



recognizing both premature and fictitious revenue. The following excerpt from the AAER describes the audit team's work in the area of accounts receivable:

During the 1993 audit, the engagement team spent considerable time auditing accounts receivable, a critical area of the audit. Particular emphasis was placed on auditing accounts receivable in SDRC's Far East Operations ("FEO") which represented approximately 50% of consolidated accounts receivable at year-end 1993. FEO also accounted for approximately 35% of the revenue recorded by SDRC in 1993. The audit team incorrectly concluded that certain revenue relating to these accounts receivable had been properly recognized and focused their attention on evaluating collectibility.

Based in large part on the percentage of year-end 1992 receivables that were written off in 1993, the audit staff calculated a \$5.8 million proposed audit adjustment to increase the allowance for doubtful accounts for FEO receivables. In the aggregate, the audit differences considered by the auditors totaled approximately \$3.1 million, which represented approximately 22% of the net income originally reported by SDRC.

Notwithstanding the analysis made by the audit team, both the engagement partner and the concurring partner concluded that the \$3.1 million net audit difference was not material to SDRC's financial statements. In reaching that conclusion, they relied in substantial part on management's representations that the rate of write-offs and reversals in 1993 were based on factors that management did not expect to recur in 1994 and that the \$5.8 million audit difference calculated by the staff was, therefore, excessive. The auditors "passed" on the audit difference and did not require SDRC to adjust its financial statements.

#### *Required*

- What factors should the audit partners have considered when deciding whether it was appropriate to "pass" on the audit adjustment? What is the role of professional skepticism in this context?
- What evidence should the auditors have gathered to support their assessment?
- Is it appropriate to net misstatements when making a materiality decision on whether an adjustment is necessary?

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**(Judging the Quality of a Client's Internal Audit Function and Determining the Effects of Internal Audit's Work, LO 6)** TLD CPAs is performing the audit of REDTOP Sports. You are on the external audit team for that engagement. Following is some information about the client and its internal audit function. After reviewing this information, you will be asked to assess the quality of the internal audit function and whether the external auditor should rely on work performed by the internal auditors.

#### *General Background Information about REDTOP Sports*

REDTOP Sports Company is a publicly held manufacturing company. The primary activities of REDTOP Sports Company include the design and manufacture of sporting and athletic goods. The major product lines are bicycle helmets for infants, youths, and adults and other bicycle accessories, including child bicycle seats, car bicycle carriers, and water-bottle cages. In the United States, a number of jurisdictions have passed mandatory helmet regulations and