasn't done** _____

Sample slice	%
% of CPAs who observed False Sign-off	25
Auditing experience last 10 years	27
Auditors with some Big 4 experience	26
Auditors with only Big 4 experience	25
Auditors with only Big 4 in last 10 years	28




False Sign-Off Survey Results




Sample slice	%
What % do you THINK commit false sign off	26
If HAVE detected false sign-off	17
If HAVE NOT detected false sign-off	32
What happened to the person	
Personally spoke to person	58
Person was terminated	9

Risk Assessment Std's

165



False Sign-Off



1. WHY COMMIT Come in under budget
2. WHAT TO SIGN OFF Something not expected to change
3. PAY AND PROMOTION Keep client and boss happy
4. WHY NOT DETECTED Assume the work was done
5. WHY TRUST
6. HOW TO MINIMIZE Audit the auditors

Audit Tip: What are you doing to **NOT** hire staff that
cheat and put you and your firm at risk?

Risk Assessment Std's

166



What Auditors Do Wrong

1. Telling the client what you're going to do
2. Letting client prepare workpapers
3. Do same thing every year
4. False sign-off of audit work by staff
5. Don't rewrite audit programs
6. Staff ask the client how to perform audit steps
7. Trust client too much
8. Don't understand the client's business
9. Accept deducting personal expenses

Risk Assessment Stds

167



What Auditors Do Wrong

10. Don't "listen" for red flags
11. Don't read industry trade publications
12. Haven't talked to client about fraud
13. Don't graph information
14. Audit only what's there
15. No leading or predictive indicators
16. Think Accuracy = Truth
17. Never get actual bank deposit items

Risk Assessment Stds

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Remember



Getting an audit is a
PRIVLEDGE,
not a **RIGHT.**



Attached Documents

1. Parmalot confirmation
2. Capitol Bank contract
3. SAS 110 Appendix: Illustrative Financial Statement Assertions and Examples of Substantive Procedures Illustrations for Inventories of a Manufacturing Company

DEC 17 2003 16:01 FR BANK OF AMERICA
17 DEC 2003 11:30

2019743939 TO 916467334972
NR.281

P.21.1

Bank of America

New York Branch



Grant Thornton Spa
Largo Augusto, 7
20122 MILANO, ITALY

March 6, 2003

Re: Bonlat Financing Corporation
BANY Account No.:
BANY Securities Deposits No.:

6550-2-52252
6550-2-85419

Dear Sir/Madam

We have received your request for audit purposes dated December 20, 2002. We confine our response to certain information concerning account balances and securities deposits from our records at this office.

1. As of the close of business on December 31, 2002, our records indicate the following deposit balance(s):

Account Type	Account Name	Account Number	Account Balance
Demand Deposit	Bonlat Financing Corporation	6550-2-52252	USD \$336,812,328.64 CR
AutoInvest Account	Bonlat Financing Corporation	N/A	N/A L-5

2. As of the close of business on December 31, 2002, our records indicate the following Securities Deposit balance(s):

Account Type	Account Name	Account Number	Account Balance
Securities Deposit	Bonlat Financing Corporation	6550-2-85419	EUR €2,811,000,000.00 G
Securities Deposit	Bonlat Financing Corporation	6550-2-85419	USD \$849,000,000.00 7-16

3. As of the close of business on December 31, 2002, our records indicate the following Letter of Credit balance.

Trade Finance	Customer Name	Reference Number	Outstanding
	N/A	N/A	N/A

This information is for your CONFIDENTIAL use and is furnished in reply to your inquiry. No responsibility is assumed by Bank of America or its officers as to the accuracy or completeness of this information. No representation is made as to any other relationship the subject may have with other Bank of America offices.

Sincerely,

Agnes Belgrave

Bank of America
100 Wall Street, New York, NY 10001

* TOTAL PAGE 01

BEST

CARPET AND FURNITURE CLEANING COMPANY

1551 CAMINO DEL RIO - SOUTH, SUITE 104, SAN DIEGO, CA 92108 • (619) 892-1991
 7040 DARBY AVE., SUITE 208, RESEDA, CA 91335 • (818) 344-7615
 2219 THOUSAND OAKS BLVD., THOUSAND OAKS, CA 91360 • (805) 495-6652
 7208 SOUTH EUCLID, SUITE 109, ANAHEIM, CA 92801 • (714) 491-2577
 6483 CALLE REAL, GOLETA, CA 93117 • (805) 683-4140

for Minkow
Steve
Quaranta
Ch

No 18886

WORK ORDER CONTR.

CHECKS PAYABLE TO
 Z Z Z BEST OR
 BARRY MINKOW

CUSTOMER'S NAME

Interstate Appraisal Services

ADDRESS

5430 Van Nuys Blvd. Suite #308

CITY & ZIP

Van Nuys, Ca 91401

Bus: 785-9021

Res:

Age of Carpet 3+/3+/2+/3+

Age of Upholstery 3+

Date 4-8

Cash ☐ Check ☐ MC ☐ BA ☐

Cleaner's Name B/M

Attention: Tom Padgett

RE- Sacramento, Ca.

