

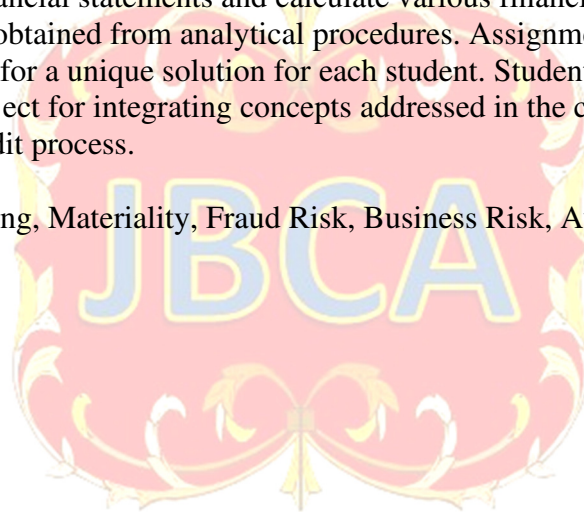
Integrating audit planning concepts and procedures

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ABSTRACT

This project was developed for use in the first auditing course and involves having students choose a unique publicly-traded company and complete the assigned questions that guide them through the audit planning process. The project corresponds to concepts learned in the first half of the course, and simulates the various aspects of planning a financial statement audit such as identifying potential users of the financial statements, assessing audit risk, understanding the client's business, assessing business risk, assessing overall materiality, allocating performance materiality, and performing preliminary analytical procedures. Students prepare common-size financial statements and calculate various financial statement ratios, and then interpret the results obtained from analytical procedures. Assignment of this project in the manner described allows for a unique solution for each student. Student feedback demonstrates the usefulness of this project for integrating concepts addressed in the course and facilitating comprehension of the audit process.

Key Words: Audit Planning, Materiality, Fraud Risk, Business Risk, Audit Risk



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PROJECT LEARNING OBJECTIVES AND IMPLEMENTATION GUIDANCE

Learning Objectives

Most instructors likely agree that the difficulty of teaching auditing is due to its ‘conceptual’ nature. Students learn about audit rules and procedures, but typically do not have the ability to apply this knowledge to an actual audit engagement. In other words, they aren’t able to practice auditing to enhance their comprehension as they do in other accounting courses. Therefore, this project was developed in order for students to apply and integrate all of the concepts learned in the first half of the beginning audit class. These concepts generally address the benefits to users of audited financial statements, audit risk, client business risk, and various aspects of audit planning (e.g. assessing materiality, allocating performance materiality, and preliminary analytical procedures). Students assume they are planning the next year’s audit for their unique company and perform many planning activities. Although some text books include a continuing case for the same purpose, this project allows for a unique solution for each student, thereby eliminating sharing work within a class, or from semester-to-semester. Questions within the project are linked to the chapter(s) in the text where the concept is covered for students’ reference. In addition, as an instructor covers these concepts in lecture s/he can easily link the concept to the specific question(s) in the project and illustrate the work to be done. The project is typically assigned in the first or second week of the semester with a due date sometime after mid-term. Students should be advised to complete the project over this period of time, and that completion will be much easier if they work on the concepts as they are covered in class.

This project is especially beneficial to less experienced audit instructors because it is a well-developed and well-tested tool they can easily implement to supplement their course materials. In addition to integrating audit planning concepts, another objective of the project is to expose students in detail to annual reports submitted to the Securities and Exchange Commission. Working through the project requires reading and abstracting a great deal of information from the 10-K. For many students, this is their first exposure to these annual reports.

Implementation Guidance

It generally takes about 20 minutes of class time to introduce the project. Students are instructed to choose a unique publicly-traded company for their project. The instructor can post electronically a list of companies used by students in past semesters that are not available for use by the current class. In addition, as current students submit to the instructor the company they would like to use, this list can be posted and updated continuously until all students have chosen and received approval¹ for a unique company. During the project introduction, the instructor should show the SEC’s Edgar website (<https://www.sec.gov/edgar/searchedgar/companysearch.html>) and demonstrate how to find a company’s annual report. It is beneficial if the instructor also downloads a 10-K for a company and discuss the various items included in the report. Upon conclusion of the introduction of the project, students are equipped with everything they need to get started. Students should be strongly encourage to spend some time examining the 10-K for their company and learning

¹ It is recommended that the instructor take a quick look at the company each student submits to make sure it is unique, but also to help students steer clear of potential problems (e.g. overly complex companies such as large banks and insurance companies, which report to use if there is an amended 10-K, etc.).

where information is located within the report prior to beginning work on the project. The project is designed for students to work on their own with little to no help from the instructor.

