Case 13-9
ZOU's Fencing Controls

ZOU Fencing Inc. (ZOU Fencing or the Company) is a public company in the United States that files quarterly and annual reports with the SEC. ZOU Fencing has five manufacturing facilities located in Missouri and produces and provides chain-link fencing to customers throughout the Midwest (Wisconsin, Indiana, Michigan, Ohio, Illinois, and Iowa) via rail car.

ZOU Fencing sells chain-link fencing to customers under free on board (FOB) shipping point terms. Therefore, revenue is recorded when goods are shipped from the respective warehouse. ZOU Fencing currently uses a sophisticated warehouse management system (the Warehouse K-Series System), which allows the Company to (1) record sales upon shipment of goods out of the warehouse, (2) automatically price fence sales on the basis of standard pricing tables, and (3) generate multiple reports for the evaluation of ZOU Fencing's operations.

Engagement Team Note:

Materiality was determined to be $5 million. At year-end, the engagement team evaluated the internal controls related to revenue. This evaluation was done through inquiries of appropriate personnel and consideration of the results of other audit procedures including: (1) updating the risk assessment procedures (including the understanding of internal control) and substantive procedures, (2) considering the result of the entity's monitoring of controls (or our testing of the entity's monitoring of controls), and (3) obtaining an update on the status of the entity's remediation of any significant deficiency or material weakness identified as of the interim date.

As a result, the engagement team arrived at the conclusion that there have been no significant changes to controls in the period after their interim testing. Furthermore, the engagement team has determined that they will not be using the work of others for testing the operating effectiveness of controls related to revenue.

The engagement team identified three risks of material misstatement relating to the recording of sales. For each risk identified, the team documented in the excerpted worksheet (see Handout 1) the control activity that addresses the risk of misstatement, the evaluation of the design of that control activity, and the planned testing of operating effectiveness.

Required:

1. What are the key considerations when evaluating the design and testing of the operating effectiveness of internal controls in conjunction with a financial statement audit? Include considerations in determining what additional audit evidence to obtain about controls that were operating during the rollforward period.

2. For each of the three revenue risks identified by the engagement team, address the following:

a. Was the engagement team's assessment of the evaluation of the design of the controls appropriate (i.e., does the control identified by the team address the specific "what could go wrong" for each risk)?

b. Was the team's interim and rollforward planned procedures to test the operating effectiveness of controls appropriate?