**Background**

Your audit firm, VoLS LLP, recently gained a new public client. The partner has assigned your team to do the fieldwork for this audit and has asked your team to prepare a summary of information that will be helpful in completing a preliminary risk assessment. You do not have any prior year workpapers to look at, so your partner is interested in seeing how much you can learn just based on publicly available information. Specifically, she would like you to obtain an understanding of the company and its environment and perform a thorough risk assessment analytic, in order to identify where your team thinks the risk of material misstatement may be highest. Then, determine whether any previous significant deficiencies or material weaknesses in internal controls have been identified that may affect this year’s planned audit approach.

She has noted the following resources to help you with your search of information commonly available for public clients. She would like you to consider each of these sources and then think carefully about how the information you learn relates back to the risk of material misstatement in the audit.

* *Form 10-K (EDGAR)*: annually filed financial statements and other important information for shareholders. Be careful using “risk factors” (Item IA) because these are written from the perspective of the shareholder or a potential investor. Typically, auditors can determine what affects the risk of material misstatement by reading Management’s Discussion and Analysis, including Critical Accounting Policies, discussion of any pending or threatened litigation, or other contingencies, the Financial Statements and the Notes to the Financial Statements.
* *Form 10-Q (EDGAR)*: quarterly filed financial statements and other important information for shareholders. The 10-Q should always be read in conjunction with the most recently filed 10-K because disclosures are limited to material changes since the last 10-K.
* *Form 8*-*K (EDGAR)*: periodic filings that report material events or transactions throughout the year. Pay particular attention to these items:31F[[1]](#footnote-1)
  + Item 1.01 and 1.02: Entry/termination from a material agreement
  + Item 1.03: Bankruptcy or receivership
  + Item 2.01: Acquisition/disposition of assets
  + Item 2.02: Results of operations and financial conditions
  + Item 2.03 and 2.04: Material changes in financial obligations and off-balance sheet arrangements
  + Item 2.05 and 2.06: Material impairments or costs associated with exit activities
  + Item 4.02: Announcement of a restatement (non-reliance)
  + Items 5.01 or 5.02: Changes in ownership, directors, or management
  + Items 5.07 or 5.08: Shareholder voting
  + Item 7.01: Regulation FD disclosure
  + Item 8.01: Other material events
  + Item 9.01: Financial statements and exhibits

To help you organize your summary, the partner recommends compiling a memo with the following information:

1.      Summary of company operations and discussion of types of potential RMM at the entity and/or account level:

a.       Description of the nature of the business/operations

b.      Key industry changes or developments that may affect this year’s audit

c.       Geographic locations and description of Business Segments

e.       Pending or threatened litigation risk

f.        Other relevant information that may affect this year’s audit (including previous years’ internal control assessments)

2.      Summary of the results of the risk assessment analytical procedures.

a.      Explanation of materiality and identification of significant accounts (work with instructor for approval of materiality before submitting project).

b.     Summary of the top three accounts that you believe to be highest RMM based on analytical procedures: list the specific assertion(s) that are highest risk and describe how the auditor could respond to that risk.

c.      Analytical procedures should be provided in Excel as supporting information to the Word document:

                                                              i.      Income statement: vertical and horizontal analysis (see example)

                                                            ii.      Balance sheet: vertical and horizontal analysis (see example)

The partner would then like to do a quick video conference with you to hear you summarize the most important facts from the memo in a 10-15 minute presentation. You can assume that the partner has read your audit planning memo when you conduct the presentation.

**Requirements**

1. Pick a publicly traded company (and receive approval from your instructor before proceeding).
2. Turn in a single-spaced memo that captures the information listed above, no longer than 6 page. It should include headings to separate the various sections as recommended above. Feel free to use bullets and tables to visually organize lists.
3. Turn in your risk assessment analytical procedures in Excel (with formulas so that your instructor can see how you calculated changes, ratios, etc.). Ensure that each procedure is clearly labeled (e.g., “% Changes 2018 vs. 2019” or “Five-Year Trend of Ratio A,” etc.) in a way that can be referenced back to conclusions and discussions in the memo.

1. Record a 10-15 minute video and upload it to YouTube using the “unlisted” feature, to ensure privacy. Your instructor will not share this video with anyone else. The video is not graded on production quality, so it does NOT have to be a professionally edited/high quality video. You just need to ensure the audio/video is working well enough that it can be graded for content. Because there are many university resources available (see Canvas for details), we will not accept technical difficulties as an excuse for a late submission of the planning meeting video.

**Grading**

***Note on any “Free Rider” issues*:** If you have problems in your group, particularly a ‘free rider’ problem, it is your responsibility to communicate that with the professor **before** the due date of the project. The professor reserves the right to require non-participating group members to turn in a separate individual project (on a different company) if there are concerns about equitable work performance. If the professor suspects free riding or inequitable work in the final deliverable, the professor has the right to request each individual member to provide evidence of his/her contribution to the final deliverable and will adjust grades accordingly.