As mentioned, this project can be used on an individual basis, thus eliminating much cheating/copying. Grading time for each project is substantial and requires approximately 30-45 minutes per project. However, the time investment in this project should be extremely worthwhile. Students are often overwhelmed with group projects in other classes and typically indicate they appreciate the opportunity to work alone on this project. They can work on the project according to their own schedules and the typical problems of shirking and freeloading often encountered in group work are eliminated. On the other hand, for larger classes the project can easily be assigned to groups, thus reducing grading time. This project is easily adapted for use with any auditing textbook.

Student Feedback

No formal evaluation was obtained for this project. However, informal discussions in class after project completion generally reveal that students perceive it to be time consuming, but very beneficial. Some unsolicited comments related to the project (included in annual course evaluations) are listed below:

- The audit project was excellent and worthwhile.
- The project was very resourceful.
- The auditing project really got me to utilize the processes and skills we learned with a real business. I think this was the best learning experience anyone could have for auditing.
- The audit project helped bring everything together and gave a good review of everything we had covered.
- The individual company project was very worthwhile to my learning experience.
- The auditing project was the only thing that actually tied everything together for me.
- The project was wonderful. It was a directed, concrete assignment that enhanced my understanding of the material. Honestly, without that assignment, I'm not sure I would have understood what we were trying to do in any real way.

THE PROJECT AND INSTRUCTIONS

Audit Planning Project

This project simulates much of the information gathering and analyses auditors do when planning an audit engagement. For the company you selected, assume you are planning the next (or upcoming) audit engagement and answer the following questions.

1. In what state is your company incorporated?
2. What is your company's SIC? What does this represent?
3. Give a brief description of the purpose of each of the three most recent 8-K (special reports) forms. Indicate the date of each. (one paragraph total) [p. 735]
4. What securities has your company registered with the SEC? Which exchange is each registered with?
5. Briefly (one paragraph) describe your company's business (what do they make/sell/produce/service, where are they located, etc.)
6. What are the major sources of revenue for your company?
7. Which CPA firm audited your company (name and city)? [pp. 714, 775, 779]
8. What is the date of the audit report? What is the significance of this date? [C2]
9. What type of audit opinion was given? If unqualified, state if there was modified wording or an explanatory paragraph, and the reason why. [pp. 714, 775, 779]
10. Did the CPA firm prepare a separate report on internal controls over financial reporting, or combined? [pp. 714, 775, 779]
11. What opinion was given on internal controls? [pp. 714, 775, 779]
12. Who signed management's report on internal controls (name and title)? If there are no actual signatures on the electronic report, answer based on your knowledge of who should sign it. [p. 763]
13. Review the footnotes for your company and answer the following:
 - a. Briefly (one paragraph) describe the company's revenue recognition policy.
 - b. Do you see any potential for abuse with this policy? Why or why not? [C11]
 - c. What is your company's fiscal year end (not necessarily the date on the financial statements)?
 - d. What inventory costing methods do they use?
 - e. What are the major accounts listed within PP&E and what is the depreciation method used for each?
 - f. Is your company reporting any accounting changes in any of the years reported (list)?
 - g. What are your company's reportable business segments?
 - h. What types of commitments/contingencies/guarantees does your company report (list)?
 - i. How much long-term debt matures over each of the next five years (dollar amount for each year)?
 - j. What estimates does your company use in preparing their financial statements (list)?
 - k. What related party transactions are identified by your company (list)?
 - l. Does your company have any subsequent events (describe)?

14. Who are the likely users of your company's financial statements, and how will each user benefit from these audited financial statements? [C1]
15. Given the nature of your company's business, and from reviewing their financial statements, do you think any specialists are needed to audit this company? Why or why not? [C5]
16. List at least six significant business risks your company faces, and briefly explain why each is a risk. [C6]
17. For each of the risks identified above, list one or more financial statement accounts (e.g. Sales, Cost of Goods Sold, Accounts Receivable) that might be affected by the risk, and explain why. [C6]
18. Using the interactive data in Edgar, open and save the excel document. For the last two years, calculate each of the ratios shown on pages X-Y in your text. Use the formulas exactly as they are shown there, and show all of your work (not just the answer). You will need to access the previous 10-K for balance sheet amounts for the third most recent year. These answers should be hand-written. [C5]
 - a. Ratios include the following:
 - 1) Short-Term Debt-Paying Ability (Cash Ratio, Quick Ratio, Current Ratio)
 - 2) Liquidity Activity (Accounts Receivable Turnover, Days to Collect Receivables, Inventory Turnover, Days to Sell Inventory)
 - 3) Ability to Meet Long-Term Obligations (Debt to Equity, Times Interest Earned)
 - 4) Profitability (Earnings Per Share, Gross Profit Percent, Profit Margin, Return on Assets, Return on Common Equity)
19. Prepare a common-size income statement using Net Sales as the base (for three years), and a common-size balance sheet using Total Assets as the base (for two years). Do not change/rearrange the format of your company's financial statements (i.e. use exactly as downloaded). Make sure your formulas are visible. [C5]
20. Review the fluctuations in your ratios and common size statements across years, and identify at least five items of concern, explain why each is a concern, and explain how each concern will be addressed in the planned audit. [C5]
21. What would you consider to be the top two fraud risks for this company (explain why)? [C6-App. B]
22. Decide what you consider to be the overall materiality dollar amount for your company. Show all calculations and describe how you came to this conclusion. [C6]
23. Allocate performance materiality amounts to the balance sheet accounts using the general rules described in the text. For five accounts, explain why you allocated a certain amount to that account (be sure to discuss all of the factors affecting your allocation). [C6]
24. From all of the work you have done so far, set an acceptable level of audit risk (a percentage) for your company and justify your decision. [C6]
25. What do you think will be the most expensive account to audit for your company, and why? [C5]
26. Which accounts would you recommend the auditor send confirmations for your company? Why? [C5]