QUANTITY	THE FOLLOWING ARTICLES ARE TO BE CLEANED SUBJECT TO THE PRICES STATED HEREON AND THE CONDITIONS STATED BELOW	PRICE PER	ESTIMATE	AMOUNT
	CARPET CLEANING WATER DAMAGE / FLOOD DAMAGE			
1	REPAIRS FURNITURE MOVING (emergency)	62,425.00		62,425.00
2	UPHOLSTERY FURNITURE CLEANING AND REPAIR (all)	563,750.00		563,750.00
3	PRE-CONDITIONING STORE ALL FURNITURE DURING REMODELING	147,175.00		147,175.00
4	DUPONT TEFLON NEW UNDERLAYMENT (sub floor) & PLANK	1,023,078.15		1,023,078.15
5	MISC FLOORING INCLUDES CARPET/VINYL/TILE/LINOLEUM	1,819,579.70		1,819,579.70
6	SANITIZER PADDING ALSO INCLUDED CEILING TILES AND (1111) PLUS SPRAYING	933,828.00		933,828.00
7	SHAMPOO CROWN MOLDINGS/BASEROARDS, FLOOR CASING	1,021,042.75		1,021,042.75
	SUPERVISION/MANAGEMENT RENTAL OF SPECIAL EQUIPMENT	1,145,250.00		1,145,250.00
	SUB TOTAL			6,716,128.60
	SALES TAX			301,122.50
	ADJUSTMENTS			
	TOTAL			7,017,251.10

TICE: GUARANTEE DOES NOT
 PLY—PAYMENT DUE EVEN IF FAB-
 : DOES NOT CLEAN. THE CUS-
 MER HAS BEEN INFORMED
 CAUSE OF EXTREMELY POOR
 NDITION OF FABRIC THAT IT
 OABLY WILL NOT CLEAN AND
 REES NONETHELESS TO PAYING
 OVE COSTS FOR Z Z Z BEST
 ING ITS BEST TO TRY AND CLEAN
 E FABRIC.

IL
 1

TICE Z Z Z BEST WILL NOT BE
 D RESPONSIBLE FOR ANY IN-
 IES OR DAMAGE THAT MAY
 UR FROM FLOORS THAT MAY
 LEFT DAMP OR WET.

CONDITIONS Z Z Z BEST agrees to perform the service indicated in a proper and workmanlike manner, using equipment
 detergents standard for the cleaning industry. The customer agrees that Z Z Z BEST shall not be liable for the failure to REM-
 STAINS nor for any DISCOLORATION from non water fast dyes or backing threads, nor for any CHANGE IN COLOR of the fa-
 regardless of the cause nor CHANGES IN TEXTURE OR SHADING that may appear either before or after cleaning, nor for
 SHRINKAGE, opening of pested seams, or FACING OF FABRICS which may appear in the process of cleaning. FRAYING of fabri-
 areas of normal wear will not be a responsibility of Z Z Z BEST. All fabrics cleaned only at customer's risk. Z Z Z BEST will ac-
 liability for conditions existing prior to cleaning. Nor will Z Z Z BEST be responsible for any damage to fabrics cleaned.

Upon inspecting the articles to be cleaned, the store's representative pointed out to me the following

BECAUSE BUILDING WAS UNDER-WATER THERE IS SEVERE PLUMBING AND

SEWAGE BACK-UP THROUGHOUT, ELEVEN STORIES WERE COMPLETELY

DAMAGED. COMPLETE GERMICIDAL AND ANTI-BACTERIAL RINSE

THROUGHOUT. NEW CARPET/FLOORING INSTALLED WHERE NEEDED.

I have been advised that the above visible conditions cannot be corrected by cleaning and I have given my permission to clean
 furniture and/or carpeting having full knowledge of the visible conditions of my furniture and/or carpeting prior to cleaning.
 The signature of the customer constitutes acknowledgment of the contract and the acceptance of the conditions stated above.

4-13 1986
 DATE

CUSTOMER'S SIGNATURE

Our Customers. Servicemen are required to have work slips signed, this is done to protect you, the Servicemen and ourselves and to enable us
 to give you absolute satisfactory service. You are respectfully requested to examine this contract before the servicemen leave the house, and if you
 find everything satisfactory, okay this ticket. If service is unsatisfactory, in any way, please phone our office immediately.

