

MARKING GUIDE
FUN, FIT AND SOCIAL CLUB

Assessment Opportunity #1

The candidate calculates overall materiality and performance materiality for the engagement.

The candidate is demonstrating competence in Assurance.

Competencies**4.3.4 Assesses materiality for the assurance engagement or project (Level A)**

Per CAS 320, when establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures. The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures.

As the Club is a private not-for-profit organization it would be appropriate to set materiality based on 0.5% - 2% of gross income or 0.5% - 2% of total expenditures. Since materiality is calculated based on the users of the financial statements and members are concerned with how their annual dues are being utilized, a base of total expenditures has been selected. The high end of the range, 2%, has been selected as based on the information provided the Club appears to be operating as a normal not-for-profit and no unusual circumstances were encountered. Therefore materiality for December 31, 2021 is \$80,000 ($\$3,982,700 \times 2\% = \$79,654$).

Performance materiality is used because planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatement may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. Performance materiality is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. In practice, performance materiality is ordinarily set at between 50 and 75% of materiality. Generally, it would be set at 75% of materiality; however this would be reduced depending on the circumstances encountered.

Performance materiality has been set at 75% for the following reasons:

- Historical adjustments have been low
- Management is willing to make adjustments provided by AP

- Per review of the internal financial statements, none of the financial statement areas are subject to significant estimation uncertainty
- The entity is in a single location with a consistent management team
- Control testing will be applied where possible in the current year
- Therefore performance materiality is \$60,000.

Note: Some candidates may identify the prior period error to support a lower performance materiality being assessed. This is an appropriate approach.

Assessment Opportunity #2

The candidate discusses the risk of material misstatement.

The candidate is demonstrating competence in Assurance.

Competencies

4.3.5 Assess the risks of the project, or, for audit engagements, assesses the risks of material misstatement at the financial statement level and at the assertion level for classes of transactions, account balances, and disclosures (Level A)

The risks of material misstatement may exist at two levels:

- The overall financial statement level; and
- The assertion level for classes of transactions, account balances, and disclosures.

Risks of material misstatement (RMM) at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions. The risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.

Inherent Risk

Inherent risk is the susceptibility of an assertion about a class of transactions, account balance or disclosure, to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

The following comments can be made about the Club's inherent risk:

- The Club is not exposed to significant assertion level risk from estimates. Per review of the financial statements, none of the areas identified have a particularly high estimation uncertainty.
- The Club generates its revenue from food and beverage sales, annual fees, initiation fees, capital contributions and club activities. The Club's success is based on its membership. Major expenditures consist of cost of food and beverage, payroll and benefits, utilities and maintenance and laundry and supplies. There have been no changes in these activities from the prior year. The Club's transaction streams are routine and non-complex which supports inherent risk assessment as low.

- There are no significant customers as each member pays the same annual fee. Purchases can be assumed to be localized given the location and nature of the business and there are no significant suppliers, which supports an assessment of low inherent risk.
- The Club's revenue streams are fairly typical for a not-for-profit organization. Low inherent risk identified due to the nature of revenue being recorded.

Control Risk

Control risk is the risk that a misstatement that could occur in an assertion about a class of transactions, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, is not prevented, or detected and corrected, on a timely basis by the entity's internal control.

The following comments can be made about the Club's control risk:

- The Board and Audit Committee are charged with governance of the Club and are consulted for major decisions. The Audit Committee reviews the monthly year to date financial statements and reports to the Board. The Board is active in the oversight of management which is evidenced by the materials that are reviewed monthly. This indicates a lower control risk.
- Operating budgets are created and compared to actual results on a monthly basis which indicates a lower control risk as monitoring controls are in place.
- The Board of Directors approves all capital projects and expenditures.
- Controls exist over Club spending to ensure all cash disbursements have been authorized (as will be discussed in the control testing identified).
- Controls exist over revenue received for annual dues and food and beverage (as will be discussed in the control testing identified).
- A prior period error was discovered in the current year. It appears to be isolated in nature however controls around the booking of adjusting entries could be improved.

Conclusion

Based on the analysis above, the risk of material misstatement appears to be low.

Assessment Opportunity #3

The candidate identifies the high level tests of controls and describes the assurance that would be provided over the corresponding financial statement area.

The candidate is demonstrating competence in Assurance.

