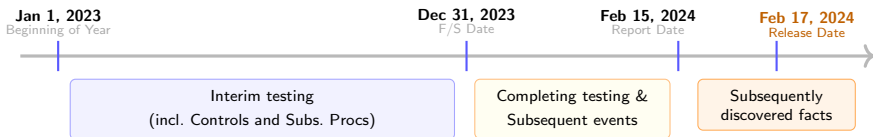


ACC531: Auditing and Assurance Services  
Ch11. Completing the Audit

Jaeyoon Yu, Ph.D.  
Central Michigan University

- 1 Completing Substantive Procedures
- 2 Final Steps in Audit Completion
  - Going Concern
  - Adjusting Entries and Financial Statement Disclosure
  - Audit Documentation Review
- 3 Subsequent Events and Subsequently Discovered Facts
  - Subsequent Events
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# Audit Timeline



## LO 11-1

Identify major activities performed by auditors in completing the substantive procedures following the date of the financial statements.

## Interim Testing

Audit procedures performed \_\_\_\_\_.



Two examples:

- Observe inventory count on November 30 rather than on December 31
- Test operating effectiveness of internal controls for the period Jan – Sep

Auditors need to make sure that the conclusions remain valid through the \_\_\_\_\_.

⇒ **Roll-forward Procedures** needed.

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⇒ **Roll-forward Procedures** needed.

## Roll-Forward Procedures

Procedures that extend conclusions to the balance sheet date.



Common roll-forward procedures include:

- Examine significant transactions that occurred in the roll-forward period.

## Analytical Procedures

Evaluations of financial information through analysis of plausible relationships among financial and non-financial data.

Three purposes throughout the audit:

Stage	Req?	Purpose
Planning	_____	Understand the entity and identify areas of potential risk.
Subs. testing	_____	Obtain evidence about specific account balance assertions.
Overall review	_____	Assess whether the F/S are consistent with the auditors' understanding of the entity at end of fieldwork.

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The **overall review** serves as a final **catch-all** check. Two specific objectives:

- 1 Evaluate the adequacy of evidence \_\_\_\_\_ in response to unexpected account balances or relationships identified during the audit.
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## Accounting Estimates

Approximations of a financial statement amount when no precise measurement is possible.

Examples: allowance for doubtful accounts, warranty reserves, pension obligations, fair value.

Key characteristics:

- Based on \_\_\_\_\_ — and therefore susceptible to **bias**
- Reflect uncertainty about future outcomes
- Cannot be **verified** or audited in the traditional sense — no single “correct” answer exists

## Auditor's Role

Auditors cannot verify the estimate outright, but must evaluate the \_\_\_\_\_ of the estimate — whether it falls within an acceptable range given available evidence and consistent assumptions.

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# Common Accounting Estimates

<b>Estimate</b>	<b>Key Uncertainty</b>
Allowance for doubtful accounts	How much of A/R will ultimately be uncollectible?
Warranty & return obligations	How many products will be returned or require repair?
Pension / post-retirement benefits	What will future benefit payments and discount rates be?
Fair value of financial instruments	What price would a willing buyer pay in an orderly market?
Impairment of goodwill / assets	Will the asset generate sufficient future cash flows?
Inventory obsolescence reserve	Which items will not sell at cost or above?

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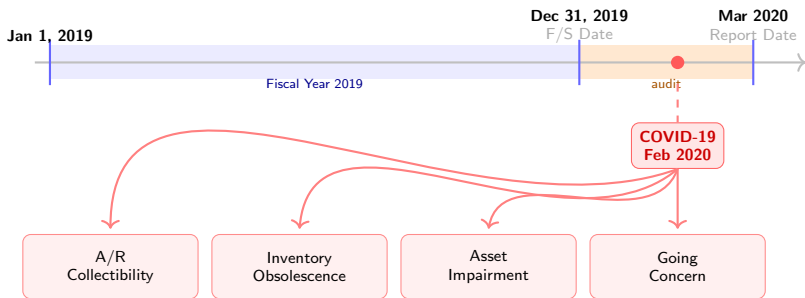
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# Accounting Estimates: COVID-19



Accounting estimates are a prime vehicle for **earnings management** — MGT can shade assumptions to nudge reported income toward a desired target.

