

Case 23-3c

Evaluation of Misstatements

A misstatement, if material individually or in combination with other misstatements, causes the financial statements not to be presented fairly in conformity with the applicable financial reporting framework. A misstatement may relate to a difference between (1) the amount, classification, presentation, or disclosure of a reported financial statement item and (2) the amount, classification, presentation, or disclosure that should be reported in conformity with the applicable financial reporting framework. Misstatements can arise from error or fraud.

The auditor has a responsibility to investigate the nature and cause of any misstatements identified and evaluate the possible effect on the purpose of the audit procedure and on other areas of the audit. The auditor's evaluation of uncorrected misstatements takes into account relevant quantitative and qualitative factors.

When evaluating misstatements from a quantitative perspective, the techniques most commonly used in practice are the iron curtain approach and the rollover approach:

- *Iron curtain approach* — Quantifies a misstatement on the basis of the effects of correcting the misstatement existing in the balance sheet at the end of the current year, irrespective of the misstatements year(s) of origination.
- *Rollover approach* — Quantifies a misstatement on the basis of the amount of the error originating in the current-year income statement. Thus, this approach ignores the effects of correcting the portion of the current-year balance sheet misstatement that originated in prior years (i.e., it ignores the carryover effects of prior-year misstatements).

Case Facts — Part I

You are a member of the 20X2 audit team for Sven's Security, an entity that provides security services to other entities and high-profile individuals. Materiality for 20X2 is \$800,000. In this case, the tax-related effects of the identified misstatements have been omitted.

During 20X2, the following misstatements were identified when performing a test of details using audit sampling:

- Revenue was understated by \$400,000 for 20X2. This misstatement was not corrected by management.
- Accounts payable was overstated by \$275,000 for 20X1. This misstatement was not corrected by management.

The engagement team performed procedures to understand the nature and cause of the identified misstatements. The following facts were gathered:

- The first misstatement was the result of management incorrectly recording revenue related to a new revenue stream for the provision of security services. Management's process to record revenue is to analyze each contract related to this revenue stream, including identifying performance obligations, and record revenue when the performance obligations are met. For this contract, Sven's Security did not previously estimate or record a contract asset for revenues

earned but not received, and it incorrectly recorded revenue when cash was received after year-end. The entity receives payments from its high-profile customers for this type of revenue on a quarterly basis after the period in which the revenue was earned because the billing occurs in arrears. In the current year, this revenue stream was material, and the lack of recording a contract asset is a misstatement.

- The second misstatement was the result of management recording an accrual for an invoice twice. Management's process is to record an accrual for goods received before year-end if the invoice has not been received. During 20X1, Sven's Security purchased \$275,000 of supplies that were received in December 20X1; however, the invoice for these supplies was not received until January 20X2. For this contract, an accrual was recorded upon receipt of the goods. Upon receiving the invoice in January 20X2, the accounts payable clerk failed to identify that the amount was already (1) accrued for in accrued liabilities and (2) recorded the amount in the 20X1 accounts payable ledger. As a result, a misstatement was identified for an overstatement of liabilities as of the end of 20X1.

Discussion Questions

1. On the basis of the information gathered to date, summarize the engagement team's preliminary understanding of the nature and cause of each misstatement identified.
2. The engagement team is preparing to meet with Sven's Security management to enhance its understanding of the nature and cause of the identified misstatements. What questions should the engagement team ask to gain this further understanding and to determine the potential effect of the misstatements on the audit response and other areas of the audit?

Case Facts — Part II

For the *first* misstatement, on the basis of the engagement team's discussion with Sven's Security management, the team has learned the following supplementary information:

- The security services revenue stream has standard contracts that contain consistent terms, with the exception of contracts with high-profile individuals.
- Contracts with high-profile individuals are not contingent on a future event (i.e., satisfaction of an additional performance obligation) and follow a different billing structure than the security services revenue stream with standard contracts.
- Management performed an analysis for this revenue stream (i.e., contracts with high-profile individuals) to further investigate, identify, and quantify any additional misstatements.
- The entity's revenue department experienced significant employee turnover, and the clerk who misapplied the revenue recognition accounting guidance was a temporary contractor that lacked sufficient competence and experience in analyzing contracts and an understanding of when revenue and a contract asset should be recorded.

Discussion Question

3. On the basis of its understanding of the nature and cause of the *first* misstatement, the engagement team considered the potential effect to the audit response and audit plan. For risk assessment, internal controls, and substantive procedures, what should the engagement team have considered?

Case Facts — Part III

Sven's Security management performed additional analysis to examine revenue from contracts with high-profile individuals and accounts payable in response to the two misstatements identified during 20X2. Subsequently, the engagement team evaluated management's work and performed further audit procedures on management's analysis and did not identify additional misstatements.

In this case, assume there are no other misstatements.

Discussion Questions

4. Evaluate the misstatements identified during the Sven's Security audit under the **iron curtain approach**:

- Revenue and contract assets were understated by \$400,000 for 20X2. This misstatement was not corrected by management.
- Accounts payable and operating expenses were overstated by \$275,000 in 20X1. This misstatement was not corrected by management.

Under the **iron curtain approach**, what is the total of uncorrected misstatements affecting pretax income for 20X2?

5. Evaluate the misstatements identified during the Sven's Security audit under the **rollover approach**:

- Revenue and contract assets were understated by \$400,000 for 20X2. This misstatement was not corrected by management.
- Accounts payable and operating expenses were overstated by \$275,000 in 20X1. This misstatement was not corrected by management.

Under the **rollover approach**, what is the total of uncorrected misstatements affecting pretax income for 20X2?

Case Facts — Part IV

The engagement team has the responsibility to evaluate whether the uncorrected misstatements are material, either individually or in combination with other misstatements. In making this evaluation, the engagement team has the responsibility to evaluate the misstatements related to (1) the specific accounts and disclosures involved and (2) the financial statements as a whole, taking into account relevant quantitative and qualitative factors.

Discussion Question

6. What qualitative factors should the engagement team consider in its evaluation of the materiality of the uncorrected misstatements?