Competencies

4.3.6 Develops appropriate procedures based on the identified risk of material misstatement (Level A)

Designing and Performing Test of Controls

Per CAS 330, tests of controls are performed only on those controls that the auditor has determined are suitably designed to prevent, or detect and correct, a material misstatement in an assertion. Testing the operating effectiveness of controls is different from obtaining an understanding of and evaluating the design and implementation of controls. However, the same types of audit procedures are used. The auditor may, therefore, decide it is efficient to test the operating effectiveness of controls at the same time as evaluating their design and determining that they have been implemented.

Typically, when determining which controls to test, we consider which controls help obtain sufficient appropriate audit evidence over financial statement accounts with higher risk and those controls which contribute to the efficiency of our audit by altering the nature, timing and extent of substantive testing. The controls contributing most to efficiency of the audit are those that provide assurance over multiple assertions. In this scenario, we should focus on testing controls over expenditures as these balances are of interest to the users, and revenue given the presumed risk of fraud.

Therefore, the following high level control should be tested as part of the Club's audit:

- Monthly financial review – AP would need to determine the level of precision the Club uses when reviewing monthly financial information. If it is determined that the level of precision is sufficient to detect and correct a material misstatement, this control would provide assurance over the completeness, existence and accuracy of most of the Club's account balances.
- For example, the control would likely only partially cover purchases. Due to the nature of the Club, there are a high volume of low dollar transactions in purchases. The fact that the Board reviews monthly and year-to-date amounts compared to budget would not provide sufficient assurance over the accuracy of the expenditures (i.e. that the exact dollar amount is remitted to the correct vendors). For this reason, it is recommended that the Club also test cashdisbursement approval.
- Asset purchase approval - Capital expenditures are approved by the board and all work orders and agreements approved by Marty and Clyde. These controls ensure that significant purchases and commitment of funds are authorized, which supports the existence and validity of the asset purchases. To test this control, we would review the GL and select a sample of asset purchased in the year. We would then inspect the supporting invoices, contracts or work orders for evidence of approval (e.g. a signature or board minutes for larger purchases).

We could also consider testing the following control to gain assurance over areas of higher fraud risk:

Bank reconciliations – There is a risk of fraud surrounding the cash balance, given that Marty can individually sign cheques under \$1,000. This creates an opportunity for Marty to issue a cheque to himself. However, the compensating control is that Marty prepares a monthly bank reconciliation and Clyde reviews the bank reconciliation and indicates his review by initialing.

We could select a sample of bank reconciliations and verify that they've been completed and that they've been initialed by Clyde. This control would provide assurance that fraud risk is minimized, and in addition provide assurance over the existence and completeness of cash.

There are also some detailed controls that are present at the Club, which we could decide to test as part of our audit. Therefore, the following controls should be tested as part of the Club's audit:

- Cash disbursement approval – this control should be tested to provide additional assurance over the purchases stream. As the members of the Club are very concerned with how their annual dues are being spent it is important to ensure that all purchases have appropriate approvals and are for valid expenditures. This would provide assurance over the occurrence and accuracy of expenses.
- Initiation fee review – This control should be tested as it addresses the appropriateness of revenue recognition. If the Club is not appropriately tracking members and ensuring the right documentation is on file, they do not have the right to collect revenues. This provides assurance over the occurrence and accuracy of revenue

We could also consider testing the following control to gain assurance over areas of higher fraud risk:

- Existence of sales sign-off review and segregation of duties – There is a fraud risk surrounding the existence of sales, as servers may provide free food to members or friends. However, at the end of each day, the Food & Beverage Manager ensures all sales recorded have signed bills and follows up with the server if any bill is incomplete. The accounts receivable clerk ensures all bills have appropriate sign offs and posts them to accounts receivable. We could select a sample of signed bills and verify that a corresponding A/R has been recorded, This would provide assurance that the fraud risk is minimized, and in addition provide assurance over the existence and accuracy of A/R.

Assessment Opportunity #4

The candidate assesses the accounting treatment and the appropriate disclosures for the prior period error.

The candidate is demonstrating competence in Financial Reporting.

Competencies

- 1.2.2 Evaluates treatment for routine transactions (Level A)
- 1.3.2 Prepares routine financial statement note disclosure (Level A)

During the year, Marty identified an error related to fiscal 2018 which resulted in 2018 year-end revenue being overstated and unearned fees being understated by \$125,000.

According to Section 1506.27, “An entity shall correct material prior period errors retrospectively in the first set of financial statements completed after their discovery by:

- a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or
- b) if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.”