- Each individual adjustment may be **below materiality** (e.g., slightly under-provisioning bad debt, extending asset lives, deferring warranty accruals)
- **Cumulatively**, however, the combined effect can be \_\_\_\_\_
- Common motive: **beat analysts' forecasts**, avoid debt covenant violations, or boost executive compensation

### Auditor's Response

Remain alert to patterns across estimates that collectively suggest \_\_\_\_\_ — even when no single estimate is individually unreasonable.

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# Earnings Management: Hypothetical Example

Actual EPS meets or barely beats consensus<sup>1</sup> every quarter. Beat margin: \$0.00, \$0.01, or \$0.02.



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## LO 11-2

Understand the role of attorney letters in evaluating litigation, claims, and assessments.

### Contingency (ASC 450)

An existing condition involving \_\_\_\_\_ as to a possible gain or loss, resolved when future events occur or fail to occur.

Examples: pending lawsuits, IRS disputes, warranty claims, environmental liabilities.

### Attorney Letter

A letter sent by the \_\_\_\_\_ to its attorneys, asking them to respond **directly to the auditors** with a list of pending or threatened legal matters and their evaluation.

Why needed? Auditors lack legal expertise to independently assess litigation outcomes.

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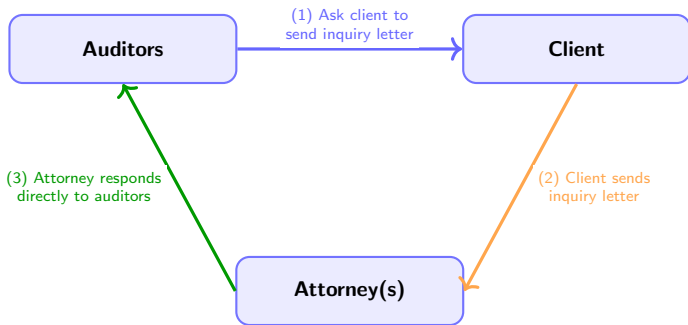
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# Attorney Letter: Flow of Correspondence



Key point: the attorney responds directly to the auditors — not through the client.

## Unasserted Claim

A potential claim where no formal lawsuit or threat has been made yet — but a known event (accident, product defect, environmental incident) could give rise to one in the future.

## The Privilege Tension

Attorneys owe a duty of \_\_\_\_\_ to their clients — yet auditors need candid disclosure of all legal exposure.

How this is resolved:

- The inquiry letter is drafted by the **client** — the client implicitly **waives** privilege only for the matters it chooses to list.
- Per **ABA guidelines**, attorneys need **not** disclose unasserted claims unless the client \_\_\_\_\_ them in the inquiry.
- Creates an audit gap: the client controls what the attorney can reveal — a motivated client can **omit** damaging potential claims entirely.
- If an attorney limits or refuses to respond ⇒ **scope limitation**.

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## LO 11-3

Explain why auditors obtain written representations and identify the key components of written representations.

## Written Representations

A \_\_\_\_\_ to the auditors formally confirming certain matters and supporting other evidence obtained during the audit.

The letter is usually:

- On the client's letterhead, addressed to the auditors
- Signed by responsible officers (CEO and CFO for issuers; appropriate level for nonissuers)
- Dated as of the date of the auditor's report

Written reps are **NOT** substitutes for other audit evidence — auditors cannot replace corroborating procedures with client inquiry alone.

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## ① MGT's Responsibility for the Financial Statements

- ▶ F/S are prepared and presented fairly in accordance with GAAP
- ▶ ICOFR is designed, implemented, and maintained effectively

## ② Completeness of Information Provided to Auditors

- ▶ All known actual or possible **fraud** has been disclosed
- ▶ All uncorrected misstatements are immaterial (or have been corrected)
- ▶ All related-party transactions and litigation have been disclosed

## ③ Representations Related to ICOFR<sup>2</sup>

- ▶ Acknowledgment of responsibility for designing and maintaining internal control
- ▶ Disclosure of any significant deficiencies or material weaknesses

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<sup>2</sup>Required for issuers under SOX §302; CEO/CFO must certify ICOFR in 10-K and 10-Q filings. 