The Above work has been satisfactorily completed

ESTIMATED COMPLETION AUGUST 29th 1986

CUSTOMER'S SIGNATURE

We wish to thank you for your valued patronage and trust we may have the pleasure of serving you in the future should the need arise

Appendix

Illustrative Financial Statement Assertions and Examples of Substantive Procedures Illustrations for Inventories of a Manufacturing Company

A1. This appendix illustrates the use of assertions in designing substantive procedures and does not illustrate tests of controls. The following examples of substantive procedures are not intended to be all-inclusive, nor is it expected that all of the procedures would be applied in an audit. The particular substantive procedures to be used in each circumstance depend on the auditor's risk assessments and tests of controls.

1692**Risk Assessment Standards: SAS No. 104–SAS No. 111*****Illustrative Assertions About Account Balances******Examples of Substantive Procedures*****Existence**

Inventories included in the balance sheet physically exist.

Inventories represent items held for sale or use in the normal course of business.

- Physical examination of inventory items.
- Obtaining confirmation of inventories at locations outside the entity.
- Inspection of documents relating to inventory transactions between a physical inventory date and the balance sheet date.
- Inspecting perpetual inventory records, production records, and purchasing records for indications of current activity.
- Reconciling items in the inventory listing to a current computer-maintained sales catalog and subsequent sales and delivery reports using computer-assisted audit techniques (CAATs).
- Inquiry of production and sales personnel.
- Using the work of specialists to corroborate the nature of specialized products.

Rights and Obligations

The entity has legal title or similar rights of ownership to the inventories.

Inventories exclude items billed to customers or owned by others.

- Examining paid vendors' invoices, consignment agreements, and contracts.
- Obtaining confirmation of inventories at locations outside the entity.
- Examining paid vendors' invoices, consignment agreements, and contracts.
- Inspecting shipping and receiving transactions near year end for recording in the proper period.

Completeness

Inventory quantities include all products, materials, and supplies on hand.

Inventory quantities include all products, materials, and supplies owned by the company that are in transit or stored at outside locations.

- Observing physical inventory counts.
- Analytically comparing the relationship of inventory balances to recent purchasing, production, and sales activities.
- Inspecting shipping and receiving transactions near year end for recording in the proper period.
- Obtaining confirmation of inventories at locations outside the entity.
- Analytically comparing the relationship of inventory balances to recent purchasing, production, and sales activities.

Statement on Auditing Standards No. 110

1693

***Illustrative Assertions About
Account Balances***

Examples of Substantive Procedures

Completeness

Inventory listings are accurately compiled and the totals are properly included in the inventory accounts.

- Inspecting shipping and receiving transactions near year end for recording in the proper period.
- Examining the inventory listing for inclusion of test counts recorded during the physical inventory observation.
- Reconciliation of all inventory tags and count sheets used in recording the physical inventory counts using CAATs
- Recalculation of inventory listing for clerical accuracy using CAATs.
- Reconciling physical counts to perpetual records and general ledger balances and investigating significant fluctuations using CAATs.

Valuation and Allocation

Inventories are properly stated at cost (except when market is lower).

- Examining paid vendors' invoices and comparing product prices to standard cost build-ups.
- Analytically comparing direct labor rates to production records.
- Recalculation of the computation of standard overhead rates.
- Examining analyses of purchasing and manufacturing standard cost variances.

Slow-moving, excess, defective, and obsolete items included in inventories are properly identified.

- Examining an analysis of inventory turnover.
- Analyzing industry experience and trends.
- Analytically comparing the relationship of inventory balances to anticipated sales volume.
- Walk-through of the plant for indications of products not being used.
- Inquiring of production and sales personnel concerning possible excess, or defective or obsolete inventory items.
- Logistic and distribution business process (e.g., cycle time, volume of returns, or problems with suppliers).

Inventories are reduced, when appropriate, to replacement cost or net realizable value.

- Inspecting sales catalogs or industry publications for current market value quotations.
- Recalculation of inventory valuation reserves.
- Analyzing current production costs.
- Examining sales after year end and open purchase order commitments.

AU §RAS

1694**Risk Assessment Standards: SAS No. 104–SAS No. 111*****Illustrative Assertions About
Presentation and Disclosure******Examples of Substantive Procedures*****Rights and Obligations**

The pledge or assignment of any inventories is appropriately disclosed.

- Obtaining confirmation of inventories pledged under loan agreements.

Completeness

The financial statements include all disclosures related to inventories specified by generally accepted accounting principles.

- Using a disclosure checklist to determine whether the disclosures included in generally accepted accounting principles were made.

Understandability

Inventories are properly classified in the balance sheet as current assets.

- Examining drafts of the financial statements for appropriate balance sheet classification.

Disclosures related to inventories are understandable.

- Reading disclosures for clarity.

Accuracy and Valuation

The major categories of inventories and their bases of valuation are accurately disclosed in the financial statements.

- Examining drafts of the financial statements for appropriate disclosures.
- Reconciling the categories of inventories disclosed in the draft financial statements to the categories recorded during the physical inventory observation.

This Statement entitled Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained was unanimously adopted by the assenting votes of the nineteen members of the board.

Auditing Standards Board (2004–2005)

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