

ZOU Fencing Inc. (Case 13-9 handout)
Account Scoping and Risk Assessment
Account Balance and Disclosure: Revenue
Class of Transaction: Recording Sales

Risk #1	
Identification of risk of misstatement ("what could go wrong")	All orders shipped are not recorded as revenue.
Relevant assertion	Completeness.
Significant risk?	No.
Risk of material misstatement because of fraud?	No.
Control activity that addresses risk of misstatement	Control #1: Sales are automatically recorded and invoices are automatically generated upon the release of the order in the Warehouse K-Series System. Orders are not released until the goods have been confirmed for shipping in the system (which occurs when the goods are scanned as they are loaded in the shipping area).
Does the control rely on information produced by the entity (or IPE)? If yes, list relevant information	No.
Will we obtain audit evidence of the accuracy and completeness of information produced by the entity by testing controls or by performing procedures directly on the information?	N/A
Is the control automated?	Yes.
Relevant application system (if we are testing information produced by the entity through tests of controls or the control is automated)	Warehouse K System, which is subject to IT controls performed by management and tested within the IT controls workpaper.
Tests of controls: evaluation of design	<p>On the basis of the following factors, we concluded that the control is appropriately designed to address the stated risk of material misstatement:</p> <ol style="list-style-type: none"> 1. The control is the automation of the invoicing of goods shipped as the system will automatically record revenues when goods are shipped from the warehouse (revenue generating activity), thus resulting in no shipped goods going unrecorded in the system that appropriately addresses the related risk of material misstatement and assertion. 2. Automated control prevents errors from occurring as opposed to identifying them once they have occurred (preventive control). 3. Control operates at the transaction level and, as such, is sufficiently precise to mitigate the risk. 4. Control is performed on a continual basis and thus addresses the risk directly and for the period under audit. 5. There are no historical issues with operation of the control and the control has not been modified in the period under audit.
Tests of controls: planned operating effectiveness testing	<p><u>Interim Procedures (test as of 9/30):</u></p> <ol style="list-style-type: none"> 1. Contact the Director of Customer Service and obtain detailed explanation of how control operates. 2. View samples of the shipping request. 3. Verify that understanding through testing of general IT controls; i.e., program change controls that there have been no changes to the control since the previous year. <p><u>Rollforward Procedures:</u></p> <ol style="list-style-type: none"> 1. Make inquiries of the controller and the IT manger to determine if any events have occurred that might impact the design or operation of the control (e.g., changes, additional risks, operating deficiencies) after our interim testing date. If any significant changes are noted, retest control.

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Risk #2	
Identification of risk of misstatement ("what could go wrong")	Revenue is recorded for orders not shipped or fictitious sales.
Relevant assertion	Existence or occurrence.
Significant risk?	Yes
Risk of material misstatement because of fraud?	Yes
Control activity that addresses risk of misstatement	Control #2: The "Orders Shipped & Invoiced Report" is reviewed by the warehouse director on a daily basis for unusual items and reasonableness; evidenced by the warehouse director's initials on the report, which is <u>maintained</u> .
Does the control rely on information produced by the entity (or IPE)? If yes, list relevant information	Yes — The "Orders Shipped & Invoiced Report," which details orders that were shipped and invoiced for a given day. The report is automatically generated by the Warehouse K system.
Will we obtain audit evidence of the accuracy and completeness of information produced by the entity by testing controls or by performing procedures directly on the information?	Because the operating effectiveness of the control is dependent upon the accuracy and completeness of the IPE, we will test the controls around accuracy and completeness. As the IPE is a system generated report, refer to our testing of the company's IT general controls. In addition, we will test the controls around report logic as well as the internal controls around the source data.
Is the control automated?	No.
Relevant application system (if we are testing information produced by the entity through tests of controls and/or the control is automated)	Warehouse K System, which is subject to IT controls and tested within the IT controls workpaper.
Tests of controls: evaluation of design	<p>On the basis of the following factors, we concluded that the control is appropriately designed to address the stated risk of material misstatement:</p> <ol style="list-style-type: none"> 1. The warehouse director has been with the company for over 10 years and has been acting in this current role for the last five. The warehouse director is in charge of overseeing operations at all five warehouses and directly supervises the warehouse managers. The director is knowledgeable of the business and focuses reviews on activity that seems unusual given the customer and quantities purchased. The review is directed to the identification of unusual trends and thus appropriately addresses the related risk of material misstatement and assertion. 2. Control is performed on a daily basis. 3. Control identifies exceptions after they have occurred (i.e., its a detective control), yet given the frequency of performance, it would identify errors in a timely manner. 4. Although the control entails the review of daily revenue activity, it is done on a transaction by transaction basis, and as such it is sufficiently precise to mitigate the risk. 5. Control involves the judgment of the warehouse director since there is no specific threshold set. However, since all transactions are evaluated and ZOU Fencing has a cyclical business, the report results are predictable. In addition, the warehouse director has been employed by the company for 10 years.
Tests of controls: planned operating effectiveness testing	<p><u>Interim Procedures (tested as of 9/30):</u></p> <ol style="list-style-type: none"> 1. Discuss the performance of the control procedure with the warehouse director. 2. Select 15 days out of the year. 3. Obtain the "Orders Shipped & Invoiced Report" reviewed by the warehouse director. 4. Determine whether the reports were signed off by the warehouse director and dated on the day following the report date. <p><u>Rollforward Procedures:</u></p> <ol style="list-style-type: none"> 1. Make inquiries of management and the process owner of the control activity to determine if any events that might impact the design or operation of the control (e.g., changes, additional risks, operating deficiencies) have been identified after our interim testing date.