# When MGT Refuses to Provide Written Representations

---

MGT's refusal to furnish written representations:

- constitutes a \_\_\_\_\_.
- could result in
  - ▶ a qualified opinion
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  - ▶ a disclaimer of opinion

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## LO 11-4

Identify the final steps in the completion of an audit.

## Going Concern Assumption

F/S are prepared on the assumption that the entity will continue operating for the foreseeable future — assets are valued \_\_\_\_\_ (not \_\_\_\_\_ value) and liabilities reflect normal settlement terms.

Auditors must consider whether substantial \_\_\_\_\_ exists about the entity's ability to continue as a going concern for a reasonable period.<sup>3</sup>

Category	Examples
Financial	Recurring <b>operating losses</b> ; working capital deficiency; <sup>4</sup> negative cash flows; inability to service debt
Operational	<b>Work stoppages</b> ; dependence on a single project or product
External	Legal proceedings; loss of key <b>franchise, license, or patent</b> ; loss of major customer or supplier

<sup>3</sup> "Reasonable period" usually means one year beyond the date of the financial statements.

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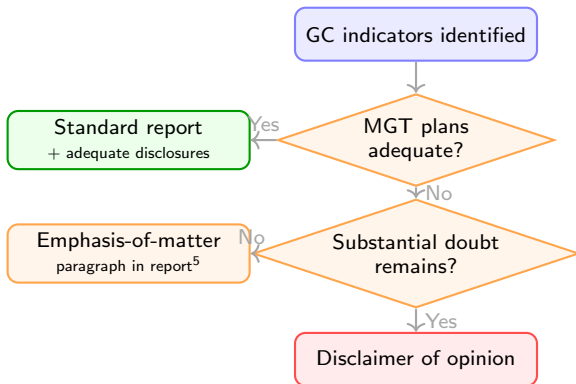
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# Going Concern: Auditor Actions and Outcomes



<sup>5</sup>Still, an unqualified (i.e., clean) opinion as long as the MGT plans are adequate.

When GC indicators are identified, auditors assess whether MGT has credible \_\_\_\_\_ to address the uncertainty.

## ① Obtain new financing

- ▶ Issue new equity (e.g., seasoned equity offering, private placement)
- ▶ Secure a new credit facility or line of credit from a lender

## ② Restructure existing debt

- ▶ Negotiate extended repayment terms or interest rate reductions with creditors
- ▶ Convert short-term debt to long-term to relieve near-term cash pressure

## ③ Dispose of assets or reduce costs

- ▶ Sell non-core business segments or assets to generate immediate cash
- ▶ Implement cost-reduction plans (workforce reduction, capex deferral)

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- 1 [T/F] If MGT presents a credible plan to refinance its maturing debt, auditors may issue a standard unmodified opinion. \_\_\_\_
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### Proposed Adjusting Entry

A journal entry auditors find during fieldwork that has not yet been recorded by the client — labeled “proposed” because the client (not the auditor) decides whether to record it.

- MGT is responsible to \_\_\_\_\_ the F/S for all material misstatements.
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## Exhibit 11.3: Proposed Adjusting Journal Entries

	Income	Assets	Liabilities	Equity
<i>(1) Unrecorded cash disbursements</i>				
Accounts payable	—	—	(\$42,000)	—
Cash	—	(\$42,000)	—	—
<i>(2) Improper sales cutoff</i>				
Sales	(\$13,000)	—	—	(\$13,000)
Inventory	—	7,800	—	—
Cost of goods sold	7,800	—	—	7,800
Accounts Receivable	—	(13,000)	—	—
<i>(3) Unrecorded liabilities</i>				
Utilities expense	(700)	—	—	(700)
Commissions expense	(3,000)	—	—	(3,000)
Wage expense	(2,500)	—	—	(2,500)
Accounts payable	—	—	700	—
Accrued exp. payable	—	—	5,500	—
<b>Net before taxes</b>	<b>(\$11,400)</b>	<b>(\$47,200)</b>	<b>(\$35,800)</b>	<b>(\$11,400)</b>
<i>(4) Reduction in income taxes</i>				
<i>(\$11,400 × 21%):</i>				
Income tax expense	2,394	—	—	2,394
Income taxes payable	—	—	(2,394)	—
<b>Current-year effects</b>	<b>(\$9,006)</b>	<b>(\$47,200)</b>	<b>(\$38,194)</b>	<b>(\$9,006)</b>
Uncorrected (prior audits)	(\$18,000)	—	—	(\$18,000)
<b>Cumulative effect</b>	<b>(\$27,006)</b>	—	—	<b>(\$27,006)</b>

