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CASE STUDY: PIZZA SHOP, INC.

Identifying Risk: Understanding the Entity and its Environment

Pizza Shop, Inc. (PSI or the Entity) owns and operates dine-in restaurants offering Italian cuisine. PSI was formed as a corporation in the 1960s, and all of its outstanding common stock is held by one individual. PSI's management team consists of the stockholder and his two brothers, each of whom operate one of the Entity's three restaurants. PSI's bookkeeper, who is responsible for financial reporting, is the stockholder's nephew.

PSI operates in a highly competitive industry with continual price pressure from both suppliers and customers. They also undergo periodic onsite inspections by the local Health Department.

Two of the Entity's three restaurants are located in buildings owned by PSI (the third restaurant is leased from an unrelated party). The restaurants are all located within a 10-mile radius and have historically been very profitable.

However, a downturn in the local economy has led to population flight, resulting in reduced demand and net losses for the past two years. The leased restaurant has been a loss leader for PSI, and the stockholder has indicated that the Entity will consider closing that restaurant if performance does not improve.

PSI has no investment accounts, and their checking and savings accounts have been used to keep the Entity in business for the past two years. While those accounts remain material to the financial statements, PSI has become increasingly reliant on a line of credit (LOC) from their local bank to meet their obligations. The LOC is renewable on an annual basis and renewal is dependent on the Entity maintaining a quick ratio ([Cash + Marketable Securities + Accounts Receivable] / Current Liabilities) of at least 0.5.

The Entity recognizes revenue at the time food is sold to customers and has no accounts receivable. The members of the management team receive bonuses that are tied to the revenue generated by their respective restaurants.

Instructions

1. Consider the facts of the case and determine which factors are relevant to the audit.
2. Identify the risks that are relevant to the audit and classify them as financial statement- or assertion-level risks.
3. Where assertion-level risks are identified, document which assertions are affected.
4. Determine which risks would qualify as "significant risks" and document why.

Identifying Risk: Understanding the Entity's Internal Control

PSI has no documented controls, and the auditor does not intend to reduce the extent of audit procedures by relying on the operating effectiveness of controls.

The bookkeeper is the only member of the accounting department, and the auditor's experience in past audits has been that the bookkeeper is competent to properly record routine transactions. The management team establishes an operating budget each year and the stockholder compares it to actual results on a monthly basis. The stockholder regularly communicates the importance of accurate reporting to the bookkeeper and follows up on any discrepancies.

The bookkeeper reconciles all bank accounts each month and provides the bank reconciliations to the stockholder for review. The authority to sign checks is limited to the bookkeeper and the stockholder, and the checks are issued sequentially. The stockholder reviews the monthly payroll, comparing hours to time sheets, and manually signs payroll checks.

The entity has historically engaged the auditor to perform non-attest services by assisting with fixed asset depreciation and financial statement preparation, but starting in the year under audit, these tasks were performed by the bookkeeper.

Instructions

1. Assume that the controls described in the narrative have been appropriately designed and implemented. Identify the risks that are relevant to the audit and classify them as financial statement- or assertion-level risks.
2. Where assertion-level risks are identified, document which assertions are affected.

Assessing Risk

The risks that the auditor of PSI identified include, but are not limited to, the items below. The auditor will not rely on the operating effectiveness of controls to reduce substantive testing.

Class of transaction, account, balance or disclosure	Risk Description	Assertion Affected	IR	CR	RMM
Cash	PSI has been liquidating cash accounts to provide sufficient cash flow to sustain itself. There is a risk such liquidations may be unrecorded.	Existence			
Cash	PSI has become increasingly reliant on their line of credit to finance operations. Renewal of the LOC is dependent on maintaining a quick ratio of 0.5. There is a risk that cash could be overstated to meet that metric.	Existence, Rights			
Cash disbursements	There is no indication that the Entity has established an approval process for payment of vendor invoices.	Obligations, Existence			
Inventory	PSI operates in a highly competitive industry and is experiencing price pressure from both suppliers and customers. This creates an incentive to override controls to misstate inventory in order to misstate profit margins.	Existence, Valuation			
Inventory	There is no indication that the Entity has established controls around inventory receiving or that PSI conducts periodic physical inventory counts.	Existence, Rights, Cutoff			

Class of transaction, account, balance or disclosure	Risk Description	Assertion Affected	IR	CR	RMM
Fixed assets	The bookkeeper has recently taken on responsibility for recording fixed asset depreciation for the first time. The bookkeeper has demonstrated the competency to record routine transactions appropriately.	Valuation			
Current liabilities	PSI has become increasingly reliant on their line of credit to finance operations. Renewal of the LOC is dependent on maintaining a quick ratio of 0.5.	Completeness, Valuation			
Sales	Compensation of PSI management is directly linked to revenue at their respective restaurants. There is a risk that sales will be recorded in the wrong period in order to overstate revenues.	Cutoff			
Sales **Operating expenses**	The leased restaurant has been a loss leader and the stockholder has indicated it may be closed if performance does not improve. This presents risks that sales will be overstated and operating expenses will be understated for that restaurant.	Cutoff Completeness			
Financial closing and reporting	PSI has historically engaged the auditor to assist with financial statement preparation, but in the year under audit the bookkeeper took on this task.	Accuracy, Completeness, Understandability			
Financial statement-level	Several relatives of the stockholder are employed in key management roles	N/A			

Instructions

Based on the information provided, assess Inherent Risk (IR), Control Risk (CR) and the Risk of Material Misstatement (RMM) for each class of transaction, account, balance or disclosure.

Inherent Risk is the risk of material misstatement assuming there are no controls, while Control Risk is the risk that the client's controls will not prevent or detect a material misstatement. Inherent and Control Risk combine to form the Risk of Material Misstatement.

Responding to Risk

The auditor noted that compensation of PSI management is directly linked to revenue at their respective restaurants, and that there is a risk that sales will be recorded in the wrong period in order to overstate revenues.

Under AU-C 240.27, risks of material misstatement due to fraud should be treated as a "significant risk," and there is a presumption that revenue recognition is a risk of material misstatement due to fraud. As such, the auditor has concluded that the risk associated with sales cutoff represents a "significant risk."

This means the risk requires special consideration and an audit approach above and beyond what a standardized audit program would address.

Instructions

Design audit procedures that would reduce the risk associated with sales cutoff to an appropriately low level.