General Instructions

- Where applicable, chapters are listed by each question if you need help on the concept, e.g. [C5]

- When asked to briefly explain or describe something, DO NOT copy and paste from your company's documents. Use your own words.
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Teaching Notes

The chapters referenced in the project correspond to the Whittington and Pany (2019) textbook, but again, this project is easily adapted to any auditing textbook. A grading guide is included in the appendix that offers step-by-step instructions to work through each project in the most efficient manner. Also shown in the guide are suggested point values assigned for each question and general guidelines for grading (e.g. correct or incorrect, reasonableness, etc.). The raw scores can be converted to the project's overall point value (e.g. 100%).



Appendix

Grading Guide			
Websites, files, etc. to use in grading questions	Question	Points Assigned	Suggestions for Grading (√ = Correct, X = Incorrect)
Step 1: In Edgar ² , open the current page of the student's company using the CIK# included on the student's report.	1	1	√ or X
	2	1	√ or X
Step 2: Locate and open the three most recent 8-K reports identified by the student.	3	3 (1 per each √)	√ or X
Step 3: Locate and open the 10-K with the filing date included on the student's report.	4	1	√ or X
	5	2	Read the student's answers to see if they are reasonable and adequate. If not, click on <u>Item 1 – Business</u> in the 10-K and check the information against the student's answer.
	6	1	
Step 4: Click on <u>Item 8 – Financial Statements and Supplementary Data</u> ³ .	7-12	6 (1 per each √)	√ or X
Step 5: Move down to the footnotes accompanying the financial statements.	13	a & b: 4 (2 per each √)	Scan the footnotes and compare to the student's answer.
		c-1: 10 (1 per each √)	
	14	1	Grade for reasonableness and offer suggestions if incomplete/unreasonable (and count wrong).
	15	1	
	16	6 (1 per each)	Grade for reasonableness and offer suggestions if incomplete/unreasonable (and count wrong); You may also look back to <u>Item 1a – Risk Factors</u> in the 10-K if needed.
17	6 (1 per each)		
Step 6: Obtain the student's hand-written ratios and move back to the financial statements in the 10-K.	18	14 (1 per each √)	Compare the amounts included in the ratios to the amounts on the financial statements (e.g. Current Assets).
Step 7: Open the student's Excel file.	19	10	Spot check formulas to make sure the common-size statements were prepared correctly (e.g. the base is used consistently, no errors in copying formulas)
	20	5	Read the student's answers and compare to their ratios and common-size statements. Grade for reasonableness and offer suggestions if incomplete/unreasonable (and count wrong). Specifically, point out noticeable fluctuations they may have missed and correct inaccurate explanations.
	21	2	Grade for reasonableness and offer suggestions if incomplete/unreasonable (and count wrong).

² www.sec.gov/edgar/searchedgar/companysearch.html

³ The reports typically precede the financial statements, but are sometimes located at the end of Item 8, or incorporated by reference to a separate Exhibit

	22	2	Grade for reasonableness and refer the student back to the page in the chapter if incomplete/unreasonable. Most students will follow the general guidelines described in the text.
	23	10 (2 per each)	Grade for reasonableness and offer suggestions if incomplete/unreasonable (and count wrong). Specifically, look at reasonableness of explanations (e.g. the cost to audit, number of misstatements expected, number of transactions, etc.)
	24	3	Grade for reasonableness and offer suggestions if incomplete/unreasonable (and count wrong).
	25	2	
	26	2	
Total Points		93	



References

Whittington, O. R. and K. Pany. 2019. *Principles of Auditing & Other Assurance Services*, 21st Edition. McGraw-Hill/ Irwin, New York, NY.