If PM = \$100,000, then:

- Rollover: \$9,006 < PM ⇒ **immaterial.**
- Iron Curtain: \$27,006 < PM ⇒ **immaterial.**

## Evaluating Uncorrected Misstatements: Two Methods

Method	Evaluates	Focus
Rollover	Effect of <u>current-year</u> misstatement on the income statement only	Current period income
Iron Curtain	<u>Aggregate</u> effect of all uncorrected misstatements on the balance sheet	Cumulative B/S balance

- *Staff Accounting Bulletin No. 108* (SEC): auditors must evaluate using \_\_\_\_\_ methods simultaneously.
- If uncorrected misstatements exceed performance materiality under *either* method ⇒ adjustment required.
- Identification of material misstatements = “strong indicator” of a material weakness in ICOFR.

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### Part 1 — Review by the Engagement Team

After fieldwork, the audit \_\_\_\_\_ (manager or partner) reviews all documentation prepared by staff auditors.

Purpose — ensure that:

- All procedures performed are adequately documented
- Explanations in the workpapers are understandable
- Conclusions are supported by sufficient appropriate evidence
- All open review comments are resolved before the report is issued

Process: supervisor prepares review comments ⇒ staff responds ⇒ cycle repeats until all items are cleared.

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### Part 2 — Engagement Quality Review (EQR)

An independent review by a second partner (or equivalent) who was **not** involved in the engagement — also called concurring partner review.

- Evaluates significant judgments, accounting treatments, and the appropriateness of the opinion
- Provides a high-level assessment: is the evidence sufficient to support the opinion?
- Serves as an important \_\_\_\_\_ mechanism for the firm
- \_\_\_\_\_ for all PCAOB-registered (issuer) engagements; recommended for nonissuers

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- 1 Completing Substantive Procedures
- 2 Final Steps in Audit Completion
  - Going Concern
  - Adjusting Entries and Financial Statement Disclosure
  - Audit Documentation Review
- 3 Subsequent Events and Subsequently Discovered Facts
  - Subsequent Events
  - Subsequently Discovered Facts

# Subsequent Events and Subsequently Discovered Facts

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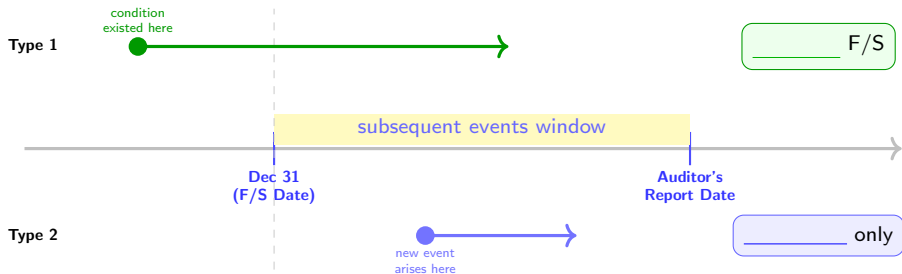
## LO 11-5

Understand auditors' responsibility for subsequent events and subsequently discovered facts.