Your instructor will use the grading rubric on the following page to grade your audit team’s performance. If the instructor suspects that your audit team “divided up” the work, or did not truly work as a team (all team members should understand all aspects of the project), your instructor has the right to arrange individual meetings with each team member to assess individual performance, and if needed, to penalize the team and individual team members. It is highly encouraged that you “self-grade” your project before turning it in to avoid missing easy points.

**Grading Rubric**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **Lowest** |  |  |  | **Highest** |
| **Memo:**Appropriate identification of audit-relevant information and appropriate explanation of the RMM and potential responses to risk: |  |  |  |  |  |
| ·         Description of the nature of the business/operations | 1 | 2 | 3 | 4 | 5 |
| ·         Key industry changes or developments that may affect this year’s audit | 1 | 2 | 3 | 4 | 5 |
| ·         Geographic locations and description of business segments | 1 | 2 | 3 | 4 | 5 |
| ·         Pending or threatened litigation risk | 1 | 2 | 3 | 4 | 5 |
| ·         Other relevant information that may affect this year’s audit (including prior year’s internal control assessment) | 1 | 2 | 3 | 4 | 5 |
| **Excel:**Appropriately annualized quarterly information for the upcoming year (if applicable based on fiscal year end) | 1 | 2 | 3 | 4 | 5 |
| **Excel:**Appropriate explanation and identification of materiality and significant accounts | 1 | 2 | 3 | 4 | 5 |
| **Excel:**Appropriate calculations for horizontal and vertical analyses; clear labeling and organization of Excel file; free of typos; professional writing quality | 2 | 4 | 6 | 8 | 10 |
| **Excel:**Thoroughness of explanations for fluctuations compared to previous year (using MD&A and other sources) | 2 | 4 | 6 | 8 | 10 |
| **Memo:**Appropriate explanation of highest risk account-assertions and relevant responses to risk (*based on Excel findings*) | 3 | 6 | 9 | 12 | 15 |
| **Memo:**Going above 6 pages in the memo (one point reduction per extra page) | -4 | -3 | -2 | -1 | 0 |
| **Memo:**Clear labeling and organization; proper grammar and punctuation; professional deliverable | 1 | 2 | 3 | 4 | 5 |
| **Planning Video:** Appropriate discussion of key risks using correct terminology from class/Casebook | 3 | 6 | 9 | 12 | 15 |
| **Planning Video:** Prioritized limited time to focus on the most significant issues identified in the Memo/Excel file; professional language and behaviors throughout video | 1 | 2 | 3 | 4 | 5 |
| Going “Above and Beyond” (e.g., ratio analyses, explanation of additional account risks, etc.) | 1 | 2 | 3 | 4 | 5 |
|  | **Total Possible Points** | | | | **100** |

**Sample Memo Template**

**[Company Name] WP 1000**

**[Year End of Upcoming Audit]**

**Risk Assessment and Planning Memo**

**PURPOSE**

We have been engaged to audit the financial statements of [Company Name] (the “Company”) as of and for the year ended December 31, 20X8. To plan for the upcoming audit, we have reviewed publicly available information about the company, as referenced at the end of this memo. This memo describes the information that we identified as relevant to potential risks of material misstatement in the audit, along with planned audit procedures to reduce those risks to an acceptable level.

**Section 1: SUMMARY OF COMPANY OPERATIONS AND EFFECT ON RMM**

***Description of the nature of the business/operations***

The Company is publicly traded on [NYSE or Nasdaq] using the ticker [ticker symbol]. The Company is [describe the nature of the company and the industry they operate in]. Tangible and intangible assets include [describe the nature of material tangible and intangible assets]. A key component of the Company’s strategy is [what does the company purport their main business strategy to be? – what’s unique about them compared to others in the industry?]. The Company earns revenue through [describe how the company earns revenue]. Approximately [#] fulltime equivalent employees.

*Potential effects on Risk of Material Misstatement (RMM):*

* [Brainstorm 3 – 5 factors that you learned about that would affect RMM and explain how you would respond to this risk – for example, if the company operates in a highly competitive industry, this could put additional pressure on management to meet earnings targets; and you could respond by assigning more experienced team members, increasing professional skepticism, and increasing unpredictability in audit procedures, for example. Each bullet should list the factor that contributes to RMM and the potential response(s) from the auditor.]

***Key industry changes or development that may affect this year’s audit***

Per review of the latest 10-Q filings, \_\_\_\_\_\_\_\_\_\_ changes have affected the industry this year.

*Potential effects on RMM:*

* [Brainstorm 1 – 2 factors that you learned about that would affect RMM and explain how you would respond to this risk – for example, if the industry experienced new accounting regulations this year, there is increased risk of material misstatement due to new accounting policies; and you could respond by assigning team members experienced with these new standards and increasing manager/partner review time for this section of the audit, for example. Each bullet should list the factor that contributes to RMM and the potential response(s) from the auditor.]