As there was a prior period error, the following must be determined before a conclusion can be reached:

- i) Is this definitely an error that requires correcting?
- ii) Have all comparative amounts been properly restated?
- iii) Should financial statements be re-issued?

The error is material (both in the current and prior year) at \$125,000 and should therefore be corrected. Materiality for 2021 is \$80,000 and performance materiality is \$60,000. The 2020 materiality was \$78,000.

Although the error took place in 2018, as per the handbook guidance, it is appropriate to adjust the amount in the December 31, 2020 comparative figures in the financial statements. Financial statements do not need to be re-issued based on the guidance noted above. Based on our knowledge of the users of the financial statements, and their awareness of the misstatement, we have concluded that there will not be a significant impact to the users (members) decision making as a result of this prior period adjustment.

Financial Statement Note Disclosure

In accordance with part II, Section 1506.37, the disclosure requirements are set out below.

“In applying paragraph 1506.27, an entity shall disclose the following:

- (a) the nature of the prior period error;
- (b) for each prior period presented, the amount of the correction for each financial statement line item affected; and
- (c) the amount of the correction at the beginning of the earliest prior period presented.

The appropriate details are disclosed in the Notes to the financial statements as per below:

During the current year, the Club determined that deferred revenue was incorrectly taken into income during the year ended December 31, 2018 by \$125,000. As a result, deferred revenue was understated at the prior year end. The result of this correction to the prior year is as follows:

January 1, 2020

	As previously reported	Adjustments DT /(CT)	As restated
Unearned fees	\$XXX	(\$125,000)	\$XXX
Fund balance	\$XXX	\$125,000	\$XXX

December 31, 2020

	As previously reported	Adjustments DT /(CT)	As restated
Unearned fees	\$XXX	(\$125,000)	\$XXX
Fund balance	\$XXX	\$125,000	\$XXX

Assessment Opportunity #5

The candidate assesses the audit implications of the prior period error.

The candidate is demonstrating competence in Assurance.

Competencies

4.3.10 Draws conclusions and communicates results (Level A)

Specific Audit Considerations

Root cause of the error and effect on engagement

The root cause of the misstatement was the failure to book an audit adjustment in 2018 as a result of lack of knowledge transfer during the transition of Controllers. This resulted in revenue being overstated by \$125,000 and unearned fees being understated by the same amount that year. This error was carried forward from 2018 to 2021 when it was identified by Marty. Last year is the first year AP performed the year-end audit of the Club. We should consider areas that we may have missed as part of our audit last year as a result of the discovery of this misstatement and whether additional risks should be raised or audit procedures changed.

It is important to consider the audit work performed in the prior year to assess whether our audit procedures are sufficient. The error would not have an impact on 2021 revenue, therefore given that a substantive audit approach was used in the prior year, where we specifically tested that 12 months of revenues were recorded, AP would not have identified this error as part of the work performed on revenue. However, unearned fees would remain understated at the end of 2021, therefore AP should have discovered the error as part of the procedures performed on unearned fees. As a result, it appears that our procedures in the area of unearned fees are lacking. We should look at the procedures performed on this balance and increase our work in this areas going forward.

In terms of whether additional risks should be raised, since AP did not identify any errors in the prior year audit and the Club was open to making adjustments proposed by AP, it would appear as though the error is isolated and that there is no management bias.

We should add an additional representation to the management letter to identify that management is not aware of any further impact as a result of the prior period adjustment.

Regulatory Considerations

The Club is a not for profit organization and therefore no additional documents will need to be filed with any regulatory agencies as a result of the prior period adjustment.

Financial Reporting Requirements**Addition of the Emphasis of Matter Paragraph**

CAS 706, Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report, requires the auditor to include an Emphasis of Matter paragraph in the auditor's report if the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements. In such a circumstance, the auditor may include an Emphasis of Matter paragraph to alert readers that the comparative information in the financial statements has been restated.

I do not believe that an Emphasis of Matter paragraph would add additional value to the users of the financial statement and therefore we have opted not to add an additional paragraph to the audit report.

Conclusion

Based on the analysis above, we recommend that the prior period error be adjusted. The appropriate disclosures should be added to the notes to the financial statements to identify the adjustment. The adjustment has no impact on the excess of revenue over expenditures for the current year. Overall the users should not be significantly impacted, however if the bank receives the annual financial statements because of the long term debt, then we should ensure that they are informed of the error.