# Two Types of Subsequent Events

## Definition

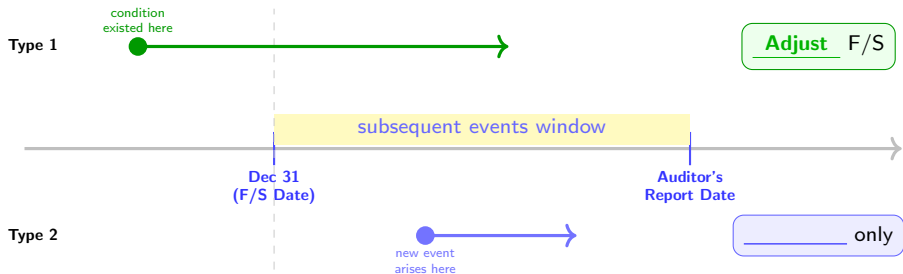
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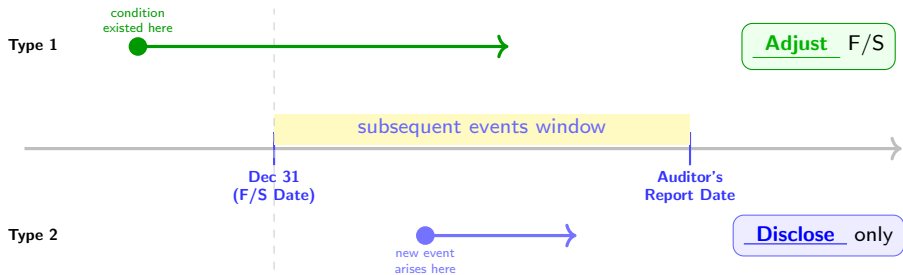
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# Two Types of Subsequent Events

## Definition

**Subsequent events:** events occurring between the date of the financial statements and the date of the auditor's report.



Auditors actively search for subsequent events through the date of the auditor's report:

- Inquire of MGT and those charged with governance about events after year-end
- Review minutes of shareholder, board, and audit committee meetings
- Read the entity's latest [interim financial statements](#) (e.g., draft Q1)
- Review correspondence with legal counsel regarding post-year-end developments
- Obtain [written representation](#) confirming no undisclosed subsequent events

Auditor's responsibility to *search* for subsequent events ends at the date of the auditor's report.<sup>6</sup>

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<sup>6</sup>After the report date the auditor is no longer required to actively search, but must respond if new facts come to attention (subsequently discovered facts).

# Subsequently Discovered Facts

## Definition

**Subsequently discovered facts:** material facts known after the auditor's report date. Key question: discovered **before** or **after** the release date?



**Scenario A** — discovered **before** the release date:

- Auditors typically \_\_\_\_\_ the report, limiting the updated date to the specific note affected.
- Example: "Feb 19, 2024, *except for Note X, as to which the date is March 5, 2024.*"

**Scenario B** — discovered **after** the release date:

- Auditors notify individuals relying on the F/S that they should **not** be relied on, and that revised F/S and a new auditor's report will be issued.
- Client and auditors then issue \_\_\_\_\_ and a new auditor's report.
- Similar to Scenario A, dual dating may be used to limit the scope of the updated date.

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**Scenario B** — discovered **after** the release date:

- Auditors notify individuals relying on the F/S that they should **not** be relied on, and that revised F/S and a new auditor's report will be issued.
- Client and auditors then issue **revised F/S** and a new auditor's report.
- Similar to Scenario A, dual dating may be used to limit the scope of the updated date.

- 1 A lawsuit is settled after year-end for an amount less than the reserve accrued at year-end. This is a: \_\_\_\_
- A) Type 1 subsequent event — adjust the financial statements
  - B) Type 2 subsequent event — disclose only, no adjustment needed
  - C) Subsequently discovered fact requiring dual dating
  - D) Not the auditor's responsibility after the F/S date
- 2 [T/F] If a material subsequently discovered fact comes to light before the audit report release date, the auditor may use dual dating to limit the scope of the updated dating to the specific note affected. \_\_\_\_
- 3 [T/F] After the audit report is released, the auditor has no obligation to take any action if a subsequently discovered fact comes to light. \_\_\_\_

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Topic	Key Takeaway
Interim & Roll-forward	Test before year-end; roll-forward procedures extend conclusions to the F/S date.
Analytical Procedures	Required at planning and overall review; optional during substantive testing.
Accounting Estimates	MGT judgment $\Rightarrow$ susceptible to bias; auditors evaluate reasonableness.
Attorney Letters	Client sends inquiry; attorney responds <b>directly</b> to auditors.
Written Representations	MGT letter dated at report date; refusal = scope limitation.
Going Concern	Substantial doubt $\Rightarrow$ assess MGT plans; may require emphasis-of-matter.
Uncorrected Misstatements	Evaluate under both Rollover and Iron Curtain methods (SAB 108).
Subsequent Events	Type 1: adjust F/S. Type 2: disclose only. Search ends at report date.
Subsequently Disc. Facts	Before release: dual date. After release: notify, withdraw, re-issue.