***Geographic locations and description of business segments***

As of December 31, 20X7 [prior year 10-K], the Company operated [describe geographic locations – if possible, separate locations by manufacturing vs. sales vs. R&D vs. corporate headquarters, etc.]. For GAAP purposes, the company operates using the following reporting segments: [describe segments, or state “operates as a single reporting unit.”]

*Potential effects on RMM:*

* [Brainstorm 1 – 2 factors that you learned about that would affect RMM and explain how you would respond to this risk – for example, if locations are geographically dispersed, there is increased risk of material misstatement due to error if the company does not properly consolidate operations across different reporting standards and foreign currencies; and you could respond by increasing control testing of the consolidation process, particularly the IT systems.]

***Pending or threatened litigation risk***

* [List pending or threatened litigation as of the latest 10-Q as separate bullets]

*Potential effects on RMM:*

* [Brainstorm 1 – 2 factors that you learned about that would affect RMM and explain how you would respond to this risk – for example, if there are no pending or threatened litigation, there is a risk of material misstatement related to disclosure of contingencies and legal liabilities; and you may respond by examining a listing of legal expenses for the period to determine whether the company has been paying legal fees indicative of pending or threatened litigation not yet disclosed.]

***Other relevant information***

* [In separate bullets, list another piece of relevant information not already discussed above that would affect the upcoming audit. For example, adoption of new IT systems, modifications to previous audit opinions over financial statements or internal controls, change in management, etc. It would be expected that you’ve identified 2 – 3 bullets’ worth of information].
  + *Potential effects on RMM:* Under each bullet, describe the potential effects on RMM and your response

**Section 2: SUMMARY OF FINDINGS FROM RISK ASSESSMENT ANALYTICAL PROCEDURES**

***Materiality & Identification of Significant Accounts***

To calculate the Company’s materiality, we reviewed the most recent 10-Q, filed [date] for the period ended June 30, 20X8 and the most recent 10-K, filed [date] for the year ended December 31, 20X7. [Describe materiality choice and justification – for example, “We noted that the Company’s revenues were the least volatile among the common benchmarks selected for calculating materiality; therefore, we selected the Company’s total revenues as the basis for calculation. Given that the Company is publicly traded, we set materiality at the low end of the acceptable range: 0.5% of the Company’s total revenues. Based on projected revenues for the year ended December 31, 20X8, we set overall materiality at $X million. We also set the tolerable misstatement value at the low end of the range, 50% of overall materiality, bringing the amount to $Y million.”] The calculation for these numbers is provided at the top of **WP 1010.1**. In **WP 1010**, we have classified as “significant” all accounts for which amounts are greater than the tolerable misstatement amount we set above, or that are deemed to have significant fluctuations.

***Results of Analytical Procedures***

See **WP 1010** for a **horizontal flux analysis** and a **vertical analysis** of all accounts on the Company’s Income Statement and Balance Sheet. We pulled 20X7 and 20X6 information from the 10-K filed on [date]. To estimate the 20X8 income statement amounts for our upcoming audit, we use the 6 months’ ended figures from the most recent 10-Q (2nd quarter 20X8) and multiply by [multiplier used to project 6 months to 12 months] to establish a projected income statement for the year ended December 31, 20X8. We believe this is reasonable because [insert explanation. For example “the originally reported 6 months revenue for 20X7 was $X compared to year end revenues of $Y (nearly a perfect 2x multiplier). The industry’s seasonality is concentrated in the summer months, with higher Q2 and Q3 than Q1 and Q4, suggesting that the 2x multiplier as of the end of Q2 is also reasonable from an industry perspective”]. In the workpaper, we define expectations for the current year, including changes deemed to be “significant.” [Explain what is deemed significant. For example, “Because we are not aware of any changes in operations that would suggest greater than standard macroeconomic growth, we have conservatively used 5 percent for the flux analysis and 1 percent changes for the vertical analysis.”]

We noted the following significant issues from our analytical procedures that will affect planning for the 20X8 audit:

* [In three separate bullets, pick the three things that you see as most significant to risk of material misstatement at an account-assertion level for the upcoming audit. In addition to describing the RMM, describe the planned response. For example, “The effective income tax ratefor the company is extremely volatile. Income taxes are complex and subject to management estimates; we will engage a tax specialist to assist the audit team in performing sufficient testing over the **Income Tax Expense - Valuation** assertion. We will also test the accuracy and completeness of data used in management’s calculations, as well as obtain supporting documentation for key assumptions in book-tax differences.”]

**LIST OF REFERENCES OF INFORMATION USED TO COMPLETE THE RISK ASSESSMENT**

2ND QUARTER 20X8 FORM 10-Q (filed [date]): [link]

20X7 FORM 10-K (filed [date]): [link]

[Company] Investor Relations website as of [current date]: [link]

1. A full list of 8-K topics is available here: <https://www.sec.gov/fast-answers/answersform8khtm.html>. [↑](#footnote-ref-1)