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Risk #3	
Identification of risk of misstatement ("what could go wrong")	Orders shipped are not recorded accurately to actual quantities shipped and prices per invoice do not reflect <u>approved pricing</u> .
Relevant assertion	Valuation or allocation.
Significant risk?	No.
Risk of material misstatement because of fraud?	No.
Control activity that addresses risk of misstatement	Control #3: On a monthly basis, the reporting package is reviewed and analyzed by the controller and presented and discussed at the operations review meeting. The Controller focuses on differences or amounts greater than \$4 million or fluctuations greater than 15 percent from prior year actual or current budget. The controller documents the results of any follow up.
Does the control rely on information produced by the entity? If yes, list relevant information	Yes. 1. Monthly reporting package. 2. Budget.
Will we obtain audit evidence of the accuracy and completeness of information produced by the entity by testing controls or by performing procedures directly on the information?	<u>Monthly reporting package:</u> The monthly reporting package, which includes revenue information, is generated by the assistant controller from the PeopleSoft general ledger using data query tools by selecting certain data fields and defining calculations using the data. We tested the general IT controls (in particular program change controls) for completeness and accuracy. <u>Budget:</u> The CFO and CEO develop a budget annually in accordance with a set of defined budgeting procedures that require that the budget be "zero set" (i.e., determined on the basis of reasonable expectations of future events, rather than a percentage increase over previously budgeted amounts). The application system used for this process is Budgetpro. The CFO and CEO review the budget to confirm that the budgeted amounts have been determined in accordance with the established procedures and are based on reasonable expectations of future events. Upon finalization and approval of the budgets and forecasts within the Budgetpro system, the information is uploaded to PeopleSoft. The financial analysis team then performs a tie-out and reconciliation of the Budgetpro information versus the reports created in PeopleSoft to assure accuracy of the upload. PeopleSoft budget information is important since management compares the P&L, BS, and other activity budgets to the actual monthly actual performance as indicators of unusual activity. All budgets and forecasts are subject to several tiered reviews. The final budget is then presented in a slide deck to the CEO and CFO for final approval. According to the budgeting procedures, the budget cannot be reset once approved by the CEO. We plan to test the budget process and controls directly as follows: 1. Obtain a copy of the original budget and gain an understanding of how it was prepared and how it is modified during the year for known changes. <u>Final procedures:</u> 1. Verify that Budgetpro information is tied out and reconciled to Peoplesoft. 2. Verify through review of board minutes that annual budget is approved by President-Americas and CEO and CFO.
Is the control automated?	No.
Relevant application system (if we are testing information produced by the entity through tests of controls or the control is automated)	No.
Tests of controls: evaluation of design	On the basis of the following factors, we concluded that the control is appropriately designed to address the stated risk of material misstatement: 1. Control appropriately addresses the related risk of material misstatement and assertion since any unexpected variances would be detected by the controller's analysis of budget to actual. 2. The control is detective and therefore identifies exceptions after they have occurred, yet given that the control is performed on a monthly basis, it would detect errors in time to prevent material misstatement of the financial statements. 3. The control is sufficiently precise to detect a material misstatement in the revenue account (which is based on \$5 million materiality threshold). 4. Management has defined quantitative thresholds for investigating variances. 5. The company's financial results have historically been consistent with budget. There are no significant changes planned in the current year to the company's business nor are there any external factors related to the industry, regulatory environment, or economy that would be expected to impact the company's current year financial results.
Tests of controls: planned operating effectiveness testing	<u>Interim Procedures:</u> <u>Inquiry:</u> 1. Inquire of the controller and assistant controller of the following: a. Explanation of the steps involved in performing the control. b. Reports and other information used, including how such information is used and from where it is obtained. c. Procedures performed when an exception or misstatement is identified. d. Procedures performed when the individual is absent. e. Procedures performed with respect to unusual transactions. f. Changes to controls during the period, including changes in personnel who perform them. <u>Inspection:</u> 2. Obtain the meeting minutes for two months and determine if the monthly package was appropriately discussed. <u>Rollforward Procedures:</u> 1. Select a month from Q4 and perform the above procedures consistent with interim.