

Case 19-9: Dandelion Company — Handout 1

Discussion 1

Read the following **excerpt** from the Investment Risk Assessment Memorandum of Dandelion Company (Dandelion or the “Company”). This memo was prepared by the audit engagement team just after the close of Q3 (as of September 30, 20Y2) to plan its approach for the year-end audit (as of December 31, 20Y2).

Note that the current year and prior year are represented by 20Y2 and 20Y1, respectively.

Dandelion is a public entity with a December 31 fiscal year-end. The Company is an accelerated filer that issues annual and quarterly consolidated financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP). We are engaged to perform an integrated audit of the Company’s annual U.S. GAAP consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (PCAOB).

The Company has an investment portfolio that is 70 times materiality. The portfolio consists of (1) exchange-traded equity securities and U.S. treasury securities that are classified as Level 1 in accordance with the ASC 820 fair value hierarchy and (2) mortgage-backed securities, asset-backed securities, and corporate debt securities that are classified as Level 2. The Company does not have any Level 3 securities. The classification of investment types as of September 30, 20Y2 (see Figure 1 below), is consistent with the classifications as of December 31, 20Y1 (e.g., agency securities as of September 30, 20Y2, remained classified as agency securities as of December 31, 20Y1). In addition, the classification of investment types by level as of September 30, 20Y2 (see Figure 2 below), is consistent with the classifications as of December 31, 20Y1 (e.g., agency securities were classified as Level 2 as of September 30, 20Y2, and December 31, 20Y1).

We plan to use a “control reliance” approach to address the risks of material misstatement (RoMMs) and assertions related to the Company’s investment account balance, including identifying and testing operating effectiveness of the controls that address the RoMMs. The Company’s investment professionals, which include the vice president of treasury and the risk manager, are very experienced and have the appropriate skills and capabilities to price and monitor the Company’s investment activities. On the basis of interactions during our audit procedures, we believe the vice president of treasury and the risk manager are competent and have the relevant experience.

Fiscal Year 20Y2 Audit Materiality (in Millions)

Materiality	Performance Materiality
\$150	\$105

Figure 1. Company's Investment Balances as of September 30, 20Y2 (in Millions)

Description	Book Value	Unreal Gains	Unreal Losses	Fair Value
<i>Debt securities</i>				
U.S. treasury	\$ 733	\$ 2	\$ 0	\$ 735
Agency	5,979	98	(1)	6,076
Residential mortgage-backed	866	13	(5)	874
Mortgage-backed	306	1	(1)	306
Asset-backed	707	4	(1)	710
Corporate debt	<u>1,543</u>	<u>35</u>	<u>(3)</u>	<u>1,575</u>
Total debt securities	<u>\$10,134</u>	<u>\$153</u>	<u>(\$11)</u>	<u>\$10,276</u>
<i>Equity securities</i>	<u>403</u>	<u>4</u>	<u>(58)</u>	<u>349</u>
Total debt and equity securities	<u>\$10,537</u>	<u>\$157</u>	<u>(\$69)</u>	<u>\$10,625</u>

The classification of investment types as of September 30, 20Y2, is consistent with the classifications as of December 31, 20Y1 (e.g., agency securities as of September 30, 20Y2, remained classified as agency securities as of December 31, 20Y1).

Figure 2. Fair Value Footnote as of September 30, 20Y2 (in Millions)

This is a partial fair value footnote disclosure that excludes other assets, derivatives, and liabilities and shows only the amounts related to the investment portfolio.

Description	Level 1	Level 2	Level 3	Total
<i>Debt securities</i>				
U.S. treasury	\$ 695	\$ 40	\$0	\$ 735
Agency	0	6,076	0	6,076
Residential mortgage-backed	0	874	0	874
Mortgage-backed	0	306	0	306
Asset-backed	0	710	0	710
Corporate debt	<u>0</u>	<u>1,575</u>	<u>0</u>	<u>1,575</u>
Total debt securities	<u>\$ 695</u>	<u>\$9,581</u>	<u>\$0</u>	<u>\$10,276</u>
<i>Equity securities</i>	<u>349</u>	<u>0</u>	<u>0</u>	<u>349</u>
Total debt and equity securities	<u>\$1,044</u>	<u>\$9,581</u>	<u>\$0</u>	<u>\$10,625</u>

The classification of investment types by level as of September 30, 20Y2, is consistent with the classifications as of December 31, 20Y1 (e.g., agency securities were classified as Level 2 as of September 30, 20Y2, and December 31, 20Y1).

Prior audit results indicate no history of errors related to the valuation and presentation of investments, and the portfolio composition (e.g., asset class, level) has remained relatively stable in the current year. On the basis of our inquiries of management and our knowledge of the business, we do not expect any significant changes in the Company, market environment, or the portfolio composition between the interim date and year-end. We considered the risk of fraud, as documented in workpaper XXXX, and do not believe a fraud risk is present.

Note that to increase consistency and comparability in fair value measurements and related disclosures, ASU 2011-04, *Fair Value Measurements (Topic 820)*, establishes a fair value hierarchy that categorizes the inputs to valuation techniques used to measure fair value into three levels. **Level 1 inputs** are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date. **Level 2 inputs** are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. **Level 3 inputs** are unobservable inputs for the asset or liability. In other words, a reporting entity may develop an internal model using the best information available in the circumstances.